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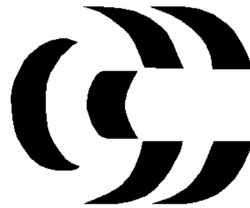

COMMERCE COMMISSION

DECISION NO 459

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

NATIONAL FOODS LIMITED

and

NEW ZEALAND DAIRY FOODS LIMITED

The Commission: MJ Belgrave
PR Rebstock
PJM Taylor

Summary of Application: The acquisition by National Foods Limited through a wholly owned subsidiary of up to 100% of the issued shares in New Zealand Dairy Foods Limited.

Determination: Pursuant to section 66(3)(a) of the Commerce Act 1986, the Commission declines to give clearance for the proposed acquisition.

Date of Determination: 22 March 2002

CONFIDENTIAL MATERIAL IN THIS REPORT IS CONTAINED IN SQUARE BRACKETS

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THE PROPOSAL

1. On 8 February 2002 National Foods Limited (National Foods) registered a notice with the Commission seeking clearance under s66(1) of the Commerce Act 1986 (the Act) for it to acquire through a wholly-owned subsidiary up to 100% of the issued shares in New Zealand Dairy Foods Limited (NZDF).

THE PROCEDURES

2. Section 66(3) of the Act requires the Commission either to clear or to decline to clear a notice given under section 66(1) within 10 working days, unless the Commission and the person who gave notice agree to a longer period. Extensions of time were sought by the Commission and agreed to by the applicant. Accordingly, a decision on the application was required by 22 March 2002.

3. In its application, National Foods sought confidentiality for specific aspects of the application. A confidentiality order was made in respect of the information for a period of 20 working days from the Commission's determination notice. When that order expires, the provisions of the Official Information Act 1982 will apply.

4. The Commission's determination is based on an investigation conducted by staff.

5. The Commission's approach is based on principles set out in the Commission's Practice Note 4.[1]

THE PARTIES

National Foods

6. National Foods is a publicly listed company incorporated in Australia. National Foods is one of Australia's largest food companies with core activities in milk and fresh dairy foods. It was floated in 1991 following the amalgamation of several dairy and food related businesses. Today it is Australia's largest, and only national, fresh milk processor, with an annual turnover of around $1.25 billion (A$1.0 billion).

7. The company produces a range of full cream, flavoured and modified fresh and UHT milks. National Foods is also a major producer of dairy foods, manufacturing yoghurt, fromage frais, dairy desserts, cream and cheese under brands such as "Yoplait", "Fruche", "Pura", "Divine Classic", "Yogo" and "Farmers Union".

8. The company exports cheese to many countries throughout the world and milk and fresh dairy products primarily to the Asian region.

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[1] Commerce Commission, *Practice note 4: The Commission's Approach to Adjudicating on Business Acquisitions Under the Changed Threshold in section 47 – A Test of Substantially Lessening Competition*, May 2001.

9. National Foods has production facilities and sales offices in every Australian state and in New Zealand (through National Foods International Fine Foods Limited (NFIFF), described below). It has a workforce of approximately 2,000 people.

NFIFF

10. NFIFF is a wholly-owned subsidiary of National Foods. It manufactures, distributes and markets yoghurt and dairy desserts in the New Zealand domestic market under the "Yoplait" brand name which it holds on licence for New Zealand from the owner, Sodima, a large French dairy co-operative. NFIFF also distributes and markets non-dairy products, including the "Edgell", "Plumrose", "Leggo" and "Birds Eye" brands, as agent for Simplot Australia. NFIFF has one production facility at Palmerston North, and employs about 51 people nationally. It has an annual turnover of about $30 million.

NZDF

11. NZDF is currently 50.004% owned by Fonterra Co-operative Group Limited (Fonterra), with the balance being held by approximately 6,300 farmers.

12. NZDF manufactures, markets and distributes chilled dairy products in domestic and export markets. It has three divisions – Foods, Beverages and International. The Beverages division processes milk, cream and flavoured milk. The Foods Division produces speciality cheeses and cultured foods, including yoghurts, desserts, cottage cheese, sour cream and dips. It also markets butter and cheese. Brands include "Fresh 'n Fruity", "Swiss Maid", "Country Goodness", "Anchor", "Chesdale" and "Ornelle". NZDF's Export Division exports UHT milk, cultured foods and speciality cheeses to the Asia Pacific region.

13. NZDF sells yoghurt under the brand names of "Fresh 'n Fruity", "Swiss Maid", "Cartoons", "Metchnikoff" and "De Winkel", and dairy desserts under the principal brands of "Swiss Maid Calci-Yum" and "Cartoons".

14. NZDF's turnover is about $420 million, and it has a workforce of about 850 people.

Fonterra

15. The Dairy Industry Restructuring Act 2001 (DIR Act) authorised the amalgamation of New Zealand's two largest dairy co-operatives, the New Zealand Co-operative Dairy Company Limited and Kiwi Co-operative Dairies Limited, along with the New Zealand Dairy Board into Fonterra.

16. Fonterra's annual turnover is about $14 billion. It generates over 20% of New Zealand's export revenue, and more than 7% of its GDP.

17. About 20,000 people are employed by Fonterra in approximately 120 countries. The company operates two major divisions - New Zealand Milk and New Zealand Milk Products (NZMP). New Zealand Milk accounts for about 41% of the company's annual turnover, and produces fast-moving consumer goods. NZMP is responsible for about 55% of NZDF's annual turnover, and handles milk collection and processing, as well as the company's ingredients business.

OTHER RELEVANT PARTIES

Mainland Products Limited (Mainland)

18. Mainland is a New Zealand private company which is 100% owned by Australasian Food Holdings Limited, which is majority owned by Fonterra. Mainland has divisions marketing dairy products, meat products, and frozen foods. Its dairy products division manufactures a full range of cheeses, butter, speciality cheeses, yoghurt, dairy desserts, other cultured products, fresh milk and other beverages. Its brands include Mainland, Tararua, Meadow Fresh, Ferndale, and Galaxy.

19. Mainland sells yoghurts under the "Meadow Fresh" and "Naturalea" brands and dairy desserts under the "Meadow Fresh" and "Barney" brand names.

20. Mainland has an annual turnover of about $700 million, and employs about 2,000 people.

INDUSTRY BACKGROUND

21. The Commission has assessed a number of business acquisition proposals involving dairy companies in recent years. These include:

    - *Mainland Products Limited/South Island Dairy Farmers Co-operative Limited (SIDF) Decision 324, 12 May 1998.*
    - *Kiwi Co-operative Dairies Limited/South Island Dairy Co-operative Limited (SIDCO) Decision 341, 26 February 1999.*
    - *MergeCo Draft Determination, 27 August 1999.*
    - *Mainland Products Limited/Nelson Milk Company, Decision 396, 7 June 2000.*
    - *Mainland Products Limited/Southern Fresh Milk Company Limited, Decision 428, 18 May 2001*
    - *Mainland Products Limited/Southern Fresh Milk Company Limited, Decision 454, 14 February 2002.*

22. These reports provide a detailed background to the dairy industry. The following is a description of the recent changes that have occurred in the industry.

23. The DIR Act came into force on the 26th of September 2001. The DIR Act gives rights to dairy farmer supplier/shareholders of Fonterra to cease, either in whole or in part, supplying milk to Fonterra, and to switch supply of milk to independent processors, including NZDF.

24. Fonterra is required by the Dairy Industry Restructuring (Raw Milk) Regulations 2001 to supply raw milk to any independent processors who seek it, including competitors, up to a maximum total of 400 million litres per year (around 3% of the Fonterra's total annual milk production) at prices and on terms that are publicised. These must not disadvantage the independent processors, particularly when compared to the prices and terms on which Fonterra's own processing subsidiary, Mainland, is able to acquire raw milk from

Fonterra. Of the 400 million litres, Fonterra must supply NZDF with up to 250 million litres a year, and any other customer up to 50 million litres a year.

25. Under ss 9 and 10 of the DIR Act, Fonterra must dispose of its shares in NZDF within 12 months of the commencement of the DIR Act. The disposal must be unconditional, and must have the effect of passing control of the assets of NZDF (other than those sold in the ordinary course of business) to a person not an "associated person" of Fonterra.

PRODUCTS AFFECTED BY THE PROPOSED ACQUISITION

26. The products that would primarily be affected by the proposed acquisition are yoghurt and dairy desserts as these are the only products that both NFIFF and NZDF manufacture and supply. Dairy desserts are made from the same dairy ingredients as yoghurt but are not cultured. They are flavoured with similar flavourings as those used for ice cream. NZDF, Mainland and NFIFF sell a range of yoghurt and dairy desserts. They are packaged as single units of between 100g and 250g, 6 packs of the units, and 1kg packs.

27. National yoghurt and dairy desserts production is $118.8 million a year. The sales consist of approximately 90% yoghurt and 10% dairy desserts. 90% of yoghurt is either fruited or plain and sold under one of three brands – Yoplait, licensed by NFIFF, Fresh 'n Fruity, owned by NZDF, and Meadow Fresh, owned by Mainland. The remaining 10% of yoghurt is a niche market generally referred to by industry participants as health yoghurt and includes "lite", Greek, organic, acidophilus and herbal yoghurt. Some of these niche products are also produced by NFIFF, NZDF and Mainland.

28. 90% of yoghurt and dairy desserts are sold through supermarkets and 80% of that volume is sold on promotion at low prices. Yoghurt and dairy desserts have a short shelf-life of about 4 weeks, which, together with the constant promotion and resulting uncertainty regarding volume sold each week, means that stock management is particularly important.

ASSOCIATED PERSONS

29. Under s 9 of the DIR Act Fonterra must dispose of all of its shares in NZDF to a person not "associated" with Fonterra.

30. As part of the investigation under the Commerce Act, the Commission therefore needs to establish whether Fonterra is able to divest NZDF to National Foods in light of its obligations under s 9 of the DIR Act. If National Foods is "associated" with NZDF in terms of the DIR Act, this divestment would be prohibited by s 9.

31. In addition, if National Foods were associated with Fonterra under the Commerce Act, this would have an implication for the competition analysis relating to this investigation.

The tests for Association.

32. Section 5(2) of the DIR Act sets out a definition of "associated":

> **"A person is an associated person of another person if---**
> *(a) they are both bodies corporate and they consist substantially of the same members or shareholders or are under the control of the same persons; or*

> *(b) either of them has the power, directly or indirectly, to exercise, or control the exercise of, the rights to vote attached to 25% or more of the voting securities of the other; or*
> *(c) one is a director of the other; or*
> *(d) either of them is able, directly or indirectly, to exert a substantial degree of influence over the activities of the other."*

33. Section 47(2) of the Commerce Act sets out the relevant definition for "association" as follows:

    "For the purposes of this section, a person is associated with another person if that person is able, whether directly or indirectly, to exert a substantial degree of influence over the activities of the other."

34. There is one principal difference between the test for association set out in the DIR Act and that in the Commerce Act.

35. Section 5(2) of the DIR Act contains three situations where persons will be deemed to be associated (sections 5(2)(a), (b) and (c)). There is then a catch all situation in s5(2)(d) which is identical in wording to s47(2). Section 47(2) does not have any per se provisions.

36. Each of s47(2) and s5(2) must be read within its relevant statutory context. It is possible that by including the per se provisions in s 5(2) of the DIR Act it was intended by Parliament that the test for a finding of association in the catch all provision (s5(2)(d)) is lower than set out in s47 (2) of the Commerce Act which sets out no minimum per se thresholds.

37. The Commission considers that while the sections may have different stringencies in terms of what constitutes a substantial degree of influence, the factors which must be taken into account under each Act are identical. Its analysis proceeds on this basis.

