COMPETITION TRIBUNAL
REPUBLIC OF SOUTH AFRICA

Case no: 92/LM/Nov04

In The Large Merger Between:

Clover Fonterra Ingredients (Pty) Ltd **Acquiring Firm**

And

Clover SA (Pty) Ltd and
New Zealand Milk Products SA (Pty) Ltd Target Firms

Reasons for Decision [NON CONFIDENTIAL]

APPROVAL

1. On 13 May 2005 the Competition Tribunal issued a Merger Clearance Certificate conditionally approving the merger between Clover Fonterra Ingredients (Pty) Ltd, Clover SA (Pty) Ltd and New Zealand Milk Products SA (Pty) Ltd.

THE TRANSACTION

2. The parties to this merger are Clover SA (Pty) Ltd ("Clover") and New Zealand Milk Products SA (Pty) Ltd ("NZMPSA"). Clover is a wholly owned subsidiary of Clover Industries Limited, a public company.[1] NZMPSA is a wholly owned subsidiary of Fonterra International Limited ("Fonterra International"),[2] and will be referred to as either NZMPSA or Fonterra henceforth.

3. Clover and Fonterra have agreed to form a joint venture company, Clover Fonterra Ingredients (Pty) Ltd ("CFI"), in respect of Clover's and Fonterra's dairy ingredients businesses. Clover and Fonterra will own 51% and 49% of the issued shares in CFI respectively. However, according to the parties, they will have joint control of CFI by virtue of the provisions of a shareholders' agreement to be concluded between Clover and Fonterra in relation to CFI.[3]

4. The joint venture is aimed at marketing, selling and distributing these dairy ingredients in bulk, i.e. as commodity products, in the countries of sub-Saharan Africa. It is intended that CFI will market, sell and distribute these commodity products to customers that prepare food for direct on-sale to the consuming public ("food service customers") and

1 No one firm directly or indirectly controls Clover Industries Limited.
2 Ultimately controlled by Fonterra Co-operative Group Limited.
3 Paragraph 9.3 of CFI's CC4(2).

customers who use products supplied to them for processing to create new products for distribution and/or purchase products packed in bulk whether for resale to third parties or not ("ingredients customers"). [4] It is thus not the intention of the joint venture partners to use CFI to sell to retail customers. Retail sales will remain the prerogative of the partners individually, and to the extent these activities overlap they remain competitors of one another. We deal with the consequences of this more fully below.

5. The transaction between the parties is contained in a number of agreements, the Master Agreement being the core of the consensus between the parties. The Master Agreement seems to have gone through a number of iterations before the parties reached finality. [5] Whilst the joint venture is generally in relation to the bulk/commodity segment of their respective ingredients businesses, excluding retail, the agreement seems to be a compromise of different strategic objectives with some products being included, some not, some customers being included and some not. [6]

6. The evaluation of this merger has been an equally iterative process, somewhat convoluted and at times difficult, with information being furnished in piece-meal fashion by the parties.

HISTORY OF THE PROCEEDINGS

7. On 31 January 2005, the Commission filed its first recommendation ("the Commission's Report") with the Tribunal in which it recommended that the transaction be approved unconditionally.

8. At a pre-hearing held on 14 February 2005 the Tribunal requested further documentation from the parties relating to the transaction.

9. At a subsequent telephonic pre-hearing on 15 March 2005, the Tribunal requested the parties and the Commission to make submissions to it on the basis that the transaction constituted a full merger between Clover and Fonterra.

10. On 4 April 2005 and after receipt of the additional documentation the Commission filed a supplementary submission ("Supplementary submission") with the Tribunal, consisting of an evaluation of the newly submitted documentation. In the Supplementary submission the Commission revised its analysis of the market shares and competitive landscape for skimmed milk powder but persisted with its recommendation that the transaction be approved unconditionally.

11. A hearing of the matter was held on 7th and 8th April 2005. The following witnesses were examined:

    1. Karin Purchase – Aspen Nutritionals (procurement manager);

4 See CFI's CC4(2).
5 See various versions of the project documentation.
6 For a further discussion see section on the *nature of the joint venture*.

2. Adam Prinsloo – Nestle South Africa
3. Malcolm Tweed – New Zealand Milk Products SA (general manager)
4. Manie Roode – Clover SA (executive director)
5. Mike van den Berg – Milk Producers Organisation (director)
6. Pieter Uys – Clover SA (general manager: Ingredients and Exports)

12. In the course of the hearing further documentation was referred to by the parties, which documentation was later furnished to the Tribunal.

13. Subsequent to the hearing and after receipt of the further documentation, the Commission was asked to confirm certain information on market shares and prices. The Commission filed its second supplementary submission ("2nd Supplementary submission") on 11th May 2005.

14. As a consequence of the submissions of the parties, the documentation provided, the evidence led at the hearing and the reports by the Commission this merger has been approved conditionally. The reasons follow.

