

20 July 2012

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FONTERRA / NZDL : STATEMENT OF PRELIMINARY ISSUES

Anthony

Fonterra provides the following further information in response to the Commission's Statement of Preliminary Issues dated 12 July 2012 (*Statement*). The headings are the same as those used in the Statement.

As indicated to you, this letter was prepared prior to our receiving your email of today containing specific questions for Fonterra. We will respond separately to those questions.

Areas of overlap

- 1 **Attached** as Appendix A is a detailed South Island map showing:
 - The locations of independent dairy processors plants and the respective suppliers to those plants.
 - The location of Fonterra plants and Fonterra suppliers.
 - Concentric circles representing 150km radius (being the outer radius adopted in Decision 574) from each of the NZDL, Synlait, Westland (Rolleston) and Gardians sites.
- 2 This map has been compiled based on [

]
- 3 Subject to that limitation, the map does illustrate the large geographical spread of the suppliers to the competing processors and the distances those processors are now transporting milk. In particular:
 - o Westland transports milk from Canterbury to process it at Hokitika on the West Coast
 - o Synlait collects milk from South Canterbury and transports it to process at their Dunsandel site
 - o We understand OCD has recently agreed to take milk from [
], Central Otago to its plant in Southland.

4 The recent trend of supplier growth has been for popular dairying regions (e.g. in Canterbury and Southland) to become more “filled in” through further dry farm conversions. However, conversions are now beginning to develop dairying in more outlying areas e.g. Omakau near Central Otago, the edges of Western Southland and Hawea Flats near Wanaka. This more recent development is likely to see the popular dairying regions “converge” geographically.

Existing competition

5 Not only do most suppliers of raw milk in the South Island have a choice of processor – and as shown in Appendix A will continue to do so post-acquisition – but there is clear evidence of suppliers switching with relative ease.

6 Suppliers’ incentives to switch are varied, as suppliers base their choice of processor on a number of considerations including capital, economic considerations and processor ownership. Seemingly, however, the primary factor attracting suppliers away from Fonterra over recent years has been the desire to free-up share capital, whether it is to reduce debt, or free-up capital for further development or further land purchases.

7 The key value proposition of alternative processors is that they enable suppliers to free-up share capital, either fully by moving to a corporate processor (Synlait, OCD), or reducing the shareholding requirement by going to Westland (whose suppliers are required to hold a nominal share costing of [] (cf. Fonterra Fair Value Share of []).

8 Both Westland and Synlait already have a number of suppliers located close to the Studholme plant:

- Synlait collects milk from 25 farms supplying 5m kgMS close to Studholme (formerly NZDL suppliers).
- Westland collects milk from two farms located [], in close proximity to the NZDL plant.

9 The payout mechanisms of those other processors is **not** linked to Fonterra’s price for farm gate milk. To elaborate:

Westland

- []
- []
- []
- []
- []

OCD

- []

-

- o

- o

- o

-

-

]

- Synlait*

-

- [

-

]

Potential competition

10 Since filing the application seeking clearance, Fonterra has become aware of further developments regarding new entry.

Oceania Dairy Project

11 Synlait entered into negotiations with Oceania Dairy Ltd in 2011 to buy the entire business of that company. Synlait completed the purchase of the Oceania supply contracts, [

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12 Fonterra further understands that over the past few weeks, the owners of Oceania have entered into negotiations with Inner Mongolia Yili Group, one of China's largest dairy processors, [

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Carrickmore Nutrition

- 13 **Attached** as Appendix B is a report from *The Press* of 12 July 2012 describing the launch of Carrickmore Nutrition, with plans to produce and export significant volumes of infant formula to China.
- 14 **Attached** as Appendix C is the transcript of the “Campbell Live” programme televised on 17 July 2012 describing the lengths to which exporters of formula are prepared to go to access product for the Chinese market.
- 15 All these developments support and supplement information already provided in Fonterra’s application, namely:
- Interest in investing in the New Zealand dairy industry remains high;
 - Capital is available for such investments providing there is a sound business case;
 - Barriers to entry are low;
 - Suppliers can be incentivised to switch and do so;
 - Fonterra’s acquisition of NZDL does not create any additional barriers to entry.
- 16 Please note that some of the contexts of this letter are confidential. A public version with confidential information excluded will be provided shortly.

Yours faithfully

Grant David

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APPENDIX A

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APPENDIX B

“Press” article of 12 July 2012

19/07/2012

Carrickmore Nutrition To Sell Infant Formula In... | Stuff.co.nz



NZ infant formula to be sold in China

TAMLYN STEWART Last updated 08:44 12/07/2012

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3

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Share

A Christchurch-based company is launching a New Zealand-made infant formula, which it will sell in New Zealand and China, in Christchurch today.