38. In a submission to the Commission, the applicant has also suggested that because the definition of association in the DIR Act specifies at s5(2)(b) the shareholding limit of 25%, any consideration of substantial degree of influence as per s5(2)(d) must look at sources of influence other than those arising from Fonterra's shareholding of less than 25%. The Commission disagrees. Each of the subclauses of section 5(2) is, in Commission's view, independent. Clearly, if the shareholding exceeds 25%, association is deemed to occur. But if the shareholding is less than 25%, the Commission considers it is entitled to look at all factors which might contribute to a substantial degree of influence, whether these relate to the shareholding or other factors.

Analysis of the per se provisions of the DIR Act.

39. In order to establish an association between National Foods and Fonterra, only one of the four subclauses of s5(2) of the DIR Act needs to be satisfied. As noted, the first three sub-clauses specify a set of per se provisions. The Commission has considered these sub-clauses in light of the current factual context.

    (a) "they are both bodies corporate and they consist substantially of the same members or shareholders or are under the control of the same persons".

- Fonterra and National Foods are both bodies corporate.
- The Commission has no evidence that Fonterra and National Foods consist substantially of the same members or shareholders or are under the control of the same persons.

(b) "either of them has the power, directly or indirectly, to exercise, or control the exercise of, the rights to vote attached to 25% or more of the voting securities of the other".

- Neither Fonterra nor National Foods has the power to exercise or control the exercise of 25% or more of the voting securities of the other.

(c) "one is a director of the other".

- Neither Fonterra nor National Foods is a director of the other.

Analysis of substantial degree of influence

40. The Commission has previously concluded that a "substantial degree of influence" means "able to bring real pressure to bear on the decision-making process of the other"[2]. The Commission has also previously accepted the rebuttable presumptions postulated by Berry and Riley[3] as a useful working approach. In the end, however, it is necessary to stand back and look at all the facts against the statutory test.

41. The Commission's approach to considering the issue of association as set out in the *Air New Zealand/Ansett Holdings* decision is:

> " *in considering whether persons are associated in terms of s47(3), (the Commission) has regard to all relevant factors and considers as a whole the total effect, actual or likely, of all elements of the relationship between the parties. These factors include:*
> *(a) the historical basis of the relationship and reciprocal connections*
> *(b) actual and prospective shareholdings*
> *(c) board membership and representation*
> *(d) motivation and expectation of parties*
> *(e) any premiums or concessions paid or provided to pursue the relationship*
> *(f) distribution of other shareholdings, and*
> (g) *evidence of influence on management and policy."*

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[2] See Commerce Commission, *Decision No. 278: Air New Zealand/Ansett Holdings/Bodas,* 3 April 1996, especially paragraph 180

[3] MN Berry & A Riley, "Beware the new business acquisition provisions in the Commerce Amendment Act 1990", (1991) 21 VUWLR, 91 at 111. Within this article, the authors put forward the following rebuttable presumptions for the analysis of association:

(a) a shareholding between 30% and 50% is likely to give rise to a substantial influence, without any other contributing factors.
(b) a shareholding between 20% and 30% is likely to give rise to a substantial influence only if there are "other factors". These other factors would include the distribution of other shareholdings, the ability to defeat shareholder resolutions, board representation, and the ability to influence the target's management and policy.
(c) a shareholding between 15% and 20% is unlikely to give rise to a substantial influence unless there are special circumstances.
(d) a shareholding of less than 15% does not give rise to the necessary degree of influence.

42. Applying the above statements to the present application, the Commission notes the following points:

    (a) In terms of history between Fonterra and National Foods, Fonterra's shareholding was acquired by New Zealand Dairy Group prior to the dairy merger as a strategic acquisition to establish a foothold in the Australian dairy industry. Although Fonterra did not itself acquire the shareholding, it has chosen to maintain the shareholding of one of its predecessors. National Foods advised that Fonterra has been a passive shareholder.

    (b) Fonterra holds 17.9% of National Foods. Fonterra could increase its shareholding to 20% and "creep" up its shareholding by 3% per annum without triggering the Australian takeover rules. It has the potential to increase its shareholding through National Foods' dividend investment plans, though it has in the past declined to take up any further shareholding offered by National Foods in lieu of dividends. There is no evidence of National Foods having any shareholding in Fonterra. Neither Fonterra nor National Foods has a representative on the board of the other, or common directors. National Foods' directors have stated [ ] Fonterra is not entitled to a position on the board of National Foods by virtue of its shareholding alone. Fonterra could gain representation on the board through the normal process of election at a National Foods' AGM (as is discussed subsequently). The significance of any potential board representation would be dependant on the number of board representatives Fonterra was able to get.

    (c) The 17.9% shareholding is twice the size of any other single shareholding and is sufficient to prevent a 100% takeover of National Foods. Such a 100% takeover would normally be required in order for the acquirer to obtain the full benefit[4] of a corporate rationalisation. There is no expectation on the part of National Foods that Fonterra will take any greater interest in National Foods than currently. However, Fonterra has stated [ ] There is evidence that the Australian dairy industry is set to restructure and that both Fonterra and National Foods wish to participate in this restructuring.

    (d) There is no evidence of any premiums or concessions paid between the parties.

    (e) Fonterra is the single biggest shareholder of National Foods. The other shareholdings are dispersed through nominee companies. Dairy Farmers holds 7.71%.

    (f) Fonterra does not appear to currently have any influence on the management or policy of National Foods (or vice versa), but the Commission notes that both the association tests in s5(2)(d) and s47(3) only require the person to be able to exert a substantial degree of influence, not that the person actually does.

43. These points are discussed in more detail below in relation to a submission received by the Commission.

44. The submission claims that Fonterra is able to exert a substantial degree of influence over the activities of National Foods. It states that both Fonterra and National Foods have acknowledged the need for rationalisation of the Australian dairy industry and have

[4] For example, for the acquirer company to easily access the cash flow of National Foods.

expressed desires to be participants in that rationalisation. It submits that further evidence of the Australian dairy industry's intention to restructure and rationalise is the recent purchase by Dairy Farmers of a 7.71% shareholding stake in National Foods. It states that it cannot be predicted what form the ultimate rationalisation and restructuring will take, but that three major participants in the Australasian dairy industry, Fonterra, National Foods and Dairy Farmers, now have a forum through National Foods to advance rationalisation activity.

45. The submission also argues that:

- Fonterra's stake in National Foods is sufficient to constitute a strategic "blocking" shareholding stake, in that it could give Fonterra the power to block any attempt by a third party to achieve a 100% takeover of National Foods, and thus enable Fonterra to dictate the future role of National Foods Limited in the Australian dairy industry;
- this strategic shareholding means that National Foods will respond by working positively with Fonterra and accepting its influence;
- though currently Fonterra has no representation on the National Foods board, the shareholding gives it the ability to gain board representation; and
- Fonterra's ability to substantially influence the activities of National Foods is strengthened by the relative sizes of National Foods Limited (annual turnover of approximately NZ$1.25 billion) and Fonterra (annual turnover of approximately NZ$14 billion).

46. The submission also noted that post-acquisition, there would be strong and significant financial links deriving from the supply and distribution contracts between Fonterra and NZDF.

47. The submission claimed that taken together, these factors create a direct and indirect ability for Fonterra to exert a substantial degree of influence over the activities of National Foods and its potential subsidiary, NZDF.

48. In relation to the ability of Fonterra through its supply and distribution links with NZDF to influence National Foods, the Commission notes that any influence would be post-acquisition and is more appropriately addressed as a potential incentive for collusion post-acquisition. The Commission notes that under s47(3) of the Act a person is not able to exert a substantial degree of influence on another by reason only of the fact that those persons are in competition in the same market or one of them supplies goods or services to the other.

49. The Commission notes there is evidence of a desire within the Australian dairy industry for rationalisation. National Foods has advised [ ] Approximately 15 months ago National Foods demonstrated its desire to participate in this rationalisation through an unsuccessful bid for Dairy Farmers.

50. The Commission has been provided with a report prepared by Credit Suisse First Boston (CSFB), which gives examples of where a shareholding of between 15% and 25% was sufficient to exert a substantial degree of influence over the activities of that company.

51. In response to this report, National Foods claimed that the examples cited by CSFB were not representative of the Fonterra – National Foods relationship. It pointed out that in the

CSFB case studies, the exercise of control was facilitated either by friendly relationships between the minority shareholder and other shareholders, or by extremely poor performance of the parent company which encouraged other shareholders to examine alternatives.

52. The Commission acknowledges that this is not currently the situation with respect to Fonterra – National Foods. However, it considers that if Fonterra were to change its currently passive stance, it could well, as a result of its size and influence within world dairy markets, gain the support of other National Foods shareholders. For example, if Fonterra and Dairy Farmers, which has recently taken a 7.71% shareholding in National Foods, were to co-operate, they would control more than 25% of National Foods.

53. The Commission considers that either on its own, or if it gained the support of even a small percentage of other shareholders of National Foods, Fonterra would have the power to advance its own interests. For instance, it could prevent National Foods from restructuring or participating in a rationalisation of the Australian dairy industry, should Fonterra not agree with such plans or unless some "quid pro quo" were agreed to. Alternatively, or in addition, it could influence the competitive stance that National Foods might adopt in New Zealand dairy markets. .

54. Also, with the support of other shareholders, Fonterra could gain representation on National Foods' board. Board representation is common commercial practice with a shareholding such as Fonterra's in National Foods.

55. As mentioned above, Fonterra has advised that it is reviewing its position within Australia. This involves its shareholding in National Foods, its 25% equity stake in Bonlac and its 80% control of Peters and Brown. It is possible that Fonterra could sell its shareholding in National Foods. Alternatively it could attempt to increase its shareholding. A further submission received by the Commission postulated that Fonterra did not have a history of acquiring shares as an investment. The acquisition of the shareholding in National Foods by New Zealand Dairy Group prior to the formation of Fonterra was undertaken as a strategic measure to establish a foothold in the Australian industry. The Commission notes Fonterra's statements regarding its intentions for the Australian dairy industry and considers that by maintaining its National Foods shareholding, Fonterra is keeping open the possibility of using this shareholding to secure its position within the Australian dairy industry.

56. In summary, the Commission has formed the view that the following factors are sufficient to enable Fonterra to exercise a substantial degree of influence over the activities of National Foods:

- the likelihood of rationalisation within the Australian dairy industry;

- indications that National Foods and Fonterra want to participate in such rationalisation;

- Fonterra's strategic power via its current shareholding in National Foods;

- Fonterra's shareholding in National Foods being twice the size of any other single shareholding;

- Fonterra's potential ability, as a result of its size and position in world dairy markets, to influence other shareholders in National Foods;

- Fonterra's potential ability to gain the support of other shareholders and thereby gain more influence within National Foods by, for example, Board representation; and

- Fonterra's indication that it is reviewing its position in the Australian dairy industry.

57. Although the tests between the two Acts may differ in stringency, the Commision has formed the view that National Foods and Fonterra are likely to be associated in terms of both the DIR Act and the Commerce Act.

Implication of Association

58. Because of the conclusions reached with respect to the competition analysis, the Commission has not had to reach a conclusion on association in order to make a decision with respect to National Foods' application to purchase NZDF. However, the Commission considers that if it were to reach a conclusion on the basis of association, it would find that the parties are associated.

59. If the Commission were of the view that Fonterra and National Foods are associated, it would mean that Fonterra would not be able to divest NZDF to National Foods by reason of section 9 of the DIR Act and the Commission could also decline to grant clearance pursuant to section 68(2) of the Commerce Act in that the acquisition would be unlikely to proceed. The Commission has completed its competition analysis as though Fonterra and National Foods are not associated.

