TATUA

The Tatua Co-operative Dairy Company Limited
Submission on

REVIEW OF THE STATE OF COMPETITION IN THE NEW ZEALAND DAIRY INDUSTRY - SUBSTANTIVE ISSUES

August 2015

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SUBMITTER

Formed in 1914, The Tatua Co-operative Dairy Company Ltd (Tatua) is one of the few dairy companies in New Zealand that has remained unchanged by merger or take-over. The Company operates as a co-operative, with 114 supplying shareholders and concentrates its business activities in the added value and higher technology sectors. The Tatua business model can be considered as being part dairy processor and part food company.

Having had a long history of trading dairy materials, including raw milk, with other New Zealand based dairy companies as part of its normal business activities, Tatua continues to take a keen interest in all milk markets. We are grateful for the opportunity to provide our unique view of market development over an extended period.

EXECUTIVE SUMMARY

1.1 A strong and functional Fonterra is vital for the ongoing economic prosperity of New Zealand, but just as importantly, vibrant independent processors are needed to ensure Fonterra performs to its potential. The safeguards provided by the existing DIRA framework have served as a valuable foundation to advance this outcome.

1.2 **Future Vision.** In this submission we provide Tatua's vision of a future state of the dairy industry and the regulatory elements we consider will be important to allow that state to be achieved. We note that the domestic competitive environment has steadily evolved over the past decade, but that with an anticipated reduction in milk growth, the level of competition at the farm gate is likely to increase in future. As this new phase of competition develops some aspects of the DIRA may become redundant and others will need to be strengthened. At present however, we certainly do not see a need for wholesale reform, but rather, for incremental adjustments to help ensure the DIRA continues to achieve the outcome of providing a level playing field for all industry participants. We contend that:

The review must consider the future state of the New Zealand dairy industry, which will be quite different from the past fifteen years where all parties have benefitted from an expanding milk supply.

1.3 **Balance Fonterra's Position.** Fonterra holds a pivotal position in the New Zealand economy that should not be inadvertently eroded by operation of the DIRA. While we note that Fonterra has continued to grow in the face of increased competition, we must be mindful of ensuring that any change to the regulatory regime continues to draw a balance between protecting the interests of the whole industry, including independents, through a competitive and efficient raw milk market, versus recognising the benefits of Fonterra maintaining a strong international presence. To achieve this outcome we contend that:

Any proposed changes to the DIRA must recognise the important role of Fonterra in the New Zealand economy and the desirability of it maintaining a strong domestic and international position over the long term.

1.4 **A Credible Milk Price.** Milk pricing is central to efficient milk market operation as it impacts on interactions and transactions at both farm and factory gate level. We have concerns with the current pricing model both in terms of how incentives to price high or low are balanced, and how revenue is accounted for. In particular, our analysis suggests that the range of legitimate market activities employed by Fonterra, both inside and outside gDT, is resulting in revenue inputs that are not fully reflective of prevailing market pricing. In the absence of credible milk pricing signals, there is a significant risk that perverse and inefficient milk supply and capital investments will occur. To improve confidence in the calculated milk price, it is our strong view that:

A new milk pricing panel must be established that operates with complete independence from Fonterra; and

The first task of the new Panel must be to commission a full and independent review of the milk pricing model. As a minimum, we would expect the review scope to address the issues identified in this submission, along with others identified by other independent processors.

1.5 **Keep the Door Open.** Open entry/exit provisions provide a critical risk management instrument for farmers contemplating switching milk supply to a new and untested independent processor. To avoid unnecessarily stifling farm gate competition, we submit that:

The existing open entry/exit provisions be retained, and where necessary strengthened, to ensure that milk purchasing schemes or similar vehicles cannot be used to circumvent the intent of the legislation.

1.6 **Factory-Gate Milk Market Remains Thin.** The scale and distribution of independent processors makes it unlikely that a viable factory-gate milk market could be sustained without participation by Fonterra. The loss of this market would deter independent processors wishing to establish in New Zealand, as well as severely disadvantage many small domestic market producers. To avoid this outcome, we contend that:

The requirement for Fonterra to supply milk under the Raw Milk Regulations be retained in full.

1.7 **Threshold Response.** Economic indices demonstrate that the New Zealand milk market remains highly concentrated, and that Fonterra is the dominant participant. While we consider this to be a positive outcome for New Zealand, it does create a set of milk market challenges that require regulatory control. This situation is unlikely to change in the foreseeable future, but should be tested through periodic review. We contend that:

Instead of setting a single trigger point, a legislative process is adopted that would trigger each time Fonterra's share of milk collection decreases by 10%, or a period of five years elapses, whichever occurs first; and

The moral dilemma associated with implementing predetermined changes in response to a threshold being met would be mitigated by changing that purpose to one of simply triggering a review where deregulation is not a presumed outcome.

PAST AND FUTURE COMPETITION IN MILK MARKETS

2.1 The Commerce Commission proposes to proceed by 'examining how competition has developed to date and may develop in the future', including specifically the 'extent to which independent processors have entered, exited and expanded, relative to expansion by Fonterra and the growth of the market'. We acknowledge this approach and take the opportunity here to outline an important future scenario for the New Zealand Dairy Industry with particular relevance to the state of competition.

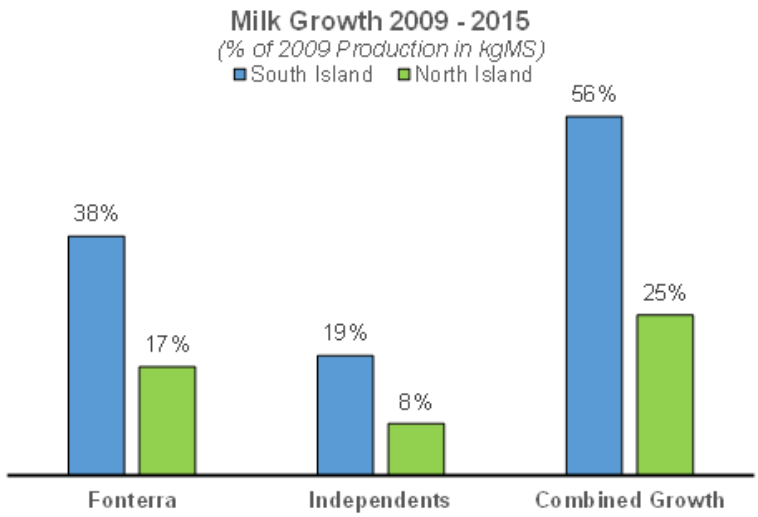
2.2 Tatua wishes to highlight that since dairy industry restructuring in 2001, competition in the dairy industry has taken place in the relatively benign context of rapidly growing milk production. However, this growth rate cannot be sustained indefinitely, and the likely future state that regulation must address is one of relatively static production and consequently much fiercer competition for raw milk. Lessons from other countries and industries suggest this could potentially bring about a retrenchment of the dairy industry through over-payments for raw milk, weakening of manufacturers' financial positions, and ultimately the consolidation of participants. We suggest the important question is how robust the future regulatory regime must be in order to provide for a sufficient state of competition for raw milk under such conditions, while at the same time not inhibiting the performance of the New Zealand dairy sector as a whole in international markets.

2.3 Since deregulation, New Zealand has experienced high growth in dairy production. Over the period 2002 – 2014 a compound annual milk growth of more than 4% has added over 690 million kilograms of milk solids. This is above the long-run historic average. Two thirds of the growth has come from the South Island, mainly in Canterbury and Southland, followed by Otago. The compound annual growth rate in the South Island has been four times (8%) that of the North Island (2%). In the North Island, most of the growth has occurred in the Waikato, with a lesser amount in the Central Plateau. Other North Island regions such as Auckland, East Coast, Hawkes Bay and Wairarapa have each accounted for less than 1% of total milk growth. Please refer to Attachment 1 for detailed figures on share of total milk production and milk growth in the dairy regions of New Zealand that we have obtained and used in our analysis.

2.4 The new independent producers are closely aligned to the regions of highest milk growth and highest concentration of milk production. This is shown in the attached table, which in order of commencement shows a clear preference. The rankings indicate relative position across the 17 dairy regions in each category.