BACKGROUND TO THE DAIRY INGREDIENTS INDUSTRY

15. The merging firms are both involved in the processing and manufacturing of dairy, beverage and other related food products and the marketing, distribution and sale of such dairy, beverage and other related food products.

16. The dairy industry is broadly divided into the raw milk (fresh milk) segment and the dairy products or ingredients segment. Dairy products or ingredients, which consist of products such as cheese, butter, UHT milk and milk powders, are sold both in the retail and non-retail channels. The non-retail channels involve the sale of such products in bulk as commodities to food service customers[7] and ingredients customers.[8]

17. Clover's ingredients division supplies sprayed and roller-dried dairy ingredients and vegetable fats and blends to various customers including infant formulae manufacturers, bakeries, ice cream and dessert manufacturers. The dairy ingredients products consist of -
    - Skimmed milk powder
    - Full cream/ whole milk powder
    - Buttermilk powder
    - Whey powder
    - Natural cheese for use in the manufacture of processed cheese
    - Non-dairy creamers and whiteners
    - Butter

7 Customers who prepare food for direct on-sale to the consuming public, including HORECS (hotel, restaurant, catering and airline systems) and QSR (quick-service restaurant) systems.
8 Customers who use products supplied to them for processing to create new products for distribution to market and/or who purchase products packed in bulk whether for resale to third parties or not.

18. The business of Fonterra International follows the cow-to-customer value chain, from milk collection, through manufacturing and logistics and ultimately to the marketing of ingredients to the international food industry under the New Zealand Milk Products brand. According to the parties, New Zealand produces more milk than it consumes, and therefore a major part of the Fonterra group's business involves selling manufactured dairy products around the world.[9] Its activities can be divided into three segments namely Ingredients, New Zealand Milk and Fonterra Enterprises.

19. The four main dairy ingredients sold by the New Zealand Milk Products brand are milk proteins, milk powders, cheese ingredients and cream products. [10]

20. NZMPSA conducts the Fonterra group's business in relation to ingredients in South Africa. The products that NZMPSA sells in South Africa are -
    - Milk and whey proteins
    - Milk powders
    - Cream products
    - Cheese and cheese ingredients
    - Portion controlled (<20ml) UHT milk
    - Refined and edible lactose

21. While the Fonterra group is considered to be one of the largest milk-producing companies in the world, NZMPSA does not import raw milk into South Africa nor does it have a retail (branded) aspect of its ingredients business in South Africa. Clover SA on the other hand has between 30 - 35% of the raw milk market in South Africa[11] and has approximately 32% of the ingredients business,[12] both in the commodity and retail segments. Clover also exports ingredients and UHT milk to other parts of Africa and EU.[13] Fonterra International also exports milk and dairy products to other parts of the world including Africa.[14]

NATURE OF THE JOINT VENTURE

22. The joint venture is designed by the parties along very discrete aspects of their ingredients businesses and assumes a hybrid or "mongrel character"[15] with some products included, some excluded, with some customers included, some not.

23. The products to be sold by CFI ("the defined products') will be (subject to certain contractual exclusions):
    23.1. Certain bulk-packaged commodity products (with or without value-added

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9 Letter from Deneys Reitz dated 1 April 2005.
10 Letter from Deneys Reitz dated 1 April 2005.
11 Extract from Clover Mail (November 2004)
12 NZMP South Africa Overview – 21 February 2005
13 A list of these products can be found in the letter from Deneys Reitz dated 1 April 2005.
14 The African footprint of the two companies is not relevant for purposes of this matter.
15 As described by the Chairperson at the hearing, page 67 of transcript.

components[16] which do not result in the packaging being altered) to be sold to food service customers and ingredients customers, and comprising:

23.1.1. Milk powders (whole milk, skimmed, butter milk),
23.1.2. Whey powder,
23.1.3. Butter,
23.1.4. Anhydrous milk fat,
23.1.5. Edible and refined lactose,
23.1.6. Natural cheese for use in the manufacture of processed cheese,
23.1.7. Whey protein concentrates,
23.1.8. Casein,
23.1.9. Caseinate,
23.1.10. Bulk-formulated powdered products e.g. filled milk, whey/milk mixtures, coffee creamers;

sold to food service customers and ingredients customers.

23.2. Commodities where the value-added component takes the form of altered packaging into consumer or catering packs, sold to ingredients customers.

23.3. As special inclusions, sliced processed cheese, portion-control (<20ml) UHT milk, and frozen diced and shredded mozzarella cheese which is supplied to **[confidential information]**[17] and **[confidential information]**.

24. The following are specifically excluded from the activity of CFI:
24.1. Fonterra's filled milk, whole milk and infant formula contracts with Promasidor;
24.2. Fonterra's customers which purchase the defined products on a multinational purchasing contract basis i.e. from Fonterra's head office;
24.3. Clover inventory management transactions which result in ownership of the product ultimately reverting to Clover;
24.4. Clover's contract with Nestle for manufacturing of skimmed milk powder; and
24.5. Ingredients used internally by the Clover group (Clover SA, Danone Clover, Clover Danone Beverages).

