

22 April 2010

# Statement of Issues — Murray Goulburn Co-operative Co. Limited – proposed acquisition of Warrnambool Cheese and Butter Factory Company Holdings Ltd

- Outlined below is the Statement of Issues released by the Australian Competition and Consumer Commission (ACCC) in relation to the proposed acquisition of Warrnambool Cheese and Butter Factory Company Holdings Ltd (WCB) by Murray Goulburn Co-operative Co. Limited (Murray Goulburn) (proposed acquisition).
- 2. A Statement of Issues published by the ACCC is not a final decision about a proposed acquisition, but provides the ACCC's preliminary views, drawing attention to particular issues of varying degrees of competition concern, as well as identifying the lines of further inquiry that the ACCC wishes to undertake.
- 3. In line with the ACCC's *Merger Review Process Guidelines* (available on the ACCC's website at www.accc.gov.au) the ACCC has established a secondary timeline for further consideration of the issues. The ACCC anticipates completing further market inquiries by 7 May 2010 and anticipates making a final decision by 3 June 2010. However, the anticipated timeline can change in line with the *Merger Review Process Guidelines*. To keep abreast of possible changes in relation to timing and to find relevant documents, market participants should visit the Mergers Register on the ACCC's website at www.accc.gov.au/mergersregister.
- 4. A Statement of Issues provides an opportunity for all interested parties (including customers, competitors, shareholders and other stakeholders) to ascertain and consider the primary issues identified by the ACCC. It is also intended to provide the merger parties and other interested parties with the basis for making further submissions should they consider it necessary.

# Background

- 5. In February 2010, Murray Goulburn provided a submission to the ACCC seeking clearance of its proposed acquisition of WCB under section 50 of the Act.
- 6. At this time, Murray Goulburn's offer to acquire WCB has been rejected. In December 2009, WCB revealed that it had rejected two indicative takeover proposals one made by Murray Goulburn and one made by a third party. On

- 29 January 2010 Murray Goulburn made a proposal to WCB's Board to acquire WCB. This proposal was also rejected. On 19 February 2010 WCB rejected a revised takeover offer from Murray Goulburn.
- 7. On 22 February 2010 the ACCC commenced its review of the proposed acquisition at the request of Murray Goulburn.

### The parties

### Murray Goulburn Co-operative Co. Limited

- 8. Murray Goulburn is an integrated dairy co-operative company, which was formed in 1950, and is owned by approximately 2,600 supplier shareholders. Murray Goulburn's turnover for the 2008/2009 financial year was reported to be approximately \$2.4 billion.
- 9. Murray Goulburn's principal activities are the processing, manufacturing, packaging, distribution, marketing and wholesale supply of a range of milk and dairy products, including fresh dairy products (fresh white milk and cream), and 'non-fresh' dairy products (cheese, UHT milk, milk powder, butter, and whey products). Its products are produced under both private label and manufacturer brands.
- 10. In 2008/09 Murray Goulburn acquired approximately 3.25 billion litres of raw milk from dairy farmers. This represents approximately 36% of Australia's milk supply. Murray Goulburn currently sources raw milk from farms in the south east region of Australia comprising Victoria, the Riverina area of New South Wales, central and south east of regions of South Australia and Tasmania.
- 11. Murray Goulburn produces dairy products for both domestic consumption and export, with exports accounting for over half of Murray Goulburn's sales. Murray Goulburn exports to more than 100 countries and its international business accounts for approximately 45 per cent of Australia's dairy exports and approximately 9 per cent of world dairy trade. It is Australia's largest exporter of processed food.
- 12. Murray Goulburn's operations are organised across a number of business units. The majority of Murray Goulburn's products are sold under the retail brands shown in Table 1. Murray Goulburn also supplies cheese, milk, and cream products domestically as industrial ingredients to other food manufacturers.

Table 1 Murray Goulburn's branded products

Product	Brands
Fresh White Milk	Devondale
UHT Milk	Devondale Full Cream Milk, Devondale Skim Milk, Devondale Semi-Skim Milk, Devondale Point One, Devondale Smart Milk, Devondale Smart Plus, Devondale Reduce, Liddels Lactose Free Milk (full cream, low fat, skim)
Flavoured UHT Milk	Liddels Lactose Free Chocolate Milk
Cheese	Devondale Moo Zoo, Devondale Organic Tasty, Devondale Mild, Devondale Colby, Devondale Tasty, Devondale Light'N Tasty, Devondale Vintage, Devondale Sandwich Slices, Devondale Seven, Cobram Vintage Cheddar
Butter & Spreads	Devondale Butter, Devondale Dairy Soft, Devondale Extra Soft, Devondale Light, Devondale Light with Calcium
Yoghurt	Liddels Yoghurt
Creams	Devondale Thickened Cream, Devondale Long Life Thickened Cream, Devondale Sour Light, Liddels Lactose Free Thickened Light Cream
Other	Devondale Skim Milk Powder