New Independent Producer	Dairy Region	Region Size Rank	Region Growth Rank
OCD – Waharoa (2004)	Waikato	#1	#3
NZDL (2007)	South / North Canterbury	#7, #2	#4, #1
OCD – Awarua (2008)	Southland	#3	#2
Synlait (2008)	North Canterbury	#2	#1
OCD – Wanganui (2009)	Taranaki and Manawatu	#4, #9	#7, #9
Miraka (2011)	Central Plateau & South Waikato	#6, #1	#6, #3
Gardians (2012)	Otago	#5	#5

2.5 Notwithstanding the establishment of these new independent producers, Fonterra remains the dominant competitor for raw milk. Analysis of the period 2009 – 2015 shows that Fonterra has not only retained its historical milk collection volumes, but has also claimed over two thirds of all new milk growth. Independent processors have only become established and grown through winning less than a third of the total milk growth. This is illustrated in the following figure.



2.6 The New Zealand dairy industry anticipates growth of milk production to slow considerably by 2020, and to then increase only modestly in the subsequent decade. Some industry forecasts suggest that milk growth between 2020 and 2030 could be less than 1.5% per annum. There are several reasons for this shift:

a) Conversion of the most productive land will have already occurred by 2020;

b) Environmental constraints will make obtaining resource consents more challenging, and limit the rate at which they occur; and

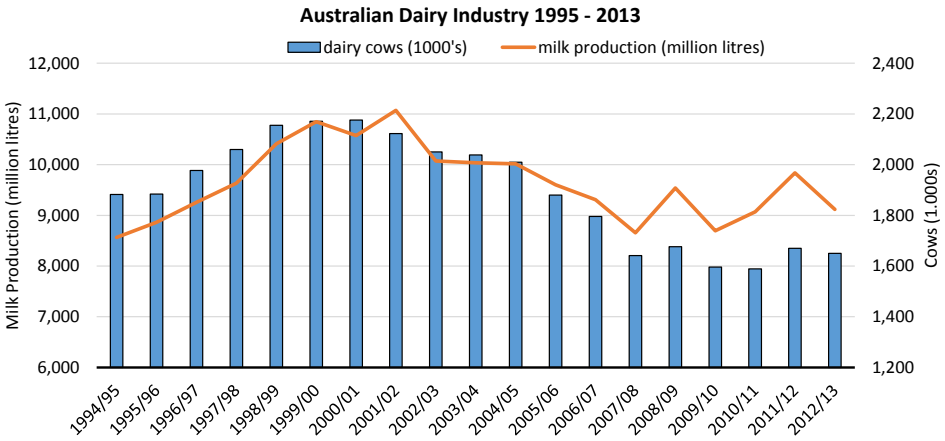
c) More recently, adverse economic conditions may force a re-think of farm intensification where this has involved heavy reliance on imported feed and unsustainable increases in the marginal cost of production.

2.7 It is possible that milk production could actually decrease in some regions, particularly in sensitive catchments where environmental outcomes from farming activity are deemed unsustainable.

2.8 The New Zealand dairy industry should anticipate that lower milk growth will intensify competition at the farm and factory gates for raw milk. This is an accepted tenet of competition theory, i.e. "In a slow growth market, companies can only grow by capturing market share from each other, which leads to increased competition"[1]. Critically for the dairy industry, low milk growth will lead to a slow-down in the influx of new capital, as well as considerable pressure to maintain utilisation of existing capital.

2.9 It is instructive to consider the Australian dairy industry, which deregulated in 2000. A sustained drought then impacted Australian milk production, which reduced by up to 10% per annum over the period from 2002 to 2008. This is shown in the figure below.

[1] Porter, M.E. (1980) Competitive Strategy, Free Press, New York, 1980. (Porters Five Forces Model)



2.10 This created intense competition for the remaining milk supply in Australia. Companies then paid a premium for milk, particularly for the period from 2004 to 2009 when the supply fell rapidly. On average, Australian dairy farmers received the equivalent of an extra NZ$0.55 per kgMS compared to New Zealand dairy farmers over this period, whereas the long-run average is close to equivalence. That in turn drained the Australian dairy processing industry of capital, and fuelled rationalisation and consolidation of manufacturing. The result eliminated many of the smaller competitors over the decade, and saw a transfer into foreign ownership of some of the larger ones.

2.11 In summary, the review of the state of competition must consider the future state of the New Zealand dairy industry, which will be quite different from the past fifteen years where all parties have benefitted from an expanding industry and new milk supply. The provisions of DIRA, particularly those which allow free entry and exit and a regulated milk price, will come under pressure. The following sections of this document deal with the relevant issues.

2.12 As a final note to this section, it is also important to reflect on global trends, particularly the consolidation of participants through merger and acquisition activity. As reported by Rabobank in its July 2014 report[2], mergers and acquisitions "have been an attractive route to growth and profitability in challenging conditions, with weak economies and supply constraints undermining sales growth in key markets". The global dairy giants Nestle, Danone and Lactalis head the list of top companies over Fonterra in 4th place. These companies are positioning in key markets such as China, forming alliances and joint ventures with the likes of emerging powerhouses including Yili (10th largest) and Mengniu (14th largest). This same pattern is reflected all over the world.

2.13 In this context, it is desirable for New Zealand to have a large dairy company that is able to participate at scale in the global market. Conversely, it could be disastrous to undermine and erode Fonterra to the extent New Zealand's production became vulnerable to predatory actions of other global dairy companies. **Therefore the regulatory regime must draw a balance between protecting the interests of the whole industry including independents through a competitive and efficient raw milk market, versus recognising the benefits of retaining a internationally strong Fonterra.**

[2] Rabobank Global Dairy Top-20: challenging conditions pave the way for acquisitions and tie-ups, Rabobank, July 2014

BASE MILK PRICE

3.1 The mechanism by which the milk price is set is absolutely fundamental to ensuring the efficient and contestable operation of both the farm-gate and factory-gate milk markets in New Zealand. A credible and transparent milk price will ensure efficient resource allocation decisions are made on-farm and in factory. Without this, there is a high probability of investment decisions by farmers and processors being sub-optimal.

3.2 If the milk price is overstated it will incentivise milk production, especially in areas where it may not otherwise happen. It will also disincentivise profit maximising firms from setting up milk processing operations in New Zealand. Furthermore, it will cause a lower investment in added value processing than would otherwise be the case.

3.3 If the milk price is understated, uneconomic competition and value add investments may be encouraged. Over time this could be expected to reduce the competitiveness of both New Zealand farms and milk processors.

3.4 Also important in the context of milk pricing, particularly for farmers and purchasers of DIRA milk, is the issue of timeliness and form of pricing information. Fonterra's current process of providing seasonal milk pricing forecasts infrequently through the 15 month period from season start to financial year end can result (and arguably has resulted) in misleading pricing signals being provided at times when there is significant market price movement. In our view, monthly publication of both seasonal price forecasts and the spot milk price would provide greater clarity, and help avoid poor investment decisions.

3.5 Along with other independent processors, we share concerns around the ability of the current Fonterra pricing model, and assumptions, to deliver an accurate and timely base milk price. These are discussed below.

Milk Price Tension

3.6 An accurate and transparent milk price is central to resolving the natural tension which exists around the objectives of various parties in relation to the milk price. Co-operatives are focused on maximising the milk price to their supplying shareholders. Conversely, private companies are incentivised to minimise the milk price (consistent with securing the milk) in order to maximise profits and share price.

3.7 Fonterra, due to its unique capital structure arrangements, is attempting to do both, but can be expected to give priority to maximising the milk price due to the governance arrangements (all farmer or related interests) of the milk price panel. In order to resolve these competing interests, in a way which maximises market efficiency, it is essential that the New Zealand milk price discovery mechanism is credible, accurate, independent, transparent and timely.

Overview of Milk Price Methodology

3.8 The methodology employed to set the base milk price for both farm-gate and factory-gate markets is a product of both logic and expedience. A representation of the methodology is outlined below, and each year the specific application of this methodology is documented in the Fonterra Milk Price Manual and the Fonterra Milk Price Statement.