Carrickmore Nutrition managing director Chris Claridge and his father Richard formed the company 18 months ago with backing from American investors.

The first shipment of 36,000 cans of Carrickmore infant formula leaves for China on Friday, and will appear on shelves the South Island next week. The company had orders for "hundreds of thousands" of the 900-gram cans of the product, Chris Claridge said. "Our food standards and quality of dairy produce is a competitive advantage in China," he said.

Gentech Food supplies the milk base for Carrickmore's formula, and other ingredients are added at the canning stage, which takes place in Auckland.

Gentech Food, based in Guangzhou and Shanghai, is Carrickmore's master distributor for China. Gentech distributes infant products to more than 600 stores throughout China.

Carrickmore had forward orders for the next three years, Claridge said.

In New Zealand Carrickmore has a sole-distribution agreement with Foodstuffs South Island, through its subsidiary Trents.

The company plans to begin distributing its product in the lower North Island towards the end of the year, and the upper North Island early next year.

The company would manage its supply chain carefully, because babies did not like changing, Claridge said.

Carrickmore had signed a memorandum of understanding on research partnership with the University of Canterbury to help the company ensure it stayed competitive in the market, he said.

Arrangements around intellectual property would be determined case by case.

Caringrace Inc is listed as owning a half share in the company on the Companies Office website. They were "private, wealthy individuals" who wanted their details kept confidential, Claridge said.

Claridge has a food science qualification from Canterbury University but has years of experience in advertising and marketing, while his father Richard is an obstetrician and gynaecologist now practising in Wellington. The Claridge family had set up a food exporting business in the 1980s that they subsequently sold.

Chris Claridge decided to return to the food export industry after the February 2011 earthquake.

"My father has delivered thousands of Christchurch babies . . . we are quite passionate about mother-and-baby nutrition."

That had given the family a "natural affinity" with neonate and maternal care so they decided to focus on infant formula. They noticed there were no New Zealand brands on shelves here, so they developed the product and the branding and packaging, with help from family and consultants.

 **The Press - www.press.co.nz** on Facebook
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APPENDIX C

Transcript of "Campbell Live" programme televised on 17 July 2012



Transcript

| | | | |
|----------|--|-------------|---------------------|
| Station: | 3 | Date: | 17/07/2012 |
| Program: | CAMPBELL LIVE | Time: | 07:00 PM |
| Compere: | JOHN CAMPBELL | Summary ID: | W00049526231 |
| Item: | <p>HOST JOHN CAMPBELL EXPLAINS THAT THERE IS A SHORTAGE OF NEW ZEALAND-MADE INFANT MILK FORMULA IN THE RETAIL MARKET IN NEW ZEALAND. REPORTER KATE KING INVESTIGATES AND FINDS THAT TINS OF MILK FORMULA ARE BEING DISTRIBUTED FOR SALE OVERSEAS.</p> <p>INTERVIEWEES: BO BURNS, MOTHER; UNIDENTIFIED WORKER</p> | | |

| | | | |
|-----------|----------|------------|------------|
| Audience: | Male 16+ | Female 16+ | All people |
|-----------|----------|------------|------------|

JOHN CAMPBELL: Fonterra are world leaders in the production of milk solids. Milk solids obviously a key ingredient in many infant formula so why is it so hard to buy infant formula in New Zealand? This isn't a new question, but we believe some of the key players haven't been completely straight about this in the past and we're not talking about Fonterra.

Tonight clear evidence that the New Zealand retail market is being plundered by people who are exporting overseas, we see it happening. Nothing wrong with that, it's completely legal, but the determination of retailers to pretend it's not happening means a product made for the domestic market is frequently not available here. Why? Infant formula is readily available in the markets it's being exported to but not made in New Zealand formula. And in China in particular where four years ago contaminated milk powder made 300,000 babies sick, made in New Zealand is a very popular phrase indeed.

Kate King investigates.

REPORTER:

We're in the industrial south of Auckland. A familiar sight here, a cul-de-sac of small businesses sharing a lane way. It's two in the afternoon. Over a period of four days we observed as people, cars and trucks came and went from here. This is typical of what we saw; newspaper is being put into the bottom of the boxes and then forms are filled out. These people appear to be waiting for something. But what? A few minutes later we find out.

A woman in red arrives with more goods; boxed milk formula. Keep watching. Another box, then a single tin, then bags, supermarket bags filled with cans of Karicare milk formula. What you're watching here is not illegal, it seems to be a collection and distribution point. Those cans we saw earlier are being put in boxes, sealed up, ready to go. But go where? Bo Burns would love to know.

BO BURNS:

Oh my God. Look how much he's got. Oh my God.

REPORTER:

She's a Kiwi mum who spends half her week trawling the supermarkets trying to find formula for her baby.