Source: Murray Goulburn

13. Murray Goulburn has eight manufacturing sites located in Victoria and one in Tasmania which manufacture dairy products derived from processed raw milk.<sup>1</sup>

### Warrnambool Cheese and Butter Factory Company Holdings Ltd

- 14. WCB was established as a private company in 1888 and is the oldest surviving dairy company in Australia. WCB was publicly listed on the Australian Stock Exchange in May 2004. Many of WCB's shareholders also supply raw milk to WCB. In 2009 WCB's total revenue was \$441.1 million.
- 15. WCB has a raw milk intake of approximately 922 million litres acquired from farmers in south western Victoria principally the regions surrounding Allansford, Simpson, and Ballarat; and the Adelaide Hills and Fleurieu Peninsula regions of South Australia.
- 16. WCB produces dairy products for both domestic and export markets, with exports accounting for over half of WCB's sales. WCB manufactures the following products:
  - Cheese the majority of the cheese produced at WCB's plant is standard cheddar which is on-sold in an unpackaged and unbranded form to other manufacturers to be further processed. WCB also produces a range of other natural cheeses including low fat cheddar, gouda, romano and swiss style cheeses. WCB's cheese products are sold to wholesale customers in Australia and on the international market;

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<sup>&</sup>lt;sup>1</sup> Murray Goulburn recently announced the closure of its cheese factory in Leitchville, Victoria. The raw milk previously processed in that factory will be re-directed and transported to Murray Goulburn's other facilities in western Victoria.

- Whey protein concentrate, which is primarily exported but also used as an ingredient in WCB's Prime Nutrition food supplements;
- Butter and cream, sold mainly in bulk to domestic and international food manufacturers and wholesalers – including fresh cream, pasteurised cream, concentrated cream, frozen cream, salted butter, unsalted butter, butter blends:
- Milk powders Sungold branded skim milk powder products;
- Fresh white and flavoured milk;
- Bulk raw milk WCB sells raw milk to other dairy processors for input into their products.
- 17. WCB's main processing plant is located in Allansford, Victoria. It also has a small speciality cheese cutting and wrapping plant at Mil Lel in South Australia, and a nutritional ingredients manufacturing plant in Allansford.
- 18. WCB and Royal Friesland Campina have a 50/50 joint venture company Great Ocean Ingredients Pty Ltd which manufactures a pre-biotic nutritional ingredient Vivinal GOS (galacto-oligosaccharides) for worldwide food, infant nutrition and pharmaceutical industries. Great Ocean Ingredients plant is located alongside WCB's plant at Allansford and has the capacity to produce up to 15,000 metric tonnes of Vivinal GOS. The majority of products manufactured by Great Ocean Ingredients are exported.

# Industry background

- 19. The major categories of dairy products include fresh milk, flavoured milk, long life milk, cheese, butter, powders (and other non-fresh dairy), yoghurt, dairy desserts, cream and custard.
- 20. Processors acquire raw milk supplied by dairy farmers, and transform it into various dairy products for sale to retailers or for export. Some processors also sell product in bulk to other food manufacturers to produce various food products. In some cases, processors may acquire raw milk and on sell it to other processors.

# Other industry participants

## Suppliers of raw milk - dairy farmers

21. Dairy products are manufactured from raw milk that is produced and supplied by dairy farmers (farmers).

### **Processors**

22. The major processors in Australia include National Foods, Parmalat, Murray Goulburn, Fonterra, Bega and WCB. Each of these organisations is active in the acquisition of raw milk and, to varying degrees, in the production

of dairy products. Processors supply both branded and 'private label' products to retailers.

- Parmalat Australia Ltd (Parmalat) (formerly Pauls Limited) is a wholly owned subsidiary of the Italian based global dairy company, Parmalat SpA. Its key operations include the production and distribution of fresh milk, cream, and yoghurt. It produces other long life and fresh dairy products and beverages, primarily for sale in domestic markets and some export supply.
- Fonterra is a co-operative owned by New Zealand dairy farmers. In Australia, Fonterra operates primarily through Fonterra Brands (Australia) Pty Ltd and Fonterra Australia Pty Ltd. Fonterra primarily supplies a range of cheese and milk products.

Bonlac Supply Company (BSC) acts as an agent for Fonterra Australia Pty Ltd ('Fonterra Australia') for milk supply in Victoria and Tasmania. Bonlac's shareholders are suppliers to Fonterra and their equity is invested in Fonterra Australia in the form of Unsecured Capital Notes.