25. The parties do not intend to exchange technology or know-how and any expenditure on research and development of new products can only be incurred with the approval of the boards of directors of the parent companies.[18] The joint venture company will determine its own prices through a process of adding a percentage on prices that are set independently by the parent companies.[19] Despite its independent pricing structure the

16 *Value-added components* means a component of supplied products where the supplier has contracted as an additional value adding service to the customer to supply an additional specification such as (but not limited to) packaging of the product in question into a specified container or specific pack size: see Clause 1.1.44 of the Master Agreement.

17 In a letter from Deneys Reitz dated 1 April 2005, the Tribunal was informed that **[confidential information]** has subsequently terminated its relationship with NZMPSA and has elected instead to be supplied with **[confidential information]** in South Africa.

18 Clause 8 of Master Agreement.

19 See evidence of Mr Roode.

joint venture company is seen as a marketing and distribution agent of the two parent companies rather than a principal.[20]

26. As stated above, CFI will be jointly controlled by the parties with Clover having 51% and NZMPSA 49%.

RATIONALE FOR THE TRANSACTION

27. The stated commercial rationale for the proposed transaction is that the establishment of the joint venture will lead to more effective supply of the defined products in the rest of sub-Saharan Africa. According to the parties the dairy ingredients business is characterised by a pattern of surpluses and shortages. This is because the ingredients business is dependent on the supply of raw milk, which is cyclical and seasonal. This makes it difficult for Clover to supply defined products such as skimmed milk powder on a sustained basis. The joint venture will be able to source its supplies from either Clover SA or Fonterra, which will enable Clover to supply the defined products to customers in sub-Saharan Africa on a sustained basis. Fonterra, in turn, will establish a sustained presence in the region and have access to Clover's major customers to which CFI can supply Fonterra's specialised products. [21]

28. In summary, the joint venture in the ingredients business has been agreed upon by the parties in order to –
    28.1. expand the range of products offered to customers of both these businesses;
    28.2. satisfy customers' requirements for ingredients on a consistent basis in a market which has cyclical features of surpluses and shortages; and
    28.3. export to sub-Saharan Africa from a stable supply base.[22]

COMMISSION'S RECOMMENDATION

29. The Commission initially recommended that this merger be approved unconditionally. This recommendation was based on the parties' submissions to it during its initial investigation.

Parties Submissions

30. The parties submit that the products sold by the ingredients businesses of Clover and NZMPSA in South Africa are largely complementary as opposed to being competitive. They submit that while both produce generic products such as skimmed milk powder or whey powder, these are not necessarily substitutable for each other on either the demand or supply side. For example, they submit that both produce whey powder but the whey powder sold by NZMPSA in South Africa is a whey protein concentrate which is used by specialised applications such as nutritional supplements for body builders,

20 Evidence of Mr Tweed and Mr Roode.
21 Paragraph 4.1 of the parties' competitiveness report.
22 Page 5 of the Commission's Report. See also page 12-13 of the parties' competitiveness report and evidence by Mr Tweed on page 50 of transcript.

while the whey powder produced by Clover is a less specialised product used for general application. They submit that the business of NZMPSA in South Africa is focused mainly on importing and selling specialised value-added varieties of the defined products which are generally not produced in South Africa. However they accept that there is a degree of competition between the merging parties in the following products:

30.1. Butter Milk Powder;
30.2. Butter;
30.3. Skimmed milk powder; and
30.4. Full cream/whole milk powder.

31. The parties submit that each of the above product categories should form the basis for a separate relevant product market because they are not substitutable from the demand side and supply side.[23] The parties accordingly submit that the four relevant product markets are butter, buttermilk powder, skimmed milk powder and whole milk powder.

32. The Commission's analysis found that there were four relevant product markets as defined by the parties, and that the geographical markets are least national.

33. The national market shares for the identified markets contained in the Commission's Report are tabulated below:

Market	Market shares %			
	Clover	**Fonterra**	**Post merger**	**Other players**
Skimmed milk powder	45.70	5.10	**50.80**	Nestle (30%) Parmalat (1,3%) Imports (12,6%)
Whole milk powder	12.72	5.46	**18.18**	Nestle (75.84) Imports (11.43)
Buttermilk powder	31.24	15.62	**46.86**	Imports (53.14%)
Butter	32.25	0.05	**32.30**	Parmalat (3.38%) Imports (54.2%) Other (10.12%)

34. The Commission found no likelihood of a substantial lessening of competition in any of the relevant product markets. Despite the high concentrations in the markets the Commission concluded that the parties' ability to exercise market power would be constrained by low barriers to entry, a strong degree of countervailing power possessed by customers and the constraining effect of the level and price of import competition.

