COMMERCE ACT 1986: RESTRICTIVE TRADE PRACTICES

SECTION 58: NOTICE SEEKING AUTHORISATION

12 September 2011

The Registrar
Mergers and Authorisations
Commerce Commission
PO Box 2351
Wellington

Pursuant to section 58 of the Commerce Act 1986 application is hereby made seeking **authorisation** of restrictive trade practices.

PART 1: DETAILS OF APPLICANT AND OTHER PARTIES

1 INTRODUCTION

Some context

1.1 The first publication of the new New Zealand Productivity Commission *Issues Paper – International Freight Transport Services* put the case for improved efficiency of the logistics supply chain very succinctly:

"Freight costs inhibit trade. They have the effect of increasing the price New Zealanders pay for imported goods and reducing the net price New Zealand exporters receive for the goods they export. A consequence of being relatively distant from other centres of economic activity is that increases in freight transport costs have a more severe impact on New Zealand than on more centrally-located countries."

1.2 The Productivity Commission duly takes the view that "overall well being is best served by promoting the economic efficiency of the logistics supply chain for New Zealand importers and exporters".

1.3 Primary products comprise two-thirds of New Zealand's exports by value and simply transformed manufactured goods a further one-tenth. Many of these commodities are relatively low value, so transport costs are an important component of the total costs. Thus, access to and efficiency of international ocean freight services potentially affect the competitiveness of those products on world markets and the returns achieved by New Zealand exporters.

1.4 For many exporters efficient transport is vital to ensure their goods reach markets in optimal condition. By way of example, 92% of Fonterra's export production needs to cross the equator to reach its customers, meaning an average transit time of 30-35 days. But, that transit time can extend to 70 days on occasion.

1.5 Other primary producers find transit times are even more crucial. For producers – like Silver Fern Farms – with particular need to maintain "freshness" of their chilled products, increased transit times could prove catastrophic for European markets.

1.6 That threat of increased transit times is real. The New Zealand Shipping Council's report entitled "The Question of Bigger Ships" (*Bigger Ships Report*) identifies the risk of shipping lines increasingly hubbing through Australian ports, if some New Zealand ports do not become capable of berthing bigger ships(i.e. 5000-7000 TEU ships, as defined) within the next 5 years. The report stresses the strategic importance of New Zealand continuing to secure shipping capacity "with direct links to key international hubs and markets". Mediterranean Shipping Company (*MSC)* already offer a "New Zealand service" which in fact is a spoke of an Australian hub.

1.7 The risk of increased hubbing through Australia is also substantial. NZIER in its report to Ministry of Transport entitled "Freight Futures – Long Term Sea Freight Scenarios" (*Freight Futures Report*) summarises the key impacts for trade beyond Australia of hubbing through Australian ports, as follows:

(a) 5% increase in shipping costs;

(b) time delays;

(c) discourage new trade with rest of world;

(d) major barrier for new exporters;

(e) bottlenecks and increased warehousing costs for Fonterra.

1.8 Freight is also a vital component in the inwards movement of goods, both as inputs for the manufacturing process and for internal consumption.

1.9 The effects of New Zealand's remoteness and geography are well documented. For example, the 2011 OECD Economic Survey (*OECD Survey*) of New Zealand recently confirmed that the "economic impact of remoteness on the New Zealand economy is far from negligible." Further, the OECD Survey found that "aspects of New Zealand's internal geography may also hamper economic performance."

1.10 In short, developing an efficient domestic freight system that effectively combines intermodal transport services (road, rail and coastal shipping) with bigger ships and capable ports to ensure continued direct service by international carriers, is vital to support productivity and enhance quality of life for all New Zealanders.

The Kotahi proposal

1.11 The Kotahi ("standing together as one") proposal envisages New Zealand producers and importers combining to promote greater efficiency of the supply chain through pooling and coordinating demand for container freight services and the leveraging of scale to deliver superior service levels and potential cost advantages. This will be achieved through Fonterra and Silver Fern Farms establishing, prospectively with appropriate partners, a specialist entity – a limited partnership called Kotahi Logistics LP (*Kotahi Logistics*) – tasked with managing transport and in-transit handling activities for a diverse portfolio of freight users across a range of sectors.

1.12 The immediate aim of the Kotahi proposal is a coordinated demand of freight services, to ensure better utilisation of New Zealand's existing supply chain assets - including intermodal transport services, port facilities, warehousing, and ocean freight capacity -for the benefit of all freight users. More efficient use of existing facilities and services will help overcome the relatively high spatial transaction costs that many New Zealand firms face.

1.13 The longer term purpose is to ensure and bring forward future infrastructure investment in ways that will ensure some New Zealand ports do in fact achieve bigger ships capability. More coordinated demand will aggregate freight volumes at certain points, which should in turn:

(a) encourage new investment in relevant domestic infrastructure, including inland ports and rail links;

(b) underwrite investment required to make some ports bigger ships capable; and

(c) attract bigger ships to those ports.

1.14 To coordinate that demand, Kotahi Logistics will offer a variety of freight procurement and management services to a diverse customer base. Its areas of operation will include:

(a) containerised freight services for importers and exporters;

(b) conventional chartering services for importers and exporters;

(c) intermodal (road, rail and coastal shipping) transport solutions for importers, exporters and carriers; and

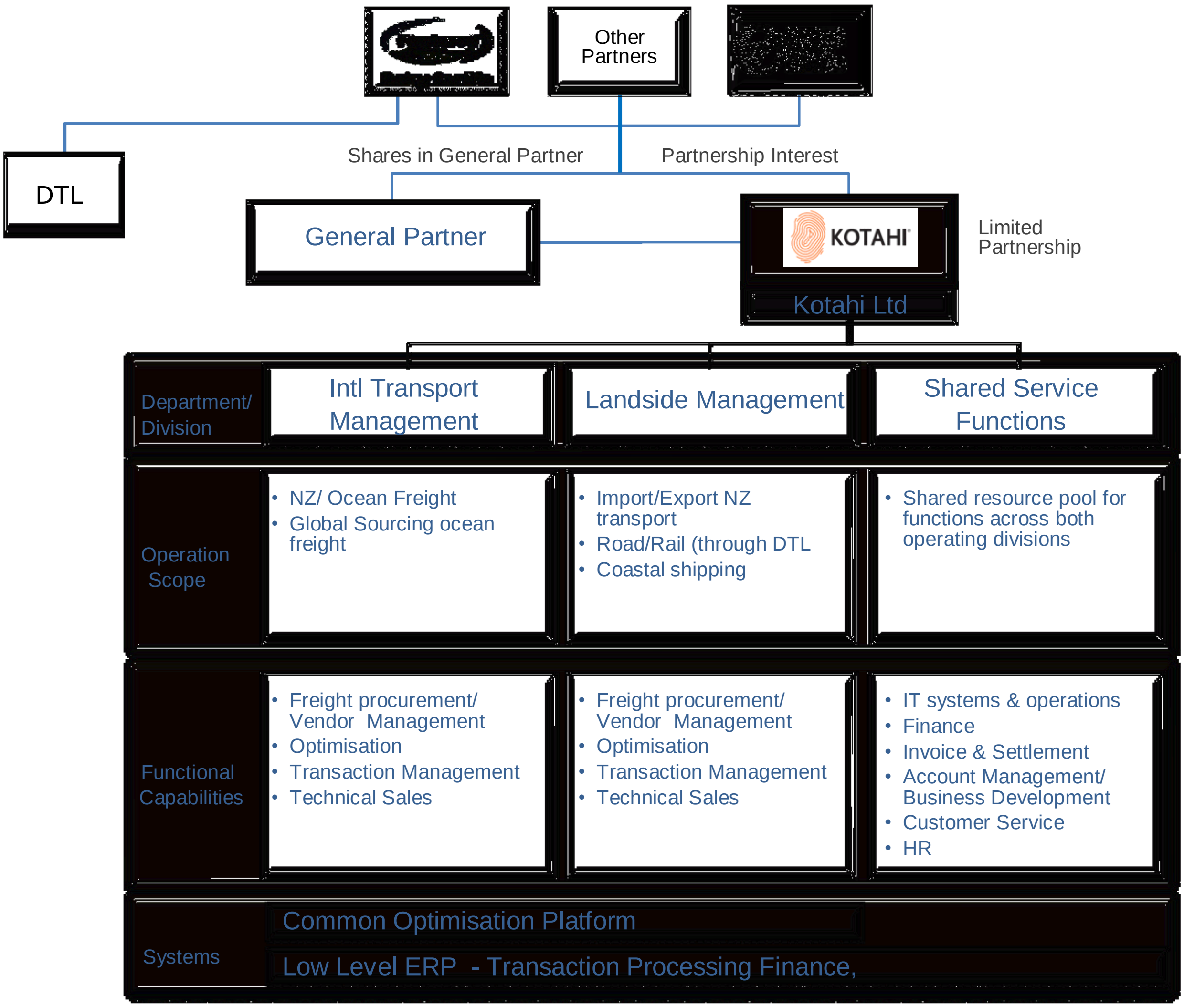
(d) other ancillary activities relating to landside and ocean freight management.

1.15 Those services will be available to freight users who are limited partners of Kotahi Logistics as well as to other customers who are not.

1.16 Importantly, the activities of Kotahi Logistics will be limited to arranging and ensuring the efficient movement and handling of imported inputs and export of finished products of its customers. The actual manufacturing and sales processes of those firms which use the services of Kotahi Logistics will remain strictly the responsibility of the individual customer. In particular, the respective businesses of those customers will be kept separate from the business of Kotahi Logistics, and from the businesses of each other.

1.17 While domestic infrastructure and transport services are vital components of the logistics supply chain for New Zealand importers and exporters, those services are also important to many other firms whose business is wholly within New Zealand. However the focus of Kotahi Logistics will be international. In particular, Kotahi Logistics will not handle local inputs (such as raw milk or livestock) or finished products destined for the domestic market.

1.18 The proposed structure and operational scope of Kotahi Logistics are shown in diagrammatic form below.



2 EXECUTIVE SUMMARY

The proposal

2.1 The Kotahi proposal envisages Fonterra combining with other New Zealand producers (led by Silver Fern Farms) and importers to promote greater efficiency of the supply chain through pooling and coordinating demand for container freight services on sea and increasingly on land. That coordinated and aggregated demand will ensure and bring forward port investment to enable use of bigger ships for the carriage of goods by sea from and to New Zealand. It will also promote development of an efficient domestic freight system that more effectively combines intermodal transport of export and import cargoes with bigger ships capable ports.

The vehicle

2.2 Fonterra has established Kotahi Logistics, which is already contracted to procure ocean freight and related services for Fonterra. Kotahi Logistics is conducting negotiations with potential service providers on the basis that both Fonterra's and

Silver Fern Farms' container export volumes will be available to Kotahi Logistics from **[ ]** (subject to authorisation being granted).

2.3 If authorisation is granted, Fonterra and Silver Fern Farms will:

(a) both become limited partners of, and shareholders in the general partner of, Kotahi Logistics; and

(b) enter into separate service agreements with Kotahi Logistics whereby they both agree to outsource all their respective ocean freight procurement and related services through Kotahi Logistics.

2.4 While those service agreements contemplate Kotahi Logistics providing limited landside services initially (e.g. carriage of goods from specified load port or other place of acceptance to vessel, and provision of sufficient empty containers at place of acceptance), it is envisaged that Kotahi Logistics will incrementally expand those landside services as it becomes fully operational. The service agreements will be amended or supplemented as Kotahi Logistics progressively expands its range of landside and intermodal transport services.

2.5 Fonterra and Silver Fern Farms, as limited partners, will also assist Kotahi Logistics to secure complementary business from other container freight users to reach a critical mass of cargo.

