The Registrar
Commerce Commission New Zealand
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FONTERRA / NZDL – FILE NUMBER 13682

The following paper sets out the position of Westland Milk Products in relation to the application for clearance of Fonterra Co-operative Groups bid for NZDL.

This submission can be made available for public release.

Westland Milk Products would welcome the opportunity to present our views directly to the Commission and to answer any questions that may arise from the positions set out below. To this end, any correspondence should be directed to:

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SUMMARY

Westland Milk Products strongly opposes the application for Fonterra Co-operative Group to acquire NZDL on the following grounds:

1. Approval of Fonterra's acquisition would substantially lessen competition in the specific market for farm gate milk relevant to the NZDL plant, thus removing opportunities for both affected farmers and potential investors in that geographic area

2. Approval of Fonterra's acquisition would have far reaching implications for the wider New Zealand dairy industry. It would enhance Fonterra's already dominant market position and allow them to aggressively target other independent processors. It would also reduce the incentive for existing or prospective independent processors to invest in new processing facilities. These consequences would lead to a substantial lessening of competition across the New Zealand dairy industry

3. There are viable and substantive options for the purchase of NZDL outside of the Fonterra bid that would provide the same, if not greater, benefits as those claimed by Fonterra. Such alternatives would also ensure the opportunity for continued competition in the direct market

around the NZDL plant and within the wider New Zealand dairy industry, in line with the intent of the Dairy Industry Restructuring Act and the competition provisions of the Commerce Act

BACKGROUND PAPER

It is the view of Westland Milk Products that the approval of Fonterra's bid for NZDL would substantially lessen competition in the relevant market within which the NZDL facility operates, as well as the wider New Zealand dairy industry.

It is the view of Westland Milk Products that the "market" which the Commission should consider when determining the impact of the Fonterra bid, must be that for the collection of milk within a specific radius from the NZDL processing facility.

We do not agree therefore with the Fonterra position that the relevant market is the entire milk producing area of the South island. Instead we believe the practical and proven market for milk should be considered as no further than 100-150km from the NZDL plant. This is generally equivalent to the South Canterbury region as reported in the LIC/DairyNZ annual dairy statistics with the addition of the Waitaki District from the Otago region.

This view is in line with precedent set by the Commerce Commission in decision number 574 (Fonterra and Kapiti Fine Foods) of 2006, where the Commission determined that "that the geographic dimension of the market would be the area within 100-150 kilometres of the KFF plant". Westland Milk Products does not see any reason why the rationale used in the Kapiti case would not also apply to the situation which the Commission is currently being asked to rule on.

In addition, standard industry practice and economics suggest that to consider a market beyond 100-150km is impractical and makes no economic sense.

By way of example, Westland Milk Products has declined applications for supply from a number of farms situated more than 100km by road from Westland's Rolleston site in the past two years. Westland has also turned down the opportunity to collect milk from farms that currently supply NZDL due to the high cost of transport.

In the 2012/13 season Westland is accepting supply within the geographic market in question from two farms. Westland has agreed to process this milk, but on less attractive terms and conditions of supply than those enjoyed by the rest of the Westland shareholder base.

The drive to minimise collection costs and limit effective geographic markets for raw milk is also evidenced by Fonterra's behaviour, most recently the establishment of the Darfield plant in mid-Canterbury.

Whilst Fonterra has transported milk to its Clandeboye plant from as far away as Culverden – 240km away – this has not been done without the establishment of a Reverse Osmosis concentration plant to make that distance economically viable. The establishment of the Darfield plant reflects the fact that, given the opportunity to determine the location of processing assets, Fonterra – the industry's largest and most efficient milk processor – will situate them in an area where farm gate milk volumes are concentrated, which in effect creates a collection area of no more than approximately 100km.

Based on the Westland view that the relevant market is the South Canterbury region plus the Waitaki district, it is our position that allowing Fonterra's bid to move forward would substantially lessen effective competition for milk in that specific market. A Fonterra acquisition of NZDL would reduce the current number of processing options in the market from three to two, increasing Fonterra's share of the milk in the market from approximately 81% today to above 96%, as detailed in Appendix 1.

It is therefore relevant to refer to the Commissions 2007 decisions 606 & 607 regarding the clearance applications from Foodstuffs and Woolworths for a potential acquisition of the Warehouse Group. In this decision the Commission ruled that as a general rule of thumb, a merger that reduced the number of competitors in a market from three to two was likely to reduce levels of rivalry to the detriment of customers. In the case of Fonterra's proposed acquisition of NZDL, the same is true to the detriment of raw milk suppliers.

Fonterra's ability to have undue influence on specific milk markets within the New Zealand industry is illustrated by the condition of the Fonterra bid for the NZDL assets that they acquire 100% of existing suppliers under long term growth contracts. This effectively locks in milk supply for seven years. This practice is one that is becoming increasingly common place within parts of the industry where Fonterra has highlighted areas of potential competition that they want to aggressively counter.