3.9 The methodology and the calculation of milk price have been the subject of intense debate since 2012 when, as a consequence of Fonterra implementing Trading Amongst

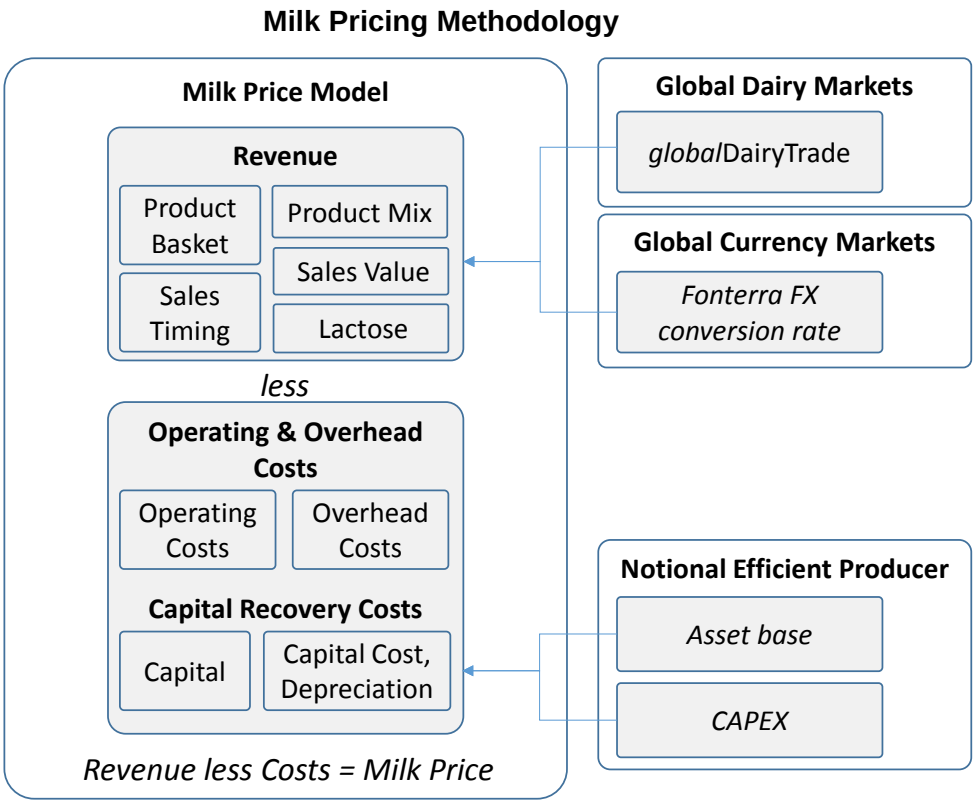
Farmers, they were enshrined in the legislation with the Commerce Commission appointed in an oversight role. As we see it, there are three issues that must be addressed:

a) The aspirations of Fonterra and related parties with respect to setting milk price;

b) The various disconnects between the logical reasoning of the milk price methodology and its practical application, particularly where this has the effect of being anticompetitive and resource allocation inefficient; and

c) The effectiveness of governance and oversight roles in restraining Fonterra's discretion in setting milk price, particularly where this differs from the mean calculated value under the methodology

The following sections deal with these in turn.



Milk Price Incentives

3.10 Separate, but related to the accuracy of this methodology are the influences on, and oversight of, milk pricing. Fonterra is influenced by both its co-operative (farmer-owned) structure and also its corporate functions.

Interest Group	Preferred Milk Price	Reasoning
Farmer members	High	To return economic surplus to the farm enterprise
	High	To lower the cost of entry (and expansion) for farmers
Fonterra 'Core' *(Collection, Manufacturing and Dairy Ingredients)*	High	To retain supply and maintain maximum throughput/asset utilisation in manufacturing and supply chain assets
	High	To deter entry of competitors and constrain existing independents by reducing the economic surplus available
Fonterra 'Value Add' *(Specialty / Fonterra Brands)*	Low	To reduce the cost of goods and thereby increase the return for brands and value-added products
Investors	Low	To increase dividends to investors in Fonterra shareholder fund units, and also thereby increase the share price
Independent Dairy Companies	Low	To lower cost of inputs (milk price), and also provide a relative advantage in competing for milk supply on price

3.11 The co-operative structure and the interests of investors have been advanced as factors which balance any tendency to over-price milk. In practice however, Fonterra Shareholder Fund unit holders have no voting rights, while Fonterra Brands is a customer of the core ingredients business. The farmer members and core corporate functions hence have predominant control over decisions which potentially result in a higher calculated milk price.

3.12 Ideally, a system of governance and oversight should remove the risk of Fonterra over-pricing milk. However, as described in the Milk Price Manual, all members of the Milk Price Panel are in some way obligated to the Fonterra board or supplying shareholders, or indeed hold a direct interest as a Fonterra supplier.

3.13 Without casting any aspersions on the members of the Milk Price Panel, it should be clear that there is a risk of bias towards the interests of Fonterra farmer suppliers (as farmers or appointees of the council) and the Fonterra board, with no balancing interests from other entities e.g. Government Agencies, Fonterra Shareholder Fund investors or independent dairy companies.

3.14 Further, the milk price calculation is a complex undertaking. It involves a multitude of assumptions and draws on information derived from selected parts of Fonterra's actual business. The technical knowledge and industry acumen required to properly scrutinise the calculation is substantial and beyond the capability of most individuals, notwithstanding the availability of expert advice.

3.15 These factors make it difficult to have confidence in the ability of the Milk Price Panel to act impartially and with full knowledge of the calculation they are responsible for. In our 2012 submission to MAF on *Proposals to Amend the Dairy Industry Restructuring Act* we noted that, given the implications on a range of stakeholder groups including purchasers of regulated milk, the milk pricing panel must be completely independent of Fonterra in order to achieve market acceptance. Our view on this point remains unchanged

Fonterra Milk Pricing Manual and Calculation Issues

3.16 The objections to the first 2012-13 Milk Price Manual were best summarised in a joint independent processors' submission[3] which criticised the 'notional producer' as unfeasible in comparison to both Fonterra and Independents. Respectively, they concluded the notional producer would outperform Fonterra's commodities business by 33 to 50 cents per kgMS, and an efficiently run independent processor by 45 cents per kgMS. A summary table of the rationale is shown below highlighting how the notional producer selects the best of each area:

Characteristic	Notional Producer	Fonterra Commodities	Independent Processor
Very High Yield	✓	×	×
Optimised Output Mix	✓	×	✓
Lean Selling and Admin Costs	✓	×	✓
Economies of Scale	✓	✓	×
Low WACC	✓	✓	×

Source: Milk Price Manual and Deloitte Analysis circa 2012

3.17 This continues to be a major theme in subsequent reviews, although submissions on these have tended to become narrower and focused on specific technical objections. One of the ongoing frustrations for independent processors and analysts is the reluctance of Fonterra, on the grounds of protecting commercially sensitive information, to release any detailed breakdown of operating costs, selling costs and other administrative costs.

3.18 Another contentious issue is the definition of the notional producer. The argument revolves around how that marginal producer should be constructed – i.e. does it represent the 'next' new entrant, or some other definition? These arguments are academic, but material to the construction of the milk price model.

Recognised Issues with the Revenue Model

3.19 The revenue model has been criticised for the construction of a basket of reference products that does not reflect New Zealand's actual dairy production, but instead more closely aligns to the competitors of Fonterra. Fundamentally, the consideration of this issue, as well as price realisation, reveals the absolute reliance of the methodology on gDT-traded products for benchmarking. Also, in absence of notional production plans and sales phasing data, there is a heavy reliance on Fonterra metrics. Finally, there is a sense that the notional competitor assumes relatively high yield assumptions (i.e. little waste or loss).

Issue	Milk Price Manual	Issue and Resolution
Reference Basket	Selection of the Reference Basket comprising standard specification commodity product manufactured from four 'base' milk powder streams, comprising four combinations of WMP, SMP, Butter or AMF, and BMP.	Justified on the basis of these being most widely traded commodities. Challenged in 2012 (unsuccessfully) as not being reflective of actual NZ production, and hence potentially creating a structural variance with actual earnings. Fundamental issue with absence of information on which to extend the basket as only a limited range of products are traded on gDT.