Competitors' concerns

23 A different technological process is used to produce each of them.

35. Ladismith Cheese and Parmalat, two competitors of Clover, made submissions to the Commission to the effect that they had concerns with the merger, which concerns were subsequently not pursued. Both Ladismith Cheese and Parmalat had concerns about potential dumping since Fonterra is the world's largest exporter of dairy products. Parmalat was particularly concerned that "*any limited scope "merger" such as this raises the competition issue that it potentially provides a platform for collusion between the merging parties in relation to activities not covered by the approved joint venture, where the merging parties should compete independently."* However, Parmalat's concerns about the *potential future conduct of the merging parties appear to have* been "*dealt with in their discussions"* with the merging parties. [24]

COMPETITION ANALYSIS

Relevant Market

36. We agree with the merging parties and the Commission that the relevant geographic markets are at least national, and accordingly this issue need not be considered any further.

37. In determining the relevant product market, the Tribunal has previously expressed its preference[25] for the test set out by the US Supreme Court in *Brown Shoe v United States.*[26] In the *Brown Shoe* case the Court recognised that within a particular (defined) broad product market, a number of well-defined sub-markets may exist which in themselves could constitute product markets for anti-trust purposes. Factors which may indicate the existence of a sub-market include but are not limited to industry or public recognition of the sub-market as a separate economic entity, the product's peculiar characteristics and uses, unique production facilities, distinct customers, distinct prices, sensitivity to price changes and specialised vendors.[27]

38. The determination of the relevant product market, while informed by a number of factors and statistics, always involves a factual enquiry in a particular matter. In *Nestle (SA) and Pet Products,* the Tribunal endorsed the approach established in *Brown Shoe* and considered a number of factors that could be taken into account in the determination of the relevant product market:

> "*There are major differences in the production facilities required for the manufacture of dry and wet pet food and the manufacturing processes are very different. Furthermore, wet pet food is generally more expensive than dry pet food, even when sold through the same channel. Products also differ in volume, with dry dog food in particular being sold by some manufacturers in 8 kg packs whilst wet food is normally sold in cans of much lower volume. The Commission's investigations also*

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24 Letter from Parmalat dated 24 February 2005

25 See *JD Group Limited and Ellerines Holdings Ltd* [1999-2000] CPLR 53 (CT); *Nestle(SA) and Pet Products* [2001-2002] CPLR 257 (CT); *JD Group Limited and Profurn Limited* [2003] 1 CPLR 64 (CT)

26 370 *US* 294 (1962).

27 At page 325.

revealed that wet pet food is perceived in the market as being something of a treat for pets and a supplement to dry food rather than a substitute thereof. Lastly, we find that pet food sold through the retail channel belongs to a separate market from pet food sold through the non-retail channel. Evidence before us reveals a significant price difference between products sold through the retail and non-retail channels. Sellers of products in the non-retail channel, for example, veterinarians, are perceived by consumers as specialists and therefore authorities in pet food. Consumers are therefore willing to pay higher prices for pet food whose nutritional value is endorsed by these sellers compared to food sold through the retail channel. Significantly certain manufacturers who distribute to both channels have different brands for each of them. Nestle markets its non-retail product under the Olympic brand and Pets Products under the IVD Life Stages brand".[28]

39. The dairy products or ingredients industry is considered to be a derivative of the raw milk industry. The ingredients business essentially consists of converting raw milk into a number of products such as milk powders, butter, cheese, buttermilk, buttermilk powders, UHT milk, whey powder and casein variations. Raw milk is converted into any number of these products in order to ensure that surpluses do not go to waste. The ingredients market may have started out as a 'balancing' strategy to the primary industry, but it is no longer merely that. Skimmed milk powder has become a critical ingredient in infant formulae, confectionery products and nutritional supplements. Whey and casein powders also play a role in nutritional supplements and energy foods. Companies such as Fonterra International spend time and money on research and development relating to new products.[29]

40. Clover, Parmalat, Fonterra and Nestle all seem to have strong brands in the *retail* segment of the dairy product or ingredients markets. However a few of these milk producers also engage in the business ofre-selling ingredients or dairy products in bulk or as commodities, which is distinguishable from the retail market. Evidence was led that the bulk or commodities market involves the selling of ingredients to food service or ingredients customers. These products are packaged in larger volumes and do not rely on the existence of a strong brand. The retail market however involves packaging in smaller volumes, sold usually to the retail sector directly and relies on the existence of a strong brand.[30]

41. In South Africa Clover and to a smaller extent Parmalat, NZMPSA, Woodlands Dairy and Ladismith Cheese engage in the non-retail ingredients market. These producers sell ingredients not only to food service and ingredients customers but also to customers who compete with them in related markets. Evidence was led that while Nestle may be the largest user of skimmed milk powder it has a skimmed milk manufacturing agreement with Clover[31] and does not sell skimmed milk powder to third parties.

28 At paragraph 26.

29 Fonterra is currently engaged in the development of a protein supplement called *Colostrum* which is extracted from a cow's first four milkings (48 hours) after calf birth. This is used as a nutritional supplement for persons *inter alia* suffering from HIV/AIDS.