MARKET DEFINITION

60. 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.*

61. For the purpose of competition analysis, a 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, could impose at least a small yet significant and non-transitory increase in price, assuming all other terms of sale remain constant (the '*ssnip* test'). For the purpose of determining relevant markets, the Commission will generally consider a *ssnip* to involve a five percent increase in price for a period of one year.

62. It is substitutability at competitive market prices that is relevant in defining markets. Where the Commission considers that prices in a given market are significantly different from competitive levels, it may be necessary for it to assess the effect of a *ssnip* imposed upon competitive price levels, rather than upon actual prices, in order to detect relevant substitutes.

63. The Commission seeks to define relevant markets in terms of four characteristics or dimensions:

- the goods or services supplied and purchased (the product dimension);
- the level in the production or distribution chain (the functional level);
- the geographic area from which the goods or services are obtained, or within which the goods or services are supplied (the geographic extent); and
- the temporal dimension of the market (the timeframe), though it notes that in this instance this dimension is not relevant.

64. The Commission aims to define the markets in a way that best assists the analysis of the competitive impact of the acquisition under consideration. A relevant market will ultimately be determined, in the words of the Act, as a matter of fact and commercial common sense.

65. Where markets are difficult to define precisely, the Commission will initially take a conservative approach. If the proposed acquisition can be cleared on the basis of a narrow market definition, it would also be cleared using a broader one. If the Commission is unable to clear the proposed acquisition on the basis of the narrower market, it will be necessary to review the arguments and evidence in relation to broader markets.

Product Dimension

66. The delineation of relevant markets as a basis for assessing the competitive effects of a business acquisition begins with an examination of the goods or services offered by each of the parties to the acquisition. Both demand-side and supply-side factors are generally considered in defining market boundaries. Broadly speaking, a market includes products that are close substitutes in buyers' eyes on the demand-side, and suppliers who produce, or are able easily to substitute to produce, those products on the supply-side.

67. The Commission takes the view that the appropriate time period for assessing substitution possibilities is the longer term, but within the foreseeable future.[5] The Commission considers this to be a period of one year, which is the period customarily used internationally in applying the 'ssnip' test (see below) to determine market boundaries. The Commission will take into account recent, and likely future, changes in products, relative prices and production technology in the process of market definition.

Demand-side substitution

68. 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.

69. Initially, markets are defined for each product supplied by two or more of the parties to an acquisition. Unequivocal substitutes are combined. For each initial market so defined, the Commission will examine 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

[5] In *Tru Tone Ltd v Festival Records Retail Marketing Ltd* [1988] 2 NZLR 351 Smellie J and the Court of Appeal on appeal approvingly quoted an earlier decision of the Commerce Commission in *Edmonds Food Ind Ltd v W F Tucker & Co Ltd* (Decision 21, June 1984) where the Commission had ruled: "A market has been defined as a field of actual or potential transactions between buyers and sellers amongst whom there can be strong substitution, at least in the long run, if given a sufficient price incentive".

must already be incorporated in the market. If not, then the next most likely substitute good or service will be added to the initial market definition and the test repeated. This process continues until a combination of products is found which defines the product dimension of a relevant market, namely, the smallest combination of goods or services for which a ssnip would be profitable for the hypothetical monopolistic.

70. On the demand-side, the technical viability of one good or service as a substitute for another must be assessed. However, even where another product may technically be suitable as an alternative for the product in question, its price may be so much higher that it may be a poor substitute in an economic sense, at least for the great majority of buyers. In judging economic substitutability between products, the Commission will have regard to relative prices, quality and performance when assessing whether they are, in fact, close substitutes in the eyes of buyers.

Supply-side substitution

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

Product definition analysis

72. National Foods claims that the products that would be affected by the aggregation of NZDF and National Foods' subsidiary, NFIFF, are:

- Yoghurt, which is manufactured and distributed by both NZDF and NFIFF; and
- Dairy desserts, which both companies manufacture and distribute.

73. National Foods submits that there are essentially three potential market definitions that could apply for the Application. They are:

- A narrow definition of "yoghurts and dairy desserts"; or
- A definition of "cultured dairy products"; or
- A definition of "consumer dairy products".

74. National Foods advised that it believes a yoghurt and dairy desserts market is too narrow a definition. It stated that market research has shown that over time the total volume of dairy foods consumed does not change to any significant degree. It claimed that this shows that substitution does occur between dairy products, and hence that a wide market definition should be used.

75. Mainland agreed that there has been movement in the different segments of the dairy sector and that the overall volume of sales of dairy products has been fairly stable. It pointed out, however, that consumers have moved from butter to margarine and other spreads and that there has been movement from milk to other non-dairy beverages. On the other hand, there has been an increase in the sales of yoghurt and dairy desserts. These shifts in consumption were confirmed by NZDF.

76. The Commission considers that National Foods proposition with respect to the total volume of dairy products is not necessarily relevant to market definition. The examples indicate that if consumers switch from a dairy product, they do not necessarily switch to another dairy product. Moreover, the proposition does not address the key issue with respect to market definition, namely switching in response to a "ssnip". It cannot be concluded from the observation of a stable total volume of dairy products that there is wide substitutability between dairy products.

77. In the MergeCo Draft Determination, the Commission recognised that: "Aside from cheese and butter, which are considered to fall into distinct markets … there is a range of other dairy products sold on the domestic market, including yoghurts, desserts, dairy foods, cottage cheese and cream cheese. Because it is difficult to distinguish the boundaries of consumer products of this type, at least without recourse to extensive econometric analysis, and because the proposed merger raises dominance concerns in all of them, they are treated as falling within the one market for the purposes of analysis here". The Commission concluded that the relevant market was the market for the manufacture and wholesale supply of cultured dairy products in New Zealand.

78. However, it was clearly specified in the Draft Determination that the decision to aggregate all cultured products in the same market was taken because "the proposed merger raises dominance in all of them".

79. In Decision 216, the Commission found that there was a distinction between "yoghurts and dairy desserts" and "other cultured dairy foods such as cottage cheese or cream cheese". Industry participants have confirmed and supported this view during the current investigation.

80. All of the supermarket chains[6] in New Zealand consider that yoghurt and dairy desserts are part of the same market and that there is no substitute for these products. The other cultured products such as cottage cheese and cream cheese are not seen by these organisations as substitutes from a demand-side point of view.

81. NZDF and Mainland share the supermarkets' view. They both said that yoghurts and dairy desserts are in the same market, and that this market does not include the other cultured products.

82. A further issue raised by the applicant is that other desserts and snack foods are potentially substitutable for yoghurts and dairy deserts. The Commission considers that substitutability from the demand-side perspective would be weak and unlikely to satisfy the requirement of a 'snipp' test. It notes that there would be no, or extremely limited, supply-side substitution.

83. The Commission considers on the basis of the views of the supermarkets and market participants, other dairy products or snack foods are not substitutes for yoghurt and dairy desserts and that the narrow market definition as put forward by the applicant is appropriate.

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[6] Progressive Enterprises Ltd (Progressive), Woolworths (NZ) Ltd (Woolworths) Foodstuffs (Wellington) Co-operative Society Ltd (Foodstuffs Wellington), Foodstuffs (Auckland) Limited (Foodstuffs Auckland) and Foodstuffs (South Island) Limited (Foodstuffs South Island)

Home made yoghurts

84. The applicant also claims that, should the Commission decide on the narrower market of yoghurts and dairy desserts, the category of home-made yoghurts needs to be included, for reasons of demand-side substitutability.

85. The Commission notes that the market for home-made yoghurt exhibits different demand-side characteristics. The Applicant submits that only brand reputation, packaging, flavour and price differentiate yoghurt and dairy desserts. The Commission considers that these characteristics differentiate fresh ready-made yoghurt and home-made yoghurt to a much greater extent.

    - There are no common brands between homemade yoghurts and fresh yoghurts. Home-made yoghurt is available from Hansells and Easi-Yo. These brands are not associated with producers of fresh yoghurt.

    - Packaging is necessarily different because of the different nature of the product, one being a fresh chilled product, the other a powder. An apparatus is required in addition to the yoghurt mix, and an analysis of packaging and price must include this. The value of fresh yoghurt packaging is another differentiation factor. Many yoghurt products are packaged to be a quick and convenient snack, or for school lunch boxes. Home-made yoghurt consumption is more cumbersome.

    - Flavours differ between fresh and home-made yoghurts. Home-made yoghurts are only flavoured whereas chilled yoghurts are flavoured and contain pieces of fruit.

    - Home-made yoghurt products are stored and shelved separately from fresh yoghurt and dairy desserts. Progressive said that the customers for home-made yoghurt are not the same as those that buy fresh yoghurt.

    - The price of home-made yoghurt ingredients is much lower in proportion to the volume of yoghurt made and bought, but the price of yoghurt mix does not completely represent the cost to the consumer of making yoghurt at home (see below).

86. The Commission also notes that in terms of demand-side substitution, supermarkets and home-made yoghurt suppliers advised that most fresh yoghurt consumers would be prepared to pay more for fresh yoghurt rather than switch to home-made yoghurt.

87. In addition to demand-side objections to including home-made yoghurt in the market, the Commission notes that supply-side substitution is likely to be weak. Home-made yoghurt requires different production methods and producers of the ingredients for home-made yoghurt cannot readily extend production to fresh yoghurt.

88. Also there are differences in the means of production of home made yoghurts. The consumer must purchase an additional apparatus (between $18 and $25) to make yoghurt at home, and then supply time, labour and energy (heat and refrigeration) to create the final product. Effectively, the consumer also partly assumes the role of manufacturer.

89. For these reasons, the Commission considers that there is no supply side substitution between producers of home-made yoghurt and fresh yoghurt and dairy dessert products.

90. The sum of these objections is that, were the price of fresh yoghurt to increase, there would not be a significant increase in demand for home-made yoghurt, indicating that they are not close substitutes.

91. Consequently, the Commission does not consider home made yoghurts to be part of the same market as fresh yoghurt.

Undifferentiated/Differentiated Products

92. In some instances, market definitional problems arise because of the differentiated nature of the goods or services involved in a business acquisition, caused by differing technical specifications, branding, packaging, warranties, distribution channels and other factors.

93. The applicant submitted that yoghurt and dairy desserts are differentiated by brand reputation, packaging, flavour and price. The Commission, therefore, investigated the extent of product differentiation as an issue in market definition.

94. Information obtained during the Commission's investigation confirmed that products are differentiated to a certain extent by brand, image, packaging and price, and to a lesser extent by flavour.

95. NZDF and Yoplait use TV advertising and other means of advertising to create brand awareness and establish an image for their products whereas, to date, Mainland has relied on its low price strategy only to sell its products. For example, in terms of brand and image differentiation:

- Fresh 'n Fruity's image has been switched from a yoghurt for children to a yoghurt for adults, that is sweet and very fruity;
- Yoplait has developed its French image;
- Symbio has been marketed as an organic yoghurt;
- De Winkel is known as an health yoghurt with extra added culture and herbs; and
- Mainland has invested in an "Action Man" licence for its dairy desserts.

96. Packaging is also used to differentiate brands. For example, NZDF has recently launched new pots that are round and easier to get the product out of, and Yoplait has launched red and blue pots: red for the creamy range and blue for the "Lite" range.

97. Products are also differentiated by price. [

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However, Mainland's brands are not all the time cheaper than the other producers' brands, particularly when the latter is on promotion and not the former.

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

- NZDF has launched new flavours for Fresh ‘n Fruity (such as kiwi fruit) and a new range of flavours for De Winkel with a mixture of fruit and herbs. It has also launched a drinking yoghurt with health properties.