Public benefit likely to result from proposal

2.6 At the moment, no New Zealand port has the infrastructure to berth bigger ships. With the coordinated and aggregated demand that the Kotahi proposal will provide, the investment required to ensure bigger ships capable ports will occur earlier and with more certainty, than without such demand. NERA Economic Consulting (*NERA*) has considered two alternative without scenarios (counterfactuals), being:

(a) the status quo, where New Zealand continues to be serviced by smaller ships until export volume growth enables port investment to occur 3 years later than the Kotahi proposal would allow; and

(b) Australian hubbing, where New Zealand continues to be serviced by smaller ships to Australia, with cargo then shipped on bigger ships from Australia.

2.7 NERA estimates that the Kotahi proposal is likely to result in net present value benefits of at least $78m - $204m if the counterfactual is (a) delayed bigger ships visits, or at least $814m - $959m if the counterfactual is (b) Australian bigger ships hubbing. In addition NERA estimates that the Kotahi proposal is likely to result in better utilisation of domestic transport assets, having further present value benefits of $**[ ]**m.

Markets affected by proposal

2.8 The Kotahi proposal is not intended by Fonterra and Silver Fern Farms to substantially lessen competition in any of the markets in which Kotahi Logistics either operates initially or may come to operate. However, Kotahi Logistics' collective purchasing power may come to have the effect of lessening competition in the markets for some of the services it provides, as it attracts the exclusive custom of more limited partners. The services to be provided initially by Kotahi Logistics are provision or procurement of container freight services by sea to and from New Zealand and related landside services. However, that range of landside services will be progressively expanded to include procurement of road, rail and coastal shipping services as Kotahi Logistics moves to provide intermodal transport solutions for its customers.

2.9 Thus, markets affected by the Kotahi proposal are:

(a) initially, provision and procurement of container freight services by sea to and from New Zealand and related landside services;

(b) potentially, procurement of intermodal transport services to and from ports.

2.10 Irrespective of any actual effect on those markets pursuant to section 27 of the Commerce Act, there is the possibility that sections 29 and 30 may apply to the Kotahi proposal – in particular, to the exclusive service agreements that Kotahi Logistics proposes to enter into with its limited partners. Those limited partners are at present notionally competing as acquirers in their own right of the services to be provided or procured by Kotahi Logistics.

2.11 In particular, the provisions that may require authorisation are as follows:

(a) exclusivity requirement (clause 4.1 and 4.4(b) of Limited Partnership Agreement refer);

(b) pricing mechanism (clause 4.8 of Limited Partnership Agreement refers);

(c) overall effect of arrangements (clause 3 of the Establishment Agreement, clauses 4.1 and 4.4(b) of the Limited Partnership Agreement and clause 12 of the Services Agreement refer);

(d) entry of new limited partners/acceptance of customers (clause 1.1 and 4.4(a) of the Limited Partnership Agreement and clause 1.1 and 44 of the Constitution refer);

(e) extension of "services" to be provided to include further landside and intermodal transport services (definition of "services" in clause 1.1, clauses 13 and 34 and Schedule 1 of Services Agreement refer).

The capitalised documents referred to in this paragraph are more fully described in Part 4 below.

Detriments resulting from lessening or deemed lessening in competition

2.12 The Kotahi proposal will involve Fonterra and Silver Fern Farms (and further New Zealand producers and importers) coordinating demand for one of their inputs – container freight services. In all other respects those participants will continue to compete fully in their output and other markets.

2.13 Arrangements relating exclusively to carriage of goods by sea into or out of New Zealand are largely exempt from Part 2 of the Commerce Act. To the extent that any related landside services to be procured by Kotahi Logistics are not so exempted, NERA notes that New Zealand is a small market for ocean carriers, who can relatively easily switch capacity away from New Zealand. Further, those carriers are all foreign-owned.

2.14 With regard to potential extension of services to include intermodal transport services, NERA notes that aggregation of demand would be very small in the case of road and larger but still relatively small in the case of rail.

2.15 NERA does not anticipate any material level of allocative efficiency detriment from the Kotahi proposal. Similarly, NERA concludes the proposal would have no material impact on the broad competitive pressures on Fonterra, Silver Fern Farms and other participants to be productively and dynamically efficient, either initially or potentially on the inclusion of intermodal transport services.

Benefits outweighs lessening or deemed lessening

2.16 NERA's analysis thus attributes no allocative, productive or dynamic efficiency loss to any lessening or deemed lessening of competition arising from the Kotahi proposal.

2.17 Against that, NERA estimates that the Kotahi proposal is likely to result in net present value benefits of at least $814m - $959m if the counterfactual is (b) Australian bigger ships hubbing. In addition NERA estimates that the Kotahi proposal is likely to result in better utilisation of domestic transport assets, having further present value benefits of $**[ ]**m.

3 IMPLEMENTATION IN PHASES

3.1 Implementation of the Kotahi proposal will occur in three distinct phases, which will see the activities of Kotahi Logistics progressively extended.

(i) Interim limited partnership

3.2 Fonterra currently is, and pending authorisation of the proposal will remain, the sole limited partner in, and sole shareholder of the general partner of, Kotahi Logistics - as provided in an Interim Limited Partnership Agreement which is basic in its form and confined to parties which are currently wholly controlled by Fonterra.

3.3 Pending authorisation, Kotahi Logistics will confine its activities to procuring ocean freight and related services for Fonterra as its only customer.

3.4 This phase is described more fully at paragraphs 5.10 and 5.11 below.

(ii) International ocean freight

3.5 Only upon authorisation of the proposal, Silver Fern Farms will become a limited partner in, and shareholder of the general partner of, Kotahi Logistics; and Kotahi Logistics will begin procuring ocean freight and related services for Silver Fern Farms, too.

3.6 This phase will centre on the combination of Fonterra's and Silver Fern Farms' respective export volumes, potentially with those of other New Zealand exporters and importers; and the creation of competitive offerings through coordination with competitive domestic freight services. Value for customers will be created in two main ways: first, by combining the multiple, volatile, same-direction demand profiles of New Zealand exporters to deliver a smooth and predictable weekly export demand curve; and second, by marrying New Zealand exporters' demand with counter flows of importers; allowing access to attractively priced "take or pay" arrangements with the ocean freight carriers for a significant portion of the combined volume.

3.7 This phase is described more fully at paragraphs 5.12 to 5.34 below.

(iii) Intermodal transport services

3.8 The final phase will involve balancing Fonterra's and Silver Fern Farms' intermodal transport movements to and from ports (i.e. road, rail and coastal shipping) with complementary flows of other New Zealand exporters and importers to improve utilisation of transport assets, reduce waste and create improved purchasing leverage.

3.9 In practice, this function will be outsourced initially to Dairy Transport Logistics Limited (*DTL*), the Fonterra subsidiary that has existing contractual arrangements with **[ ]** trucking providers and KiwiRail. Value for customers will be created primarily through improved utilisation of on-shore transport assets (trucks and trains) by balancing cargo flows across multiple freight owners to reduce the ratio of empty transport legs; driving a reduction in the number of premium priced "head-haul" legs. Additional value will be realised through the enhanced purchasing power resulting from the combined volume profile.

3.10 This phase is described more fully at paragraphs 5.35 to 5.41 below.

4 PROPOSED ARRANGEMENTS

4.1 The Kotahi proposal will be implemented through the limited partnership, Kotahi Logistics. Fonterra and Silver Fern Farms have entered into a Kotahi Logistics LP Establishment Agreement (*Establishment Agreement*) and agreed the form of the Limited Partnership Agreement (*Limited Partnership Agreement*) and Constitution of Kotahi GP Limited, being the general partner of Kotahi Logistics (*the Constitution*). These documents are attached as schedules 1, 2 and 3.

4.2 Once fully established, Kotahi Logistics will provide the kinds of freight procurement and related services described above to its limited partners and, incrementally, other freight users.

4.3 To avoid possible legal challenge, Fonterra and Silver Fern Farms have agreed to seek authorisation from the Commission for those aspects of the Kotahi proposal that potentially may breach sections 27, 29 and/or 30 of the Commerce Act prior to fully implementing the arrangements contemplated for the limited partnership.

4.4 In the interim, Fonterra has registered Kotahi Logistics with itself as the sole limited partner and the sole shareholder of the general partner of Kotahi Logistics (*Interim Limited Partnership*), on the terms set out in a limited partnership agreement between Fonterra and the general partner of Kotahi Logistics – Kotahi GP Limited (currently a wholly owned subsidiary of Fonterra) (*First Agreement*). The First Agreement is in a relatively basic form and does not contain any provisions specific to the proposed operation of the limited partnership. A copy of the First Agreement is attached at schedule 4.

4.5 Fonterra will engage the Interim Limited Partnership to conduct negotiations with shipping providers with a view to commencing provision of ocean freight services to Fonterra for cargo shipments from 1 August 2011 and (subject to authorisation being granted) to Silver Fern Farms from **[ ]**. Kotahi Logistics began accepting Fonterra bookings from 20 June 2011 for shipments commencing from 1 August 2011.

4.6 The negotiations with shipping providers will be conducted on the basis that both Fonterra's and Silver Fern Farm's cargo export volumes will potentially be available to the Limited Partnership in order to obtain the best available price and terms from the shipping providers. Silver Fern Farms commits to procure services from the Limited Partnership from **[ ]**.

4.7 Only if authorisation is granted, Fonterra and Silver Fern Farms will:

(a) adopt the Limited Partnership Agreement and Constitution in the forms set out in schedules 2 and 3 respectively, in place of the First Agreement with effect from the date that Fonterra and Silver Fern Farms enter into the Limited Partnership Agreement; and

(b) Silver Fern Farms and Kotahi Logistics will enter into either:

(i) a services agreement covering the provision of ocean freight and related landside services by Kotahi Logistics to Silver Fern Farms in the form set out in schedule 5 (*Services Agreement*); or

(ii) a more restricted services agreement in substantially the same form as the Services Agreement, with such amendments only as may be necessary to comply with the terms of the authorisation.

4.8 The Services Agreement in its present form in fact contemplates Kotahi Logistics providing limited landside services initially. Very briefly, Silver Fern Farms must present product for carriage at specified load ports or other places of acceptance; and Kotahi Logistics procures the carrier to accept the product for carriage from that point. Similarly, Kotahi Logistics must ensure that sufficient empty containers are made available to Silver Fern Farms at those points. Importantly however the definition of the term "Services" contemplates that further services may be provided, or varied, from time to time by subsequent agreement of the parties. It is envisaged that Kotahi Logistics will incrementally expand its landside services associated with ocean freight, as it becomes progressively operational.

4.9 Following adoption of the Limited Partnership Agreement, Fonterra and Silver Fern Farms will outsource *all* their respective ocean freight procurement and related management functions, including vendor management and vessel planning, to Kotahi Logistics from the dates set out in paragraph 4.5. Kotahi Logistics will also be responsible (with support from its limited partners) for capturing complementary business of other freight users to reach a critical mass of cargo.

4.10 Very briefly, the ownership structure of Kotahi Logistics may be summarised as follows:

Ownership structure attributes

- Limited Partnership.

- Limited partnership interests to correlate to the volume of cargo contributed by each limited partner (adjusted annually).

- Profit distribution to float based on actual cargo contributed in applicable year.

Partner Selection

- Common freight contributing limited partners across end to end process offering.

  - Value contribution primarily stems from volume.

  - Principle: limited partners must add value to extract value.

  - Overcomes value sharing conflict between conflicting limited partnership interests (supply vs. use).

- Complementary landside and ocean flows to existing collective profile.

- Maintenance of efficient reefer/dry ratio.

- Future potential to incorporate high volume Australasian importers to the limited partner base.

- No specific exclusion of any freight owner or commodity.

5 PROPOSED MATTERS FOR WHICH AUTHORISATION IS SOUGHT

5.1 Identifying which provisions of the Commerce Act potentially may apply to which phases of the Kotahi proposal is no easy task.

5.2 First, there is the intention that Kotahi Logistics will incrementally expand its landside activities as it becomes progressively operational.