Fonterra's current supply of milk in the geographic area is such that they certainly do not need the NZDL milk supply to fill the plant. Indeed it is our view that the transport and other efficiencies claimed in Fonterra's clearance application would be substantially enhanced if they were to take over the plant without the associated milk supply. The implication therefore is that Fonterra have made this a condition of their bid in order to block competitors from potentially obtaining that milk supply.

As noted in Fonterra's own application for clearance, the NZDL supplier representative refers to it being a "bitter pill" in having to return to the Fonterra fold. Farmers want choice in the way they run their businesses. It is the Commissions duty to ensure that such choice is preserved for the farmers that operate in the affected geographic market.

Beyond the immediate impact on the market for milk in and around the NZDL facility and the resulting substantial lessening in competition, it is the view of Westland Milk Products that approval of the Fonterra application would also have far reaching and on-going implications for the entire New Zealand dairy industry and market. The Commission must take this into account when reaching their decision to ensure that a substantial lessening in competition does not result. This approach would be consistent with the Commission's methodology in decision 606/607 related to the potential acquisition of the Warehouse Group in 2007.

One of the major reasons for NZDL's inability to avoid receivership was the on-going struggle to achieve a viable return for their business after covering the cost of contracting milk with suppliers linked to the Fonterra milk price.

It has been the position of Westland Milk Products in recent submissions to the Commerce Commission and Ministry of Primary Industries, that Fonterra effectively sets a national farm gate milk price that is higher than they actually achieve through their commodity business. This therefore significantly affects an independent processors ability to sustain a viable business, and is the most important issue facing the New Zealand dairy industry today.

Current regulations are not effective in addressing this issue. They allow Fonterra to continue to take advantage of its privileged position in the industry, which we remind the Commission was only created via specific concessions agreed to under statute in order for them to avoid the competition provisions of the Commerce Act.

It is the view of Westland Milk Products that by allowing Fonterra to acquire NZDL, a further incentive would be created for Fonterra to control the farm gate milk price in a way that will provide an opportunity to target additional processors in the New Zealand industry. This will undoubtedly create a lessening of future competition in the market, either by Fonterra taking advantage of this opportunity or the risk of this happening deterring future investment by independent processors.

This would clearly create a negative outcome when judged against the intended purpose of the Dairy Industry Restructuring Act, set out in section 4(f), to "promote the efficient operation of dairy markets in New Zealand by regulating the activities of new co-op to ensure New Zealand markets for dairy goods and services are contestable".

The DIRA also contains a sunset clause that sets a review of whether Fonterra will continue to be regulated once its share of the New Zealand milk market falls below 80%. This indicates Parliaments intent is that 80% represents a baseline for a workable competitive market for raw milk in New Zealand. The Fonterra acquisition of NZDL, when judged against that target, is clearly moving the market in the wrong direction.

In addition, contrary to Fonterra's assertion that clearance would enhance the prospects of further investment in independent milk processing assets, it is the strongly held view of Westland Milk Products that approval of the Fonterra application would undoubtedly wave a red flag for potential investors considering a move into the New Zealand dairy processing sector. Future investment must be an outcome the Commerce Commission seeks to encourage rather than destroy.

This potential for substantial lessening of effective competition in the wider New Zealand dairy market must therefore form part of the Commission's analysis of the "factual" position when determining the validity of Fonterra's application.

Not only would the above scenario be counter to the wishes of the dairy processing sector and those New Zealand farmers who want choice as to which processing company they supply, but ultimately consumers suffer if Fonterra is able to increase its share of milk and processing assets within New Zealand. The Kapiti decision made by the Commerce Commission highlights the ability for Fonterra to target consumer branded businesses, with the potential to adversely affect competition in the domestic retail market.

It is the view of Westland Milk Products that NZDL would have a viable and successful future within the New Zealand dairy industry if Fonterra's request for clearance is not approved.

Based on our assessment of the Fonterra application for clearance, there are number of inaccuracies and misrepresentations that we would welcome the chance to engage with the Commission on if it were to aid in the decision making process related to Fonterra's bid for NZDL.

However, of greatest concern to Westland Milk Products is the assertion in the Fonterra application that Fonterra's bid is the only one that can provide a long term solution for the survival of NZDL and its supplier farmers.

Westland believes that there are alternative and material bids that have been submitted to Receivers for consideration related to the NZDL plant. Significantly, at least some of these bids would not require any regulatory approval and therefore would be capable of being completed within a very short timeframe.

We also believe that NZDL farmers would be better off on a cash basis if an alternative bid were to move forward, taking into account the cost associated with being forced to share up with Fonterra, which effectively neutralises the money farmers would receive via the higher Fonterra offer price.

Like the assertion made by Fonterra, Westland is also of the view that third party bids would look to leverage the NZDL plant to facilitate the development of a nutritional capability, notably to manufacture Infant, Follow on and Toddler formula for sale to global brand owners in key emerging markets.