[3] Joint Submission to the Primary Production Select Committee; Open Country, Synlait, Miraka, April 2012

Issue	Milk Price Manual	Issue and Resolution
Production Plan	Weighting of milk volumes into the reference basket products being based on Fonterra's product plan (2012).	No practical means (in 2012) of determining what an alternative appropriate notional production plan should be.
Sales Phasing	Model aligned to actual Fonterra sales phasing for reference products	Noted potential for retrospective optimisation. Ruled that these should be phased on a prospective basis only, i.e. not able to be optimised retrospectively (2012).
gDT Sales	Prices for reference products determined from actual Fonterra sales. Interpreted as license to only use gDT data as basis for this, not the total sales result.	Endorsed use of gDT on the basis this provides transparency (i.e. gDT data publicly available), as well as appropriate incentives for parties to maximise sales value outside of gDT. Unable to resolve issues arising from lack of knowledge of product differentiation (off-gDT sales), or implications of using shipment month versus contract month (2012).
Product Yields	Yield assumptions reflect actual milk composition and reasonable provisions for manufacturing tolerances and losses of milk in the production process.	Some debate over practical feasibility of yield assumptions, with conflicting evidence presented. Identified need for expert advice in review (2012)
Implicit hedging	Sales and FX are based on Fonterra's data	The milk price is inherently aligned to Fonterra's behaviour, whereas independent producers may be out-of-phase with these timings and hence have a real variance versus the regulated milk price. This volatility carries an inherent risk premium (cost) for independents (2014, unresolved).

Recognised Issues with the Operating and Overhead Costs

3.20 One of the major issues apparent in operating and overhead costs is the difficulty in establishing independent benchmarks, and the consequent reliance on actual Fonterra performance data. This results in cost improvements being passed to the milk price, rather than to the dividend. It also, in the view of the Commerce Commission as expressed in its reports, weakens the incentives for cost improvement. However, it is an expedient and practical solution, which is deemed to have only minor drawbacks in the overall scheme.

Issue	Milk Price Manual	Issue and Resolution
Milk collection costs	Uses Fonterra's actual milk collection costs as basis for calculation. Thus includes scale advantages.	Use of Fonterra's actual milk collection costs does not actively incentivise Fonterra to minimise the same, and is inconsistent with notional producer concept i.e. smaller scale. Absence of feasible alternative benchmarks cited as reason for retaining this rule (2012).
Milk collection assets	Uses Fonterra's actual milk collection costs as basis for calculation. Thus includes scale advantages.	Use of Fonterra's actual milk collection costs does not actively incentivise Fonterra to minimise the same, and is inconsistent with notional producer concept. i.e. smaller scale No change to manual (2012).
Variable Mfg Costs - Energy	Uses Fonterra's budgeted average unit rates	Creates incentives for Fonterra to operate efficiently. Retained (2012).
Variable Mfg Costs - Packaging	Uses Fonterra's actual average unit rates	No incentive for efficiency, but not regarded as material in the larger scheme. This position to be reviewed.

Issue	Milk Price Manual	Issue and Resolution
Variable Mfg Costs - Other	Uses Fonterra's budgeted average unit rates	Creates incentives for Fonterra to operate efficiently. Retained (2012).
Supply Chain Costs	Uses reference to Fonterra's actual costs: freight costs, storage costs, minor supply chain costs and supply chain overheads costs.	No incentive for efficiency. Ruled that an independent benchmark is more appropriate, but in this instance not material. To be reviewed (2012).

Recognised Issues with Capital Recovery Costs

3.21 The main concerns raised in this area have been with the potential for over-optimisation of assets in the model, and with the inclusion of risk premiums for asset stranding in the asset beta. While the first issue is considered resolved, the beta remains contentious and methodological changes have occurred every year.

Issue	Milk Price Manual	Comment / Resolution
Adjustments for amendments to RCPs	Manual simulates consequences of adjustments to reference commodity products (RCPs) manufactured, resulting in stranded assets.	Stranded assets may be caused by changes in the reference commodity products, or milk supply. Distinction made between different causes of asset stranding in the accounting of costs (2012)
WACC – stranded assets, surplus capacity	Milk Price model WACC (beta) incorporates a provision for the risk of having stranded assets in event of milk supply shortfall.	Inconsistency noted between beta risk provision and model also continuing to account for depreciation of stranded assets. Ruled that beta should not generally include an allowance for all asset stranding risks (2012).
Capacity matching (shortfalls)	The model adjusts peak capacity to match peak milk supply	Underlying concern that notional assets may be over-optimised and relevant operating costs may not have been adjusted upwards to reflect the implicit optimisation. Unresolved in 2012, but in 2013 determined that the issue was not significant.
Asset Beta	Asset beta incorporates a provision for 'relative performance risk' between Fonterra and the notional efficient producer	Estimation of the asset beta should be specified in terms of the exposure to systematic risk, rather than the exposure to stranded asset risk (2012), but noting the issue remains contentious.
Debt Premium	Originally based on USD debt plus provisions for conversion and issuing costs.	Potentially understated debt premiums. Methodology now makes additional provisions for costs (2012).
Depreciation	Different treatment of tax vs. economic depreciation	Potentially overstates tax depreciation versus the actual asset profile of the notional producer (2014, unresolved).
WACC	WACC has reduced in the 2015 season	Inconsistent with normal practice (2015, unresolved).

Unrecognised Issues with Reliance on Global Dairy Trade

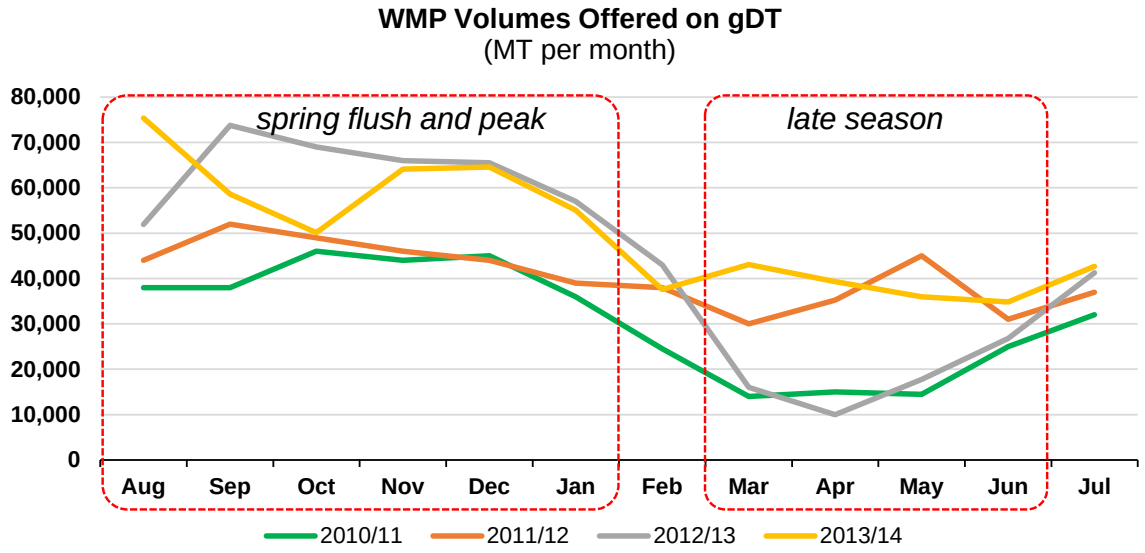
3.22 The biggest 'lever' in the calculation of the milk price is the revenue section. The key issues revolve around how reliable the Global Dairy Trade auction (gDT) is as a measure of true market prices. Tatua is concerned that reported gDT prices suffer from two potential distortions:

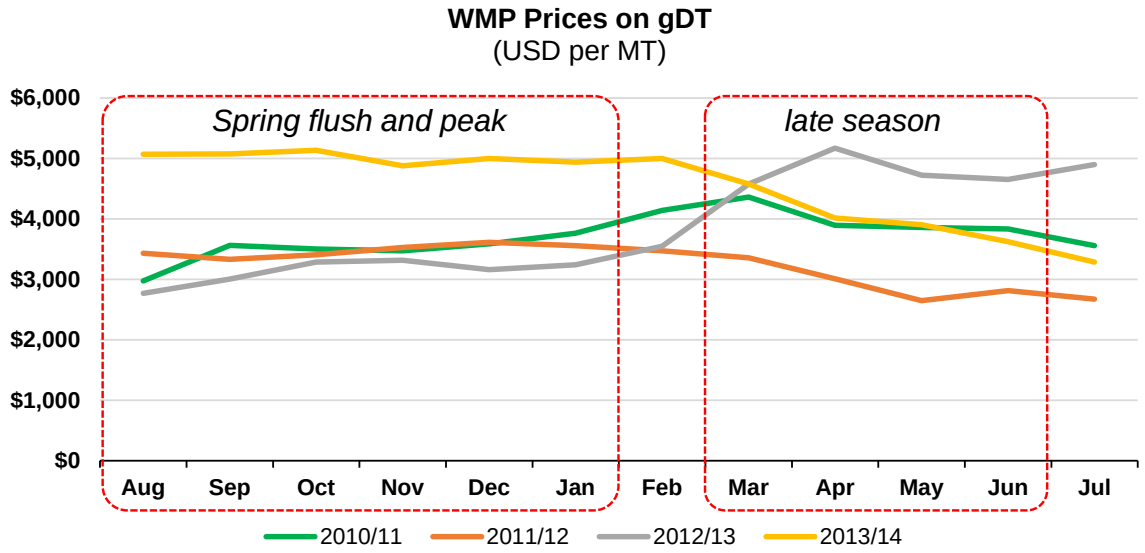
a) **Conduct of gDT Participants:** That observed behaviour of participants on the gDT platform during critical market phases indicates significant management of volumes offered.

b) **Contract Execution Risk:** Where high volumes are offered on falling markets there are significant questions about the ability of the parties to then execute those gDT contracts at the agreed price. This is material to the milk price calculation.

Conduct of gDT participants

3.23 The gDT participants appear to actively use volume offered on gDT as a market management tool. This is evident in observations of the volumes offered across each season. Comparing seasons, the volume of WMP contracts offered within a calendar month may vary by as much as 30,000 to 35,000 MT. The historical data is outlined below.





3.24 The above chart illustrates that the volumes offered in the late season period (March to June) for the 2011-12 and 2013-14 seasons were substantially higher than the volumes offered in the same periods for the 2010-11 and 2012-13 seasons. To better understand this observation, we suggest consideration of the price trends for those respective seasons. The seasons with high volumes offered had both commenced with reasonably high and stable prices through the peak, which then began to fall quickly through the late season. In comparison, the seasons with relatively low volumes had commenced with relatively low prices that then rose through the first part of the season from up until March or April. These are highlighted in the table below.

Season	Average WMP monthly price change Aug to Feb *US$ per MT*		Average WMP monthly price change Feb to Jul *US$ per MT*		WMP Volume Offered Mar to Jun *MT*
2010-11	+$194	**firm**	-$117	weak	**68,423**
2011-12	+$7	stable	-$160	weak	140,750
2012-13	+$130	**firm**	+$270	firm	**69,409**
2013-14	-$11	stable	-$343	very weak	152,133

3.25 One explanation for this observed trend is that where the market has been firm throughout the first part of season (i.e. 2010-11, 2012-13), selling will have been robust and there is less pressure to clear large volumes of product. Hence there is scope for the major participant on gDT to reduce auction volumes and instead focus on servicing key accounts and higher value opportunities. This also has the effect of constraining gDT and assisting in sustaining higher prices. Conversely, where market prices have been high in the early season, but showing signs of weakness and selling has been soft (i.e. 2011-12, 2013-14), then this will have left significant stock to clear in the latter phase of the season. In that case, gDT appears to have been used as a placement option for significant volumes despite the risk of this exacerbating the problem.

gDT "Contract Execution" Risk

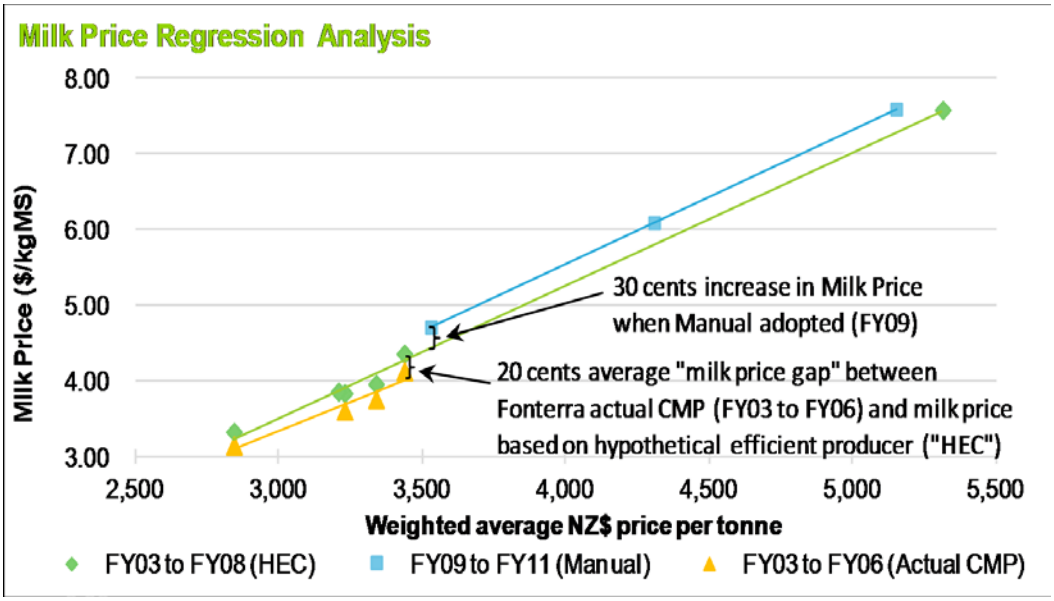
3.26 There is a further, significant effect of product volumes placed on gDT that has direct relevance to the use of gDT as a basis for the milk price calculation. Where increased gDT volumes are placed on a falling market we suggest that questions arise around contract execution. It is sometimes necessary and practical in a commodity export trade, despite already having an agreement for sale, to renegotiate terms on the invoicing (shipment) date. This case usually arises when the market price has fallen since the original terms were reached, and where there is no shortage of the commodity. The question facing the seller is whether they would prefer to be left holding the material with no sale, or to execute the contract at a lower price.

3.27 This is a material question in the case of gDT. For example, comparing the periods from March to June in 2014 (falling market) with those of the March to June 2013 (high price), an additional 82,300 MT was placed on gDT through that 2014 period. On average, the price of WMP was dropping over US$300 per MT every month. If all this additional volume had to be renegotiated on shipment and invoicing to match the actual price on shipment, then this would have reduced the actual gDT revenue for WMP by US$50 million over the period (versus what was apparent in the published gDT result). With total annual sales of WMP on gDT for the 2013-14 season of approximately 585,000 MT, this would amount to an average difference of US$87 per MT across that whole season.

3.28 We estimate that for wholemilk powder alone, this had the potential to inflate the calculated base milk price by NZ$0.14 per kilogram of milk solids in the 2013-14 season. If that price effect is then applied to all the products in milk price model, the difference is $0.21 per kilogram of milk solids. This is a significant variance. Clearly, knowledge of actual contract execution at the recorded gDT price is necessary to have confidence in the use of gDT price data. This would require a full audit of all gDT contracts post shipment date.

Systematic Inflation of the Calculated Milk Price

3.29 This is essentially the inductive analysis presented in earlier submissions that compares the weighted value of dairy commodities versus the calculated milk price, and thereby demonstrates that over time each new methodology has inflated the calculated milk price above its true value. The original analysis[i] showing a $0.50 differential is outlined in following figure:



The Effect of Fonterra Over-riding the Calculated Milk Price

3.30 At the close of the 2014 season, the Fonterra announced a final Farmgate Milk Price that was 53 cents per kgMS lower than the price calculated under the Farmgate Milk Price Manual. As declared in the Annual Report:

The Board exercised its discretion under the Constitution in order to protect the Co-operative by paying a lower Farmgate Milk Price than the price calculated under the Farmgate Milk Price Manual which would have required borrowing.