BO BURNS:

Still touch and go. Like I can go in one week and there's some and then there's none. I went to three supermarkets in the weekend and finally one had it but the other two didn't have any at all.

REPORTER: We returned to the Great South Road business at night because our informants told us it was an around the clock operation. Sure enough this was 9pm on a week night and they were still working. And then we watched as entire truck loads of milk formula arrived. The pallets were stored in the warehouse, repackaged and then sent on their way. But where? Well, we followed. At first we thought the truck was heading to Onehunga Wharf but then it turned left onto the south western motorway towards the airport. Eventually the truck arrived here at Toll, New Zealand's largest logistics company. So we know it's been flown somewhere but where is the supply coming from and is it at the expense of the domestic market?

BO BURNS: I think I'm passed the angry stage because you kind of really know what's going on, it's just how are you going to stop it. I don't know how you're meant to stop something like that unless they're illegally doing it. I don't know how they're actually getting away doing that. Supermarkets aren't going to stop it and Karicare aren't going to stop it. How will it get stopped?

REPORTER: Bo's an importer so she knows the rules and how strict they are.

BO BURNS: You have to have the correct paper work and numbers and be authorised and that sort of thing so I find it hard to believe that it's going out unrecognised.

REPORTER: The milk formula is made by Karicare, owned by Nutricia which in turn is owned by international company Danone. Nutricia sells and manufactures its



products all over the world including China, but when Nutricia is made in China and carries Chinese packaging, the Chinese are suspicious of it, they want to buy cans with these words on them; made in New Zealand.

Nutricia says it has increased its production especially for export to China. They say their product goes through official controlled export channels where quality and associated guarantees are managed and they're the responsibility of their sister company Danone in China.

So what is going on here? It was time to bowl up and ask someone.

Hi there.

UNIDENTIFIED WORKER: Hi.

REPORTER: Hi, my name's Kate, I'm from *Campbell Live* TV show...

BO BURNS: Yeah, oh *Campbell Live*, yeah, yeah...

REPORTER: Yeah it's on TV 3. We were hoping we could talk to someone about the business that you run here.

The only company name we could find registered to this address was a computer firm so that's no help.

UNIDENTIFIED WORKER: We don't have to talk but we do not have to talk.

REPORTER: You're not happy to talk?

UNIDENTIFIED WORKER: Yeah, yeah. I saw the camera [indistinct]...

REPORTER: So what do you say to that then that there is lots of New Zealanders that can't get it and you have a lot of it here.

UNIDENTIFIED WORKER: Yeah that's a good question [laughs].

REPORTER: So they say they've never met their own boss and they wouldn't put me in touch. What they would say was this.

UNIDENTIFIED WORKER: The most of [indistinct] person is not [indistinct], is a supermarket.

REPORTER: The supermarket for selling it to you?

UNIDENTIFIED WORKER: Yep. If we bought it from the supermarket - because what I confused when Tristram come here, I say why are the supermarket [indistinct] which is limited to three, but here you can buy like [indistinct] a pallet if they got it from supermarket. So that - I don't know why and you see understand, it's not our problem because we pay them, right, and the supermarket has that offer. That's a bigger problem and I don't think that Nutrition [sic], the company, the milk powder company, they like it - they want the supermarket to do that...

REPORTER: They don't want the supermarkets to supply in bulk...



UNIDENTIFIED WORKER: Exactly...

REPORTER: ... to you?

UNIDENTIFIED WORKER: Exactly. But this is not our problem, we don't know why [indistinct]. I mean I believe it's not this company's problem because we paid...

REPORTER: What supermarket - they wouldn't tell me. So we rang the two big supermarket chains. Neither would appear on camera but Foodstuffs told us; they are routinely and systematically going around our stores with the specific purpose of buying the Karicare products for export to family in Asia.

We have advised our New World and PAK'nSAVE stores that supply to the domestic market is paramount and it is only a few stores which have long standing existing relationships that are continuing to sell large orders to their customers.

So they do sell in bulk.

And Progressive says; we would only consider processing larger orders when stock levels allow for it, and we are not actively pursuing bulk orders at this time.

So they're not ruling it out either.

When this issue was highlighted last year the Ministry of Primary Industries began an investigation. We asked



them where they were at and they said they continue to monitor administrative procedures and follow up on any areas of concern.

So Nutricia, Foodstuffs and the Ministry all agree this is not ideal practice, but it's not illegal. So what's being done to ensure New Zealand babies are getting the product first?

BO BURNS:

If they are wholesalers then why isn't Karicare selling to them directly as a secondary business to the supermarkets and the supermarket selling to New Zealand children like they're meant to be doing? That's really what's the biggest thing. They're meant to be selling to - a product to New Zealand families and they're not, they're pre-selling it for money or margin.

JOHN CAMPBELL:

Kate King reporting.

* * END * *

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