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Commerce Commission  
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**DRAFT DETERMINATION ON APPLICATION FOR AUTHORISATION OF  
ARRANGEMENTS INVOLVING KOTAHI LOGISTICS LP (KOTAHI PROPOSAL) -  
SUBMISSION ON BEHALF OF FONTERRA CO-OPERATIVE GROUP LTD (FONTERRA)**

- 1 On 12 September 2011 Fonterra made an application pursuant to section 58 of the Commerce Act 1986 seeking authorisation of various aspects of the Kotahi proposal (as that proposal was described in the application). We and NERA Economic Consulting (NERA) assisted Fonterra in making that application.
- 2 Specifically, paragraph 5 of the application drew attention to the particular provisions of the Kotahi proposal that we had advised the applicant may require authorisation. Briefly, those provisions were:
  - 2.1 the exclusivity requirement ;
  - 2.2 the pricing mechanism;
  - 2.3 the likely effect of the overall arrangements as Kotahi's volumes grow (and demand available to rival suppliers is progressively foreclosed);
  - 2.4 the mechanism for entry of new limited partners and acceptance of further customers;
  - 2.5 the potential extension of Kotahi's operations to domestic freight movements and intermodal transport services.

**Why authorisation was sought**

- 3 Importantly, authorisation was not sought because the applicant (or we) believed that the Kotahi proposal would likely breach the Commerce Act at the time it was entered into. Rather, we could not dismiss entirely the possibility that it might do so prospectively, especially as Kotahi both expanded its membership to include further limited partners and extended the range and scope of services it would provide.
- 4 We were also uncertain as to when that risk might coalesce into actual legal challenge – whether by the Commission or third parties. Thus, the application acknowledges unequivocally (at paragraph 5.39) that:

*It is impossible to identify in advance either the precise nature of the service or the precise point at which the threshold may be crossed for the particular service.*

- 5 The risk we perceived arises in part from the identity of the intending participants in Kotahi. The initial sole limited partner, Fonterra, is not only the major processor of raw milk in New Zealand but sells approximately 90% of the milk solids it processes to markets outside New Zealand. Fonterra is also a substantial purchaser of certain inputs (other than raw milk) required to manufacture, market and distribute those products. Of particular relevance in the present context, as New Zealand's largest exporter by far, Fonterra is the major user of ocean freight services from New Zealand as well as intermodal transport services within New Zealand.
- 6 Similarly, Silver Fern Farms, as the first new limited partner to join, is a large scale producer and exporter of New Zealand primary products and thus major user of ocean freight services from New Zealand as well intermodal transport services within New Zealand.
- 7 Simply aggregating the combined demand of Fonterra and Silver Fern Farms for ocean freight services would therefore represent a significant portion of total demand within New Zealand for those services. There seemed to us the apparent conundrum that, the broader and more successful Kotahi might become operationally in attracting further exclusive users of its services, the more likely that the effect limb of section 27 might be triggered, and the section 29(1A) defence vitiated, at some point.
- 8 We also perceived risk to arise from uncertainty surrounding the interpretation of the section 30 deeming provision in respect of price fixing and section 31 exception to that deeming provision.
- 9 Finally, we had interpretative concerns as to the availability to Kotahi and/or extent of the section 44(2) exception for carriage of goods by sea.
- 10 Given the present lack of a clearance regime in respect of the restrictive trade practices provisions generally, those uncertainties compounded. So, it seemed to us that the only means of providing Fonterra and Kotahi's prospective partners, as well as all those firms that would be contracting with Kotahi, with the requisite level of legal comfort, was to seek authorisation for the Kotahi proposal prior to its being fully implemented. Section 58 expressly contemplates that a person who considers that sections 27 or 29 *might* apply to the arrangement they are about to enter into or give effect to, may apply to the Commission for authorisation.