30 Evidence of Mr Tweed, Mr Roode and Mr Uys.

31 See *Manufacturing and Packing Agreement* in respect of *Skim Milk Powder* between Nestle and

42. The Tribunal is satisfied that the dairy ingredients market is a separate relevant product market from the raw milk market. Furthermore, the ingredients market is sub-divided into a retail and non-retail market. The non-retail market consists of bulk or commodity ingredients supplied to food service and ingredients customers.

43. The Tribunal is also satisfied that within the dairy ingredients market separate relevant product sub-markets exist because these are not substitutable from the demand or supply sides. Butter is not substitutable for skimmed milk powder. Buttermilk powder is not substitutable for whey powder. Whey powder is not substitutable for whole milk powder. Skimmed milk powder is more stable than whole milk powder and has many more uses. If produced under low heat, skimmed milk powder can be used as an input in the production of infant formulae, ice cream and yoghurt. If produced under medium heat, it can be used in the production of dry mixes, beverages and ice creams as well as in vending machines. If produced under high heat, it can be used in the meat industry, baking industry and in frozen desserts.[32] There is only limited supply-side substitutability because of the different technological processes used to produce them.[33]

44. In addition there seem to be differences between the generic products that producers produce. For example, while Clover and NZMPSA are competitors in the ingredients business and both produce whey powder, these are not necessarily substitutable because NZMPSA's whey powder is used in more specialised applications.[34] They both produce butter and buttermilk powder but Clover does not produce casein or caseinate.

45. The Tribunal is of the view that the transaction, viewed collectively, should be considered a merger of the bulk (non-retail) ingredients business of the two companies, as described in the Master Agreement, and has evaluated it as such. For purposes of this transaction the four relevant product markets are butter, buttermilk powder, whole milk powder and skimmed milk powder.

Market shares

46. In considering the market share data submitted by the Commission and having regard to the evidence led at the hearing, the Tribunal is satisfied with the information submitted by the parties and the Commission in relation to butter and buttermilk powder. The market share figures originally submitted for whole and skimmed milk powder were

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Clover (Annexure A to letter from Werksmans dated 14 March 2005). See also Evidence of Mr Prinsloo.

32 See Paragraph 3.2.2.1 of the parties' competitiveness report.

33 Paragraph 5.1.5 of the parties' competitiveness report. See also evidence of Mr Tweed and Mr Uys.

34 Such as protein supplements for body builders, whereas the whey powder produced by Clover is used for general applications.

revised after further submissions by the parties and the Commission.

Butter and Buttermilk powder

47. The combined market share for butter of the merged entity will be 32%. The market share accretion is small, with NZMPSA having only 0.05% of the market pre-merger. Imports of butter account for 54.2% of the market. The presence of imported product has been increasing over time, with a marked increase in imports between 2003 to 2004 from 1509 to 4463 tonnes.[35] Other local suppliers of butter include Dairy Belle and Parmalat.[36] The parties' combined market share for buttermilk powder is 46.86%. Buttermilk powder imports account for 53% of the market. Imports are thus a large source of supply in both markets, indicating that the merger is unlikely to lead to a substantial lessening or prevention of competition in either of them.

Whole Milk and Skimmed Milk Powder

48. In its first report, the Commission found that there were three players, excluding imports, in the South African market for whole milk powder, namely Nestle, Clover and NZMPSA. Nestle was cited as having 75% of the bulk industrial market, followed by imports.[37] This figure was later revised by the Commission in its Supplementary submission to the effect that Nestle was not a competitor as it consumes most or all of its supply and does not sell to third parties.[38] This was confirmed at the hearing by Mr Adam Prinsloo from Nestle who was called as a witness by the Commission.[39]

49. The revised market shares of the participants (excluding Nestle)[40] in the whole milk powder market are as follows:

Market participant	Sales tons	Market share %
Clover	**657**	**42.97**
Fonterra	**282**	**18.44**
Imports	590	38.59
Total	1529	100.00

50. On the basis of the revised figures the merged entity will have a market share of 61.41% in respect of whole milk powder.

51. In the market for skimmed milk powder the local participants were listed as Clover, Fonterra, Nestle, Parmalat and Other. The data was revised by the Commission in its 2nd Supplementary submission to the effect that Nestle was not a participant as it

35 Page 12 of the Commission's Report 31 January 2005.
36 Page 15 of the Commission's Report 31 January 2005.
37 Pages 10-11 of the Commission Report 31 January 2005.
38 Page 5 of the Commission's Supplementary submission 4 April 2005.
39 At page 28 of the transcript.
40 At page 6 of the Commission's Supplementary submission 4 April 2005.

consumed all of its supply.[41] The Commission's final table of market shares for the skimmed milk powder market was as follows.