5.3 Second, there is the complication that Kotahi Logistics itself is a limited partnership, being a new statutory species of corporate entity introduced 22 years after the Commerce Act. Unsurprisingly, the limited partnership concept does not fit comfortably within some of the strictures of that legislation. For example, a limited partner does not hold any "share" as that term is defined for the purposes of Part 3 of the Commerce Act. Rather, a limited partner holds a partnership interest. That term is defined in the Limited Partnership act 2008 as follows:

> *The partnership interest of a partner—*
> *(a) is the partner's—*
> *(i) share of the assets of the limited partnership; and*
> *(ii) right to receive distributions from the limited partnership; and*
> *(iii) right to any other benefit conferred by the partnership agreement; and*
> *(b) includes any liability or other burden of the partner in relation to the limited partnership.*

5.4 Arguably, therefore, becoming a limited partner involves the notional acquisition of the prescribed share of the assets of the limited partnership as provided in paragraph (i), together with any intangible assets arising in terms of paragraph (ii) or (iii).

5.5 Section 31 may involve a further deficiency. Section 31 contains a list of exceptions to the deeming rule for price fixing provided in section 30. Those exceptions differ according to whether the joint venture is unincorporated or incorporated, or for the provision of goods or services. The exceptions apply in graduated fashion – for example, services supplied by an unincorporated joint venture must additionally be shown to be "made available as a result of the joint venture" to qualify for the exception. Unhelpfully, the limited partnership concept seems to straddle both the unincorporated and incorporated forms of joint venture.

5.6 Third, there is the overall effect of the carriage of goods by sea exception to consider. Section 44(2) of the Commerce Act currently exempts arrangements relating exclusively to the carriage of goods by sea into or out of New Zealand from Part 2 of the Commerce Act. However, this exclusion does not provide sufficient certainty or scope to accommodate the Kotahi proposal going forward, for two reasons:

(a) given the criticism that this exemption has attracted – most recently in both the OECD Survey and Productivity Commission Paper - there can be no certainty that it will endure for the intended life of Kotahi Logistics; and

(b) the arrangements that Kotahi Logistics will enter into with its customers will extend to a wider range of services than arrangements "exclusively for the carriage of goods by sea".

5.7 As to the scope of those arrangements, the section 44(2) exception expressly does not extend to the carriage of goods to or from the ship or the loading and unloading of the ship; and by implication, to any related shore based management services or domestic transport services that Kotahi Logistics may provide. Thus, already some landside elements of the services provided for in the current limited form of the Services Agreement are not covered by section 44(2) and those non-exempted aspects of the arrangements will be fully subject to Part 2.

5.8 It is also unclear whether the exception would extend at all to *procurement* of carriage of goods, as opposed to *provision* of carriage of goods, to the extent that procurement involves a separate intermediary function.

5.9 Finally, given the progressively "phased" implementation of the Kotahi proposal, there is a question as to which of the restrictive trade practices prohibitions of Part 2, or the business acquisitions regime of Part 3, or both, might apply to which of the phases described above, being:

(i) interim Limited Partnership;

(ii) full establishment of Limited Partnership for international ocean freight; or

(iii) extension of Limited Partnership to intermodal transport to and from ports.

To address that conundrum, this application deals with each of these phases in turn, considering first whether Part 2 might apply, then whether Part 3 might apply, to the particular phase.

(i) Interim limited partnership

5.10 During the initial interim phase, ownership of Kotahi Logistics will be confined to parties which are wholly controlled by Fonterra. Similarly, Kotahi Logistics' activities during that phase – international or domestic – will be confined to serving Fonterra as its only customer. Section 44(1A) provides an exception from Part 2 for wholly intra-group arrangements; and any acquisition in terms of Part 3 would involve only parties which are already interconnected bodies corporate.

5.11 Accordingly, neither the operation nor establishment of Kotahi Logistics invokes either Part 2 or Part 3 during the initial interim stage.

(ii) Full establishment of limited partnership for international ocean freight

5.12 But, as outlined above, the section 44(2) exception does not extend to any landside activities associated with ocean freight. Thus, authorisation will be required for any restrictive trade practices arising from the arrangements Kotahi Logistics enters into with Silver Fern Farmers on full establishment of the limited partnership, and subsequently with other limited partners, for the provision or procurement of non-exempted services.

5.13 In particular, upon Fonterra and Silver Fern Farms *both* becoming limited partners in, and shareholders of the general partner of, Kotahi Logistics, they propose to engage Kotahi Logistics *on an exclusive basis* to provide ocean freight procurement, freight management and other related services to them. While the carriage of goods by sea component proper will be exempted in terms of section 44(2), any landside, freight management and other related services will not be.

5.14 It is intended that other New Zealand users of ocean freight, freight management and other related services incrementally will engage Kotahi Logistics to provide these services to them, too, either as an additional limited partner (alongside Fonterra and Silver Fern Farms) or simply as a customer of Kotahi Logistics (with no ownership stake). Those who join as additional limited partners will similarly be required to engage Kotahi Logistics *on an exclusive basis*, and to actively assist Kotahi Logistics to attract further customers for its services.

5.15 Initially, Kotahi Logistics will be responsible for booking and purchasing ocean freight capacity on behalf of its limited partners and other customers (see clause 5 and Schedule 1 of the Full Services Agreement). In this role, Kotahi Logistics will negotiate pricing directly with the shipping providers in respect of each limited partner's or other customer's cargo. Kotahi Logistics will itself purchase vessel space from shipping providers to meet its limited partners' and other customers' requirements.

5.16 Kotahi Logistics will then charge its limited partners and other customers an overall fee comprising transaction costs and sea freight charges based on an agreed pricing mechanism (see clause 16 and Schedule 2 of the Services Agreement).

5.17 The need for authorisation arises because Fonterra and Silver Fern Farms (and other potential users of Kotahi Logistics' services) are at present notionally "competing" as acquirers of the ocean freight and other related services that will be procured or provided by Kotahi Logistics.

5.18 The particular provisions that may require authorisation are as follows:

Exclusivity requirement
Clauses 4.1 and 4.4(b) of the Limited Partnership Agreement (also reflected in clause 12 of the Services Agreement) – provide that each limited partner "must exclusively commit to procure all of its ocean freight services requirements from Kotahi Logistics LP". While the term "ocean freight services" is not defined, the "business" and "business activity" of the limited partnership, as described in clauses 2.6 and 2.7 respectively, clearly contemplate the inclusion of freight management and other landside activities.

- This requirement may be in breach of section 29 as an exclusionary provision, on the basis that it has the purpose of preventing the acquisition of services from a class of persons (i.e. directly from carriers or from carriers that Kotahi Logistics does not purchase from) and these persons indirectly compete with Kotahi Logistics in that they could supply their services to the limited partners directly. Depending on whether the volume of cargo available to Kotahi Logistics has the effect or likely effect of substantially lessening competition, a defence may be available in terms of section 29(1A).

- Further, as Kotahi Logistics grows its business (i.e. additional limited partners or other customers are attracted), rival suppliers of ocean freight and related services will have less independent customers available to them (i.e. demand will progressively be foreclosed). Depending on the relative volumes that Kotahi Logistics is able to attract on an exclusive basis, this may come to have the effect of substantially lessening competition in breach of section 27. Simply combining the respective export volumes of its initial two limited partners will mean that Kotahi Logistics starts with exclusive responsibility for procuring **[ ]**% of outward containerised freight services. Section 3(5)(b) provides that the effect of any similar exclusive arrangements with other limited partners must be aggregated with that volume when determining whether there is the likely effect of substantially lessening competition.

- Thus, whether the exclusivity requirement triggers the effect limb of section 27, or negates the defence in section 29(1A), will depend ultimately on the volumes of demand remaining available to other suppliers.

Pricing mechanism
Clause 4.8 of the Limited Partnership Agreement – provides that "pricing to Limited Partners and customers of the Limited Partnership (*Customers*) will reflect **[**

] and it is intended that **[ ]** in the pricing received by the Limited Partners and Customers under their respective services agreements with [Kotahi Logistics]".

- This section may be in breach of section 30 of the Commerce Act on the basis that is has the purpose and effect of providing for the fixing, controlling or maintaining of the prices of services acquired by the parties (including the price at which third party customers will acquire the services).

- This principle will be reflected in the Services Agreements entered into by both of the limited partners and other customers (see clause 17 and Schedule 2 of the Full Services Agreement which sets out how Kotahi Logistics will charge the limited partner/customer). This is effectively an agreement between Fonterra and Silver Fern Farms as to how price will be calculated both for each other and any additional limited partner or third party customer.

- Section 31 of the Commerce Act potentially may provide an exception to section 30 as this provision relates to the supply by Kotahi Logistics (the "joint venture" for the purpose of section 31) of services in pursuance of the "joint venture". However, the Kotahi Logistics limited partnership structure does not sit comfortably within the section 31 exceptions.

- Section 33 of the Commerce Act is unlikely to apply as the services will not be collectively acquired given that Kotahi Logistics will be procuring vessel space for specific customers **[** **]**.

Overall arrangements– *section 30* - the effect of the overall arrangements is that Kotahi Logistics will be jointly negotiating freight rates on behalf of its limited partners and other customers (all competitors for the acquisition of ocean freight services) – see ***clause 3 of the Establishment Agreement*** under which Fonterra and Silver Fern Farms must consult with each other in relation to negotiations with carriers.

- As a result, the overall arrangements may have the effect of providing for the fixing, controlling or maintaining of the price at which Kotahi Logistics will purchase ocean freight services on behalf of the individual limited partners and customers, **[** **]**.

- It is questionable whether section 31 covers this aspect, as it is not related to the joint supply by the parties or the price at which Kotahi Logistics LP will supply its services.

- Similarly the section 33 collective acquisition exception arguably does not apply where the rates at which services are purchased are (largely) agreed on a customer by customer basis and only apply to that customer's cargo. **[** **]**. However, **[** **]** would likely prevent a small dairy company, for example, taking advantage of Fonterra's dairy cargo rates).

Likely effect of substantially lessening competition
Overall arrangements – *section 27* – as mentioned above ***clauses 4.1 and 4.4(b) of the Limited Partnership Agreement*** require that existing limited partners and any new limited partners *must* commit exclusively to procure their ocean freight services from Kotahi Logistics (some customer's services agreements may contain a provision similar to that set out in ***clause 12 of the Services Agreement***).

- As a result, as Kotahi Logistics grows (i.e. additional limited partners or exclusive customers are attracted), rival suppliers of ocean freight and related services will have less independent customers available to them (i.e. demand will progressively be foreclosed). Depending on the relative volumes that Kotahi Logistics is able to attract on an exclusive basis, this may come to have the likely effect of substantially lessening competition in breach of section 27. Simply combining the respective export volumes of its initial two limited partners will mean that Kotahi Logistics starts with exclusive responsibility for procuring **[ ]**% of outward containerised freight services. Section 3(5)(b) provides that the effect of similar exclusive arrangements with other limited partners must be aggregated with that volume when determining whether there is the likely effect of substantially lessening competition.

- It is recognised that the overall effect on competition of the exclusivity arrangements is mitigated by the ability of limited partners to terminate the Services Agreement, without cause, on 6 month's notice prior to the end of Kotahi Logistics' financial year (see clause 23.2 of the Services Agreement). Where this ability to terminate is exercised, the limited partner will be free to contract directly with other suppliers of ocean freight services after the expiry of Kotahi Logistics' then current, financial year. The limited partner will also be required to exit the limited partnership upon the expiry of that financial year (see clause 8.5(a) of the Limited Partnership Agreement).

- The ability for a limited partner to exit the Limited Partnership is reinforced by each limited partner's right to require the Limited Partnership to purchase its interest and exit the limited partnership, again effective upon the expiry of Kotahi's current financial year (see clause 8.3(a)). The exiting limited partner will still have the ability to continue to acquire services from Kotahi Logistics if Kotahi Logistics determines that this is desirable (see clause 23.1(a) of the Services Agreement)."

- In summary, whether – and when – the exclusivity arrangements trigger the effect limb of section 27 will depend ultimately on the volumes for the time being committed to Kotahi Logistics by its then limited partners, and the volumes of demand consequently remaining available to rival suppliers.