- Yoplait has launched its “Lite” range with two flavours and has developed a range of new flavours for individual pots.

99. Although yoghurt and dairy desserts are differentiated by several means, Commission staff were advised by industry participants (manufacturers and retailers) that 80% of yoghurt and dairy desserts are sold on promotion. This is supported by AC Nielsen data on sales versus price for several supermarkets in New Zealand. Industry participants agree that price is the main driver in the buying decision, but it is not clear whether consumers switch brands to buy the brand on promotion or bring forward purchases of their favoured brand when it is on promotion. Brand loyalty is reported to be generally low (around 30%), with a greater degree of loyalty for Fresh ‘n Fruity (45%-50%).

100. After considering all the above, the Commission considers that although products are differentiated to some extent, the differentiation is not sufficient to prevent the different brands from being substitutable for each other. Accordingly, the various brands and products are not so differentiated as to affect the market definition.

Conclusion on product dimension

101. The Commission concludes that for the purpose of assessing the competition implications of the proposed acquisition, the appropriate product market is the market for yoghurt and dairy desserts, and that this does not include home-made yoghurt.

Geographic Extent

102. The Commission seeks to define the geographical extent of a market to include all of the relevant, spatially dispersed, sources of supply to which buyers can turn should the prices of local sources of supply be raised. For each good or service combination, the overlapping geographic areas in which the parties operate are identified. These form initial markets to which a ssnip is applied. Additional geographic regions are added until the smallest area is determined within which the hypothetical monopolist could profitably impose a ssnip.

103. Although buyers and sellers of a particular good or service may interact in markets that are apparently local or regional in extent, those markets may themselves overlap and interrelate so as to form a market covering a larger geographical area. In these situations, the larger market is likely to be the appropriate one for analysing the competitive effects of a business acquisition.

104. In the MergeCo Draft Determination, the Commission established that distribution of cultured products is from centralised plants on a national basis and that the geographic market is therefore nationwide in extent. The Commission’s investigation of this application has confirmed that view.

105. The Commission therefore concludes that the geographic market is a national one.

Functional Level

106. The production, distribution and sale of a product typically occur through a series of functional levels – for example, the manufacturing/import level, the wholesale/distribution level and the retail level. It is often useful to identify the relevant functional level in describing a market, as a proposed business acquisition may affect one horizontal level, but not others.[7] Alternatively, some acquisitions, such as those involving businesses at different vertical levels, may raise issues related to vertical integration. Generally, the Commission will seek to identify separate relevant markets at each functional level affected by an acquisition and assess the impact of the acquisition on each.

107. The major suppliers of yoghurt and dairy desserts, NZDF, NFIFF and Mainland, each manufacture and distribute yoghurts and dairy desserts to retailers.

108. The Commission therefore concludes that the appropriate functional level is the manufacture and wholesale supply of yoghurt and dairy desserts.

Conclusion on Market Definition

109. The Commission has defined the relevant market as the market for the manufacture and wholesale supply of yoghurt and dairy desserts in New Zealand (the yoghurt and dairy dessert market).

COMPETITION ANALYSIS

Substantially Lessening Competition

110. Section 47 of the Act prohibits particular business acquisitions. It provides that:

> *A person must not acquire assets of a business or shares if the acquisition would have, or would be likely to have, the effect of substantially lessening competition in a market.*

111. Section 2(1A) provides that substantial means "real or of substance". Substantial is taken as meaning something more than insubstantial or nominal. It is a question of degree.[8] What is required is a real lessening of competition that is not minimal. The

[7] *Telecom Corporation of New Zealand Ltd v Commerce Commission* (1991) 4 TCLR 473, 502 The High Court (Greig J, Shaw WJ, Prof M Brunt) noted: "If we ask what functional divisions are appropriate in any market definition exercise, the answer, …, must be whatever will best expose the play of market forces, actual and potential, upon buyers and sellers. Wherever successive stages of production and distribution can be co-ordinated by market transactions, there is no difficulty: there will be a series of markets linking actual and potential buyers and sellers at each stage. And again, where pronounced efficiencies of vertical integration dictate that successive stages of production and distribution must be co-ordinated by internal managerial processes, there can be no market."

[8] *Commerce Commission v Port Nelson Ltd* (1995) 6 TCLR 406, 434; *Mobil Oil Corporation v The Queen in Right of NZ* 4/5/89, International Centre for Settlement of Investment Disputes, Washington DC, International Arbitral Tribunal ARB/87/2 (paras 8.2, 19, 20).

lessening needs to be of such size, character and importance to make it worthy of consideration.[9]

112. Section 3(2) provides that references to a lessening of competition include references to the hindering or preventing of competition.[10]

113. While the Act defines the words "substantial" and "lessening" individually it is desirable to consider the phrase as a whole. For each relevant market, the Commission will assess:

- the probable nature and extent of competition that would exist in a significant section of the market, but for the acquisition (the counterfactual);
- the nature and extent of the contemplated lessening; and
- whether the contemplated lessening is substantial.[11]

114. In interpreting the phrase "substantially lessening competition", the Commission will take into account the explanatory memorandum to the Commerce Amendment Bill (No 2). The memorandum notes that:

> *Two of the 3 key prohibitions are strengthened to bring New Zealand into line with Australian competition law, which will facilitate a more economic approach to defining anti-competitive behaviour.*

and, in relation to s47:

> *This proposed new threshold is the same as the threshold for these types of acquisitions in section 50 of the Trade Practices Act 1974 (Australia).*

115. For the purposes of the analysis, the Commission takes the view that a lessening of competition and a strengthening of market power may be taken as being equivalent, since they are the two sides of the same coin. Hence, it uses the two terms interchangeably. Thus, in considering whether the acquisition would have, or would be likely to have, the effect of substantially lessening competition in a market, the Commission will take account of the scope for the exercise of market power, either unilaterally or through co-ordination between firms.

116. When the impact of enhanced market power is expected predominantly to be upon price, the anticipated price increase relative to what would otherwise have occurred in the market has to be both material, and able to be sustained for a period of at least two years, for the lessening, or likely lessening, of competition to be regarded as substantial. Similarly, when the impact of increased market power is felt in terms of the non-price dimensions of competition, these also have to be both material and able to be sustainable

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[9] *Dandy Power Equipment Ltd v Mercury Marina Pty Ltd* (1982) ATPR 40-315, 43-888; *South Yorkshire Transport Ltd v Monopolies & Mergers Commission* [1993] 1 All ER 289.

[10] For a discussion of the definition see *Commerce Commission v Port Nelson Ltd*, supra n 6, 434.

[11] See *Dandy*, supra n 5, pp 43–887 to 43-888 and adopted in New Zealand: *ARA v Mutual Rental Cars* [1987] 2 NZLR 647; *Tru Tone Ltd v Festival Records Retail Marketing Ltd* [1988] 2 NZLR 352; *Fisher & Paykel Ltd v Commerce Commission* [1990] 2 NZLR 731; *Commerce Commission v Carter Holt Harvey*, unreported, High Court, Auckland, CL 27/95, 18/4/00.

for at least two years for there to be a substantial lessening, or likely substantial lessening, of competition.

The Counterfactual

117. The Commission uses a forward-looking, counterfactual, type of analysis in its assessment of business acquisitions, in which two future scenarios are postulated: that with the acquisition in question, and that in the absence of the acquisition (the counterfactual). The impact of the acquisition on competition can then be viewed as the difference between those two scenarios. It should be noted that the status quo cannot necessarily be assumed to continue in the absence of the acquisition, although that may often be the case. For example, in some instances a clearly developing trend may be evident in the market, in which case the appropriate counterfactual may be based on an extrapolation of that trend.

118. The Applicant submitted that the counterfactual should be the status quo, that is "the market power, or control, presently (and for some eight months from now) able to be exercised by Fonterra, as the preponderant, in fact dominant, competitor in all aspect of the manufacture and distribution of dairy products generally in New Zealand".

119. However, the Applicant recognised that it could be argued that, since Fonterra is obliged by the DIR Act to sell its controlling shareholding in NZDF before the end of September 2002, the sale to a qualifying person other than National Foods should be regarded as the true counterfactual for the Commission's purposes in relation to this application.

120. The Commission is of the view that, given the statutory requirement of divestment of NZDF by Fonterra, the status quo cannot be regarded as the counterfactual for the purpose of this application. The Commission is aware that [

].

121. The Applicant also stated that [

].

122. [

].

123. [

].

124. [

]

125. Given these factors, the Commission has adopted as the counterfactual the situation where NZDF is bought by another party and NFIFF remains as a third player, owned or not by National Foods.

Potential Sources of Market Power

126. Two types of market situation conducive to the exercise of substantial unilateral market power are now considered. These involve making the distinction between undifferentiated and differentiated product markets. That distinction may also have a bearing on the scope for co-ordinated behaviour in a market.

127. In undifferentiated product markets, where buyers make their purchases largely on the basis of price, and the production capacities of firms are an important element in competition, a business acquisition may have the potential to substantially lessen competition when the combined entity has acquired a market share below that required for dominance. This is especially likely in circumstances where the rivals of the combined entity cannot easily expand production to offset its output contraction within a one-year time frame.[12] The inability of rivals to expand may result either from their facing binding capacity constraints, or because additional capacity is significantly more expensive to operate.

128. In differentiated products markets, where the product offerings of different firms vary, and in which buyers make their purchase decisions on the basis of product characteristics as well as of price, the products of firms are by definition not perfect substitutes for each other. The substitutability between products will vary depending upon differences in their various characteristics, which may include their physical specifications, brand image, associated services and location of sale. In simple terms, differentiated products can be thought of as being arranged in a "chain of substitutes", where those in adjacent positions in the chain tend to be close substitutes, and those positioned further apart are less close substitutes.

129. In paragraphs 92-100 the Commission has outlined the reasons why it considers that the products are differentiated to some extent.

130. The supply-side characteristics of differentiated products markets are important, as the potential market power of the combined entity may be offset by the actions of rivals. However, rivals may not be able to offer a competitive constraint where they are unable either to re-position their products closer to that of the combined entity to replace the lost localised competition, or to strengthen the promotion of existing products. A further possible constraint would be lost if it were not possible for new products to be added through new entry.

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[12] See, for example, Roger D Blair and Amanda K Esquibel, "The Roles of Areeda, Turner and Economic Theory in Measuring Monopoly Power" (1996) *Antitrust Bulletin*, 781, especially pp 791-95.

Conclusion – Competition Analysis Principles

131. The Act prohibits business acquisitions that would be likely to have the effect of substantially lessening competition in a market. The Commission makes this assessment against a counterfactual of what it considers would be likely to happen in the absence of the acquisition. In the present case the counterfactual is considered to be the situation where NZDF is bought by another, unknown, party and NFIFF remains as a third player, owned or not by National Foods. A substantial lessening of competition is taken to be equivalent to a substantial increase in market power. A business acquisition can lead to an increase in market power by providing scope either for the combined entity to exercise such power unilaterally, or for the firms remaining in the market to co-ordinate their behaviour so as to exercise such power.

132. In broad terms, a substantial lessening of competition cannot arise from a business acquisition where there are sufficient competitive constraints upon the combined entity. The balance of this Decision considers and evaluates the constraints that might apply in the yoghurt and dairy dessert market under the following headings:

- existing competition;
- potential competition from entry; and
- other competition factors.

ANALYSIS OF EXISTING COMPETITION

Introduction

133. One consequence of a merger between competitors is that the number of firms competing in a market is reduced or, put another way, concentration is increased. This raises the possibility that competition in the market may be substantially lessened through the exercise of unilateral or coordinated market power. These are the subjects of the analysis in this section.