- National Foods is a wholly owned subsidiary of Kirin Holdings Company Limited. Its principal activities are the processing, manufacturing, packaging, distribution and marketing of fresh milk, fresh dairy foods, juice and cheese.
- Bega is a private Australian-owned company. Bega's main activities are the manufacture of cheese and cheese products, which it does from its manufacturing facilities in Bega, NSW and North Coburg, Victoria. All Bega branded cheese products are marketed in Australia by Fonterra.

In April 2007, Bega acquired a 70% shareholding in the Victorian-based dairy company, Tatura Milk Industries Limited, which manufactures cream cheese, powders, infant formula and nutraceuticals.<sup>2</sup>

### Milk brokers

23. In addition to acquiring milk directly from farmers, to varying degrees, processors also acquire milk from milk brokers. An example of a milk broker is United Dairy Power, (UDP), who acquires raw milk from farmers and resells this milk to processors for processing and the manufacture of dairy products. In this way, UDP is both a competitor in the acquisition of raw milk from farmers and the supply of raw milk to food manufacturers.

### Milk swaps

24. In addition to acquiring milk directly from farmers, processors also acquire milk through 'milk swaps'. These are direct swaps of volumes of milk between processors that have farmers in regions that are not proximate to their own plants, but that are close to their competitors' plants.

<sup>&</sup>lt;sup>2</sup> Nutraceuticals are extracts of food with claimed medicinal effects.

### 25. For example:

- A processor whose plant is in northern Victoria could collect milk from farmers in Gippsland, and provide it to a competitor whose plant is in the Gippsland area.<sup>3</sup>
- A 'swap' would be completed if the Gippsland processor provided equal volumes of milk collected from its own farmer-suppliers to the northern Victoria processor. The ACCC understands that under swap arrangements, farmers are paid under the payment structure of the processor with which they have a supply agreement.

# Market inquiries

26. On 23 February 2010 the ACCC commenced market inquiries regarding the proposed acquisition. A range of interested parties provided responses, including farmers, other dairy processors, buyers of wholesale dairy products and dairy industry associations.

### With/without test

- 27. In assessing a merger pursuant to section 50 of the Trade Practices Act 1974, the ACCC must consider the effects of the transaction by comparing the likely competitive environment if the transaction proceeds (the "with" position) to the likely competitive environment if the transaction does not proceed (the "without" or "counterfactual" position) to determine whether the acquisition is likely to substantially lessen competition in any relevant market.
- 28. Having regard to the history of commercial events regarding the potential sale of WCB as outlined above and on the basis of its inquiries to date, the ACCC's preliminary view is that:
  - in the event that Murray Goulburn does not acquire WCB, a likely counterfactual may be that a new entrant bidder could make an offer to acquire WCB that is acceptable to the Board of WCB; or
  - in the event that Murray Goulburn does not acquire WCB, a likely counterfactual may be that WCB is not acquired by another party.
- 29. The ACCC considers that irrespective of these potential alternatives, the future state of competition without the proposed acquisition is likely to be the same as it is today and WCB continues to operate as an independently owned processor.

### Relevant markets

30. Murray Goulburn and WCB primarily overlap in the acquisition of raw milk from farmers, the wholesale supply of various dairy products to customers such as supermarkets and food service providers, and the wholesale supply of bulk raw milk and bulk cream which are used as inputs by downstream manufacturers of food products.

<sup>&</sup>lt;sup>3</sup> These regions are mentioned here for illustrative purposes only.

- 31. On the basis of its inquiries to date, the ACCC's preliminary view is that the relevant markets are likely to be:<sup>4</sup>
  - The separate markets for the acquisition of raw milk in:
    - i. south west Victoria:
    - ii. south east South Australia; and
    - iii. the central region of South Australia.
  - The market for the manufacture and wholesale supply of fresh milk in Victoria.
  - The market for the manufacture and wholesale supply of flavoured milk in Victoria.
  - The national market for the manufacture and wholesale supply of powdered milk products.
  - The separate markets for the supply of bulk raw milk in:
    - i. south west Victoria;
    - ii. south east South Australia; and
    - iii. central South Australia.
  - The market for the manufacture and supply of bulk cream in Victoria and South Australia.
  - The national market for the manufacture and wholesale supply of packaged and bulk cheese.
  - The national market for the manufacture and wholesale supply of packaged and bulk butter.
  - The national markets for the manufacture and wholesale supply of whey products.
  - The national market for the manufacture and wholesale supply of packaged cream.

### Markets for the acquisition of raw milk

32. Market inquiries to date indicate that there are separate regional markets for the acquisition of raw milk. In particular, information provided to the ACCC to date

<sup>&</sup>lt;sup>4</sup> WCB has one retail outlet in Warrnambool which sells its branded cheese products. Murray Goulburn currently does not have retail outlets, but it is certainly possible that it could commence retail operations in future. However, the ACCC considers that given the large number of other cheese retailers, including supermarkets, it is unlikely that the proposed acquisition would raise competition issues in a retail market. Therefore, this potential market is not considered further.