Authorisation sought for anticipatory breach

5.19 Clearly, it is impossible to identify in advance the precise point at which the prohibited "substantial lessening" threshold may be crossed. Further, that point may vary according to the nature of the particular service.

5.20 Thus, section 61(6A) expressly allows for authorisation in cases of anticipatory breach of section 27, by providing that *any* lessening of competition gives the

Commission jurisdiction to grant authorisation. Proof of actual substantial lessening, is not required. Similarly, any deemed lessening gives the Commission jurisdiction.

5.21 Once the Commission has determined that *any* lessening of competition (whether or not substantial) is likely to result from the proposed arrangements at some stage, the Commission may grant authorisation if satisfied that such lessening would be outweighed by public benefit resulting for the Kotahi proposal.

Entry of new limited partners/acceptance of customers

5.22 The procedure for entry by a new limited partner into Kotahi Logistics may represent a further element of the Kotahi proposal that potentially gives rise to competition concerns but does not relate to the carriage of goods by sea.

5.23 Under the terms of the Limited Partnership Agreement, additional limited partners will be introduced on the same basis as Fonterra and Silver Fern Farms:

- as is the case for Fonterra and Silver Fern Farms any additional limited partner will be required to enter into an exclusive services agreement in substantially the same form as the Services Agreement (**[** **]**); and

- additional limited partners will also contribute capital and receive voting rights and profit **[** **]**.

5.24 However, the initial limited partners will have some opportunity to control who becomes a limited partner as entry of an additional limited partner will be subject to approval by the existing limited partners by way of a special resolution (see ***clause 4.4(a) of the Limited Partnership Agreement***), being:

- initially, whilst the only limited partners are Fonterra and Silver Fern Farms, admission of a new limited partner will require the approval of both Fonterra and Silver Fern Farms (see ***clause 1.1 of the Limited Partnership Agreement***); and

- subsequently, once additional limited partners are admitted, approval of further new limited partners will only require the approval of Fonterra and other limited partners who together hold 30% of the non-Fonterra voting rights, provided that Fonterra and those other limited partners together hold 75% of the total voting rights (see ***clause 1.1 of the Limited Partnership Agreement***).

5.25 Whilst this may give existing limited partners (particularly Fonterra) the ability to prevent other exporters from becoming limited partners, this ability will be constrained in that:

- clause 4.4(a) contains a provision that a limited partner cannot refuse to give its approval of the addition of a new limited partner unless it has a bona fide commercial objection; and

- while both Fonterra and Silver Fern Farms approval is required, the parties will be looking to grow the limited partnership in order to achieve the level of scale required to realise the potential benefits and are therefore unlikely to withhold their approval.

5.26 In any event, other exporters/importers can take advantage of the services offered by Kotahi Logistics without taking an ownership stake. There is no express provision dealing with the approval of additional customers contained in the limited partnership agreement or general partner constitution.

5.27 However, under ***clause 44 of the Constitution*** an extraordinary directors resolution, carrying the same minimum approval levels as described in paragraph 4.22 above (see also ***clause 1.1 of the Constitution***) will be required for matters such as (among other things):

- adoption of budgets and the business plan (including any material deviation from these);
- material alterations to the business of Kotahi Logistics; and
- any matter that requires approval by special resolution of the shareholders of Kotahi GP Limited (i.e. the limited partners).

5.28 Further, a special resolution of the shareholders of Kotahi GP Limited is required for any transaction that is a major transaction (as defined in the Companies Act) or is likely to result in Kotahi Logistics incurring obligations or liabilities in excess of $250,000 (see clause 43.2 of the Constitution).

5.29 Accordingly, it is likely that any services agreement between Kotahi Logistics and a potential customer will require both an extraordinary director's resolution and a special resolution of the shareholders (which also carries the same approval levels described above).

5.30 These provisions (relating to approval of both limited partners and customers) may be seen as giving scope for a limited partner to prevent a rival firm wishing to acquire services from, or join, Kotahi Logistics from doing so. However, given that Kotahi Logistics may come to have a significant influence in the relevant markets in which it operates, any refusal to supply that service or deny entry as a limited partner may constitute a breach of section 36, if such denial were made for an anti-competitive purpose. Authorisation would not protect against potential breach of section 36.

Acquisition itself does not affect competition

5.31 Turning now to Part 3, the section 44(2) exception only applies to Part 2, so would not extend to any acquisition of shares or assets of a business that otherwise is caught by Part 3. Arguably, the acquisition of an interest in an entity - the major business activities of which are excluded from the Commerce Act -nevertheless may be prohibited by section 47 if that acquisition itself would have the effect of substantially lessening competition.

5.32 As outlined in paragraph 4.3 above, the entry of Silver Fern Farms into Kotahi Logistics as a further limited partner arguably would involve the "acquisition" by Silver Fern Farms of a limited partnership interest, together with the acquisition of a share in the general partner of Kotahi Logistics. A similar "acquisition" would occur with the entry of each new limited partner.

5.33 Importantly however, section 47(1) would not be triggered by those future partnership interest/share acquisitions on the basis that such acquisition, by itself, would not have, and not be likely to have, *the effect* of substantially lessening competition in the market. Rather, any lessening or deemed lessening in competition would be caused by exclusive supply arrangements to be entered into between Kotahi Logistics and the intending limited partners. The new limited partners' acquired rights in the limited partnership are merely a precursor to these arrangements and add no further effect to competition in the relevant market. In other words, the "acquisition" only occurs because of the contractual arrangements, and absent those contractual arrangements would not occur. It is the contractual arrangements themselves which have the potential or are deemed to lessen competition, not the acquisition of any interest in the limited partnership.

5.34 Section 47(1) requires an assessment of the actual or likely effect of an acquisition on competition. But, actual or likely effect on competition require that there be causation between the acquisition and the prohibited outcome. Here, the prohibited effect of substantially lessening competition would be the direct and immediate result of the contractual arrangements, not the acquisition of shares or assets of a business.

(iii) Extension of limited partnership to intermodal transport services

5.35 Subsequent extension of Kotahi Logistics' operations to Fonterra's and Silver Fern Farms' respective domestic freight movements, and those of other New Zealand exporters and importers, will not enjoy any exemption under section 44(2). Road and rail transport and coastal shipping and related activities all are fully subject to Part 2 of the Commerce Act.

5.36 Thus, those elements of the arrangements to be entered into by Kotahi Logistics and its limited partners -which have been identified above as at risk already (i.e., to the extent that section 44(2) does not apply to landside activities associated with ocean freight) -would be fully exposed in the event that Kotahi Logistics undertakes further domestic transport activities. To reiterate briefly, those elements are:

(a) exclusivity requirement – clause 4.1 and 4.4(b) of the Limited Partnership Agreement;

(b) pricing mechanism – clause 4.8 of Limited Partnership Agreement and clause 3 of the Establishment Agreement; and

(c) likely effect of substantially lessening competition – clause 4.1 and 4.4(b) of the Limited Partnership Agreement and clause 11 of the Services Agreement.

5.37 At present, the scope of the Services Agreement, and the Limited Partnership Agreement which underpin it, is focussed on activities directly related to ocean freight (such as carriage of product to or from point of acceptance to or from the ship, loading and unloading and container movement). The term "services" is defined and more fully described in clause 1.1 and Schedule 1 of the Services Agreement.

5.38 But, it is envisaged that, as Kotahi Logistics becomes progressively operational, it will combine all available intermodal transport modes with ocean freight, although some aspects of this enhanced role will be outsourced to DTL. In this regard, clause 13 of the Services Agreement allows for variation of services to be provided; and clause 34 contemplates continuous improvement of services.

5.39 Again, whether – and when – the various services involved in those future arrangements trigger the effect limb of section 27, or invoke section 29, will depend ultimately on the volumes of the particular service for the time being committed to Kotahi Logistics by its then limited partners, and the volumes of demand consequently remaining available to rival suppliers. 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.

5.40 As indicated above, section 61(6A) expressly allows for authorisation in cases of anticipatory breach.

5.41 With the pricing mechanism, however, section 30 operates to give rise to a deemed lessening of competition.

6 OVER-REACH OF PRESENT LAW RECOGNISED

6.1 Importantly, the Kotahi proposal is not intended to substantially lessen competition in any of the markets in which Kotahi Logistics operates initially or may come to operate. That is not its purpose or the purpose of its initial limited partners, Fonterra and Silver Fern Farms.

6.2 However, as indicated above, Kotahi Logistics' collective purchasing power may come to have the effect of substantially lessening competition in some of those markets – directly, in relation to those suppliers of transport services who are denied Kotahi Logistics' custom; and indirectly, in respect of rival purchasers of the same services who cannot negotiate as favourable terms as Kotahi Logistics. The risk of those unintended effects will increase as Kotahi Logistics attracts more limited partners.

6.3 There is also an immediate risk that sections 29 and 30 may apply to Kotahi Logistics' service agreements with its limited partners and customers – irrespective of actual competition effect - to the extent that those persons are at present notionally competing as acquirers of the services to be procured or provided by Kotahi Logistics.

6.4 Significantly, the exposure draft bill intended to criminalise hard-core cartel conduct and explanatory material just released by the Ministry of Economic Development (together "*Cartel Bill*") recognise the potential over-reach of the present legislation and inadequacy of the joint venture exceptions for genuine collaborative, efficiency-enhancing arrangements. To ensure that legitimate pro-competitive or neutral conduct is not caught by the new, more rigorous regime being proposed to replace the existing section 30 deeming provision, the Cartel Bill proposes a new exemption for collaborative activity. That new exemption would provide a defence to criminal or civil challenge.

6.5 Further, the Cartel Bill proposes a new clearance mechanism, whereby parties to a collaborative arrangement will be able to seek the Commission's ex-ante confirmation that the new exemption applies.

6.6 That legislative proposal has just been released for comment; and, if introduced, will not be enacted before next year. That is too late for the Kotahi proposal as Kotahi Logistics' arrangements with its limited partners will need to be authorised from the outset. It may mean however that, if the Cartel Bill is duly enacted with the collaborative activity exemption intact, the authorisation now being sought in fact will be short-lived and can be superseded by the new form of clearance.

6.7 At the least, the Cartel Bill does provide compelling recognition by Government that genuine efficiency enhancing collaborative arrangements should be allowed; but may at present be caught by overreach of section 30.

7 DETAILS OF APPLICANT

7.1 This notice is given by:

Fonterra Co-operative Group Limited
Private Bag 92032
Auckland

Telephone: 09 369 6204
Facsimile: 09 369 6292
Attention: Joe Coote, Director, Group Supply Chain, Fonterra

7.2 All correspondence and notices in respect of the application should be directed in the first instance to:

Kotahi Logistics LP
Telephone: 09 551 8500
Facsimile: 09 377 5784
Attention: Chris Greenough, Chief Executive Officer, Kotahi Logistics

and to:

Chapman Tripp
PO Box 993
Wellington

Telephone: 04 499 5999
Facsimile: 04 472 7111
Attention: Grant David

8 DETAILS OF OTHER PARTIES

8.1 Initially the only other party to the proposed practices will be:

Silver Fern Farms Limited
PO Box 941
Dunedin 9054

Telephone: 03 477 3980
Facsimile: 03 474 1087
Attention: Kevin Winders, Chief Operating Officer

8.2 It is intended that further persons will become parties to the proposed practices as Kotahi Logistics attracts further limited partners. Potential limited partners may include other major exporters of primary products and major importers.

8.3 While there have been preliminary discussions with some potential limited partners, none of those persons have entered into the proposed arrangements. Such persons include **[** **]**. The identities of those parties are confidential.

8.4 Customers of Kotahi Logistics who are not limited partners will not be required to commit exclusively to the services of Kotahi Logistics or otherwise be involved in the proposed arrangements for which authorisation is sought.

9 PERSONS INTERCONNECTED TO OR ASSOCIATED WITH EACH PARTY

Fonterra

9.1 Fonterra is a co-operative dairy company incorporated under the Companies Act 1993 and registered under the Co-operative Companies Act 1996. Shares in Fonterra are held by approximately 10,573 supplier shareholders.