NZMP EBITDA	**2013** *$millions*	**2014** *$millions*	**2014 Re-adjusted** *$millions*
Revenue	13,917	18,041	18,041
COGS	12,666	17,011	17,851
Segment gross profit	**1,251**	**1,030**	**190**
Selling and marketing expenses	-89	-105	-105
Distribution expenses	-188	-184	-184
Administrative and other operating expenses	-615	-671	-671
Segment operating expenses	**-892**	**-960**	**-960**
Other income, losses and adjustments	135	199	199
Segment earnings before finance costs and tax	**494**	**269**	**-571**
Depreciation	-320	-323	-323
Amortisation	-68	-75	-75
EBITDA	**882**	**667**	**-173**

3.31 As illustrated in the above table, if the Farmgate Milk Price had been set at $8.93, instead of $8.40, the total cost of milk would have been inflated by $840 million. As profit for the year was only $179 million, this would have driven the whole business into a loss position, not just the NZMP business.

3.32 While the motivation behind ignoring the milk price manual is evident, what it reveals is a fundamental issue with what the milk price is meant to be. Clearly, it is not aligned to the actual value of milk in Fonterra's business, and in the one instance where there has been a significant deviation which placed the business at risk then the Fonterra board has been able to exercise discretion and adjust the value. This ability to deviate from the calculated price has two effects:

a) There is a reduced risk premium for Fonterra in regards to the milk price; and

b) Fonterra has no incentive to re-align the milk price calculation imposed on the rest of the industry to better approximate some sustainable value.

3.33 Unfortunately for other competitors in the New Zealand dairy industry, they do not enjoy that privilege. Where their businesses are not aligned to the milk price in any given year, the result is either windfall gains or losses, depending on which direction the milk price has taken. The resultant volatility in earnings carries a real cost to their businesses.

3.34 Should the milk price calculation give rise to an inflated milk price this would have the effect of making it:

a) **Anti-competitive** in the sense that it raises the barrier to entry for any new firms by reducing the available economic surplus, and hence reduces the incentive to enter the market. In particular, a new firm must be able to survive entry and start-up which is potentially more challenging than continuing an existing operation. Some examples of anticompetitive behaviour are provided in paragraphs 3.36-3.38 below.

b) **Inefficient** in the sense that it allocates profits from the processing and marketing business to the farm business. This has the effect of promoting the farm business, resulting in more milk being produced than would otherwise be the case, and more commodity processing assets being built to process that milk. It also reduces the incentive to invest in added value products. Ultimately, it leads to inflation of farm land and asset values above what is otherwise reasonable. In turn, that can lead to the conversion of land-use into otherwise 'uneconomic' or 'marginal' dairy farms. This incentivises milk production in marginal areas and works against the industries goal to make dairying more environmentally sustainable.

c) **Detrimental** to the dairy industry as it removes economic surplus available for reinvestment in research and innovation. This is potentially implicated in New Zealand's low investment in 'value-add' research, product development and marketing.

3.35 **Given the importance of milk pricing to all milk markets and the significant potential for market distortion where the calculated milk price is not accepted as credible, it is our strongly held view that:**

a) A new milk pricing panel must be established that operates in complete independence to Fonterra; and

b) The first task of the new Panel must be to commission a full and independent review of the milk pricing model. As a minimum, we would expect the review scope to address the issues identified above, along with others identified by other independent processors.

Nothing short of this level of impartiality and scrutiny will provide independent processors and others with confidence in both the process and the milk price outcome.

Anticompetitive Price Behaviour

3.36 Fonterra first engaged in tactical pricing in 2007-08 with offers of un-shared contract supply and a premium over the normal contract price. These offers were made on a case-by-case basis in Southland and parts of Waikato and Canterbury where competition was intense. It provoked a negative reaction from existing shareholders who were not offered tactical pricing, and this eventually lead to its withdrawal, but the action was found to be acceptable by the commerce commission:

"In the commission's view, Fonterra's tactical pricing scheme is unlikely to breach the Commerce Act," said Deborah Battell, director of competition.

"In this instance, the commission considers that Fonterra's behaviour is consistent with what can be expected in competitive markets," said Ms Battell.

This sets a precedent for Fonterra, where the only real hurdle is making differentiated pricing acceptable to its own shareholders. It also sets a high hurdle for any other party to prove such a practice is predatory.

3.37 Fonterra's latest farm-gate pricing innovation is a Guaranteed Milk Price (GMP) scheme to give farmers more certainty in their milk price. The scheme allows farmers to lock in a milk price announced at the beginning of a season for up to 75% of their milk supply. This was piloted in the 2013-2014 season, and is essentially a book-build where suppliers bid for volumes at different price levels. In the current round, the scheme was significantly over-subscribed at a GMP of $5.25 (equivalent to the opening forecast Farmgate Milk price for the 2015-16 season), but all offers below that level were accepted by Fonterra. The total volume in the scheme for the 2015-16 season is 40 million kgMS. This scheme seems unlikely to breach the Commerce Act, given the 2008 decision.

3.38 However, farmer suppliers without access to the scheme are likely to bring strong objections to its use, especially as in the 2015-16 season it will almost certainly provide an advantage to the relative few that have participated. As with the 2008 tactical pricing scheme, it will therefore be internal pressure rather than regulatory intervention that resolves the matter.

FARM-GATE MILK MARKET

Open entry

4.1 Immediately prior to the formation of Fonterra, there were four major milk processors operating in New Zealand. With the exception of Tatua, these tended to operate in distinct areas of the country, separated by geographical features. This resulted in only limited competition for milk supply at the collection margins. One consequence of this arrangement was that the vast majority of milk producers were limited to supplying only one milk processor.

4.2 Over the years since Fonterra's formation, the establishment of several independent processors has increased the processor options for milk producers, although these have tended to be both spatially and temporally limited, with particular focus on districts with significant milk growth through land conversion. Given the economic and logistical implications of collecting milk from farms scattered over a wide area, most processors will aim to concentrate milk supply around a processing site. With this in mind, we do not contemplate a significant increase in the distribution of farm-gate competition in the foreseeable future and believe that any attempt to legislatively achieve that outcome is likely to be detrimental to the industry.

4.3 We are aware that, in some cases, conversion of ecologically marginal land to dairying may have been supported by the certainty provided by Part 2 s73 of the DIRA requiring that Fonterra accept supply, even if that milk supply ultimately went to an independent processor. However, we note that this is balanced by the ability Fonterra to not accept milk pursuant to Part 2 s74(2) of the DIRA where applicable terms of supply, including environmental requirements, are not satisfied.

4.4 From our observation of dairy industry developments over the past 15 years, we consider that the primary benefit afforded by open entry is that it provides a level of risk management to those milk producers who choose to switch supply to a new and untested independent processor. Should the new processor not perform as expected, or the relationship fail for some other reason, the farmer has the certainty of being able to return to Fonterra. We are in no doubt that this has been an important enabler for the establishment of many new entrants, and given the limited alternative supply options available, should be retained.

4.5 We submit that the risk mitigation provided by open entry is an important element in promoting farm-gate competition, and as such, must be retained.

Open Exit

4.6 A credible and transparent Fonterra farm-gate milk price is the primary means of ensuring that competitors can establish and operate in an industry dominated by a single processor. But also important in enabling competitors to establish or expand, is the ability of milk producers to switch supply if they so choose, without facing an unreasonable financial or administrative burden.

4.7 Over the past two years, Tatua has taken on additional supply, resulting in 9% of milk currently collected being sourced from farms that were previously supplying Fonterra. During this period we were not made aware of any problems encountered by those farmers switching supply. This provides us with a level of confidence that that provisions of Part 2 s97-109 of the DIRA are operating as intended.

4.8 Notwithstanding the above, we note the emergence of milk collection schemes such as mymilk™ that are backed by Fonterra, enable it to offer supply arrangements to that fall outside of the Fonterra co-operative structure. We are concerned that the use of such vehicles has the potential to undermine the intent of DIRA Part 2 s106 & 107 in particular, and create barriers to exit that are not contemplated by the current legislation.