Scope for Unilateral Market Power

Introduction

134. An examination of concentration as measured by market shares in a market post-acquisition can provide a useful guide to the constraints that market participants may place upon each other, including the combined entity. Both structural and behavioural factors have to be considered. However, concentration is only one of a number of factors to be considered in the assessment of competition in a market. Those other factors are considered in later sections, as noted above.

135. Market shares can be measured in terms of revenues, volumes of goods sold, production capacities or inputs (such as labour or capital) used. All measures may yield similar results in some cases. Where they do not, the Commission may, for the purposes of its assessment, adopt the measure that yields the highest level of market share for the

combined entity. The Commission considers that this will lead to an appropriately conservative assessment of concentration, and that the factors which lead to the other different market share results, are more appropriately considered elsewhere during the assessment of the acquisition.[13]

136. In determining market shares, the Commission will take into account the existing participants (including 'near entrants'), inter-firm relationships, and the level of imports. This is followed by a specification of the Commission's 'safe harbours', an estimation of market shares, and an evaluation of existing competition in the market. Each of these aspects is now considered in turn.

Existing Participants

137. The existing competitors are:

- New Zealand Dairy Foods ("Fresh 'n Fruity", "Swiss Maid Calci-Yum", "Cartoons", "Symbio" – "Metchnikoff", "De Winkel", "Simply Organics", "Slimmers' Choice", "Baby and Toddler");
- Mainland ("Meadow Fresh", "Weight Watchers", "Action Man", "Naturalea");
- NFIFF ("Yoplait", "Vigueur", "Yogo", "Petit Miam", "Le Rice");
- Serra Natural Foods Limited ("Cyclops");
- Biofarm Products Limited ("Biofarm"); and
- Karikaas Natural Dairy Products Limited ("Supreme Flora"), though not distributed everywhere; and
- Verona Farms.

Extent of competition under the counterfactual.

138. [ ]

139. [ ]

140. [ ]

[13] For example, where market share measured in terms of capacity produces a significantly lower share of the market in the hands of participants than a measure in terms of sales volumes, the constraint on a combined entity from that unemployed capacity might be taken into account when identifying near entrants or the constraint from new market entry. In some cases, the model of market power being used may influence the choice as to which market share measure is used.

141. [

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Imports

142. In markets where imports are present, the Commission will consider whether actual competition from imported products is equivalent to that from domestic supply. In undertaking this evaluation, the Commission will take into account the existence of any limits on quantities of imported product (the price elasticity of supply), and the effects on trade of various factors. Imports channelled through the parties to an acquisition, or persons associated with them, will be added to their domestic production in assessing market share, rather than being treated as independent sources of supply.

143. Potential imports may also provide a constraint on domestic suppliers. This is considered as part of the assessment of the constraint from market entry below.

144. There are currently few imports of yoghurt and dairy desserts. The following are the only known examples:

- NFIFF imports “Petit Miam” (thick and very creamy yoghurt sold in 6x60g packs for young children) and “Le Rice” (rice pudding). It has been importing “Petit Miam” for 10 years and has just started importing “Le Rice” in October 2001. The revenue of these products is between [ ] a year. Both products are air freighted into New Zealand.

- Kapiti Cheeses imports Italian Dairy Desserts from Italy in a frozen form. They are thawed and then sold refrigerated.

145. These products are imported by New Zealand companies already in the yoghurt and dairy dessert market. They compete directly with products made in New Zealand and their sales figures are included in the figures used to calculate market shares.

Safe Harbours

146. Once the relevant market has been defined, the participants have been identified, and their market shares estimated, the Commission’s ‘safe harbours’ can be applied. Under these safe harbours, a business acquisition is considered unlikely to substantially lessen competition in a market where, after the proposed acquisition, either of the following situations exist:

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

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

Market Shares

147. The total yoghurt and dairy desserts market is approximately $118.8 million in value and 24.4 million tonnes in volume.

148. Market share information has been provided by the applicant based on AC Nielsen data[14]. These market shares have been checked and confirmed by markets participants. Estimated market shares are shown in Table 1.

Table 1: Market Shares in Yoghurt and Dairy Desserts Market

Manufacturer	Market share Value ($)	Market share Volume
NZDF	[ ]	[ ]
NFIFF	[ ]	[ ]
Sub-total for merged entity	**[ ]**	**[ ]**
Mainland (Fonterra)	[ ]	[ ]
Others	[ ]	[ ]
Total	**100%**	**100%**

149. The three firm concentration ratio exceeds [ ] in value and in volume. With a market share of [ ] in dollar value and [ ] in volume, the merged entity is outside the safe harbours. This indicates the high concentration that would result from the proposed merger.

150. As already noted, market shares are insufficient in themselves to establish whether competition in a market would be lessened. It is the interplay between a number of competition factors, of which seller concentration is only one, that has to be assessed in determining the impact of a business acquisition on competition. Other competition factors include entry conditions; the presence of an aggressive, innovative or maverick firm; countervailing power of buyers or suppliers; rapid innovation in the market; and others. These are considered for the relevant market in subsequent sections.

State of Existing Competition

Nature of competition

151. Yoghurt and dairy dessert market participants use four main different means of competing with each other:

- advertising campaigns;
- packaging innovation;
- product innovation; and

[14] *Key accounts only, MAT December 2001.*

- in-store price promotions.

152. Advertising is used to create an image and brand and product awareness. It is an important part of a supplier's ability to obtain and retain shelf space for its products in supermarkets (see below). Successful differentiation will also help to justify the higher price of a product (for example, the price premium for Fresh 'n Fruity).

153. Mainland stated that [ ]

154. Packaging is a substantial means of differentiating products on supermarkets' shelves and competitors have been active in developing and launching new packaging. Examples of such differentiation by packaging are described above in paragraph 96.

155. Industry participants also compete via product innovation, as described above in paragraph 98.

156. In-store price promotions are characterised by price competition to get promotion slots. Suppliers submit [ ]

157. Supermarket sales are crucial to suppliers, as 90% of yoghurt and dairy desserts are sold in supermarkets, and 80% of those are sold on promotion.

158. NZDF advised that competition also occurs at the level of trade relationships, service offered to the stores and supply chain management. NZDF also claimed that Mainland was able to bundle its dairy and meat products to get better promotions.

Competitiveness of market participants

159. Information provided by industry participants indicates that the market is currently competitive.

Mainland

160. Foodstuffs Auckland and Wellington and NZDF all stated that Mainland competes aggressively at the moment. Mainland increased its market share from [ ] in February 2000 to [ ] in January 2002, primarily on price.

161. Mainland told the Commission that [ ]. It has been competing on price alone, but [ ]. It recognised that it is necessary for a brand to have some credibility in the market and that it has been difficult to bring an unknown brand into the North Island.

162. Fonterra, Mainland, NZDF and most retailers said that Fonterra could not afford to be seen as second in a market in its home country, which is a showcase of its performance. Most retailers believe that Mainland will work hard to gain market shares and become first in the market.

163. Mainland has spent [

]

NZDF

164. Foodstuffs Wellington said that NZDF is competing aggressively at the moment and that the rest of the market is responding.

165. NZDF stated that it [

]

NFIFF

166. Commission staff understand that NFIFF's market share [

]

Profitability of Yoghurt and Dairy Desserts Market

167. Mainland advised the Commission that the profitability of yoghurt and dairy desserts fluctuates but has increased over the last few years. Mainland advised that [

]

168. NZDF informed the Commission that yoghurt is its [

]

Principles of Unilateral Market Power

169. Under the new substantial lessening of competition threshold, the focus of the competition analysis must take into account the oligopoly structure of the market in question. In such markets, economic theory suggests that even where firms do not coordinate their behaviour, but instead seek independently to maximise their profits, it is possible for unilateral market power to emerge, in that prices are held above costs. In addition, a merger in such a market, which in the present case would result in a reduction in the number of firms from three to two, and where entry is considered to be unlikely (see below), can result in an increase in that market power. That increase in market power could be sufficient to constitute a substantial lessening of competition.

170. An important feature of the yoghurt and dairy dessert market is that the product offerings of the market participants are differentiated. The Applicant has proposed, and the Commission has accepted, that the product is differentiated by brand, image, packaging, flavour and price. In differentiated product markets, consumers develop preferences for one brand as compared to the others. These preferences allow producers to raise prices above costs without losing all of their customers, as they would if they attempted to do the same in a market where there was no differentiation. In other words, firms are able to exert some degree of market power with respect to

their brands, even though they are competing with the similar brands of rival firms. This ignores supply-side constraints, such as would be provided by new entry (which are considered below).

171. Broadly, the degree of market power exhibited in a differentiated product market will depend upon two factors. The first is the extent of the product differentiation, and consequently the degree to which the pricing of one brand is constrained by the 'closeness' of the competition provided by other brands. The various brands may be distributed quite widely over 'differentiated product space', with the result that some pairs of brands are more closely substitutable, and therefore more price constraining one on the other, than other pairs. The second factor is whether each firm produces a single brand, or multiple brands. In the latter case, the firm will have a profit incentive to raise prices further, on the basis that a proportion of the customers lost to one brand will be 'recaptured' by its other brands, so that overall the price rise will be profitable. These affects are well illustrated in an empirical study of the United States beer market, which examined the interactions between the different brands within the main product groupings – premium, light (low calorie), imported and non-premium (popular) beer.[15]

172. In differentiated product markets, mergers between significant firms (especially those with closely competing brands) are likely to allow the merged entity (and to a lesser extent other firms) to raise prices. The essential basis for this is the loss of the competition between the merging brands. Suppose firm A acquires firm B, and each has a single brand. Previously, it may have been unprofitable for firm A to increase its price further because it would have lost too many customers, some of whom would have switched to firm B. Following the merger, the same price increase will see fewer customers lost, since those switching to B will now be internalised within the merged entity. A price increase that was unprofitable before the merger may become profitable after, when the profits of A and B are considered jointly. The application of a simplified version of an oligopoly model (the Bertrand model) to estimate crudely the possible post-merger price increase with the proposed merger in the yoghurt and dairy desserts market is presented in Appendix 1. This suggests that the price increase could be as high as 5.6 – 8.7%, depending upon the assumptions used.

173. A potentially important qualification to the preceding analysis is that the potential for post-merger price increases may be constrained by the presence of supply-side constraints, or by other competition factors, such as the possible countervailing power of buyers. Supply-side constraints include new entry, and the potential for existing firms to re-position their brands closer to, and therefore competing more directly with, those of the merged entity. These issues are considered in later sections.

174. In summary, mergers in differentiated products markets are expected to lead to a price increase through the exercise of unilateral market power, although their magnitudes are very difficult to forecast. The yoghurt and dairy desserts market is not expected to be any different.

Conclusions – Unilateral Market Power

175. The Commission has found that the proposed acquisition would cause a significant increase in concentration in the yoghurt and dairy desserts market. The number of

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[15] Jerry Hausman, Gregory Leonard and J. Douglas Zona, "Competitive Analysis with Differentiated Products", *Annales D'Economie et De Statisque*, No. 34, 1994.

major participants would fall from three to two and the market share of the merged entity would be [ ].

176. The presence of significant product differentiation suggests that a degree of market power is likely to exist pre-merger, and that competition is likely to be further eroded by the elimination of the constraint provided by the "Yoplait" brand because of common ownership. Potential off-setting factors may be the growth aspirations of Mainland, and the possible countervailing power of the supermarkets. However, that countervailing power is likely to be more muted when the supermarkets have only two, rather than three, suppliers to play off one against the other, and when one has the lion's share of the market.