9.2 Fonterra operates within New Zealand, and extensively throughout the world through subsidiaries, associated companies and joint ventures.

9.3 Kotahi GP Limited, Kotahi Logistics and DTL, are the persons interconnected to or associated with Fonterra that are primarily relevant to this application.

Silver Fern Farms Limited

9.4 Silver Fern Farms is a red meat products co-operative company incorporated under the Companies Act 1993 and registered under the Co-operative Companies Act 1996.

9.5 Silver Fern Farms operates within New Zealand, and throughout the world, through subsidiaries, associated companies and joint ventures.

10 THE BUSINESS ACTIVITIES OF EACH PARTY (AND INTERCONNECTED OR ASSOCIATED PARTIES)

Fonterra

10.1 The Commission will be familiar with the activities of Fonterra due to its regulatory role under the Dairy Industry Restructuring Act 2001, and its prior consideration of Fonterra in Decision 562 *Fonterra/Rank* and Decision 574 *Fonterra/Kapiti Fine Foods*.

10.2 In summary, Fonterra is a vertically integrated dairy products manufacturer and marketer, operating in all dairy product markets in New Zealand and numerous other countries. Fonterra currently collects approximately 89% of raw milk in New Zealand.

10.3 Fonterra is New Zealand's largest exporter. It exports an estimated **[ ]**% of its total product, representing approximately **[ ]**% of New Zealand's containerised exports.

10.4 As New Zealand's largest exporter, Fonterra is also a major user of ocean freight services from New Zealand as well as intermodal transport services within New Zealand. This is described in detail in paragraphs 14.1 to 14.16 below.

Silver Fern Farms

10.5 Silver Fern Farms is a vertically integrated procurer, producer and marketer of sheep, lamb, beef and venison meat. It operates in all markets for sheep, lamb, beef and venison meat in New Zealand and several other countries. Silver Fern Farms currently acquires and processes **[ ]**% of red meat in New Zealand.

10.6 Silver Fern Farms is also a large scale exporter of New Zealand produce. Approximately **[ ]**% of its produce is exported, representing **[ ]**% of New Zealand's containerised exports.

10.7 As a major exporter, Silver Fern Farms is also a significant user of ocean freight services from New Zealand as well as various transport services within New Zealand. This is described in detail in paragraphs 15.1 to 15.16 below.

11 BENEFICIAL INTERESTS OF PARTIES

Fonterra has no beneficial interest in Silver Fern Farms.

12 LINKS, FORMAL OR INFORMAL, BETWEEN THE PARTIES

12.1 Fonterra is not aware of any links between Fonterra and Silver Fern Farms other than on commercial arms-length terms.

12.2 Any arrangements between Fonterra and Silver Fern Farms are conducted on strictly commercial arms-length terms.

12.3 The respective arrangements proposed to be entered into by Fonterra and Silver Fern Farms are described in paragraph 4 above and set out more fully in the Services Agreement.

13 CROSS-DIRECTORSHIPS

13.1 John Waller, a director of Fonterra, is also a director of Alliance Group Limited, being a company which is involved in the markets in which Silver Fern Farms operates.

13.2 Fonterra is not aware of what (if any) other directorships directors of Silver Fern Farms hold. Certainly they hold no directorships in Fonterra or its interconnected bodies corporate.

PART 2: THE INDUSTRY

14 FONTERRA'S EXISTING FREIGHT ARRANGEMENTS

Raw Milk

14.1 Raw milk transportation involves the collection of milk from the farm gate and movement to factory for processing, and where necessary, between factories. Collection of milk from the farm gate is exclusively performed by a Fonterra owned and operated fleet of approximately 480 tanker trucks. Most raw milk is transported direct to factory by the Fonterra fleet. The remaining **[ ]**% is transported by the Fonterra fleet to rail served bulk milk transfer points and then transported by KiwiRail on dedicated "Milk Trains". Transportation of raw milk between factories is performed by a combination of the Fonterra fleet and contracted trucking providers.

14.2 Fonterra contracts directly with KiwiRail and its contracted trucking providers. Raw milk transportation is not within the scope of Kotahi Logistics' proposed activities.

14.3 Coal and rural supplies handled by Fonterra's subsidiary RD1 are also not within the scope of Kotahi Logistics' proposed activities.

Packaging and Ingredients

14.4 Packaging and Ingredients transportation involves the import of packaging and other inputs (excluding raw milk, coal and rural supplies) from international suppliers and the domestic transport of those products and inputs from local suppliers to Fonterra factories. Contracted road, rail and coastal shipping providers all are used. Whether the responsibility for transport rests with Fonterra or the supplier will depend upon the terms on which the particular product is supplied.

14.5 Predominantly the supplier is responsible for ocean freight transportation and they procure services from the global ocean freight market.

14.6 Where Fonterra is responsible for domestic transport, largely the same model as for finished products is used. Where the supplier is responsible, they will use their own transport assets or procure services from the general freight market.

Finished Products

14.7 Finished product transportation involves the movement of processed dairy products from Fonterra factories to domestic storage facilities or onward to ports for export. Contracted road, rail and coastal shipping providers all are used. In 2010 Fonterra used KiwiRail for approximately 50% of all landside movements of finished products. The balance was primarily carried by road with some minor usage of coastal shipping.

14.8 Fonterra presently procures road transport for finished products non-exclusively from DTL, which in turn subcontracts to a supplier pool of approximately **[ ]** trucking providers. Finished products are transported on road in either palletized form in curtain sided truck trailers or in shipping containers on skeleton trailers.

14.9 Fonterra acquires rail services directly from KiwiRail under long term supply agreements primarily related to specific high volume routes linking factories, handling facilities and ports. Finished products are transported on rail in either palletized form in dedicated curtain sided wagons or in shipping containers on flatbed wagons.

14.10 Fonterra acquires coastal shipping services directly from specialist coastal shipping providers such as Pacifica Shipping.

14.11 Some of Fonterra's domestic freight involves the combination of various transport modes. For example, if the origin and destination sites are not rail served locations: collection from factory by truck; interchange to rail at the local railhead for long distance travel, and finally, interchange to a second truck from the destination railhead for final delivery to destination store. In such cases, Fonterra appoints a lead supplier for end to end movement. That lead supplier is responsible for the procurement and invoicing to Fonterra of all the required transport from multiple suppliers.

14.12 In addition, some domestic freight is currently procured and managed by the ocean freight provider as part of an export bill of lading. For example, many ocean freight providers offer container acceptance at the Port of Tauranga Metroport facility in south Auckland for transport by rail to the Tauranga container terminal. In this case, the ocean freight provider procures the rail transport from Port of Tauranga which in turns holds a contract with KiwiRail for provision of the service.

14.13 In summary, domestic freight involves a combination of direct acquisition by Fonterra and procurement.

Ocean freight of exports

14.14 Contracted ocean freight carriers are used to transport finished products from ports to export customers. Procurement of ocean freight services is conducted primarily through a tender process. Selection of carrier and award of business is based the competitiveness of each carrier's offers.

14.15 Contracts with international carriers vary in term from 1 to 3 years. A carrier's share of a destination is expressed as a percentage share of Fonterra's total requirement for container freight services in respect of that Destination over the duration of the Agreement. The key criteria for awarding carrier share include:

(a) port calls and capacity to satisfy demand and flex;

(b) service quality (schedule integrity, frequency, transit time, lead time); and

(c) cost and sustainability.

14.16 Fonterra makes no guarantee about the volume of work that will be required to be performed by the carrier, but provides the carrier with a rolling forecast of anticipated volumes of services to be performed and uses reasonable endeavours to provide the carrier with orders with respect to services such that the carrier will process a minimum share of services during each financial year.

15 SILVER FERN FARMS' EXISTING FREIGHT ARRANGEMENTS

Domestic Transport

Livestock

15.1 Livestock transportation involves the collection of livestock from the farm gate and movement to factory for processing. Collection of livestock from the farm gate is managed by Livestock Logistics, a joint venture with Silver Fern Farms. Livestock Logistics in turn contracts the cartage of livestock to trucking providers.

15.2 Livestock transportation is not within the scope for Kotahi Logistics' proposed activities.

Packaging and Ingredients

15.3 Packaging and ingredients transportation involves the import of packaging and other inputs (excluding livestock) from international suppliers and the domestic transport of those providers and inputs, local suppliers to Silver Fern Farm factories. Whether the responsibility for transport rests with Silver Fern Farms or the supplier will depend upon the terms on which the particular product is supplied.

15.4 Predominantly, the supplier is responsible for ocean freight transportation and they procure services from the global ocean freight market.

15.5 Where Silver Fern Farms is responsible for transport, largely the same model as for finished products is used. Where the supplier is responsible, they will use their own transport assets or procure services from the general freight market.

Ocean Freight Transport

Finished Goods (Exports)

15.6 Finished product transportation involves the ocean freight transport of processed meat products from ports for export customers. Contracted ocean freight carriers are used to provide these services.

15.7 Procurement of ocean freight transportation is conducted primarily through a tender process. Selection of carrier and award of business is based the competitiveness of each carrier's offer.

15.8 Contracts with international carriers vary in term from 1 to 2 years. A carrier's share of a destination is expressed as a container volume per destination region over the duration of the Agreement. The key criteria for awarding carrier share include:

(a) port calls and capacity to satisfy demand and flex;

(b) service quality (schedule integrity, frequency, transit time, lead time); and

(c) cost and sustainability.

15.9 Silver Fern Farms makes no guarantee about the volume of work that will be required to be performed by the carrier, but provides the carrier with a forecast of anticipated volumes of services to be performed and uses reasonable endeavours to provide the carrier with orders with respect to services such that the carrier will process a minimum share of services during each calendar year.

15.10 Where Silver Fern Farms is responsible for domestic transport, largely the same model as for finished products is used.

Finished Products

15.11 Finished product transportation involves the movement of processed meat products from Silver Fern Farms factories to domestic storage facilities, between Silver Fern Farms Factories for the purpose of consolidating product for export load and onward to ports for export. Additionally, transport delivery to New Zealand customers for domestic sales and to airport for export of air freighted goods. Road, rail and coastal shipping providers all are used.

15.12 Silver Fern Farms presently procures road and rail transport for finished products directly with selected transport operators.

15.13 Some of Silver Fern Farms domestic freight involves the combination of various transport modes. For example, if the origin and destination sites are not rail served locations, the following is required: collection from factory by truck; interchange to rail at the local railhead for long distance travel. Silver Fern Farms holds direct contractual arrangements with both the land transport and rail transport operator in these situations.

15.14 Some domestic freight is currently procured and managed by the ocean freight provider as part of an export Bill of Lading. For example, many ocean freight providers offer container acceptance at the Port of Tauranga Metroport facility in South Auckland for transport by rail to the Tauranga container terminal. In this case, the ocean freight provider procures the rail transport from Port of Tauranga which in turns holds a contract with KiwiRail for provision of the service.

15.15 In addition, ocean freight providers accept cargo at non direct ports of loading and arrange to move this cargo coastally on the deep sea vessels for exchange at a terminal for shipment on the deep sea vessel servicing the required destination.

15.16 In summary, domestic freight involves a combination of direct acquisition by Silver Fern Farms and procurement.

16 KOTAHI PROPOSAL WILL EFFECT A FUNDAMENTAL CHANGE

16.1 It is intended that the Kotahi proposal will effect a fundamental change to those existing transport arrangements, to the benefit of all users of the relevant services, as Kotahi Logistics acquires a substantial degree of influence in the various markets in which it comes to operate.

16.2 Following the initial phase during which Kotahi Logistics confines its activities to procuring services for Fonterra, and upon authorisation, Kotahi Logistics combine that procurement with complementary volumes for Silver Fern Farms, and progressively will extend its activities into:

(a) international ocean freight; and

(b) domestic transport.

16.3 Each of these phases is now described in more detail below.

17 INTERNATIONAL OCEAN FREIGHT

Concept

17.1 This concept involves combining Fonterra's and Silver Fern Farms' export volumes with complementary volumes of importers and other New Zealand exporters and the creation of competitive import/export offerings through coordination with competitive domestic transportation services.