4.9 **In our view the open exit provisions of the DIRA have largely achieved their intended purpose to date, and we would be concerned at the potential negative consequences if the protection they afford were removed. We submit that the existing open exit provisions be retained, and where necessary strengthened, to ensure that milk purchasing schemes or similar vehicles cannot be used to circumvent the intent of the legislation.**

FACTORY GATE MILK MARKET

5.1 As noted in Tatua's February 2012 submission to MAF on its *Proposals to Amend the Dairy Industry Restructuring Act*, Tatua had a long history in trading milk and milk components with other dairy processors prior to deregulation. While the scale of these trades was small in national terms, they were nonetheless important in ensuring the efficient operation of dairy processors within the Waikato and neighbouring regions.

5.2 With the exception of milk supplied under the DIRA Regulations, the factory-gate market was largely extinguished with the formation of Fonterra. Opportunities for trade were limited due to the absence of willing trade partners and an inability to negotiate economically efficient pricing in a non-competitive market. Over the past several years, and with the emergence of other independent processors in the Waikato, we are beginning to see a re-emergence of trade opportunities. We currently have trading relationships with Fonterra, Miraka and Open Country Dairy.

5.3 Tatua purchased milk from Fonterra under the DIRA Regulations over a 13 year period from 2001 to 2014. In 2013, in anticipation of the cessation of DIRA milk availability, we initiated discussions with Fonterra for supply of milk outside of DIRA for a period commencing in 2014 and extending beyond 2016. The offer received in return made it clear to us that Fonterra had no serious interest in participating in a non-regulated raw milk transaction.

5.4 While Tatua's decision to purchase DIRA milk was to help offset the trading opportunities that were lost with the formation of Fonterra, it is our view that, for other independent processors, it has been a primary establishment enabler.

5.5 Given relatively small scale and geographic distribution of independent processors, and that many are single site and largely focused on processing on a seasonal milk supply curve, we do not believe that a viable factory-gate milk market could be sustained without participation by Fonterra. This leads us to the inescapable conclusion that, in the absence of regulatory control of milk supply, the factory-gate milk market as it is, would fail, leaving manufactures for domestic supply vulnerable, and potential start-ups excluded.

5.6 We are nonetheless mindful that if Fonterra's share of milk collected in New Zealand falls to 50 – 70% (refer paragraph 6.7 below), the requirement for Fonterra to provide factory-gate milk would lessen. This is something we would expect to be considered in future reviews.

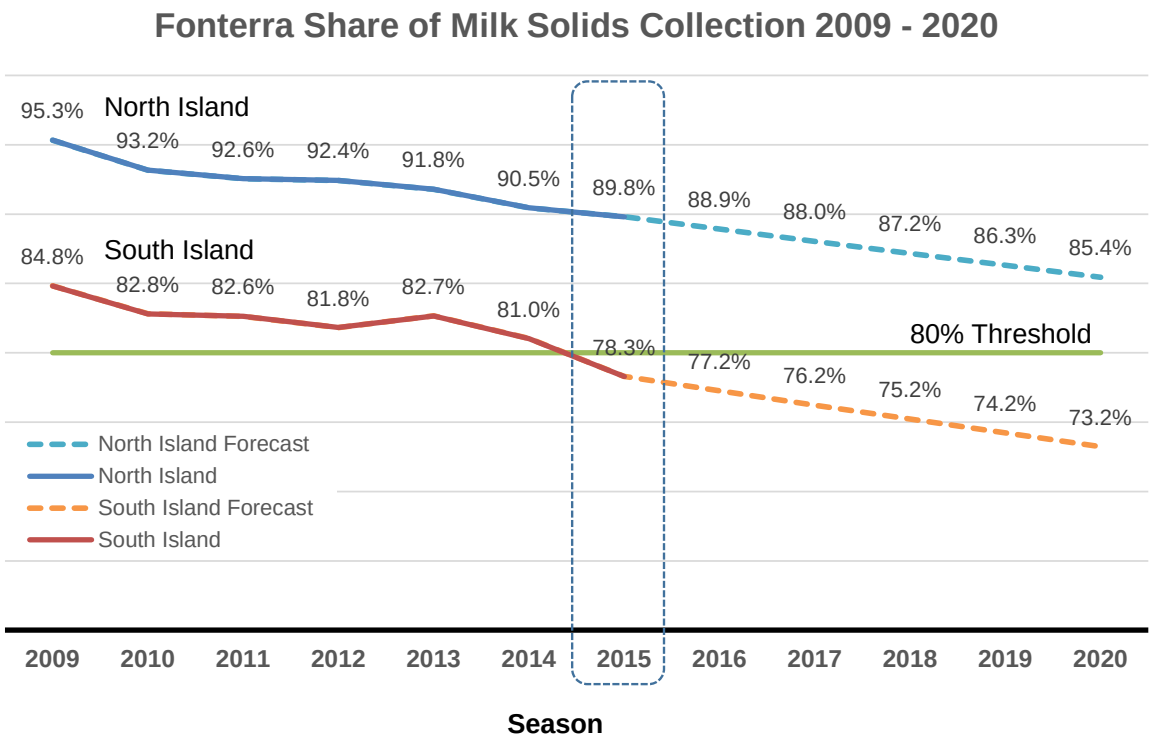
5.7 **The ongoing provision of raw milk under the Raw Milk Regulations is currently pivotal to the effective operation of the factory-gate milk market, both in terms of satisfying the needs of domestic market manufacturers, and to provide pathway for independent processors wishing to establish in New Zealand. Tatua submits that the requirement for Fonterra to supply milk under the Raw Milk Regulations be retained in full. Tatua also note that this requirement is time bound, and as described in 5.6, future situation dependent.**

DIRA THRESHOLDS

Current Milk Collection Share versus Thresholds

6.1 Primary Industries Minister Nathan Guy recently confirmed that the current DIRA threshold for the South Island was reached at the conclusion of the 2014-15 season when Fonterra's share of milk solids fell to 78% i.e. independent processors now collect 22% of South Island milk solids. For the North Island, Fonterra's share of milk collected remains above the threshold at around 90%.

6.2 The figure below shows an extrapolation of the past seven years historical trends to 2020. This suggests the North Island will not breach the threshold in the foreseeable future.



Threshold Set Points and Actions

6.3 In considering the appropriateness of a review trigger level we note that in addition to the market share held by Fonterra, it is important to consider the overall market structure, and in particular, the relative size (and therefore market power) of competitors.

6.4 Leading into the 2001 dairy industry restructure, mergers of regional co-operatives had reduced the industry to just four main participants in terms of raw milk collection and exports: Kiwi Co-operative Dairies based in Taranaki, NZ Co-operative Dairy Co based in the Waikato, Westland Milk products and Tatua. The first two comprised approximately 96% of the industry, and were of similar size. The formation of Fonterra lead to a significant concentration of market power.

6.5 To assist in illustrating past and current states of dairy industry competition we have utilised two commonly used indices, the Herfindahl–Hirschman Index (HHI), and Kwoka's dominance index. These have been applied to:

a) The New Zealand dairy industry in 2000 (pre DIRA), 2001 (immediately post DIRA) and 2015 (refer to Attachment 2 for estimated 2015 milk production data);

b) The 2014 New Zealand meat processing sector (beef and lamb) - as a closely aligned primary industry reliant on procurement; and

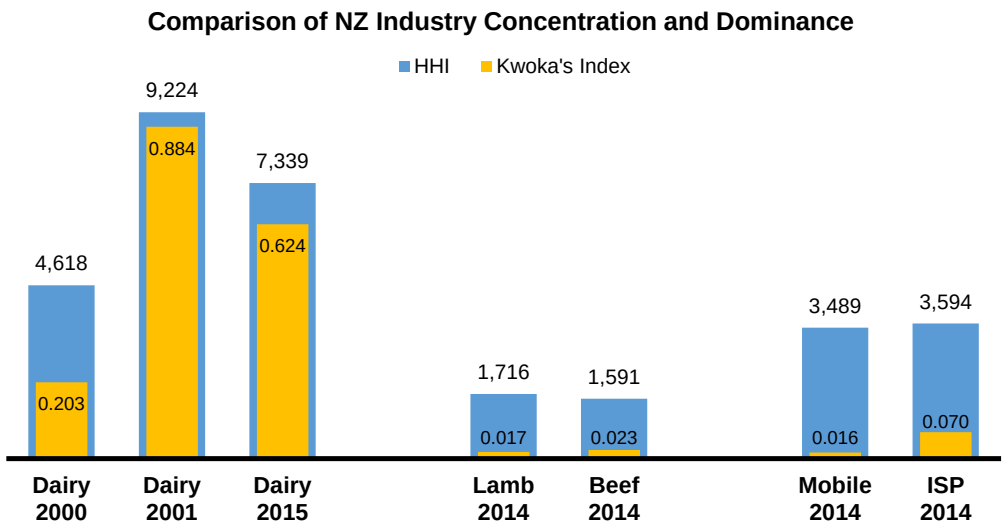
c) The 2014 telecommunications sector (mobile and internet service providers) - as a regulated market under regular scrutiny by the Commerce Commission.