- indicates that there are separate markets in each of the following regions south west Victoria, south east South Australia and central South Australia.
- 33. These regional areas are generally defined by the distances between dairy processors' plants and the dairy farms that supply them, usually within a radius of less than 400 kilometres. Information obtained by the ACCC during market inquiries indicates that processors would incur substantially higher costs if they were to acquire and transport large quantities of raw milk from farms more than 400 kilometres from their processing plants.
- 34. The ACCC understands that to some extent, drought conditions have resulted in processors acquiring raw milk from farms that are located at greater distances from their processing plants than has traditionally been the case. However, despite this, the ACCC's preliminary view is that in response to a small but significant decrease in price, processors with plants that are located more than 400 kilometres from the dairy producing regions in central and south east South Australia, and south west Victoria, are unlikely to acquire raw milk in substantial volumes from these regions.
- 35. However, the ACCC is also considering whether milk swaps might broaden the geographic markets.

### Markets for the wholesale supply of milk

- 36. As outlined above, the merger parties manufacture and supply various types of milk products, including fresh flavoured milk, UHT flavoured milk, fresh white milk and powdered milk.
- 37. In previous matters, the ACCC has defined markets for the supply of various milk products as follows:<sup>5</sup>
  - State-based markets for the manufacture and wholesale supply of fresh white milk;
  - State-based markets for the manufacture and wholesale supply of flavoured milk; and
  - A national market for the manufacture and wholesale supply of UHT white milk.
- 38. The ACCC has not received information during its market inquiries to suggest that the definition of these markets should be altered. However, market definition is unlikely to significantly affect the competition analysis for the current proposed acquisition as it involves minimal aggregation of the supply of these products.

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<sup>&</sup>lt;sup>5</sup> ACCC, National Foods proposed acquisition of Australian Co-operative Foods Limited and associated joint venture with Warrnambool Cheese and Butter Factory Company Holdings Limited, *Public Competition Assessment*, 19 September 2008.

#### Powdered milk

- 39. Powdered milk is manufactured from raw milk using milk-drying equipment. It is used as an ingredient in the manufacture of various food products, including dairy desserts such as yoghurt and ice-cream. It can also be recombined into liquid milk when fresh milk supply is limited. The ACCC considers that substitution between fresh and powdered milk is limited on both the demand and supply side.
- 40. The ACCC considers there may be separate markets for the bulk supply of powdered milk as distinct from powdered milk that is packaged for wholesale supply. However, this distinction is unlikely to materially affect the competition analysis for this matter.
- 41. Powdered milk is a long-life product, and most Australian production of powdered milk is exported. Therefore, the relevant geographic market is likely to be national.

### Markets for the supply of bulk raw milk

- 42. Murray Goulburn and WCB both supply raw milk in bulk quantities to domestic food manufacturers, including other food manufacturers.<sup>6</sup>
- 43. The ACCC understands that for food manufacturers, bulk raw milk is a significantly lower-cost ingredient than processed milk. Market inquiries suggest that there are no close substitutes for raw milk as an ingredient for many food manufacturers. However, in its next phase of market inquiries the ACCC will explore the substitutability of powdered milk in this context.
- 44. Market inquiries revealed that bulk milk is delivered to customers straight from the farm gate. It is then used as an ingredient in the manufacture of other foods. Therefore, , the ACCC considers the geographic dimension of the relevant markets for the supply of raw milk is likely to mirror the geographic scope of the markets for the acquisition of raw milk. Accordingly, it is likely that there are separate regional markets for the supply of raw milk in each of south east South Australia, central South Australia and south west Victoria, where Murray Goulburn and WCB acquire raw milk which can then be delivered to food manufacturers.

# Markets for the supply of 'non-fresh' dairy products – cheese, butter, cream, and whey products

- 45. Murray Goulburn and WCB both manufacture and supply cheese, butter, cream (bulk and packaged) and whey products for supply in domestic and export markets.
- 46. Consistent with its consideration of previous matters, the ACCC considers that there is little demand-side substitution between each of these products.

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<sup>&</sup>lt;sup>6</sup> This is distinct from the separate markets for the wholesale supply of fresh and flavoured milks, where the products are packaged.