17.2 Value will be created through:

(a) Combining multiple, volatile, seasonal transport demand profiles to deliver a smooth and predictable weekly demand curve; allowing access to attractively priced "take or pay" arrangements with the ocean carriers for a significant portion of the combined volume at minimal risk for freight owners or transport providers.

(b) Improved utilisation of export vessels by export flows across multiple freight owners and seasonal profiles to reduce the occurrence of empty slots; driving a reduction in the premium charged on ex-New Zealand "head-haul" legs.

(c) Creating differentiated foreign port to New Zealand door solutions, combining ocean freight and landside transport offerings marketed through freight forwarders and ocean carriers.

(d) Creating and leveraging balanced north and southbound flows combining Australian import and New Zealand export cargo flows, to disrupt carrier ability to maintain constrained capacity profiles through the potential introduction and support of new players to the Australasia-Asia market.

Value proposition

17.3 Sustainable savings will be achieved by driving down the underlying cost to serve through improved asset utilisation and the introduction of shared risk procurement models, and then extracting the value created (rather than simply leveraging the increased buying power afforded by increased volume). Specific service enhancements will include:

Value for Freight Users	Value for Freight Providers
• Improved service (e.g. schedule integrity, transit time, capacity certainty) • Reduced ocean freight costs • Reduced inland transportation costs • Improved sustainability of ocean freight offerings • Influence on ocean freight industry and capacity • Coordinated infrastructure investment in domestic transport and port • Increase of competitive tension between carriers • Big ships enabler • Reduced vendor management resource requirement	• Value extraction through value creation not simply scaled buying power • Asset utilisation focus • Square demand curve • Shared risk models • "Take or Pay" purchasing • Reduced customer management resource requirement

Services scope

17.4 Kotahi Logistics will develop and offer the following core service scope:

(a) Containerised freight services for importers and exporters.

(b) Inter-modal (land and ocean) based transport solutions for importers, exporters and carriers.

(c) Through DTL, balanced complementary landside freight flows of New Zealand importers and exporters, to improve utilisation of Fonterra's transport arrangements with trucking providers and KiwiRail.

Processes

17.5 Kotahi Logistics will develop a range of core process capabilities:

Capacity Procurement

- Ability to purchase and contract ocean freight capacity and ancillary services.
- Combination of fixed price and spot price procurement.
- Combination of usage based and committed capacity purchasing.
- Combination of round trip and one way purchasing.
- Through DTL, better utilisation of Fonterra's transport arrangements with trucking providers and KiwiRail.

Forecasting

- Ability to consolidate multiple conflicting demand signals into reliable forecast data for suppliers.

Modal Management

- Ability to contract and manage warehouse-to-destination transport demands.

Single Mode Transport Optimisation

- Ability to buy round trip, and price as two one-way journeys, to different cargo owners.

- Ability to optimise disparate loads to maximise vessel utilisation, year round and round trip.

Multi-Mode Transport Optimisation

- Ability to price and invoice for end-to-end multi-modal transport on a single waybill.

- Ability to optimise disparate loads to maximise vehicle & vessel utilisation, year round and round trip.

Visibility

- End-to-end tracking of cargo across different modes – summary and exception based.

- Tracking of cost vs. revenue across multiple customers; multiple suppliers and multiple modes of transport.

Customers

17.6 Kotahi Logistics will actively target those New Zealand freight owners with complementary seasonal and/or directional flows to the existing Fonterra cargo base.

17.7 Meat, forestry, fishing and horticultural producers all provide a useful fit to Fonterra for export flows; as do large Australian and international importers for inward flows. Forestry would only include containerised export of logs, not bulk logs.

Pricing

17.8 Kotahi Logistics will be a self funding entity recovering costs of operation through a combination of discount retention and booking transaction fees. The objective is to lower the cost/price bar for all customers not to create a common rate for ocean freight.

- Buy and sell pricing will not be directly correlated.

- **[ ]**.

- **[ ]**.

17.9 Value will be delivered to customers, and New Zealand generally, primarily through waste reduction and lowering of cost to serve.

- Sustainable model based on creating value through cost reduction not simply price reduction.

- Key cost reduction drivers:

    - Reduced cost of under utilisation through risk sharing with carriers through commitment based purchasing.

    - Removal of complexity costs through:

        - simplification of the supply chain -consolidated demand to fewer hub ports, requiring less port calls, fewer container stocking points and lower container inventories;

        - later allocation of vessel to minimise occurrence of booking re-work; and

        - carrier margin reductions in line with lower risk profile.

17.10 This is shown diagrammatically below:

[ ]

Note: diagram not to scale

18 INTERMODAL TRANSPORT

Concept

18.1 The on-shore concept involves balancing Fonterra's local transport movements to and from ports with complementary flows of other New Zealand exporters and importers. Fonterra's current landside operations are outsourced to DTL, which has existing contractual arrangements with **[ ]** trucking providers. Kotahi Logistics will continue to outsource this function to DTL initially. DTL's current operations account for around **[ ]**% of freight movements by road. It is anticipated that when Kotahi Logistics becomes fully operational that share may get to **[ ]**% at best.

18.2 Value will be created through:

(a) Improved utilisation of New Zealand domestic transport assets (trucks and trains) by balancing cargo flows across multiple freight owners to reduce the ratio of empty transport legs; driving a reduction in the number of premium priced "head-haul" legs.

(b) Combining multiple, volatile, transport demand profiles to deliver a smooth and predictable weekly demand curve; allowing access to attractively priced "take or pay" arrangements with the transport providers for a significant portion of the combined volume at minimal risk for Fonterra.

Value proposition

18.3 Sustainable savings will be achieved by driving down the underlying cost to serve through improved asset utilisation and the introduction of shared risk procurement models and by then extracting the value created rather than simply leveraging the increased buying power afforded by increased volume.

Value for Freight Users	Value for Freight Providers

• Reduced transportation costs
• Reduced transportation assets required
• New revenue generation – clip the ticket
• Improved sustainability of transport solution
• First mover advantage
• Ocean Freight Strategy alignment – bigger ships enabler
• Reduced vendor management resource requirement
	• Value extraction through value creation not simply scaled buying power
	  ○ Asset utilisation focus
	  ○ Balanced head vs. backhaul
	• Square demand curve
	• Shared risk models
	  ○ Unit trains/trucks
	  ○ "Take or Pay" purchasing

Services scope

18.4 Kotahi Logistics will develop and offer the following core service scope:

- Through DTL, point to point road services (existing capability);

- Point to point rail services (new capability).

- Point to point coastal services (new capability).

18.5 Over time Kotahi Logistics' scope will be further expanded to include, as demand dictates, intermodal transport – through investment in or procurement of cross dock facilities and/or dedicated intermodal cargo units.

Processes

18.6 In order to sustainably deliver on this expanded service portfolio to the customer base, Kotahi Logistics will need to develop core skills in the procurement and optimisation of freight events, and enhanced capabilities in information provision to existing and prospective freight owners/controllers.

Freight Procurement

- Ability to purchase and contract across all modal options.

- Combination of fixed price and spot price procurement.

- Combination of usage based and committed capacity purchasing.

- Combination of round trip and one way purchasing.

Modal Management

- Ability to contract and manage rail based transport demands.

Single Mode Transport Optimisation

- Ability to buy round trip and price as two one-way journeys to different cargo owners.

- Ability to optimise disparate loads to maximise vehicle utilisation, year round and round trip.

Multi-Mode Transport Optimisation

- Ability to price and invoice for end to end multi-modal transport on a single waybill.

- Ability to optimise disparate loads to maximise vehicle utilisation, year round and round trip.

Visibility

- End-to-end tracking of cargo across different modes – summary and exception based.

- Tracking of cost v. revenue across multiple customers; multiple suppliers and multiple modes of transport.

Customers

18.7 Kotahi Logistics will actively target freight owners with complementary seasonal or directional flows to the existing cargo base that will enable higher year round and/or round trip utilisation.

18.8 Again, the primary target customer segments, will include **[**

].

18.9 The initial focus will be on routes and cargo's that best complement Kotahi Logistics' anticipated flows. These include:

North Island

- Whangarei - Auckland
- Auckland, Hamilton, Tauranga (Golden Triangle)
- Auckland/Hamilton – Palmerston North (Main Trunk)
- Palmerston North – Napier
- Palmerston North – New Plymouth

South Island

- Marlborough – Christchurch
- Christchurch – Dunedin
- Invercargill – Dunedin

Pricing

18.10 The objective is to lower the cost/price bar for all participants, not to create a common rate for landside transport.

- Buy and sell pricing will not be directly correlated.
- Service based tariff levels will remain a feature.
- **[** **]**.

18.11 Value will be delivered to customers, and New Zealand generally, primarily through waste reduction and lowering of cost to serve.

- Sustainable model based on creating value through cost reduction not simply price reduction.
- Key cost reduction drivers:
    - Optimisation of loads (reduction in head-haul ratio).
    - Reduced cost of under utilisation through:

    - balancing transport demands to reduce the occurrence of "empty legs"; and

    - risk sharing with providers through commitment based purchasing.

- Removal of complexity costs through:

    - Simplification of the supply chain. Consolidated demand to fewer hub ports, increasing the potential of two-way loading and consolidating transport asset deployment.

- Carrier margin reductions in line with lower risk profile.

PART 3: MARKET DEFINITION

19 SERVICES

19.1 As indicated above, Kotahi Logistics will provide, incrementally, a variety of container freight procurement and management services to an expanding limited partner and other customer base.

19.2 While the initial focus will be on servicing customers' container freight requirements from and to New Zealand, the intention is to access and deliver the most efficient global freight solutions potentially available to New Zealand firms. That necessarily will involve Kotahi Logistics actively pursuing improved utilisation of intermodal services (i.e. road, rail and coastal shipping), as well as transport infrastructure within New Zealand on behalf of its customers.

19.3 Specific areas of operation initially will include provision or procurement of all the following services by Kotahi Logistics:

(a) containerised freight services for importers and exporters;

(b) conventional chartering services for importers and exporters;

(c) intermodal (land and ocean) based transport solutions for importers, exporters and carriers; and

(d) other ancillary activities relating to land and ocean freight management.

19.4 That list is not exhaustive. It is intended that the operations of Kotahi Logistics will expand and modify in accordance with customers' changing requirements and developments to New Zealand's transport infrastructure.

19.5 However, those services are unlikely to extend to air cargo services. Carriage of goods by air is seldom a substitute for carriage of goods by sea, with very few dedicated freighters with main deck capacity now servicing New Zealand, especially on the regional routes specified in paragraph 21.5 below. Main deck capacity is important, given container size and the need for certainty of timely delivery. Cargo carried in the belly of passenger planes is vulnerable to competing passenger demand for space. The Commission determined in *Decision No. 511 Air New Zealand/Qantas* that freight services supplied on passenger planes serve a market distinct from that supplied by dedicated freighters.

19.6 Further, relative value of goods carried by air is substantially higher than that carried by sea. Carriage of goods by air only occurs – subject to availability – where the shipper is prepared to pay a substantial difference in price because of time or security reasons.

19.7 The primary market affected is the provision or procurement of container freight services to or from New Zealand by sea. However, carriage of goods by sea to or from New Zealand mostly is exempted from Part 2 of the Commerce Act by section 44(2). Section 44(3) expressly excludes specific landside services from that exemption.

19.8 It is not envisaged that the activities of Kotahi Logistics will be confined to the carriage of goods by sea within the strictures of section 44(2). Kotahi Logistics will provide various landside services directly related to provision of carriage of goods by sea to or from New Zealand.

19.9 In addition, Kotahi Logistics progressively will provide intermodal transport services (involving road, rail and coastal shipping) for its customers. In *Decision No. 533, Port of Tauranga Limited/Toll Limited* the Commission determined that there is one general market for intermodal transport services of export and import cargos to and from ports. That same service definition is relevant here.