6.6 The output of this analysis is shown in the figure below where we see that:

a) The formation of Fonterra in 2001 virtually doubled the HHI from an already concentrated market to approach the maximum level of concentration. Similarly, Kwoka's index for dominance more than quadrupled, reflecting the substitution of two similar-sized firms with a single, dominant one.

b) Over the 15 years subsequent to the formation of Fonterra, both indices show a decrease in market concentration and dominance, but remain significantly higher than the pre DIRA situation. This outcome is aligned with Tatua's observations of factory-gate milk market evolution over time, where we have seen an increase in opportunities to trade and a greater willingness by Fonterra to consider commercial opportunities.

c) In comparison to both the meat and telecommunication industries, the dairy industry remains highly concentrated. We note, however, that in our view the high level of disaggregation in the meat industry evident in this comparison is arguably destructive to its interests, and as such we would be concerned if the regulatory framework resulted in the dairy industry reaching that point.



6.7 By any of the above measures, the economic indices demonstrate that the New Zealand milk market remains highly concentrated, and that Fonterra is the dominant participant. This is consistent with Tatua's November 2010 submission to MAF on the *Dairy Industry Restructuring (New Sunset Provisions) Amendment Bill*, in which we suggested that Fonterra's share of milk collection would need to fall to at least 70% (but in all probability closer to 50%) of New Zealand's milk collection before its monopoly power would be at a level where removal of regulation could be contemplated. Our position on this point remains unchanged.

6.8 **We are in no doubt that at 80% milk collection share, the current threshold for winding back of DIRA protections is too high. We nonetheless recognise that New Zealand dairy markets will evolve and that over the longer term changes to the DIRA will be needed to ensure milk markets continue to operate as efficiently as possible. To this end we submit that instead of setting a single trigger point, a legislative process be adopted that would trigger each time Fonterra's share of milk collection decreases by 10%, or a period of five years elapses, whichever occurs first.**

Action when Trigger is Met

6.9 The use of trigger levels to evaluate the effectiveness of current regulations and assess the appropriateness of any move toward deregulation is an important facet of the DIRA. In our view, however, a milk collection share trigger on its own is an unreliable and problematic measure.

6.10 Firstly, as discussed above, the simplistic measure of milksolids collected fails to recognise the structure of milk markets, including the number and relative size of competitors, and is therefore unlikely to be useful for estimating market dominance.

6.11 Secondly, the inherent purpose of the threshold in triggering deregulation creates a moral hazard around the level at which the threshold is set, where affected parties that would benefit from deregulation will lobby for resetting the trigger at some higher level of market share or some other alternative that would accelerate deregulation. Similarly, parties with an opposite motivation will lobby the reverse.

6.12 **Tatua submits that concerns associated with a single threshold would be mitigated by changing that purpose to one of simply triggering a review where deregulation is not a presumed outcome.**

Possible Regionalisation of DIRA Thresholds

6.13 The Commerce Commission has signalled its intention to consider the state of competition in regional farm-gate and factory-gate milk markets. We understand this will consider more closely the geographic boundaries of the relevant markets as part of the investigation. We understand the motivation to bring greater granularity to the understanding of competition. However, we caution both the accuracy of such analysis and also the risks inherent in any move towards regionalising the regulation.

6.14 Current regulation considers a separate market share test across each of the North and South Islands. We understand that application of this test doesn't consider the transport of raw milk and milk components (e.g. lactose / permeate) between Fonterra's North and South Island sites, which occurs for the purposes of optimising operations. However, the practice naturally creates a divergence between the regional farm-gate share and the regional factory-gate share where raw milk is transported across regional boundaries. This inter-regional transport occurs at even greater scale between the sub-regions of the North and South Islands. We caution that a proper analysis of this normal business practice will potentially be complex and the outcome in any period inherently subject to the operational decisions of Fonterra.

6.15 In terms of applying a more granular market share test, the dominant role of Fonterra is also relevant. Fonterra has virtually unchallenged dominance in some regions adjacent to other regions where independent producers are established. Regionalised market share tests could incentivise the management of raw milk movements to achieve particular

outcomes, and otherwise encourage Fonterra to exert considerable influence in one region at the expense of others.

6.16 On a practical level, given the quantity of inter-regional milk movement that is already occurring, we are also concerned that any attempt to regionalise the regulatory framework would result in significant legislative complexity, and necessitate active policing of the boundaries.

6.17 Tatua is also concerned that any regionalisation of the regulations would lead to differentiated milk values across regions. Tactical pricing, where some farmers are preferentially offered higher payments, has previously been employed by Fonterra to compete for milk, and the recent emergence of mymilk™ is another example of this behaviour. Fonterra's dominant position across multiple regions would afford it the opportunity to employ such tactical pricing to the disadvantage of both independent producers and also those farmers in 'captive' regions who would effectively be subsidising the action. We note that this would be entirely counter-productive to the goal of competitive and efficient markets.

6.18 **We are not convinced that any move to regionalise DIRA would enhance the efficiency of either the farm-gate or factory-gate milk markets. On the contrary, such a move could reduce market value through inefficient farm-gate milk pricing and suboptimal milk processing facility placement. We submit that the current North and South Island application of the DIRA be maintained.**

Tatua is grateful for the opportunity to comment on the above issues. Our views are provided in the spirit of co-operation which has characterised all dealing between Tatua and the New Zealand Government. We would welcome the opportunity to meet with the Commerce Commission to further discuss any aspect of our submission.

Stephen B Allen
Chairman of Directors

Paul D McGilvary
Chief Executive Officer

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ATTACHMENT 1: MILK PRODUCTION SHARE AND SHARE OF GROWTH

Region	Share of Milk	Milk Growth 2002-2014	Share of Growth 2002-2014	CAGR
Northland	5%	8.7	1.3%	0.9%
Auckland	2%	-3.2	-0.5%	-0.7%
Waikato	23%	95.3	13.8%	2.2%
Bay of Plenty	4%	16.2	2.3%	2.1%
Central Plateau	5%	33.9	4.9%	3.8%
Western Uplands	1%	6.6	1.0%	5.8%
East Coast	0%	0.1	0.0%	0.5%
Hawkes Bay	1%	7.1	1.0%	4.6%
Taranaki	10%	27.0	3.9%	1.3%
Manawatu	4%	19.2	2.8%	2.3%
Wairarapa	3%	8.6	1.2%	1.3%
North Island	**58%**	**222.1**	**32.1%**	**2.0%**
Nelson/Marlborough	2%	7.2	1.0%	2.1%
West Coast	3%	23.9	3.5%	5.0%
North Canterbury	14%	178.0	25.7%	10.0%
South Canterbury	5%	64.9	9.4%	10.8%
Otago	5%	48.3	7.0%	6.0%
Southland	12%	130.8	18.9%	7.6%
South Island	**42%**	**458.5**	**66.3%**	**8.0%**
New Zealand	**100%**	**691.3**	**100.0%**	**4.0%**

ATTACHMENT 2: ESTIMATED MILK PRODUCTION DATA

Dairy Company	2000 share %	2001 share %	2015 000 kgMS	2015 share %
Kiwi	49.0%	-		
NZCDC	47.0%	-		
Fonterra		96.0%	1,613,000	86.2%
Open Country			100,000	5.3%
Westland	2.0%	2.0%	70,000	3.7%
Synlait			50,000	2.7%
Miraka			21,000	1.1%
Tatua	2.0%	2.0%	17,000	0.9%
TOTAL	100%	100%	1,871,000	100%