Name of firm	Country of origin	Quantity (tons)	Market share %
Clover	**South Africa**	**3 186**	**58.97**
Fonterra	**New Zealand**	**409**	**7.57**
Imports[42]	Argentina	296	5.48
	Australia	256	4.74
	Canada	49	0.91
	Switzerland	26	0.48
	Ireland	233	4.31
	Poland	112	2.07
	Uruguay	350	6.48
	Other	77	1.43
Ladysmith Cheese[43]	South Africa	200	3.70
Parmalat	South Africa	300	5.55
Dairybelle	South Africa	100	1.85
Total		5 403	100.00

52. In its first report the Commission stated that Parmalat had a share of 1.3% in the market for skimmed milk powder.[44] This figure seems to have been obtained from the merging parties. Parmalat itself estimated its market share to be closer to 22%.[45] At the hearing, however, it emerged that Parmalat was not involved in selling skimmed milk powder to third parties.[46] No reasonable explanation could be provided by either the Commission or the merging parties for the difference between the two figures (i.e. the parties' estimation of Parmalat's market share and Parmalat's own estimation) nor why Parmalat was, in the first instance, included as a competitor in the market for skimmed milk powder. Parmalat itself stated that it did indeed produce ingredients for Quick Service Restaurants.[47] On this basis, the Tribunal has included Parmalat as a competitor in the market for skimmed milk powder.

53. A further anomaly in the figures related to the market share of Fonterra for the year 2004. The import figures obtained from SARS did not tally with the sales figures provided by the parties.[48] NZMPSA later clarified the discrepancy, saying that the sales

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41 This was confirmed by Mr Prinsloo in the hearing.
42 According to the SARS figures total imports for 2004 amounted to 1409 tons. The Commission only listed the major country of origins. The market share for all imports amount to 26%.
43 This figure was provided by Ladysmith Cheese and is for 2004. It estimates that 2005 it will produce and sell approximately 300 tons.
44 Pages 13-14 of the Commission Report dated 31st January 2005.
45 Parmalat's submission to the Commission dated 9th December 2004.
46 Evidence led by Ms Purchase and Mr Prinsloo.
47 Parmalat's submission to the Commission dated 9 December 2004.
48 Page 4 of the Commission's 2nd Supplementary submission 11 May 2005.

figure was in fact 140 tons and not 400 as it had initially stated. [49]

54. The revised figures for skimmed milk powder (with the correct sales figure for Fonterra) are-

Name of firm	Country of origin	Quantity (tons)	Market share %
Clover	**South Africa**	**3 186**	**59.83**
Fonterra	**New Zealand**	**140**	**2.63**
Imports[50]	Argentina	296	5.56
	Australia	256	4.81
	Canada	49	0.92
	Switzerland	26	0.49
	Ireland	233	4.36
	Poland	112	2.10
	Uruguay	350	6.57
	Other	77	1.45
Ladismith Cheese	South Africa	200	3.76
Parmalat	South Africa	300	5.63
Dairybelle	South Africa	100	1.88
Total		5325	100[51]

55. On the basis of the revised figures the merged entity will have a market share of 62.46% in respect of skimmed milk powder. While Clover is a dominant player in the market, NZMPSA has a very small market share compared to other importers and other local players such as Ladismith Cheese and Parmalat.

56. In our view the impact of the merger on competition in the whole milk powder and skimmed milk powder product markets will be similar, and the following analysis applies to both these products.

Demand Characteristics

57. Customers for the bulk commodity ingredients are in general large firms which have countervailing power. Food service customers such as **[confidential information]** [52] and ingredients customers such as Aspen Nutritionals ("Aspen") are all large- volume customers. They have the power to negotiate volume discounts but also have the ability and capability to arrange and organise foreign sources of supply of these products through international traders. Evidence led by Ms Karin Purchase, procurement manager of Aspen, which is a customer of both Clover and NZMPSA, confirmed that it was the practice of Aspen to obtain prices from at least four different suppliers, including importers and international suppliers, for skimmed milk powder. While quality, availability and seasonality were taken into account, the price of

49 Letter from Deneys Reitz dated 12 May 2005.

50 According to the SARS figures total imports for 2004 amounted to 1409 tons. The Commission only listed the major country of origins. The market share for all imports amount to 26%.

51 99.99%

52 Customers approached by Commission.

the product was the most important factor in determining which supplier to choose. Aspen would switch suppliers for a small change in price. This was because "*price was king*" in a business that involved large volumes and low margins. A small difference in the price of a kilogram could have a large impact on the bottom line. As an example Ms Purchase postulated that she could obtain a notional shortfall of 300 tons from the next-best supplier when the difference in price between Clover and the next supplier was 60c a kilogram.[53] This increased Aspen's costs by R500 000.[54] Hence, in her view, if Clover or the merged entity raised its prices by 5-10%, Aspen would seek other suppliers of skimmed milk powder, including importers. In her view, a merger between Clover and Fonterra would be beneficial for Aspen because the merged entity could provide her with sustained supplies of product and a wider range of products than was available from either Clover or Fonterra.[55]

Barriers to Entry

58. According to the parties, barriers to entry, in the form of capital expenditure on equipment, are high. Powder products require expensive equipment such as spray towers costing approximately R180 million. However, new entrants can easily access second-hand equipment and could enter the market within six months. According to the evidence of Mr Uys,[56] in South Africa there is currently a lot of excess capacity in the installed base of approximately 24 spray drying towers, some of which are standing idle.[57] This means that producers who may have been in the market previously, such as Parmalat, can re-enter the market easily. In addition, the bulk commodity ingredients market does not depend as much on the ownership of a strong brand as the retail segment does.