20 FUNCTIONAL LEVEL

20.1 While Kotahi Logistics will be providing some of the above services directly to its customers – e.g., export documentation, customs clearance and ancillary management services – its provision of freight services will be mostly through procurement rather than direct provision. That is, Kotahi Logistics will operate at the wholesale level of the supply chain for freight services, although it will be able to bundle freight services with those services which it does provide directly.

20.2 Further, while Kotahi Logistics' limited partners must, and other customers may, acquire their freight services through Kotahi Logistics, other users of those freight services will continue to acquire those services directly, i.e., at retail level from the shippers and other carriers.

20.3 It is therefore suggested that there is nothing material to be gained by separating functional levels of wholesale and retail acquisition into separate markets on this occasion.

21 GEOGRAPHIC DIMENSIONS

21.1 Obviously, the geographic parameters of the relevant market will depend on the particular service which Kotahi Logistics is providing.

21.2 With regard to ocean freight, guidance is to be gained from the Commission's approach to market definition in *Air New Zealand/Qantas*, and the High Court's approval of that approach. Very briefly, with regard to passenger air services the Commission there adopted a single Tasman market (in preference to markets on the basis of individual city pairs); and separate markets between New Zealand and Asia, Pacific Islands, USA and other international destinations.

21.3 While a generic (and thus more geographically expansive) approach was taken to air freight services, those services were not the focus of that decision.

21.4 A much more granular approach was accepted by the parties in *Commerce Commission v Cargolux Airlines*, where markets in New Zealand for the provision of both inbound and outbound air cargo services between New Zealand and individual regions throughout the world were taken. A similar, more detailed approach to ocean freight service markets seems applicable here.

21.5 Adopting a similar approach would see markets for the carriage of goods by sea to or from New Zealand delineated by regional routes serviced by shippers and required by freight users. Those regional routes might be:

- Caribbean;
- Central America;
- East and South Africa;
- Mediterranean;
- Middle East;
- North Africa;
- North America;
- North Asia;
- North Europe;
- Oceania;
- South America;
- South East Asia;
- West Africa; and
- West and Central Asia.

21.6 With intermodal transport, the question of geographic dimension becomes even more complex, according to which combination of road, rail and coastal shipping is involved.

21.7 Historically, the view has been that, even with containerised cargo, individual ports tend to have a hinterland, with costs of intermodal transport in practice deterring most competition between ports on an on-going basis. Rather, volumes are dictated more by surrounding infrastructure of the particular port.

21.8 Thus, competition has tended to occur mostly when major freight owners are contemplating investing in new warehousing facilities or production plants and there is a choice of location. Ports vie keenly for that new investment; but once it is made, the freight user tends to be "captured". That said, as described below, a major user like Fonterra is able to switch substantial volumes from one port to another, through greater utilisation of KiwiRail.

21.9 This would suggest that for domestic transport of containers, separate markets exist for the North and South Islands albeit with some pockets in both Islands where lack or costliness of intermodal transport requires more restrictive dimension.

21.10 With regard to the various ancillary services provided by Kotahi Logistics, market dimension is much simpler. All such markets are national in dimension.

PART 4: COUNTERFACTUAL

22 THERE ARE TWO COUNTERFACTUALS

22.1 Case law provides that, where there is more than one possible counterfactual, it is not a matter of choosing the counterfactual that may seem most likely. Rather, *all* likely counterfactuals must be subject to a competition analysis to assess the "substantiality" of any lessening of competition. Each real and substantial possibility becomes a counterfactual against which the factual is to be assessed: *Woolworths v Commerce Commission*.

22.2 Divining what is likely to happen in the ocean freight sector in the event that the proposed practices for which authorisation is sought do not take place is far from simple. The scenario or scenarios "without" the Kotahi proposal ultimately will depend upon actions taken by the various shipping lines servicing New Zealand, the unilateral reactions of major freight users and freight providers, as well as the potential responses of related infrastructure operators such as ports, rail and other intermodal service providers.

22.3 The reactions of major freight users and responses of infrastructure operators will be closely linked. For example, Fonterra has previously expressed its preference that two ports in each Island invest in the deep water capacity necessary to attract bigger ships. It demonstrated that two port preference by switching its export production at Clandeboye from Timaru to Lyttelton and at Whareroa from New Plymouth to Auckland. That switching was achieved through greater utilisation of KiwiRail; and left ports of Auckland and Tauranga and ports of Lyttelton and Otago servicing Fonterra in the North and South Islands respectively.

22.4 That example has given a message to those ports that they will need to continue to invest to retain a major freight user like Fonterra. Any significant reduction in a port's container volumes risks loss of direct service by the shipping lines servicing that port; with the result that the port potentially becomes under-utilised. That reduced throughput at the port may mean that other customers that are stranded at that port may have to bear the burden of any attempted cost recovery by the port.

22.5 While risk of losing a major freight user may mean continued "competition" between the two major ports in each Island, that competition is unlikely to ensure the level of investment required to enable ports to achieve bigger ships capability. Rather, that competition will likely provoke suboptimal and sporadic investment by individual ports. Further, that investment is more likely to be subsidized by the port's owners than underpinned by assured demand for the port's services.

22.6 If one port does make substantial investment in infrastructure and consequently attracts new voluments of freight, the other port would tend to follow suit, with freight then continuing to be split between them. That "two ports preference" per Island will not promote the commitment required to attract direct service by bigger ships.

22.7 Major realignment of global shipping lines means that the status quo is unlikely for them, too. Even if shipping lines were to continue to use small vessels to service New Zealand routes, rising fuel costs and increasing environmental concerns will prejudice New Zealand freight users.

22.8 In the Freight Futures Report NZIER considered the "direction of travel" that the ocean freight sector will take over the next twenty years. Besides the status quo, NZIER developed three possible scenarios after discussions with Ministry of Transport, being:

(a) hubbing of all New Zealand export and import containers through Australian ports to utilise larger vessels;

(b) a "two ports" strategy – one large port in the North Island and one in the South Island for container traffic; and

(c) a reduction in ship operators willing to service the New Zealand market.

22.9 NZIER concluded that all those alternative scenarios would involve losses for New Zealand relative to the status quo. However the losses that NZIER attributed to the "two ports" strategy would come mostly from perceived increased market power of the ports relative to freight users. The co-ordinated demand of freight services brought to bear by Kotahi Logistics should provide an effective counter to any increased market power of the ports.

22.10 The Bigger Ships Report sees the choice of future direction as more stark. It concludes that:

(a) New Zealand export trade is already being impacted by consolidation of shipping lines;

(b) if New Zealand ports are not "bigger ship capable" within 5 years, only relatively small and old vessels will continue to visit;

(c) significant supply chain benefits could be gained using 7,000 TEU ships;

(d) New Zealand's four largest ports (being Auckland, Tauranga, Lyttelton and Otago) do not presently have the capability to handle such vessels;

(e) with significant infrastructure developments, two of those ports could become bigger ships capable by 2015/16;

(f) if some of New Zealand's ports are not bigger ships capable by then, there is a significant risk of hubbing through Australian ports which are already becoming bigger ships capable.

22.11 Importantly, the Bigger Ships Report concludes that New Zealand could support service by bigger ships within 5 years, based on conservative cargo growth rates. In that regard, port of Tauranga has just reported a 15% growth in container traffic over the last year.

22.12 Taken together, those reports suggest that the status quo is not likely counterfactual from any perspective – shipping lines, ports or freight users.

22.13 Two alternative scenarios seem far more likely:

(a) some infrastructure investment being made by those largest ports but, without certainty of container throughput, no port becoming bigger ships capable within 5 years. That would occur only at a later date;

(b) hubbing to bigger ships capable Australian ports becoming a reality, with only relatively small and old vessels continuing to provide a direct service.

22.14 Both those alternative scenarios are considered as counterfactuals in the NERA report.

23 LAW MAY CHANGE, TOO

23.1 The competition law playing field in the ocean freight sector currently is not a level one. While section 44(2) of the Commerce Act provides a limited exemption for freight users for carriage of their goods to or from New Zealand by sea, shipping lines are much more generously treated. Section 14 of the Shipping Act 1987 provides that nothing in parts 2 and 4 of the Commerce Act shall apply to outward shipping.

23.2 Instead, the Shipping Act provides the Minister of Transport with powers to initiate investigations and issue directions in relation to unfair practices by shipping companies. In practice, that Ministerial regime has been in abeyance for some time and is generally regarded as "toothless".

23.3 The fact that New Zealand retains a Ministerial regime in preference to general competition law has been the subject of ongoing criticism, the most recently being the OECD Survey.

23.4 In contrast, some infrastructure providers, like international airports, now are subject to enhanced regulatory control under the new Part 4 of the Commerce Act. While Part 4 has not yet been applied to ports, potentially it may be if little or no competition were seen to exist in the ports sector. Certainly, if the increased market power of ports relative to freight users perceived by NZIER were to eventuate as a result of a "two ports" strategy, there must be a real prospect of regulation being imposed on those two ports.

23.5 In short, the present inequality of approach is unlikely to be sustained long-term. The recent OECD and Productivity Commission reports both stress the need for New Zealand to re-examine its regulatory settings for international freight services, especially given the importance of such services to New Zealand. Some legislative levelling of the playing field will likely occur, at least in the medium term; and certainly within the intended life of Kotahi Logistics.

23.6 It is possible that legislation to enact the Cartel Bill may become a vehicle to remove the present inequality of treatment of shipping lines, freight users and infrastructure providers, with all becoming subject at least to Part 2 and potentially Part 4 within 2 years. The need for a legislative framework that is able to prevent anti-competitive behaviour by all market participants-ports, shipping lines and freight users – is stressed in the Bigger Ships Report. In the meanwhile, lack of more balanced legislative framework should not act as a further barrier to bigger ships being attracted to New Zealand.

PART 5: EXISTING COMPETITORS

24 IDENTIFY COMPETITORS

24.1 Notional competitors comprise all persons other than Kotahi Logistics (and its limited partners and other customers) who acquire or procure ocean freight and related services to or from New Zealand; and domestically, all persons who acquire or procure trucking, rail or coastal shipping services or intermodal combination of those services. That includes firms that acquire such services directly, as well as those firms that utilise the procurement services of intermediaries.

25 MARKET SHARES

25.1 With regard to ocean freight services, the relative outward containerised market shares of major users are estimated as follows:

Freight Owner	**Estimated Approx Volume (TEU pa)**
Fonterra	[ ]
Carter Holt Harvey	[ ]
Silver Fern Farms	[ ]
Alliance Meats	[ ]
ANZCO	[ ]
AFFCO	[ ]
Zespri	[ ]
Sealord	[ ]
Sanford	[ ]
Apples buying group (Matchbox Brokers)	[ ]
DM Palmer (Apples)	[ ]
Mr Apples	[ ]
Other Apples	[ ]
Talleys Group	[ ]
Other Dairy (OCD, Westland, Tatua)	[ ]
Dong Wah	[ ]
Fletchers Group	[ ]
Onions	[ ]
Wine Industry	[ ]
Other direct shippers	[ ]
Freight Forwarders (consolidators)	
Mondiale	[ ]
Oceanbridge	[ ]
K&N	[ ]
Mainfreight	[ ]
Toll	[ ]

25.2 With regard to inward containerised ocean freight, the market is highly fragmented with a few large importers and a huge tail of small players. Neither Fonterra nor Silver Fern Farms is a significant direct purchaser of inward freight. Fonterra imports approximately **[ ]** TEU.

25.3 The Bigger Ships Report indicates that in 2008, New Zealand exported a total volume of approximately 624,000 TEU of containerised goods, and imported a total volume of approximately 507,500 TEU of containerised goods. The total value of New Zealand's containerised trade in 2008 was NZ $28.3 billion (FOB) for exports, and NZ$22.7 billion (CIF) 39 for imports. This represents 21% and 17% of New Zealand's GDP respectively.

25.4 Those totals now may be a little dated. It is estimated that Fonterra would be responsible for approximately **[ ]**% of containerised exports with Silver Fern Farms responsible for a further **[ ]**%.