177. The application of a differentiated product oligopoly model by the Commission suggested conservatively that the merger could lead to significant price increases—possibly in the range from about 5% to 8%, assuming entry is not likely—with the lower figure including the impact of continuing market share growth by Mainland. An increase of this magnitude is consistent with a finding that the acquisition would increase market power sufficiently for there to be a substantial lessening of competition. The possible constraints provided by countervailing power and by potential entry are considered below.

Scope for the Exercise of Coordinated Market Power

Introduction

178. A business acquisition may lead to a change in market circumstances such that coordination between the remaining firms either is made more likely, or the effectiveness of pre-acquisition coordination is enhanced. Firms that would otherwise compete may attempt to coordinate their behaviour in order to exercise market power by restricting their joint output and raising price. In extreme cases, where all firms in the market are involved and coordination is particularly effective, they may be able to behave like a collective monopolist. Where not all firms are involved, and market share in the hands of the collaborators is reduced, coordinated market power becomes more difficult to exercise because of competition from the independent firms in the market.

179. In broad terms, successful coordination can be thought of as requiring two ingredients: 'collusion' and 'discipline'. 'Collusion' involves the firms individually coming to a mutually profitable expectation or agreement over coordination; 'discipline' requires that firms that would deviate from the understanding are detected and punished (thereby eliminating the short-term profit to be gained by the firm from deviating).

180. When assessing the scope for coordination in the market during the consideration of a business acquisition, the Commission will evaluate the likely post-acquisition structural and behavioural characteristics of the relevant market or markets to test whether the potential for coordination would be materially enhanced by the acquisition. The intention is to assess the likelihood of certain types of behaviour occurring, and whether these would be likely to lead to a substantial lessening of competition.

Collusion

181. "Collusion" involves firms in a market individually coming to a mutually profitable expectation or agreement over coordination. Both explicit and tacit forms of such behaviour between firms are included.

182. The structural and behavioural factors that are usually considered to be conducive to collusion are set out in the left-hand column in Table 2. The significance of these is explained more fully in the Commission's *Practice Note 4*. The right-hand column of the Table then assesses the extent to which those factors are present, or are likely to be enhanced post-merger, in the yoghurt and dairy desserts market. A high proportion of 'yes' responses would suggest that the market was particularly favourable to 'collusion'; a high proportion of 'no' responses the reverse.

TABLE 2
Testing the Potential for 'Collusion' in the Yoghurt and Dairy Dessert Market

Factors conducive to collusion	Presence of factors in the market
High seller concentration	Yes, the three main players have more than [ ] market share.
Undifferentiated product	No: products are somewhat differentiated through brand, packaging and price
New entry slow	Yes, there is no likely entry in the future (see paragraphs 227 to 252)
Lack of fringe competitors	Yes: there are some fringe competitors such as Biofarm, Karikaas, Serra Natural Foods Limited, Verona Farm, but as they produce niche products rather than core products they would not provide constraint against the merged entity and Mainland.
Price inelastic demand curve	Yes: price elasticity appears to be low for the products as a whole.
Industry's poor competition record	No previous evidence of collusion
Presence of excess capacity	Yes, most of the manufacturers have excess capacity, but this appears not to reflect output reduction caused by pre-existing collusion.
Presence of industry associations/fora	No

183. The factors set out in Table 2 are inconclusive and it is therefore necessary to consider the factors relevant to co-ordinated market power in the yoghurt and dairy desserts market in light of the information gathered during this investigation.

184. National Foods pointed out that the disparity of the market shares that would exist between the merged entity and Mainland, and the strong competition between National Foods and Fonterra in Australia, would remove any likelihood of collusion.

185. Mainland advised that [

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186. NZDF said that there has never been any collusion and there never will be any. It pointed out that Mainland has never increased its prices at the same time as NZDF and, to the contrary, Mainland has been using NZDF's price increases as a means of increasing its market share. Furthermore, with the sale of Fonterra's share in NZDF, the relationship between Fonterra and NZDF will be more distant.

187. Fonterra said that its aim is to build up a global business and that it has to maximise its shareholders' investment. One of Fonterra's benchmarks will be whether Mainland can outperform NZDF. Fonterra stated that it is very important for the global part of the Fonterra's business to be seen to be successful in its home market, and that it cannot be seen to be number two in a particular product market. It said the yoghurt and dairy desserts and cultured product markets are important because they are growth areas around the world and are markets where higher margins can be earned.

188. If there were co-ordination resulting in each company's price being identical or very similar, the supermarkets considered they would be able to detect it as they receive wholesale prices for three-month periods four times a year from suppliers. They could report such explicit collusion to the Commission. However, this would not deal with the case where a measure of co-ordination facilitated an upward drift in product prices, whilst possibly maintaining current relativities.

189. The Commission notes that price-signalling, which can be a feature of tacit collusion, may be made difficult by the fact that there is not a direct correlation between the wholesale price and the retail price, as the margins taken by supermarkets can vary substantially from promotion to promotion. However, the closer relationship that would develop between supermarkets and suppliers, consequent on there being two as opposed to three suppliers, and building on present practices, suggests that market participants would become familiar with the pricing tactics of other participants.

190. Although one of the supermarkets, [ ], did not believe that the proposed acquisition would result in an increased risk of collusion, the other supermarket companies all believed that there would be an increased risk. [ ], for example, stated that there was a strong possibility of tacit collusion if there were only two participants in this market and that [

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191. Mainland, NZDF and National Foods all point out that the market has been competitive to date and that Mainland in particular would need to compete vigorously in order to increase its market share. Moreover, there is some constraint in the ability of the supermarkets to trade one supplier off against the other which, together with the fact that the suppliers must commit volume and set prices for [ ], would make it difficult for the two suppliers to commence any form of co-ordinated market power.

192. The Commission notes that if Fonterra were to exercise a significant influence over National Foods, as discussed above under association, there would be a higher likelihood of co-ordinated market power. However, this analysis has proceeded as though Fonterra and National Foods are not associated.

193. The Commission concludes that there would be factors promoting collusion, not least the reduction from three participants to two. However, it considers that this would be outweighed by the asymmetrical market shares of the merged entity and Mainland, and by Mainland's drive to increase its market share as evidenced by its conduct to date. The Commission therefore concludes that collusion would not be likely to be materially increased by the proposed acquisition.

Discipline

194. Even though in paragraph 193 the Commission concludes that collusion would not be likely to be materially increased by the proposed acquisition , the possibility that it would occur makes an examination of the features conducive to discipline worthwhile.

195. For coordination to be successful, deviations of individual firms from the collusive behaviour have to be discouraged by being detected swiftly and punished by the other firms.

196. The structural and behavioural factors that are usually considered to be conducive to 'discipline' in co-ordinated markets are set out in the left-hand column in Table 3. Again, the significance of these is explained more fully in the Commission's *Practice Note 4*. The right-hand column of the Table then assesses the extent to which those factors are present, or are likely to be enhanced post-merger, in the yoghurt and dairy dessert market. A high proportion of 'yes' responses would suggest that the market was particularly favourable to 'discipline; a high proportion of 'no' responses the reverse.

TABLE 3
Testing the Potential for "Discipline" in the Yoghurt and Dairy Dessert Market

Factors conducive to discipline	Presence of factors in the market
High seller concentration	Yes
Sales small and frequent	No as suppliers have to commit to specific prices [ ], and significant volumes would be sold at these prices.
Absence of vertical integration	Not relevant to this market
Demand slow growing	No, demand has grown by [ ]
Firms have similar costs	Yes. [ ]
Price transparency	To some extent due to the repeated process of selling to supermarkets.

197. The assessment of the relevant structural and behavioural conditions in the yoghurt and dairy dessert market in Table 3 suggests that it could be possible to maintain discipline, should a collusive understanding or arrangement be attained.

Conclusions – Existing Competition

198. The Commission considers that the scope for the exercise of unilateral market power will be enhanced by the acquisition.

199. The Commission concludes that there is not sufficient evidence that the scope for co-ordinated market power will be enhanced by the acquisition.

CONSTRAINTS FROM MARKET ENTRY

Introduction

200. A business acquisition is unlikely to result in a substantial lessening of competition in a market if behaviour in that market continues to be subject to real constraints from the threat of market entry.

201. Where barriers to entry are clearly low, it will not be necessary for the Commission to identify specific firms that might enter the market. In other cases, the Commission will seek to identify likely new entrants into the market.

202. The Commission will consider the history of past market entry as an indicator of the likelihood of future entry. The Commission is also mindful that entry often occurs on a relatively small scale, at least initially, and as such may not pose much of a competitive constraint on incumbents within the relevant time frame.

Barriers to Entry

203. The likely effectiveness of the threat of new entry in constraining the conduct of market participants, following a business acquisition that might otherwise lead to a substantial lessening of competition in a market, is determined by the nature and height of barriers to entry into that market.

204. The Commission considers that, for the purpose of considering this issue, a barrier to entry is best defined as an additional or significantly increased cost or other disadvantage that a new entrant must bear as a condition of entry. In evaluating the barriers to entry into a market, the Commission will generally consider the broader ‘entry conditions’ that apply, and then go on to evaluate which of those constitute entry barriers.

205. It is the overall obstacle to entry posed by the aggregation of the various barriers that is relevant in determining whether entry is relatively easy or not, and therefore whether or not potential entry would prevent a substantial lessening of competition.

206. For entry to act as an antidote to a substantial lessening of competition stemming from a business acquisition, it must constrain the behaviour of the combined entity and others in the market.

207. The applicant submitted that there are very low barriers to entry and that entry is likely.

208. The Commission notes that Mainland though not a new entrant, has been able to build market share. This could suggest that barriers to expansion, and possibly by extension, barriers to entry, are not high. However, the Commission considers that Mainland is not representative of other companies. Its large product range and established reputation as a supplier in New Zealand, together with its previous ownership by Kiwi Co-operative Dairies Ltd, one of New Zealand premier companies, prior to the formation of Fonterra, means that it was in a stronger bargaining position than most other potential new entrants in terms of gaining access to supermarket shelf space. It already has an established distribution network. Furthermore, while it has not promoted its Meadow Fresh yoghurt brand, it has benefited from recognition of this brand in the South Island where its town milk is a market leader.

209. In contrast, the information provided by industry participants indicates that there are some substantial barriers, though not all participants considered the same factors to be the most important barriers. The following are the reasons cited for not entering the market or which have made entry or expansion difficult.

Investment in Brands

210. Industry participants such as supermarkets, NZDF, United Milk Ltd (United Milk), [ ] told Commission staff that establishing a brand would be one of the more significant barriers to entry.

211. The exception was Mainland, which has not supported its Meadow Fresh yoghurt brand with advertising but said that it had benefited from leverage from its Meadow Fresh branded milk in the South Island. It also acknowledged that it had been very difficult to enter the North Island with an unknown brand. It is now [ ]

212. The Commission understands that establishing a brand and particularly supporting it is crucial to get access to shelf space in supermarkets. All supermarkets said that they would look at the marketing campaign supporting a new brand before they gave any shelf space to a new entrant. This leads to a “chicken and egg situation”: to enter the market in a size sufficient to act as a constraint requires access to the customer. That in turn requires shelf space with the prospect that the product will sell before such shelf space is made available. To be sure that the product will sell requires a brand that is recognised and in demand. But a brand that is recognised and in demand requires not just advertising, but also availability, which requires shelf space. The problem is compounded by the product having a short shelf life, as supermarkets will not want to stock if it will not sell. The only way to break the cycle is to have a large public launch coupled with low price and incentives to encourage the supermarkets to participate in the promotional activity by offering significant shelf space for the purposes of the promotion. All of this suggests a cost significantly above that of the incumbent.