#### **Findings we agree with**

- 11 In the event the Commission's provisional findings as set out in its competition analysis (paragraphs 3 to 239) of the draft determination do much to remove the uncertainties we had perceived. In particular, the Commission finds, and we agree with its findings, that:
  - 11.1 section 27 is unlikely to apply as there will not be an actual lessening of competition in *any* market in which Kotahi operates;
  - 11.2 a lessening of competition which does not create, enhance or maintain market power, or harm consumers, should not be of concern;

- 11.3 Kotahi would not have the ability to obtain, or the incentive to use, monopsony power;
- 11.4 ocean freight rates to and from New Zealand are likely to be above competitive levels;
- 11.5 any ability on the part of Kotahi to depress those prices is likely, on average, to be an exercise of countervailing power;
- 11.6 the Commission generally views lower prices favourably as lower prices are often to the long-term benefit of consumers. Increases in countervailing power are often associated with reduced prices;
- 11.7 ports are likely to have at least some market power in regard to a number of their customers;
- 11.8 Kotahi is unlikely to foreclose its rivals from competing for customers to the extent that a lessening of competition would occur;
- 11.9 the exclusivity requirement is not tantamount to an exclusionary provision (section 29) because it doesn't discriminate;
- 11.10 the pricing mechanism is not tantamount to price fixing (section 30) because prices set will be determined by negotiation by a single entity, Kotahi;
- 11.11 in any event, the section 31 exemption for joint ventures would apply;
- 11.12 the Kotahi joint venture is *bone fide* and is not being used as cloak for price fixing.
- 12 On the basis of those findings of no likely lessening of competition in terms of section 27, no deemed lessening in terms of section 30 and no exclusionary provision to which section 29 might apply, the Commission concludes that it has no jurisdiction to grant authorisation and duly declines the application.
- 13 Further on the basis of those findings, the Commission considers that it is therefore not strictly required to form a view as to the likely public benefits. Nevertheless, the Commission does opine as to the potential public benefits arising in order to assist with the consultation process.
- 14 We also agree with the Commission's conclusion that, having regard to its findings in relation to sections 27, 29 and 30, it should decline to grant authorisation on the basis that it does not have jurisdiction.
- 15 Given the paucity of evidence, or legal or economic argument, that has been made available to the Commission to dispute those findings or that conclusion, we do not propose to make further comment in relation to them at this time. We could do so, however, if requested by the Commission; and would want to, if any of those matters were the subject of detailed comment in submissions by other parties.

### Findings we dispute

- 16 We do not agree with several of the Commission's findings in its competition analysis. In particular, we dispute:
  - 16.1 the Commission's clear distinction between *procurement* and *provision* of various freight services, supposedly excluding operation of the section 44(2) exception for a carriage of goods by sea: paragraphs 63-69;
  - 16.2 the Commission's finding that Kotahi is a procurer of port services (because port services are part of the containerised freight services it procures from ICLs): paragraphs 70-75;
  - 16.3 the Commission's finding that the most likely counterfactual is the status quo, in which scenario the ports would continue on their present intended course of investment and ICLs would gradually increase the size of ships calling at New Zealand ports as the amount of containerised exports grow: paragraph 89.
- 17 We provide more detailed information on each of those findings below. In brief, however, we say in relation to those same matters:
  - 17.1 the distinction between procurement and provision is not so clear-cut and in fact Kotahi will directly provide some ocean freight services;
  - 17.2 Kotahi is not a buyer or procurer of port services any more than it is a procurer of any of the myriad other inputs used by the ICLs;
  - 17.3 adopting a status quo counterfactual is too simplistic. In particular, the Productivity Commission's draft report recommends changing the present regulatory framework (and a number of other government interventions) that, if adopted by Government, will impact on both port investment and the regulatory regime for international shipping.
- 18 In addition, NERA at our request have prepared a Response to the Commission's views on the potential benefits, which is **attached**.

### NERA disputes Commission's narrow view of benefits

- 19 Contrary to the Commission's provisional findings that there will be no efficiency benefits arising from Kotahi beyond Kotahi's ability to exercise countervailing power against the ICLs, NERA concludes that:
  - 19.1 aggregation and coordination of transport demand will result in efficiencies;
  - 19.2 while efficiencies can result even for relatively small levels of aggregation, the scale of transport aggregation arising from Kotahi is well beyond anything currently observed in New Zealand; and
  - 19.3 Kotahi's aggregation and coordination of container volumes at a small number of ports will be an important catalyst for larger ships to service New Zealand, which at least will bring forward net benefits to New Zealand both with and without port investment.

- 20 The Response sets out NERA's reasoning and evidence underpinning those conclusions.