- 47. On the supply-side, the ACCC notes that many dairy processors manufacture multiple products with raw milk as the base input. However, market inquiries suggest that the manufacture of each of these product categories involves the use of specific rather than shared infrastructure. It appears that a supplier of one of these dairy products is unlikely to switch to supplying another of these products without undertaking significant investment in specific equipment. This may limit the degree to which it is profitable to redeploy production processes for one dairy product to another in response to a small but significant increase in prices. Therefore, the ACCC considers that the degree of supply-side substitution between butter, cheese, cream, and whey is likely to be limited.
- 48. Accordingly, the ACCC considers that there are separate product markets for cheese, butter, cream and whey products.<sup>7</sup>
- 49. However, it appears there are some differences in the supply of cheese, butter, cream and whey products to wholesale customers for the purposes of retail consumption, and customers who use these products in bulk form as ingredients for the manufacture of food. These matters are outlined below.

### Markets for the supply of bulk cream

- 50. Murray Goulburn and WCB supply bulk cream to downstream manufacturers who use it as an ingredient in the manufacture of certain food products. Unlike other dairy products, the ACCC considers there may be a market for the bulk supply of cream that is separate from the supply of packaged cream for wholesale customers, primarily because it appears there is limited demand-side and supply-side substitution between the two categories of cream.
- 51. During the process of standardising milk for retail consumption, cream is separated from the milk and pasteurised. This cream can be used either as an input in the manufacture of thickened cream and other products such as butter, yoghurt and dairy desserts, or it can be sold in bulk to other manufacturers who use the cream as an ingredient for various food products.
- 52. The ACCC understands that bulk cream is delivered to customers in tankers and in an unpackaged form, directly after the initial pasteurisation process.
- 53. By contrast, other cream undergoes additional and more complex processing before it can be sold in wholesale markets for retail consumption. These include further pasteurisation, the addition of flavouring and other additives which prolong the shelf life of the product and make it acceptable for consumer tastes. The product is also packaged for sale in retail outlets.
- 54. Therefore, the ACCC considers there are likely to be separate markets for the supply of bulk cream and the wholesale supply of packaged cream products.
- 55. The ACCC understands that packaged cream typically has a shelf life of up to 35 days. The ACCC's market inquiries indicate that bulk cream becomes

<sup>7</sup> That said, dairy processors are more likely than any new entrant to commence supply of a substitute product given they already have access to milk supply from farmers and the infrastructure to receive raw milk and distribute products to wholesale customers.

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unusable after approximately five days. In addition, bulk cream is a low-value product and the transport costs relative to the value of the product mean that supply over long distances may be uneconomic. Therefore, the geographic markets for bulk cream are likely to be based on the proximity of the merger parties' processing facilities in Victoria and South Australia to the manufacturing facilities of bulk cream buyers.

- 56. That said, the ACCC is considering whether frozen cream is a potential demand-side substitute for the supply of bulk fresh cream. Market inquiries to date have been equivocal as to the extent to which this is the case and the ACCC is continuing to investigate this issue.
- 57. The ACCC requires further information to form a more concluded view on the geographic dimensions of competition for the supply of bulk cream and hence the likely competitive effects of the proposed acquisition in this context.

### The market for the wholesale supply of packaged cream

- 58. For the reasons provided above, the ACCC considers there may be a separate market for the wholesale supply of packaged cream.
- 59. As noted above, the ACCC understands that packaged cream has a shelf life of up to 35 days. Accordingly, and consistent with the ACCC's reviews of previous matters, the ACCC considers the relevant geographic market is likely to be national.

### The market for the supply of bulk and packaged cheese

- 60. Murray Goulburn and WCB manufacture and supply various types of cheese in bulk and packaged forms.
- 61. The ACCC understands that supply of bulk cheese differs from the supply of packaged cheese in that bulk cheese is delivered to customers in a state that undergoes further processing. Buyers of bulk cheese either use it as an ingredient in the manufacture of other food products, or 'cut and wrap' the cheese for subsequent sale under their own brands.
- 62. Cheese that is supplied to wholesale customers is cut, wrapped, packaged and branded by processors such as Murray Goulburn and WCB and distributed through retail outlets such as supermarkets.
- 63. The key difference between these forms of supply is the 'cut and wrap' stage of production, which is unlikely to involve significant additional investment to the manufacturing and supply process. Therefore, the ACCC's preliminary view is that bulk and packaged cheese may be substitutable on the supply-side and likely to fall within one product market.
- 64. The geographic dimension for the supply of both bulk and packaged cheese appears to be national as there is significant interstate and export trade, as well as significant volumes of imported cheese.

### Market(s) for the supply of bulk and packaged butter

- 65. The ACCC presently does not have information to indicate the extent of substitution between the supply of butter in bulk form for use as an ingredient for manufacturing other food products, as opposed to a packaged form for sale to wholesale customers and eventual retail consumption. However, this distinction is unlikely to affect the competition analysis of the proposed acquisition.
- 66. The geographic dimension for the supply of butter is likely to be national. There is significant interstate trade, exports and imports of butter.