213. Most industry participants estimated the outlay required to launch a brand at about [ ]. NZDF had a higher estimate - between [ ]. These figures are, however, one-off figures that do not include the ongoing support required for each brand. NZDF said that it had been spending about [ ] a year supporting the Fresh ‘n Fruity brand, [ ]

214. The Commission also understands that it would take at least six months to establish a brand.

Access to Shelf Space

215. Supermarkets and some industry participants advised that access to shelf space is a barrier to entry in the market. There is limited chilled space in supermarkets, and when a new product is put on the shelves, another has to be taken off. The decision to list or delist a product is taken every week by the category manager based on sales data. Woolworths added that it had [

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216. The criteria to get shelf space are:

- offering a good price;
- having a brand that is supported by TV advertising and proper marketing (see above);
- having in-store promotion packages;
- showing ability to supply;
- having sale and sale forecast data; and
- showing that the new product adds something to the category and will grow it.

217. However, most of the criteria listed above have to be fulfilled by established incumbents. Furthermore, supermarket chains told Commission staff that a large incumbent with an established brand would not be likely to be denied shelf space even though some of the criteria were not met.

218. [

] It also said that it is harder for a new entrant to get shelf space in Progressive and Woolworths as these supermarkets are centralised. A new entrant has to negotiate at head office level and be able to provide a nation-wide offer. It is easier to enter in a Foodstuffs store as one can negotiate at store level.

Access to Skills and Resources

219. Supermarkets, NZDF and potential new entrants from New Zealand and overseas told the Commission that the capital required to build processing facilities was a barrier to entry. Industry participants have estimated the cost of a new plant on a scale big enough to achieve 10% to 20% market share at between $10 million and $15 million.

220. The necessity of establishing an efficient and nation-wide distribution network has also been mentioned by supermarkets, [ ], [ ] and [ ] as a barrier to entry. The short shelf-life of the products requires daily distribution to stores. Supermarkets can distribute from their warehouse to the store but some manufacturers are reluctant to adopt this option as it implies fewer margins for the suppliers and a loss of in-store control.

221. Both Mainland and NZDF said stock management is crucial to profitability. This has also been acknowledged by most supermarkets, which mentioned the difficulty of

managing supply and demand and inventories as a barrier for them to enter the market with a housebrand. [ ] added that it is all the more difficult for a supermarket as it can only sell its housebranded products in its own stores, whereas the likes of NZDF and Mainland have three different supermarket chains to which to sell their products with consequent ease of stock balancing and therefore alternatives in case of over-production.

Size and Nature of the Market

222. [ ] cited the small size of the market as a barrier to entry. [ ] said that the size of the market did not justify the investment.

223. [ ] advised that they were not prepared to compete with the existing well-established brands and with Fonterra.

224. [ ] It pointed out the deregulation is very new and overseas companies have not had time to see what Fonterra will be doing.

Milk Supply

225. The [ ] pointed out that the Raw Milk Regulations required Fonterra to sell up to 400 million litres of milk to independent processors, 250 of which already went to NZDF. It leaves about 150 million litres, which in his view is not sufficient for a company wanting to enter the New Zealand market as such a company would need to export dairy products as well as supply the domestic market. He was conscious of the ability of farmers to exit Fonterra or supply 20% of their production to independent processors but was concerned about the uncertainty of supply. [ ] was also concerned about the supply of raw milk.

Conclusion on Entry Barriers

226. It appears that the barriers to entry faced by potential new entrants in the market can differ significantly and are dependent on the size of the entrant. A small start-up will consider that the main barriers to entry are brand establishment, and access to shelf space, skills and resources, whereas a multinational with well-established brands will consider that the size and nature of the market together with milk supply are the main barriers to entry. Even though the barriers to entry listed above are not all applicable to all potential new entrants, the Commission considers that each new entrant would face at least the cumulative effect of some of them, which, together with the state of the market result in reasonably high barriers to entry. Therefore it is necessary to consider the possibility of entry.

The "LET" Test

227. In order for the threat of market entry to be such a constraint on the exercise of market power as to alleviate concerns that a business acquisition could lead to a substantial lessening of competition, entry of new participants in response to the exercise of market power must be likely, sufficient in extent and timely (the *let* test). If they are to act as a constraint on market participants following a business acquisition, which might otherwise

lead to a substantial lessening of competition in a market, entry must be relatively easy, or to put it another way, barriers to entry must be relatively low.

228. The mere possibility of entry is, in the Commission's view, an insufficient constraint on the exercise of market power to alleviate concerns about a substantial lessening of competition. In order to be a constraint on market participants, entry must be likely in commercial terms. An economically rational firm will be unlikely to enter a market unless it has a reasonable prospect of achieving a satisfactory return on its investment, including allowance for any risks involved.

229. In general, it is the pre-merger price that is relevant for judging whether entry is likely to be profitable. That in turn depends upon the reaction of incumbents to entry in terms of their production volume, together with the output volume needed by the entrant in order to lower its unit costs to the point where it can be competitive.

230. If entry is to constrain market participants, then the threat of entry must be at a level and spread of sales that is likely to cause market participants to react in a significant manner. The Commission will not consider entry that might occur only at relatively low volumes, or in localised areas, to represent a sufficient constraint to alleviate concerns about market power.

231. Small-scale entry into a market, where the entrant supplies one significant customer, or a particular product or geographic niche, may not be difficult to accomplish. However, further expansion from that "toe-hold" position may be difficult because of the presence of mobility barriers, which may hinder firm's efforts to expand from one part of the market to another. Where mobility barriers are present in a market, they may reduce the 'extent' of entry.

232. If it is effectively to constrain the exercise of market power to the extent necessary to alleviate concerns about a substantial lessening of competition, entry must be likely to occur before customers in the relevant market are detrimentally affected to a significant extent. Entry that constrains the exercise of market power must be feasible within a reasonably short timeframe from the point at which market power is first exercised.

233. In some markets where goods and services are supplied and purchased on a long-term contractual basis, buyers may not immediately be exposed to the detrimental effects stemming from a potential substantial lessening of competition. In such cases, the competition analysis, in a timing sense, begins with the point at which those contracts come up for renewal.

234. National Foods submitted that entry could occur in either or both of two ways:

- the expansion of existing related, but not identical, manufacturing activities by participants in the wider dairy industry in New Zealand; and/or
- by fresh entry, either through manufacturing in New Zealand or through importing, by overseas companies.

235. Commission staff interviewed potential new entrants [ ]. No one considered that it would enter the

yoghurt and dairy dessert market in New Zealand de novo, citing the various barriers to entry described above.

Entry by NZ companies

236. Commission staff interviewed [ ].

237. [ ]

238. [ ]

239. [ ]

240. [ ]

241. [ ]

Entry by overseas companies

242. Commission staff understands that the overseas companies it interviewed [ ] would not enter the New Zealand market in the near future.

243. [ ] said that [ ]

244. [ ] said that it [ ]

245. [ ] advised that [ ]

246. *[*

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247. *[*

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Entry by supermarkets via house brands

248. As discussed below in paragraphs 256 to 263, New Zealand supermarket companies are not likely to enter the yoghurt and dairy desserts market by means of housebrands.

Imports

249. Most industry participants told Commission staff that importing yoghurt and dairy desserts had already been considered and tried by a few companies, but they had all failed. The short shelf-life of the product makes supply chain and stock management very difficult and the air freight required is too costly.

250. NFIFF currently imports some yoghurts and dairy desserts (Petit Miam and Le Rice). These are, however, niche market products that bear a much higher price per kilogram than other yoghurt, and can therefore justify the cost of air-freight.

251. NZDF told the Commission that a technology developed overseas allowing extended shelf life could provide a solution to imports. However, this technology would not be available in New Zealand within three to five years.

252. Imported products make up approximately 1% of market share in the yoghurt and dairy desserts market and are fringe products. There is no importation of the main brands and the short shelf life makes importation on a significant scale unlikely. The Commission therefore does not consider that potential imports are a constraint on the conduct of domestic suppliers.

Conclusion on Constraints from Market Entry

253. The Commission concludes that the barriers to entry are high and that the likelihood of entry is low. Accordingly, the merged entity is not likely to face effective competition from new entrants.

254. The Commission does not consider there is any contradiction between this conclusion and paragraph 124. The conclusion above relates to de novo entry whereas paragraph 124 [

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OTHER COMPETITION FACTORS

Countervailing Power of Purchasers

255. National Foods submitted that it could not see that the supermarkets should have any difficulty in exercising real and effective constraint on any attempt by the merged entity to exercise market power. Supermarkets would have the ability to play off at least the major suppliers against each other, and could either enter via housebrands or encourage near entrants to enter.

Countervailing Power via Housebrands

256. The Commission investigated whether supermarkets would exercise countervailing power by introducing housebrand yoghurt and dairy desserts. The supermarkets advised that they would not be introducing such housebrands in the foreseeable future. The reasons cited were primarily as follows:

- the market is too small – housebrands are best suited to high volume products;
- the presence of other brands means there is not enough room in the market for housebrands;
- it is currently not economical (supply costs are too high and retail prices too low);
- brand and marketing are important for these products, making housebrands less suitable;
- they only have their stores to sell their products through, which reduces the volume they can sell and makes stock management more difficult; and
- supply/demand and stock management is difficult with a short shelf-life product.

257. Responses of the individual supermarket companies are set out below.

258. Progressive told the Commission that [ ]. [ ]

259. Woolworths said that it [ ]

260. Foodstuffs Auckland said that [ ]

261. Foodstuffs South Island said that [ ]

262. Foodstuffs Wellington said [

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263. The applicant pointed out that Coles Myer had tendered for a housebrand yoghurt for its supermarkets in Australia. Coles Myer advised the Commission that the yoghurt and dairy dessert market in Australia is different from New Zealand in that the majority of yoghurt is sold at normal price, not on special, and when it is on special, it is at a very shallow discount of no more than 5%. It also advised that it had been forced to enter with a very limited range of housebrand yoghurts (six SKUs) because of the entry of Aldi, an aggressively low priced supermarket.

Countervailing Power from Purchasing Practices

264. Both Mainland and NZDF claimed that supermarkets derived countervailing power from the way they purchase from suppliers. Key factors were:

- 90% of yoghurt and dairy desserts is sold through supermarkets;
- 80% of yoghurt and dairy desserts sold in supermarkets is sold on promotion; and
- The suppliers need to maintain production volume, otherwise yoghurt and dairy dessert production is not profitable. They cannot afford to lose sales volume by putting prices up.

265. Supermarket sales are crucial for yoghurt and dairy desserts. Promotions are managed by supermarkets, which have the potential to exert some power over the suppliers. Supermarket category managers choose amongst the best discounts offered by suppliers for their [ ] promotion calendar. They trade suppliers against each other for each weekly promotion before confirming the promotion calendar. AC Nielsen data do not show any brand pricing patterns over time, what has been confirmed by supermarket chains.

266. [ ] stated that the number of promotion slots suppliers have reflects their promotional activity. If supermarkets are offered the same deals by two suppliers, they look at the advertising programme to choose between the suppliers. [ ] said they have to maintain a certain degree of uncertainty for the suppliers to access promotion slots. For example, if the merged entity knows that it will get 70% of promotion slots (in proportion to its market share) in a month because it is bigger, it would have less incentive to offer low promotion prices.

267. However, [ ] pointed out that it is difficult to monitor suppliers' pricing and that therefore the supermarkets' ability to control this is limited. Similarly, [ ] said that if, for instance, Mainland and the merged entity were to collude to increase prices 4% to 5%, they would just increase the retail price: it would not be a problem for supermarkets as yoghurt and dairy desserts are a small part of their business.

