goodman fielder
our homegrown food company

10 July 2015

Alex Sim
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Commerce Commission
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Dear Alex,

Re: Commerce Commission Consultation Paper: Review of the state of competition in the New Zealand dairy industry

1. Introduction

1.1 We refer to the Commerce Commission's (**Commission's**) consultation paper in relation to its review of the state of competition in the New Zealand dairy industry (the **Review**).

1.2 Goodman Fielder (**GF**) aggressively competes in the domestic processed milk market with Fonterra Brands and other processors. While there is considerable competition in this market and also the retail market for milk products, the farm gate and factory gate markets are not subject to the same level of competition due to the incumbency of Fonterra in those markets. Accordingly, GF considers that continued regulation is required to retain downstream competition.

1.3 Until competition develops in the factory gate market, GF will remain reliant on its entitlement to raw milk supply to compete downstream. Specifically, GF considers that it will not be able to access a competitive supply of raw milk absent regulation as:

(a) independent processors represent a very small proportion of factory gate supply and cannot guarantee year round supply of milk on the scale required by GF;

(b) it is unlikely that an alternative supplier will develop within a reasonable timeframe with the scale to supply year round milk nationwide at the volumes required by GF; and

(c) it is unlikely to be feasible for GF to source its own supply of raw milk before its current supply arrangements with Fonterra expire in 2021.

1.4 GF sets out below further details in relation to each of these points to assist the Commission in settling its approach to the Review and preparing its draft report. In light of these issues, GF supports the Commission's approach to the Review and considers that the framework for the Review is appropriate.

2. Competition in raw milk markets

2.1 GF considers that there has been little or no change to the state of competition in the relevant markets since the Commission's 2011 report.[1] In particular:

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[1] *"Milk markets: consideration of whether to initiate a Commerce Act Part 4 inquiry into milk prices"* Commerce Commission (August 2011)

(a) there have been only minor and incremental increases to milk production since 2011; and

(b) there have been no new entrants of any material size in either the farm gate or factory gate markets.

2.2 Fonterra continues to dominate both the farm gate and factory gate markets, accounting for an estimated 88% of the farm gate market and over 95% of the factory market. Independent suppliers in the factory gate market may only offer milk for supply when faced with an excess of milk for their own purposes. This happens sporadically and usually the volumes offered are small and supplied on a 'one-off' basis.

2.3 In addition to accounting for only a very small proportion of supply at the factory gate, the current focus of independents is on milk collection for the purposes of manufacturing their own export products, not the supply of raw milk to domestic processors.

2.4 The inadequacy of independent supply at the factory gate is apparent from GF's irregular supply arrangements with Westland. Last year, Westland supplied around 8% of Goodman Fielder's total raw milk requirements in New Zealand which was the highest volume of milk Goodman Fielder has taken from Westland and only a consequence of Westland having a particularly productive milk season coupled with plant capacity constraints. Typically, however, Goodman Fielder's purchases from independent suppliers such as Westland are negligible, if any. Indeed, there are no current indications that any milk will be offered by Westland in the forthcoming season.

2.5 GF considers that no raw milk supplier other than Fonterra could currently guarantee GF with year round supply.

2.6 Furthermore, GF does not consider that it is likely any real competition will develop in the foreseeable future in the farm gate market. As a consequence, GF remains highly dependent on supply from Fonterra.

3. GF supply in absence of regulation

3.1 Absent regulation, GF would continue to acquire milk at the factory gate pursuant to its supply contract with Fonterra until 2021. After 2021, GF would have the option to either renegotiate supply with Fonterra or invest heavily in order to obtain its own farm gate supply.

3.2 GF considers that due to the lack of competition at the factory gate, and by virtue of Fonterra's vertical integration, neither option would be viable.

Renegotiate contract

3.3 In the absence of volume entitlements or feasible alternative raw milk suppliers, GF would have no bargaining power to secure a further supply contract on terms which would allow GF to remain competitive in the wholesale market. Equally, Fonterra would have no incentive to enter into a supply contract that would erode value from its own downstream operations.

3.4 This would especially be the case if global milk prices in the future favoured Fonterra exporting milk rather than supplying a domestic processor. In the worst case scenario, absent any legal compulsion to supply GF or any commercial incentive, Fonterra may not agree to enter into any supply contract with GF post 2021.

Source own supply

3.5 To source raw milk, GF would either have to acquire and manage farms or enter into contracts direct with farmers. Fonterra would be incentivised to prevent GF from achieving independent supply and would likely do so by offering favourable terms to farmers in order to retain farm contracts.

3.6 For viable supply, GF would need to source milk from a concentrated area within close proximity to its processing sites in Christchurch and Palmerston North. In reality, this would be difficult to obtain and it is likely GF would be collecting from dispersed pockets of farms. This would require GF to source a network of tanker trucks or outsource milk collection. Furthermore, to ensure continuous winter supply a large scale acquisition network would be required.

3.7 GF considers it would be inefficient to establish an infrastructure and network given the relatively small volumes of milk collected for GF's own purposes (generally, 200-230 million litres per annum) compared to the economies of scale Fonterra benefits from (collecting around 18 billion litres per season, based on Fonterra's forecast for the season ending 31 May 2015). Furthermore, GF currently lacks the expertise that required to manage a logistical operation of the required size.

3.8 Accordingly, GF considers that it would not be feasible for any self-supply network to reach the level required for continuous year round supply within the next 5 years

4. Competition in downstream dairy markets

4.1 Wholesale and retail dairy markets remain highly competitive, driven by vigorous competition between Fonterra and GF in markets where sales volumes have generally been flat over the last few years. There have been some new boutique processors enter the market in the last two years who have eroded GF and Fonterra's respective market shares to a small degree.

4.2 Wholesale milk margins are under constant pressure from supermarkets and oil companies as suppliers face exclusion from stores or loss of product ranging in stores if the supermarkets' or oil companies' pricing expectations are not met.

4.3 GF's ability to compete in downstream dairy markets relies on its ability to procure year round milk supply at competitive prices. Accordingly, there is likely to be significant detriment to New Zealand consumers should GF ability to procure year round milk supply at competitive prices be jeopardised.

5. Options for deregulation

5.1 GF considers that the current thresholds requiring 20% of farm gate supply are inadequate. Even if the 20% threshold is met, the independent collectors are still likely to be regionally based and incapable of supplying year round milk at a national level to the scale required by GF. Furthermore, minimum supply at the farm gate does not ensure domestic supply as these independently collected volumes may be supplied offshore.

5.2 GF considers that a more appropriate threshold would relate to factory gate supply (i.e. require 20% of milk solids supplied by independent processors at the factory gate each month for at least two years.). This would be a better indicator both that an independent supplier could guarantee year-round supply at a sufficient scale and that such volumes were not supplied offshore.

5.3 GF also agrees with the Commission's view that a more comprehensive competition analysis would be a more appropriate alternative than the current threshold triggers. This analysis should

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focus on the factory gate market and consider the specific requirements of players in the domestic wholesale milk market.

Yours faithfully,

Iain Abercrombie
General Manager New Zealand
Goodman Fielder New Zealand Limited