**Distinction between procurement and provision is not clear cut**

- 21 The Commission considers that the Kotahi arrangements are not exempt from Part 2 of the Commerce Act by virtue of the section 44(2) exception (or section 14 of the Shipping Act), as Kotahi does not provide for the physical carriage of goods: paragraph 90. Further, the Commission says that the Kotahi arrangements do not contain severable provisions "exclusively" for the carriage of goods by sea; but rather provide for the procurement and management of ocean freight carriage services: paragraph 94.
- 22 This clear cut distinction that the Commission draws between *provision* of physical carriage of goods and *procurement* of such services is crucial, because of the specific wording of the section 44(2) exception.
- 23 We do not think that the distinction between *provision* and *procurement* is so clear cut. The fact that paragraph 5.8 of the application drew attention to uncertainty whether the exception would extend to procurement should not be taken as the applicant's support for that view. Rather, we were pointing to that uncertainty as one of the reasons for applying for authorisation.
- 24 In any event, the issue may soon become moot. Despite the Commission's characterisation of the concern expressed in the application that the exceptions may soon disappear as "simply speculative" (footnote 39 in paragraph 90 refers), the subsequently released draft report of the Productivity Commission on its International Freight Transport Services Inquiry makes legislative change to remove both section 44(2) and the Shipping Act exceptions both likely and imminent.
- 25 Indeed, the Productivity Commission devotes the whole of Chapter 11 and Appendices D and E of its draft report to an exhaustive study of the history of, rationale for and effect of those exemptions; and duly recommends as follows:

*Overall, the Commission recommends removing New Zealand's exemptions for the potentially more damaging types of agreements – price-fixing (for freight and port charges) and capacity-fixing agreements – and reliance on the generic Commerce Act authorisation regime (and proposed clearance regime) for these types of agreements. Conversely, New Zealand should retain an exemption for non-ratemaking and/or non capacity-setting agreements.*

*However, this change should be conditional upon a transitional period being introduced to allow any existing ratemaking and capacity-fixing agreements to be cleared, authorised or amended to ensure compliance with the Commerce Act.*

*In the case of non-ratemaking and non capacity-setting agreements, New Zealand should also:*

- *amend the exemptions by having only one exemption (in the Shipping Act 1987);*

- *strengthen the remedial regime in the Shipping Act by introducing a registration regime for exempted agreements;*
- *extend the application of the regime to inwards shipping; and*
- *allow exemption only for agreements that permit and protect confidential individual service contracts.*

26 Significantly, the Productivity Commission's study indicates that the types of collaborative agreements for the carriage of goods by sea presently covered by the section 44(2) exception extends to a range of non-ratemaking agreements. These include "vessel sharing agreements" in terms of which carriers share vessel space. In addition, other vessel sharing agreements provide for slot charters, whereby one carrier will simply lease vessel space from another.

27 But, paragraph 5.15 of the application makes it clear that:

*Kotahi Logistics will itself purchase vessel space from shipping providers to meet its limited partners' and other customers' requirements.*

28 It seems a fine line to draw that vessel space obtained by one carrier swapping or leasing capacity from another should be covered by the exemption; while vessel space similarly obtained by Kotahi should not.

**Kotahi is not a procurer of port services**

29 The Commission's finding (at paragraphs 70-75) that Kotahi is a "procurer" of port services because port services are part of the containerised freight services it procures from ICLs, seems at odds with its above strict distinction between provision and procurement to the effect that only services that are directly supplied physically are "provided".

30 In any event, it is wrong.

31 "Procurement" is the act of obtaining particular goods or services. With ocean freight and port services, the relationship is tripartite:

Kotahi - obtains ocean freight services from the ICLs; and its shareholders (like other major exporters) rent space for specialised facilities located on or in close proximity to particular ports

ICLs - provide ocean freight services and obtain an array of inputs – including fuel and port services – necessary to provide those services

Ports - provide port services to ICLs and obtain port services charges from ICLs for those services; and rent space on the port to major exporters (and others) for a variety of facilities located on port property.

32 In fact, the port services charges paid by the ICLs to New Zealand ports would constitute a small component of the ICLs' overall operating costs.