### The market for the bulk supply of whey products.

- 67. Murray Goulburn and WCB both supply whey products. Whey is primarily a low-value by-product of the cheese manufacturing process and is primarily used as an ingredient for many different types of foods, sports drinks and health products. As such, the ACCC considers that the relevant functional level for the supply of whey products is in bulk form.
- 68. The ACCC understands that the majority of whey produced in Australia is exported. Market inquiries also indicate that whey can be readily imported. Therefore, the geographic dimension is likely to be national.

### Statement of issues

69. For the purposes of this Statement of Issues, the issues in this matter are divided into three categories, 'issues of concern', 'issues that may raise concerns', and 'issues unlikely to pose concerns'.

### Issues of concern

Markets for the acquisition of raw milk from farmers in the south west region of Victoria and central and south east regions of South Australia

- 70. The ACCC is of the preliminary view that the proposed acquisition will be likely to have the effect of substantially lessening competition in the markets for the acquisition of raw milk from farmers in the south west region of Victoria and the central and south east regions of South Australia.
- 71. The ACCC considers that in the south west Victoria market and the south east South Australia market, the proposed acquisition would result in the aggregation of two major competitors in markets that are already highly concentrated. In the central South Australia market, National Foods is and will remain the major acquirer of raw milk; however, the proposed acquisition would aggregate the only two other sizeable acquirers of raw milk.
- 72. Market inquiries have indicated there is strong rivalry between Murray Goulburn and WCB in these markets. Evidence of this includes:

- In the first half of 2009, a large number of farmers switched from WCB to Murray Goulburn in response to a reduction in the raw milk prices paid by WCB in the south west region of Victoria;
- Information that suggests that Murray Goulburn actively competes to obtain and retain farmer-suppliers. Such competition occurs in a number of ways, including on the basis of opening prices and step-up payments for raw milk throughout the yearly milk production season;
- Information that suggests that processors compete on the basis of non-price benefits offered to farmers. These include loans with favourable terms for farm projects, field advice, discounted hardware supplies and grain and fodder supplies.
- 73. The ACCC notes the presence of existing competitors in each of the relevant markets as follows:
  - In south west Victoria the firms competing with Murray Goulburn and WCB to acquire raw milk are Fonterra, National Foods, UDP and Bega.
  - In south east South Australia, the competitors to the merger parties for the acquisition of raw milk are National Foods and Fonterra.
  - In central South Australia, the only sizeable competitor to the merger parties is National Foods.
- 74. However, market inquiries suggest that the competitors in each of the acquisition markets are unlikely to have the ability and incentive to exert a strong competitive constraint on the merged entity. From market inquiries conducted to date, it appears that the merged entity's competitors would either:
  - have insufficient spare processing capacity to acquire additional milk from farmers in large volumes, following a decrease in raw milk prices; and/or
  - face insufficient incentives to invest in additional processing capacity, as
    - i. demand for downstream products in domestic markets is insufficient to provide necessary returns on investment in new capacity; and
    - ii. export markets also provide insufficient certainty of a return on investment.
- 75. The ACCC notes arguments to the effect that, given its status as a co-operative company, Murray Goulburn has no incentive to reduce prices paid for raw milk or otherwise act to the detriment of its farmer suppliers.
- 76. However, the ACCC's market inquiries suggest that many farmers benefit from the competition between WCB, Murray Goulburn and their competitors, including the receipt of tangible financial benefits from price competition and other non-price benefits.
- 77. The ACCC considers that despite Murray Goulburn's status as a farmers' cooperative, the removal of WCB would result in a permanent change to the structure of the relevant markets and competitive dynamics.

### Coordinated effects

- 78. Market inquiries suggest that the proposed acquisition may increase the likelihood of coordinated effects in the acquisition of raw milk from farmers in the south west Victoria market. The ACCC notes the farm gate pricing arrangements between Fonterra and Bonlac Supply Company (BSC) in this regard. As noted above, BSC acts as an agent for Fonterra for the acquisition of raw milk.
- 79. In its submission to the Senate Committee Inquiry into competition and pricing in the dairy industry, BSC describes Fonterra's supply agreements, via BSC, for the acquisition of raw milk from farmers (suppliers), and indicates that:
  - Central to the Supply Agreement is a commitment from Fonterra to pay its suppliers a guaranteed minimum return that is not less than that paid by the volume leading Victorian milk processor. In the year ending 30 June 2009, Fonterra's payments to farmers exceeded this minimum bundled return by \$28 million.8
- 80. The 'volume-leading' Victorian milk processor is Murray Goulburn. The ACCC considers that in the present competitive environment, Fonterra is likely to face an incentive to maintain prices that are competitive with WCB as well as Murray Goulburn, in order to attract and retain milk supply.
- 81. The ACCC is concerned that in the absence of competition from WCB post-acquisition, Fonterra's only incentive would be to set prices at the minimum level necessary to fulfil its commitment to match Murray Goulburn's prices in Victoria. Further, the ACCC considers that because Murray Goulburn is aware that Fonterra is contractually obliged to match Murray Goulburn's price, Murray Goulburn may not have a strong incentive to compete by offering better prices to farmers for raw milk in the absence of competition from WCB.
- 82. The ACCC is seeking further information on whether the proposed acquisition is likely to give rise to, or increase the prospects of, coordinated effects in the south west Victorian market for the acquisition of raw milk.
- 83. It is not currently clear whether similar arrangements exist in the other markets for the acquisition of raw milk. Therefore, the ACCC seeks further information about the potential for increased coordinated conduct in each of the acquisition markets in South Australia as a result of the proposed acquisition.