Role of Imports

59. The evidence of all the witnesses at the hearing suggests that milk is produced much more cheaply in New Zealand and certain other parts of the world than in South Africa. Milk from the EU and US is obtainable at lower prices because of subsidies in those countries.[58] The local industry is protected by tariffs from cheaper imports. Imported skimmed milk powder incurs attracted a tariff duty of R4,50 per kilogram.[59] Skimmed milk powder is imported from a number of countries including Ireland, Argentina and New Zealand. The total cost of imported skimmed milk powder is roughly between R19,00 and R21,00 per kilogram depending on the Rand/USD exchange rates. During 2003 and 2004 the volumes of imports were –

53 Page 12 of the transcript.
54 It seems that Ms Purchase was under the impression that the price offered to her by Clover was a special price negotiated for a specific volume but Mr Uys from Clover clarified that in fact the price charged in this transaction was the prevailing world price of skimmed milk powder.
55 Page 20 of the transcript.
56 Page 311 of the transcript.
57 Information provided by merging parties to the Commission.
58 See evidence of Mr Michael Van den Berg (Milk Producers Organisation), Mr Uys and Mr Tweed.
59 Commission's Report 31 January 2005.

Year	Total Import quantity (tons)	Import Value
2002	10 426	R 135 237 187
2003	5 902	R 75 635 989
2004	1 409	R 18 231 327

Source: South African Revenue Service

60. Evidence was led by Clover that in general it sets its price for skimmed milk powder at parity with the landed in-warehouse world price. Mr Uys testified that when Clover had sometimes priced its product above the price of imported skimmed milk powder it had experienced a drop in volumes sold.[60] Clover provided further details of its import parity pricing model in the form of graphs handed in to the Tribunal.[61]

61. The evidence of Ms Purchase and other witnesses, taken with the Commission's data, supports the conclusion that the price of imported skimmed milk powder does indeed act as a constraint on Clover's pricing policy. Since this is so, the merger will not lead to higher prices or a lessening in competition. Clover is already pricing at the maximum available to it. Since Fonterra is neither a domestic competitor nor, on the final figures provided to us, one of the significant importers into the South African market, it does not constitute a de facto or potential constraint on Clover's pricing power.

VERTICAL ASSESSMENT

Input foreclosure

62. The proposed transaction will result in limited vertical integration because Clover and NZMPA supply each other and certain of their competitors. However in the Tribunal's view there is not a real likelihood of input foreclosure. The level of imports is relatively high and customers have countervailing power. Customers would easily be able to source alternative sources of supply if the merged entity sought to engage in anti-competitive conduct.[62]

Impact on Milk Producers

63. Concerns were raised that the earnings of farmers (milk producers) could be squeezed as a result of the merger. At the hearing an explanation of Clover's pricing policy and structures was provided by Mr Roode. **[confidential information]**

60 Mr Uys also explained that although it appeared to Ms Purchase that Clover had charged her a lower price per kilogram in the previous year this was not the case and that the price referred to by Ms Purchase in her testimony was in fact the world price of skimmed milk powder at the time the contract was concluded.
61 The Tribunal requested the Commission to review the graphs submitted by Clover. The Commission was of the view that that the graphs illustrate that neither Clover nor the merged entity will be able to influence the price or volume of supplies of skimmed milk powder.
62 See evidence of Ms Purchase and Mr Prinsloo.

[63]

Milk production in the local market has plateaued at about two billion litres annually,[64] and there is a limit to how much local household consumption can increase. Hence farmers are seeking to increase their production and revenues by expanding into foreign markets. Exports to sub-Saharan Africa represent a particular opportunity. **[confidential information]**.

64. Evidence given by Mr Michael Van den Berg of the Milk Producer's Organisation (MPO) largely confirms the evidence given by Mr Roode on the issue of the pricing of raw milk, although Mr van den Berg's participation in the hearing was premised on a totally different basis.

65. The MPO is a voluntary body, representing some 82% of the farmers and thus 90% of the milk produced in South Africa. The participation of Mr van den Berg stems from an article in Farmers' Weekly magazine in which Mr van den Berg expressed reservations about the merger. At the hearing, Mr van den Berg raised a number of concerns, which may be valid insofar as they may apply to raw milk but which do not have a bearing on the ingredients market. A major concern is the possibility that Clover will dump raw milk on the local market that was earmarked for export purposes (C-category milk) and thereby drive down the prices paid to farmers. In addition, Mr van den Berg was concerned that the joint venture could have the result that cheaper New Zealand ingredients are brought into the country (because of lower production costs in New Zealand), and are re-constituted into raw milk, thereby driving local milk prices down and putting a squeeze on farmers. Mr van den Berg was also concerned that the merger might lead to a reduction in import tariffs, which he saw as protection against the cheaper New Zealand, EU and American products.