- 33 Thus, quantum of port charges is not the only factor influencing an ICL to favour a particular port. Determinants will involve a complex matrix of factors such as availability of landside solutions unlocking alternatives, attractiveness of the port's hinterland cargo profile, other carrier support for the port. Importantly, those factors will include efficiency of operation of the port, as delay is far more expensive to an ICL than port's services charges.
- 34 The Commission suggests (at paragraphs 73 and 74) that "exporters also have direct relationships and contracts with ports, whereby ports provide incentives for exports to use their particular port facility". Examples are given of the provisions of intermodal freight services and contracts for storing and packaging. Thus, it is suggested, ports have the ability to discriminate exporters by "implicitly lowering the price for containerised ocean freight".
- 35 It is true that Fonterra, and other major exporters maintain specialised facilities on, or in close proximity to, some ports. Similarly, intermodal operations are carried out in relation to particular ports.
- 36 But, those operations and the location of those facilities are separately and transparently contracted for by the exporter or operator with the port. There is no implicit lowering of port charges through such arrangements.

**Counterfactual is not the status quo**

- 37 As was recognised in the application, divining what is likely to happen is the ocean freight sector without the Kotahi arrangements "is far from simple". It referred, for example, to the respective scenarios propounded in NZIER's Freight Futures Report and the Shipping Council's Bigger Ships Report.
- 38 Taken together, those reports indicated that the status quo is not a likely counterfactual.
- 39 The application therefore postulated two possible scenarios, based on those reports, namely:
- 39.1 some infrastructure investment being made by the largest ports, but no port becoming bigger ships capable within 5 years;
- 39.2 hubbing to bigger ships capable Australian ports becoming a reality.
- 40 Since the release of the draft determination, the Productivity Commission's draft report has been added to the mix. That report proposes significant government interventions to impact on ports and across the freight sector generally. Those interventions include, but are not limited to:
- 40.1 strengthening ownership and/or ownership arrangements for ports;
- 40.2 improving labour relations;
- 40.3 bringing the objectives of council-owned port companies into line with objectives of SoEs;

40.4 information sharing to aid investment decisions;

40.5 changing the regulatory framework within which ports (and ICLs) operate.

- 41 The common theme linking the proposed changes is said to be that they would "strengthen the incentives for firms to seek opportunities for higher productivity".
- 42 Unfortunately, the final report of the Productivity Commission will not be made to Government until 1 April; with the Government's considered response to that final report presumably to come some months after that.
- 43 However, what is clear from the draft report is that significant opportunity for improvement in port performance and investment is perceived when measured against the status quo.
- 44 Pending those government interventions that the Productivity Commission prescribes, we submit that the advent of Kotahi and the coming into effect of the Kotahi arrangements already is stimulating improvement by aggregating and consolidating the demand for ocean freight and intermodal services by two (and potentially more) of New Zealand's largest exporters. That greater certainty must impact on individual port's willingness to invest.
- 45 It may not be that the alternative counterfactuals suggested in the application are correct; and indeed may be affected by the Productivity Commission's proposed interventions. But, they are more correct than the suggestion in the draft determination (at paragraph 89) that "ports would continue on their present intended course of investment".

### **Conclusion**

- 46 Crucially, none of those findings that we or NERA dispute, either individually or taken together, impugns the Commission's essential findings that:
  - 46.1 The Commission is not satisfied that the Kotahi arrangements contain an exclusionary provision to which section 29 of the Act would or might apply.
  - 46.2 The Commission is not satisfied that section 30 of the Act would or might apply to the Kotahi arrangements, such that there is a deemed lessening of competition.
  - 46.3 The Commission is not satisfied that the Kotahi arrangements will result, or be likely to result, in a lessening of competition. There is unlikely to be a material difference in competition, with or without Kotahi.
- 47 We therefore agree with the Commission's preliminary decision to decline Fonterra's application for authorisation on the basis that the Commission does not have jurisdiction.

48 So saying, we agree with, and Fonterra relies on, the Commission's observation that:

*The Commission's decision does not prevent Fonterra from proceeding with the Kotahi arrangements. Even though no authorisation has been granted, the Commission's determination may provide parties to the Kotahi arrangements with a degree of comfort if they proceed with the arrangements. This is on the basis that it is unlikely that the Commission would take court action in the future unless the facts on which the application is based materially change. Further, in the event that any third party attempted to challenge the arrangements in question, the limited partners of Kotahi would have the benefit of the Commission's findings in this draft determination.*

Yours faithfully



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