Conclusion on Countervailing Power of Purchasers

268. The Commission concludes that supermarkets are not likely to introduce housebrand yoghurt and dairy desserts.

269. The Commission concludes that supermarkets may be able to exert some countervailing power against the ability of the merged entity to raise prices, but that this power may be limited.

Elimination of a Vigorous and Effective Competitor

270. Sometimes an industry contains a firm that is in some way non-typical, or has different characteristics, or is an innovator, or is regarded as a maverick. The independent or less predictable behaviour of such a firm may be an important source of competition in the market, and may undermine efforts by other firms to engage in coordination. Such a firm need not be large to have an impact on competition out of proportion to its relative market size. Should it become the target of a business acquisition, the resulting elimination of a vigorous and effective competitor could have the effect of substantially lessening competition in the market (especially if there are barriers preventing the entry of new, effective competitors).

271. National Foods submitted that "it is apparent that the Commission's term 'vigorous and effective competitor' is an abbreviated form of reference to an unusual competitor, one which is in some way non-typical, or has different characteristics or is an innovator, or is regarded as a maverick". The Applicant goes on to say that it would regard such a competitor as having a history of aggressive, independent pricing behaviour (which is true of NFIFF), a record of superior innovative behaviour or low costs (while NFIFF is innovative, it is doubtful whether that is 'superior', and its costs are not particularly low), a growth rate exceeding or likely to exceed that of the market (not true of NFIFF in recent years – it has lost some market share), and a history of independent behaviour generally (true of NFIFF, but not to a unique degree). The Applicant therefore claimed that the proposed acquisition would not lead to the loss to the marketplace of a firm having "an impact on competition out of proportion to its relative market size" [16].

272. The Commission agrees that the proposed acquisition would not result in the loss of a firm that has "an impact on competition out of proportion to its relative size". Accordingly, the proposed acquisition will not result in the elimination of a vigorous or effective competitor as defined above.

OVERALL CONCLUSION

273. The Commission considers the transaction should be declined on competition grounds.

274. The Commission has considered the probable nature and extent of competition that would exist in the market for the manufacture and wholesale supply of yoghurts and dairy desserts in New Zealand. The Commission considers that the appropriate

[16] Progressive Enterprises, Decision No. 448, para 265.

benchmark for comparison is the situation where NZDF is bought by another party and that NFIFF remains as a third player, owned or not by National Foods.

275. The Commission has considered the nature and extent of the contemplated lessening of competition. The proposed acquisition would result in the merged entity obtaining a market share that falls outside the Commission's safe harbour guidelines.

276. The Commission is concerned that there may be insufficient constraint on the merged entity from existing competition and potential competition from entry. It does not consider that other competition factors remove or outweigh this concern.

277. The Commission therefore concludes that the merger will or will be likely to have the effect of substantially lessening competition in the yoghurt and dairy dessert market.

278. In addition to its competition concerns, the Commission notes that, if it were to reach a conclusion on the basis of association, it would find that Fonterra and National Foods are associated under the DIR Act and the Commerce Act.

DETERMINATION ON NOTICE OF CLEARANCE

279. Accordingly, pursuant to section 66(3)(b) of the Commerce Act 1986, the Commission declines to give clearance for the acquisition by National Foods Limited through a wholly owned subsidiary of up to 100% of the issued shares in New Zealand Dairy Foods Limited.

Dated this 22nd Day of March 2002

MJ Belgrave
Chair

APPENDIX A

Application of the Bertrand Model to Estimate the Post-merger Price Increase

Introduction

1. Given the oligopolistic nature of the market in this case, and the differentiated nature of the products provided, as discussed in the report, a model that can be used to test whether unilateral market power might be enhanced as a consequence of the merger is the Bertrand market model. The Commission has applied this model in the present case, but acknowledges its limitations, and does not place great weight on its findings. The model is a generalised one, and has not been adjusted to match the specific circumstances of the market in question. Nonetheless, the model may provide some guidance as to the scope post-merger for market power to be exercised.

The Model

2. The Bertrand model assumes non-cooperative oligopoly (i.e., firms ‘compete’ rather than collude), and that each firm independently chooses its own profit-maximising price on the basis that all other firms hold their prices constant. Although this behavioural assumption has been questioned in a dynamic setting, where firms play the ‘price-setting game’ repeatedly, it does generate a market pricing equilibrium that may in some cases approximate actual market outcomes. This model also has the desirable feature that it is a price-setting one, in which firms set their prices and allow the market to determine volume of sales, as the manufacturers in question appear to do (rather than one where firms determine output volumes and allow the market to determine the price).
3. The Bertrand pricing model combined with a model of market demand can be used to generate estimates of post-merger price increases. This model can be applied in greatly simplified form by using strong assumptions about the nature of demand (symmetry of product differentiation), as suggested by Shapiro, one of the pioneers of this form of analysis. Readers are referred to his article cited below for details of the approach applied here.[17] Shapiro is the Transamerica Professor of Business Strategy at the Haas School of Business and Professor of Economics in the Economics Department at the University of California at Berkeley. At the time he wrote the article he was Deputy Assistant Attorney General in charge of economics in the Antitrust Division of the US Department of Justice. Economists at the Antitrust Division have been at the forefront of developing applications of market models to use in predicting merger outcomes, and applications of the Bertrand model have been used by economic experts in testimonies before the American courts in merger cases.
4. Using Shapiro’s approach, the size of the post-merger price increase then depends mainly (ignoring the supply-side factors) on two elements: the size of the pre-merger industry gross margin, measured as the difference between price and incremental cost; and the diversion ratios between the merging brands, measured as the proportion of the sales lost by the brand whose price is increased captured by the brand of the merger partner. The diversion ratio is closely related to the cross-price elasticity of demand between the two brands, and hence to their degree of substitutability. In this approach there are two steps: the first is to estimate the diversion ratio (based on firms’ existing market shares),

[17] Carl Shapiro, “Mergers with Differentiated Products”, *Antitrust*, spring 1996, pp. 23-30.

and the second is to estimate the post-merger price increase (based upon the diversion ratio and the gross margin). Hence, the data requirements are market shares and gross margins. However, the results need to be checked against known market interactions and outcomes.

5. The market shares used in the analysis in rounded form are those given in Table A.1. The gross margin is used as a measure of the percentage elevation of price above average incremental cost, with incremental cost being defined as the costs of goods, trading terms, and discounts, rebates etc. From the gross margin the firm has to cover overhead costs, distribution costs, costs of sale and profit. The three main firms in the market gave their approximate gross margins as follows: Mainland, [ ]; NZDF, [ ]; and NFIFF, [ ]. A conservative figure of [ ] has been used, this being the lowest figure of the ranges cited by the merger parties.
6. The results depend upon whether demand is assumed to be linear (a straight line) or constant price elasticity. The Commission has chosen, conservatively, to use the former, as there are no good grounds for believing that demand has a constant elasticity (although it could do, and a constant elasticity demand curve would be more consistent with economic demand theory).
7. The post-merger price increase also depends upon the extent to which the market size shrinks as a result of that price increase. The available evidence suggests that although there is some switching by consumers between brands when relative prices change (e.g., in response to the "specialing" of individual brands), the market demand for the product as a whole is relatively price inelastic, at least for moderate, across-the-board price increases. A market shrinkage of 10% is therefore assumed, conservatively, to follow from a post-merger price increase. Combined with the price increases calculated below, this would imply a highly price elastic demand response (which seems likely to be an overly elastic figure).
8. When the Commission's initial analysis was put to the Applicant for its comments, a response was received from the NZ Institute for Economic Research. One comment it made was that the current market shares of the participants would be unlikely to stay the same in the future. In particular, it argued that Mainland's declared strategy of increasing its market share would be likely to see its share continuing to grow. This would reduce the post-merger price increase generated by the model over time as Mainland's share increased.
9. In order to accommodate this factor, a separate estimate of the post-merger price increase was calculated by assuming that over the next two years, Mainland's market share would increase by the same number of percentage points—namely nine—as the share had increased over the preceding two years. Its share would thus increase from [ ] to [ ]. It was also assumed that this market share gain would be at the expense of the other two major firms, whose market shares would decline proportionately to their existing shares. Mainland's assumed market share gain may prove to be optimistic, [

   ]
10. The data used, and the results of the analysis, are given in Table A.1. The model's prediction is that price is likely to increase post-merger by 8.7% with pre-merger market shares maintained into the future, and 8.7% declining to 5.6% by the end of two

years with continuing growth by Mainland. These price increases would be much greater with a constant elasticity demand curve.

TABLE A.1
Data and Estimates of Post-Merger Price Increases

Scenario	Market shares of merging firms	Mainland's market share	Diversio n ratio	Gross margin	Price increase
Existing market shares	[ ]	[ ]	[ ]	[ ]	8.7%
With Mainland growth	[ ]	[ ]	[ ]	[ ]	5.6%

11. The model estimates the post-merger price increase of the merged entity. However, arguably the relevant price increase is that expected across the entire market. The relevant figure would then be the weighted average of the prices of the merged entity and other firms. Simulation studies with the model overseas indicate that other firms will tend to follow the lead of the merged entity, but increase their prices by a smaller percentage. The size of this percentage will broadly reflect the extent to which these other brands have been constrained by the merging brands' prices in the past. Although the simplified version of the model being applied here does not allow the price increases of non-merger participants to be estimated, it seems reasonable to assume that as the Mainland brand would appear to be a fairly close substitute to those of the merging companies, the pre-merger constraint is large, and hence that when that constraint is relaxed, the post-merger price increase might also be proportionately large. This suggests that the figures in the last column of Table A.1 would have to be discounted to allow for this effect, but perhaps by not a large amount.

12. The NZIER report also pointed out that any efficiency gains by the merged entity which lowered its incremental costs would have the effect of reducing its post-merger price increase. It said that as the Applicant would [ ], savings of [ ] could be expected. Assuming that such savings were realised—and they might not be realised immediately after the merger—a further small reduction in the estimated post-merger price increase in Table A.1 could be expected.

13. However, it is important to emphasise that although the price increase is consistent with the market share and gross margin characteristics for the market in question, and the data used has been chosen on a conservative basis (i.e., to generate a result at the low end of the spectrum), the estimates do rely upon a number of strong assumptions about the nature of the market which may not be borne out in practice. These assumptions are as follows:

- The model incorporates the demand-side only, and does not take account of the potential for Mainland to re-position its "Meadow Fresh" brand closer to those of the merged entity in response to that entity's efforts to exert market power. If such re-positioning were to occur, the incorporation of it into the model would serve to reduce the post-merger price increase somewhat. However, given that there is only

one other brand in this case, it is questionable as to whether brand re-positioning would be a viable strategy.

- The NZIER report also emphasised its view that entry into this market is easy, and that this would undermine the relevance of the Bertrand model. However, the Commission believes that entry is not easy, as explained in the body of the report.
- The model does not take into account other competition factors, such as the potential for countervailing power to be exercised by buyers. It is not clear whether the gross margins cited above are generous, and hence indicative of pre-merger market power, despite the supermarkets' alleged countervailing power. The presence of pre-merger market power would be consistent with the Bertrand model.

14. Taking all of these factors into account, the estimates suggest that the possible price rise from enhanced unilateral market power following the acquisition, on the assumption that Bertrand pricing applies before and after, could be significant. Although the model has been applied conservatively, strong assumptions have been made, and so the estimated price increases have to be treated as being tentative. Unfortunately, it was not possible to apply a more sophisticated version of the model given the time, data and resource constraints that apply in a clearance application.