### Barriers to entry

- 84. Market inquiries have revealed the following requirements may be significant barriers to entry and expansion:
  - The capital costs of milk processing infrastructure are high, and would mostly be sunk. The ACCC understands that establishing a new plant of a size that could constrain the merged entity would cost in excess of \$100 million. In addition, fluctuations in international commodity prices and

<sup>&</sup>lt;sup>8</sup> Bonlac Supply Company, *Submission to the Senate Inquiry into competition and pricing in the Australian dairy industry*, October 2009.

- currency exchange create uncertainty about the level of returns on these investments.
- Murray Goulburn may have excess production capacity, as suggested by the recent closure of its Leitchville cheese processing plant.
- Some farmers are contracted to suppliers on a 1- 5 year basis and there could be other barriers to farmers switching readily. This may increase difficulties involved in quickly building a critical mass of milk suppliers to justify investment in new or additional processing.

### Preliminary view on competition issues in acquisition markets

- 85. For the reasons outlined above, the ACCC considers that if the merged firm were to reduce the prices it offers for raw milk and/or other non-price benefits post-acquisition, it would be unlikely that competing processors in each of the respective relevant markets would have the ability and incentive to compete vigorously to acquire raw milk from farmers who may otherwise wish to switch away from supplying the merged entity. This compares to the present situation where it appears that WCB provides a strong competitive constraint.
- 86. Therefore, the ACCC is concerned that the proposed acquisition would substantially lessen competition for the acquisition of raw milk from farmers in the relevant markets within South Australia and Victoria. The potential effects in the relevant markets include:
  - A significant reduction in farm gate prices paid to farmers for raw milk; and
  - Reduced competition in the offer of non-price terms such as finance, field advice services and discounted hardware and grain supplies.

### Issues that may raise concerns

### Bulk supply of raw milk to dairy product manufacturers

- 87. The ACCC considers that competition concerns may arise in relation to the bulk supply of raw milk to dairy product manufacturers in south east South Australia where the merger parties supply raw milk in bulk volumes.
- 88. The ACCC is continuing to gather information about buyers of bulk raw milk in central South Australia and south west Victoria. To the extent that there are other buyers of bulk raw milk in these markets, the proposed acquisition may raise concerns, as it would result in the aggregation of two of the largest suppliers of bulk raw milk.
- 89. In the south east region of South Australia there are four processors that acquire raw milk and are competitors or potential competitors in the supply of bulk raw milk to downstream food manufacturers.
- 90. However, market inquiries also suggest that only two of the four processors the merger parties are likely to be in a position to consistently supply bulk raw milk to these food manufacturers and that WCB is a strong competitor in the supply of bulk raw milk in this market. Market participants have raised concerns

that the competitors of the merger parties only occasionally have surplus raw milk available to sell to third parties. However, the ACCC requires further information about the relative abilities of the processors to supply consistent volumes of bulk milk.

- 91. Market inquiries to date suggest that countervailing power is limited, as dairy product manufacturers are unlikely to be in a position to readily arrange the necessary infrastructure to collect and store milk, particularly given the seasonal variations in milk production. The ACCC also recognises that many major food manufacturers are vertically integrated in the supply of bulk raw milk. Therefore, the ACCC continues to investigate the potential for customers in these markets to exercise countervailing power.
- 92. The ACCC also continues to investigate the extent to which bulk raw milk can economically be transported to customers beyond the geographic markets listed here.