It is important that the Commission recognise that there is an alternative to the Fonterra bid that can provide a real, competitive option for current and prospective farmer suppliers to the NZDL facility. Receivers have carried out their duty in selecting the bid that best meets the short term needs of creditors. However, Westland Milk Products believes it is important that the successful bid is one that can balance the immediate needs of creditors with the long term interests of the supplying farmers. A successful bid should also satisfy the legislative framework set out in the Dairy Industry Restructuring Act that aims to support a competitive dairy industry in New Zealand

In conclusion, it is the view of Westland Milk Products that the Commerce Commissions decision related to the proposed Fonterra acquisition of NZDL is significant for the entire industry and one that must be fully considered in light of the future ability to maintain a competitive dairy market in New Zealand.

Westland Milk Products is of the strong belief that the Fonterra bid for NZDL is motivated by factors that are not in the best interests of the competitive milk and dairy processing market that underpins the Dairy Industry Restructuring Act. It is instead focused on attacking the interests of their domestic competitors as opposed to NZDL creating any real value to Fonterra's current business model.

Fonterra has proven itself to be willing to take advantage of its dominant position in the market to the detriment of a truly competitive industry. Allowing Fonterra to move forward with this acquisition would simply enhance Fonterra's position, allowing them to not only continue to manipulate milk price but also operate with greater freedom around a strategy of future acquisitions.

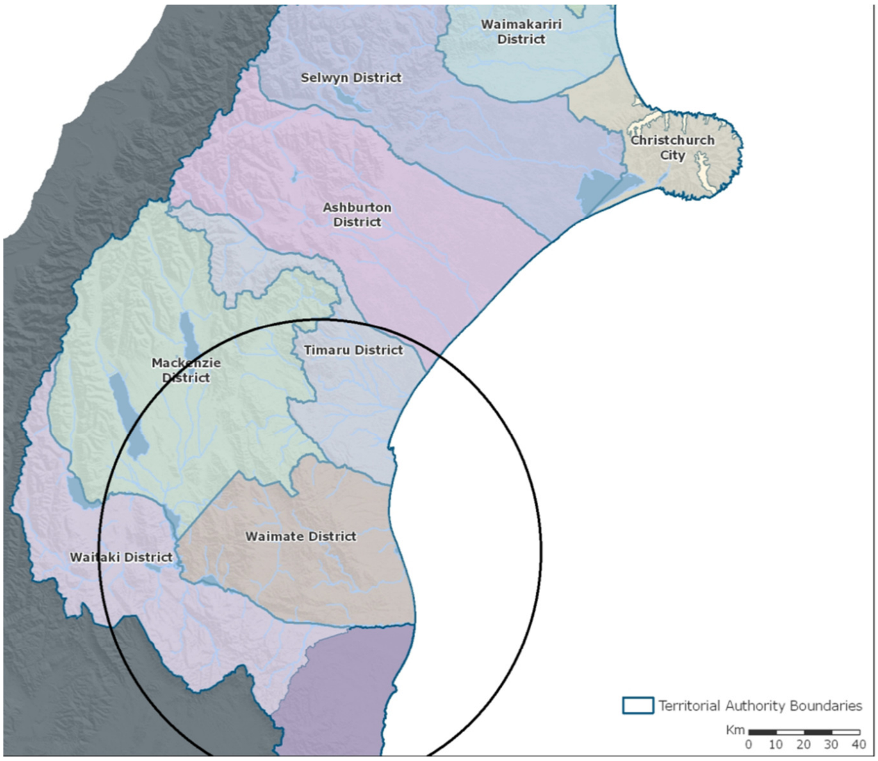
This scenario would prove to be detrimental to current and future independent processors as well as those farmers that operate within the defined market around the NZDL facility. It would also impact the wider farming community who should be guaranteed the long term ability to operate within a truly competitive market place for milk.

We therefore urge the Commission to take a forward looking view of the implications related to the Fonterra bid, and allow competition to be maintained through the introduction of a new bidder for NZDL. This outcome would promote a competitive market for farm gate milk in the geographical market in question. It would also serve the best interests of the long term future of independent processors in New Zealand. Finally, it will ensure a line in the sand is drawn related to Fonterra's continued encroachment on the legislative principles that were established at the time of their creation.

Appendix 1

Calculation of NZDL milk market shares. Approx. 100km circle by road from the NZDL plant.

Milk volume statistics sourced from LIC/DairyNZ - New Zealand Dairy Statistics 2010/11.



District	Num Herds	Litres/herd	ms/herd	Total Litres
Timaru	132	3,129,976	268,321	413,156,832
MacKenzie	15	3,359,597	291,874	50,393,955
Waimate	99	3,220,867	280,129	318,865,833
Waitaki	121	2,954,347	254,575	357,475,987
Total Market Size				1,139,892,607
NZDL contract supply				127,000,000
NZDL DIRA entitlement				50,000,000
NZDL total supply				177,000,000
Total NZDL current market share				**15.5%**
Synlait Oceania milk contract				40,000,000
Synlait current market share				**3.5%**
Fonterra market share pre-acquisition (and counterfactual)				**81.0%**
Fonterra market share post-acquisition (and factual)				**96.5%**