66. However Mr Van den Berg conceded that he could not contemplate Clover being in agreement with such a strategy and he accepted that increasing the export market was a good opportunity for the local dairy industry since milk production had stagnated. He conceded further that these were concerns that would prevail even if there was no merger, and that he did not have specialised knowledge of the ingredients business.

67. While Mr van den Berg's evidence was useful in assisting the Tribunal to gain a better understanding of the broader dairy industry and the anxieties of the milk producers, it was clear that these concerns were more relevant to a merger in the raw milk segment or retail segment of the industry.

CONCLUSION

68. The Tribunal is satisfied that despite the large post-merger market share of the parties,

63 Page 227 of the transcript.

64 Page 247 of the transcript.

NZMPSA has a relatively small share in the markets for whole and skimmed milk powder. Barriers to entry are not particularly high, and previous players and new competitors can fairly easily enter the market. The existing significant level of imports and the free availability of imported supplies serve as competitive constraints on any exercise of market power in the form of price increases. Local producers are already pricing at import parity. Prices are relatively transparent and customers are sophisticated, so that there is a strong likelihood that they would switch to imported products if the merged entity increased prices without justification. The merger will not lead to the removal of an effective competitor because NZMPSA is a relatively small player in the relevant markets (other than that for whole milk powder) and the parties generally offer complementary rather than identical products to customers. Hence it is unlikely that the merger will lead to lessening or prevention of competition in the relevant markets.

Potential for collusion in other markets

69. However, some residual concerns remain. These concerns were also raised by Mr van den Berg of the MPO and by Parmalat.

70. A significant aspect of the agreement between the parties is that the parties have reserved their rights to compete, and continue to do so, in the retail segment of the ingredients market. The parties also continue to compete in the supply of raw milk.

71. Fonterra does not yet have a retail business in South Africa but does have a retail presence in other parts of Africa through its brands such as Anchor Butter. Clover has a strong retail business in South Africa and sub-Saharan Africa. It was made clear by Mr Roode of Clover that Clover would jealously guard its brands in the retail business such as Ultra-Mel and Mooirivier butter against those of Fonterra.[65] Evidence led by Mr Tweed of Fonterra confirmed that Fonterra intended to maintain its freedom to enter the retail market outside of the joint venture.

72. A second and equally significant aspect of the agreement is that not all of the bulk ingredients products of the parties have been included in the merger and the agreement which designates the affected products can be amended at any stage by the parties.

73. The Tribunal is concerned that because the parties still compete in the dairy industry the merger could create or strengthen a likelihood of collusion between them.

74. In addition, the Tribunal cannot approve a merger transaction of limited scope if the parties can subsequently amend their agreement at any time without notification to the Commission.

75. Hence the merger is approved subject to the following condition:

Clover Fonterra Ingredients (Pty) Ltd ("CFI") shall not in the Republic of South Africa

65 At page 166 of the transcript.

sell or distribute any product of Clover SA (Pty) Ltd ("Clover SA") (or any firm controlled by Clover SA, controlling Clover SA or controlled by a firm controlling Clover SA) or New Zealand Milk Products (SA) (Pty) Ltd ("NZMPSA") (or any firm controlled by NZMPSA, controlling NZMPSA or controlled by a firm controlling NZMPSA), **other than**

(a) defined products (including the customer scope) as defined in clause 1.1.18, read with Schedule A of the Master Agreement; or

1 (b) any product developed for CFI by Fonterra Limited or Clover SA in terms of clause 8 of the Master Agreement,

unless the relevant parties notify the Competition Commission in the manner prescribed in the Competition Act 89 of 1998 for a small, intermediate or large merger (as the case may be), of the intended sale or distribution of such additional product by CFI and obtain the relevant Competition authority's prior approval for such sale or distribution by CFI.

For purposes of this condition, 'Master Agreement' means the agreement titled "Master Agreement" between Clover SA and Fonterra International Limited, a copy of which is attached as Schedule 8 to the Form CC4(2) filed on behalf of CFI in the merger filing that was lodged with the Commission in this matter.

Public Interest

76. According to the merging parties no employees will be retrenched as a result of the transaction. Furthermore, the employees of both Clover's ingredients business as well as of NZMPSA will be transferred to CFI on terms no less favourable than the terms on which they are currently employed.[66]

77. We therefore find that there are no significant public interest issues which would alter our conclusion.

Y Carrim **21 June 2005**

Concurring: N Manoim, L Reyburn

For the merging parties: Advocate R Bhana instructed by D Rudman/P Naggan (Werkmans) for Clover and L Morphet/V Koovejee (Deneys Reitz) for NZMPSA/Fonterra.

66 See paragraph 7 of the parties' competitiveness report.

For the Commission: Maarten van Hooven (Mergers and Acquisitions).