### Supply of bulk cream

- 93. As indicated above, the ACCC's market inquiries suggest that the relevant geographic dimension for the supply of bulk cream to food manufacturers may be a market comprising Victoria and South Australia.
- 94. Market inquiries suggest that there are a range of processors that produce bulk cream. However, a number of these use their bulk cream for their own downstream manufacturing of products which have cream as an input, such as butter, yoghurt, thickened cream and dairy desserts. The ACCC understands that these processors will only sell bulk cream to other food manufacturers when they have a surplus of cream. The extent to which there is a surplus of cream depends on the fat content of raw milk, which varies.
- 95. Market inquiries suggest that compared to the fresh milk processors, Murray Goulburn and WCB are in a better position to supply bulk cream to food manufacturers as they manufacture small quantities of cream products relative to their intake of raw milk and consequently have more surplus cream to sell in bulk to food manufacturers. On this basis, the proposed merger may result in a significant increase in concentration in the supply of bulk cream to food manufacturers. However, these are preliminary observations, and further information is needed to determine the extent of existing and future competition between the merger parties in this market.
- 96. WCB may be considered to be a strong competitor in this market. The ACCC understands that this is because WCB has large quantities of bulk cream to shift WCB is a major manufacturer of skim milk powder, which produces bulk cream as a by-product and WCB has only a small downstream presence in the manufacture of products that use cream as an input.
- 97. Therefore, market inquiries have raised a concern that post-acquisition, Murray Goulburn will have the ability and incentive to increase the price of bulk cream supplied to customers in this market.

### Issues unlikely to pose concerns

98. The ACCC considers that the proposed acquisition is unlikely to result in a substantial lessening of competition in the following markets:

The (separate) national markets for the supply of the following 'non-fresh' dairy products:

- the national market for the supply of bulk and packaged cheese;
- the national market(s) for the supply of bulk and packaged butter;
- the national market for the supply of packaged cream;
- the national market for the bulk supply of whey products; and
- the national market for the wholesale supply of powdered milk products.
- 99. In the national market for the manufacture and wholesale supply of bulk and packaged cheese, the ACCC notes that the proposed acquisition would result in the aggregation of 5 to 4 major producers of cheese that is manufactured in Australia. The ACCC understands that approximately 28 per cent of cheese sold in Australia is imported. On this basis, the ACCC's preliminary view is that the proposed acquisition is unlikely to substantially lessen competition in the national market for the manufacture and supply of bulk and packaged cheese. However, the ACCC invites further submissions and will further consider this product market if it considers that such an assessment is necessary.
- 100. In the other markets listed above, the ACCC considers that post-acquisition, the merged entity is likely to be constrained by existing domestic competitors, and competition from imports.

The markets for the wholesale supply of fresh milk in Victoria, and the wholesale supply of flavoured milk in Victoria

- 101. The ACCC considers that the proposed acquisition is unlikely to result in a substantial lessening of competition in the separate markets for the wholesale supply of fresh milk in Victoria, and the wholesale supply of flavoured milk in Victoria.
- 102. In these markets, the ACCC considers that the proposed acquisition would result in a small increase in market concentration and the merged entity is likely to be constrained by existing competitors.

# Areas under further investigation

103. The ACCC is seeking information and evidence from market participants in relation to the preliminary competitive analysis outlined in this Statement of Issues, and in particular, whether there are further factors that should be taken into consideration by the ACCC in forming a concluded view, including:

- Whether milk swaps are likely to broaden the geographic scope of competition in markets for the acquisition of raw milk. For example, whether a milk processor located more than 400 kilometres from a dairy farming region could constrain the merged entity by acquiring milk in the region and re-selling it to a competitor with processing facilities that are proximate to the farms.
- The extent to which frozen cream is a substitute for fresh cream in the manufacture of downstream dairy products, such as processed cheese, cream cheese, and ice cream.
- The extent to which fresh bulk cream can be economically transported.
- The extent to which bulk raw milk can be economically transported across state borders or beyond localised markets, such as south west Victoria and the central and south east regions of South Australia where the merger parties overlap in the acquisition and resupply of raw milk for downstream processing.
- The likelihood that downstream dairy product manufacturers could bypass the merged entity through backward integration into raw milk acquisition and collection.
- 104. The ACCC also welcomes comments and information on other matters raised in this Statement of Issues.

## **ACCC's future steps**

- 105. The ACCC will finalise its view on this matter after it considers market responses invited by this Statement of Issues.
- 106. The ACCC now seeks submissions from market participants on each of the issues identified in this Statement of Issues and on any other issue that may be relevant to the ACCC's assessment of this matter.
- 107. Submissions are to be received by the ACCC no later than 7 May 2010. The ACCC will consider the submissions received from the market and the merger parties in light of the issues identified above and will, in conjunction with information and submissions already provided by the parties, come to a final view in light of the issues raised above.
- 108. The ACCC intends to publicly announce its final view by 3 June 2010. However the anticipated timeline may change in line with the *Merger Review Process Guidelines*. A Public Competition Assessment for the purpose of explaining the ACCC's final view may be published following the ACCC's public announcement.