PART 6: POTENTIAL COMPETITION

26 Potential competitors comprise all persons who in the near future may individually seek to acquire the ocean freight, domestic carriage of goods or related services of a kind being acquired or procured by Kotahi Logistics. Again, that would include both direct acquisition of such services as well as procurement through intermediaries.

27 That would include any combination of persons established to collaboratively acquire or procure such services. Such collaborative activity will become much easier when the Cartel Bill becomes law.

28 REQUIREMENTS OF ENTRY

28.1 Not relevant – all persons seeking to acquire or procure ocean freight or other services are able to enter the market.

29 FACTORS IMPEDING ENTRY

29.1 Not relevant.

30 FACTORS PROMPTING ENTRY

30.1 Not relevant.

31 COUNTERVEILING POWER IN THE MARKET

31.1 Kotahi Logistics' initial focus will be procurement of ocean freight services of finished products to export customers and of imports to New Zealand. The foreign shipping lines which provide those ocean freight services exert a substantial degree of influence, not only when negotiating with freight owners, but also when negotiating with the ports. New Zealand port charges may represent a small proportion of the overall costs to the shipping lines; but they provide the vital income stream for port companies. Changes to ship calls can have a significant impact on a port's profitability, both through revenues associated with volume changes and with revenues flowing from other marine services. Cargo volumes that are lost by a port cannot be easily replaced. The recent experience of Timaru – which now has only one weekly service – illustrates this vulnerability.

31.2 Freight owners are similarly at risk of change, or threatened change of route or frequency of calls by shipping lines. Different cargos are more time-sensitive than others. But, ultimately, all export cargos must get to market in accordance with customers' expectations. Further, freight owners and third party infrastructure providers may have invested in transport or port-side infrastructure (such as warehousing facilities) at or near to the particular port. That investment will be "stranded" if the shipping line changes its route.

31.3 The relative bargaining strength of industry participants and their negotiation strategies is discussed in detail in section 2.4 of the Freight Futures Report. Those paragraphs are attached as Appendix A.

31.4 However the 4 subparagraphs which describe most succinctly the countervailing power of the shipping lines are set out in full below:

- *Through mergers and differential rates of growth, container shipping lines have become very much larger and trade is becoming increasingly concentrated in the hands of fewer shipping lines. In 1995, the largest container shipping line, Sealand (Maersk), had capacity of only 188,000 TEUs. By January 2009, the 15 largest container lines all had capacity of more than 250,000 TEUs each. Nine of these 15 container lines have scheduled services to New Zealand. Maersk is the largest with capacity of 2,000,000 TEUs, followed by MSC (Mediterranean Shipping Company) with 1,400,000 TEUs. In the case of Maersk, much of its growth has come through mergers with other European shipping lines, like P&O. On the other hand, MSC's growth has been entirely organic and not at all due to mergers. In 2000, the top three container shipping lines had a combined market share of 22%. By 2009, this had climbed to 34%;*

- *Shipping lines are effectively exempt from the provisions of Part 2 of the Commerce Act when it comes to arrangements relating to international shipping. Thus, they are able to collude with one another and act as a cartel when setting rates and charges and can use their market power to reduce competition. Port companies have no such exemption. They are required to compete with one another and are precluded from colluding or using their market power to countervail against large shipping companies;*

- *The proportion of New Zealand's trade carried in containers has increased markedly over the last 15 years or so, which has strengthened the negotiating position of the container shipping lines relative to the port companies as they now handle more of the trade. In 1995, New Zealand's total container volume amounted to approximately 650,000 TEUs and this represented only 15% of the total volume of trade by weight. By 2009, the number of containers had increased to approximately 2,350,000 TEUs and this represented 38% of trade by weight. In value terms, the share of containers would be even higher as it is mainly the low value to weight cargoes such as timber, coal and fertiliser that are not containerised.*

- *The size of the container ships operating in New Zealand has recently increased from around 3,000 TEUs to around 4,100 TEUs with suggestions that the next generation of ships will be in the 5,000 to 7,000 TEU range. In 1988, the average container ship in the global fleet had a capacity of 1,303 TEUs. By 2009, this had increased to 2,654 TEUs and, on the basis of ships under construction and likely retirements, is projected to increase to 3,127 TEUs by 2012. The larger the vessels, the fewer visits required for a given volume of cargo, the greater the pressure to provide larger infrastructure to service arriving vessels and the greater the negotiating strength of the container shipping lines.*

PART 7: PUBLIC BENEFITS AND DETRIMENTS

32 PUBLIC BENEFITS

Benefits must be viewed against National Infrastructure Plan

32.1 While Kotahi Logistics will be seeking to drive down ocean freight and other transport costs for its limited partners and customers - through the coordination of demand, leveraging of scale and promoting of greater efficiency throughout the supply chain, achieving costs savings for the benefit of individual firms is not the primary driver. Rather, the Kotahi proposal is aimed at creating a more efficient freight system for all New Zealand firms by promoting greater consistency and more integrated investment in the transport sector.

32.2 Those changes are most unlikely to occur while demand for ocean freight and intermodal transport services remain so fragmented. Even Fonterra – whose usage of containerised freight services currently dwarfs that of any other users – standing alone cannot expect to drive the necessary change. Demand for change will only be successful where that demand comes from a critical mass of freight users standing together as one.

32.3 Further, to the extent that the benefits resulting from that change will be external to the individual firm, such benefit is difficult to quantify in the abstract. However, as the Commission has very recently noted in the authorisation context:

> *Quantification is only one tool to be used in its judgment in such a case.*

Indeed, analysis at a higher and qualitative level may be more appropriate in this case. The assessment in the just released *National Infrastructure Plan 2011* of the key issues facing New Zealand's transport sector well illustrates this.

32.4 The Plan says:

> *Efficient movement of freight into, out of, and across New Zealand, is of critical importance to economic performance. Transport infrastructure supports the movement of exports from production, to port and then to market. As transport can be a large component of the cost of supplying goods to markets, any improvements in efficiency will make a significant difference to the competitiveness of our products.*
>
> *It is not simply about moving goods in and offshore. A well functioning domestic freight sector links raw materials with processors, distributes goods to retailers and consumers.*
>
> *Some key issues for freight movement:*
>
> *Most freight in New Zealand is moved by road. Coastal shipping and rail (with the improvements that the government is supporting through the KiwiRail Turnaround Plan) provide alternative networks. A more strategic approach to logistics management may result in different decisions being made in the future. Longer term, the logistics required for the overall supply chain need to be considered alongside land use decisions.*

The volume of surface trade and New Zealand's distance from global markets means it is vulnerable to changes in international shipping patterns. New Zealand's primary ports need to retain flexibility in their operations to continue to meet challenges like larger ships and less frequent port calls. A port sector that is competitive both domestically and internationally is a must for our tradables sector. Ultimately, ports operate in a commercial environment in New Zealand and, provided regulatory settings are appropriate, this framework should continue. This will be important for ensuring the port infrastructure is expanded in the future if necessary.

Attention must be paid to the impact of land use decisions on the transport network. Also, transport technology affect infrastructure, and road user charges reflect this. Changes to allow for heavier trucks, and thus fewer journeys to deliver a given amount of freight provide a maintenance and renewal challenge. Aligned with a more strategic approach to land use considerations is the need to examine the resilience of our supply chains across the country. The key focus is on ensuring that each mode understands the demand pressures and development plans of the other modes and responds with their own investment decisions accordingly. Greater certainty and consistency in developed plans will allow logistics operators to operate in a more integrated way benefiting exporters, the economy and community in general.

32.5 The following benefits, which will more quickly and more certainly arise in the context of the Kotahi proposal than without it, must be viewed against issues facing New Zealand.

Reduction in land transport costs

32.6 At present New Zealand's intermodal transport infrastructure is poorly utilised, with a substantial proportion of all truck and rail wagon movements occurring simply to reposition equipment without revenue generating cargo loads. Underutilisation of deployed assets has resulted in a high percentage of all cargo moves being charged at premium "head-haul" rates as providers seek to recover the cost of empty transport legs. In particular:

(a) New Zealand import flows run primarily from North to South;

(b) New Zealand export flows tend toward intra-regional movements although Fonterra also maintains significant inter-regional South to North flows;

(c) Most New Zealand cargo movements are highly time sensitive i.e. must move on a specific day. In contrast, Fonterra with its ability to pack early; typically has flexibility of **[ ]** in transport timing.

32.7 Thus there is opportunity to balance Fonterra landside transport movements with complementary flows within the New Zealand freight community.

32.8 Value will be created through:

(a) Improved utilisation of New Zealand intermodal transport assets (trucks and trains) by balancing cargo flows across multiple freight owners to reduce the ratio of empty transport legs;

(b) Combining multiple, volatile, transport demand profiles to deliver a smooth and predictable weekly demand curve;

(c) Accessing attractively priced "take or pay" arrangements with transport providers for a significant portion of the combined volume.

32.9 Sustainable savings will be achieved by reducing waste in the underlying cost to serve through improved asset utilisation and the introduction of shared risk procurement models. The value thus created may be extracted rather than simply leveraging the increased buying power afforded by increased volume.

Value for New Zealand Freight Users	Value for Intermodal Transport Providers

• Improved sustainability of transport solution
• Reduced vendor management resource requirement
• Reduced transportation costs
	• Reduced transportation assets required to service the same volume
	• Value extraction through value creation not simply scaled buying power
	  o Asset Utilisation Focus
	  o Balanced head vs. backhaul
	• Square demand curve
	• Shared Risk Models
	  o Unit Trains/Trucks
	• Take or Pay purchasing

Better connectivity to markets

32.10 The OECD estimate New Zealand's distance to market adds a 10 percent penalty on gross domestic product.

32.11 Global fuel costs have increased dramatically, further and disproportionately impacting New Zealand exporters due to distance to market and the relatively small fuel inefficient vessels currently serving the New Zealand coast. e.g. Zespri announced a significant drop in annual profit with fuel cost exposure being cited as the single largest influence.

32.12 The efficiency, reliability and cost-effectiveness of the international supply chain is vitally important for New Zealand, because not only is it geographically most distant from its key trading partners, but its economic prosperity is highly dependent on the performance of its primary export sectors. Djankov et al (2006) finds that each additional day a product is delayed is equivalent to a country distancing itself from its trading partners by 1%.

32.13 Unless bigger ships can be enticed to New Zealand, there are two possible scenarios:

(a) Only relatively small and old vessels will continue to visit New Zealand, which becomes less competitive as fuel and other costs trend upwards;

(b) Carriers will reduce direct services to New Zealand in favour of services connecting with bigger ships servicing Australia.

32.14 At a strategic level, a key benefit of bigger ships is they can assist in protecting and enhancing the efficiency of freight services between New Zealand and key international hubs, by reducing the risk of New Zealand being relegated to 'boutique' services that use relatively small and old ships with higher cost-to-serve.

32.15 Maersk has intimated already there is "even a long-term possibility that New Zealand may lose all direct international callers and accede to a feeder role via Australia". (PortStrategy.com (29 May 2010). http://www.portstrategy.com/news101/australasia/nz-ports-future-under-scrutiny).

32.16 Hubbing through an Australian port such as Melbourne, Sydney or Brisbane would be detrimental to New Zealand's trade performance. The competitiveness of New Zealand's exports will be at risk if loss of direct access to key overseas transhipment hubs results in increased shipment time and costs, and reduces the reliability of shipment times to market.

32.17 Further, each time cargo is handled at a port, it incurs an additional cargo-handling charge. For an Australian hub port scenario, because all cargo (imports and exports) would be transhipped through Australia, they would incur an additional cargo handling (or transhipment) charge in Australia. Auckland Regional Holdings (2009) estimates the average cargo handling charge at Australian ports is approx. NZ $400 per TEU.

32.18 Auckland Regional Holdings (2009) also estimates transit times would increase by at least four days if New Zealand cargo were transhipped through Australia, compared with more direct services from New Zealand to the same destination (holding all other parameters constant, including sailing speed, port calls etc).

32.19 Transhipping through Australia would also put New Zealand cargo in a vulnerable position during peak Australian export seasons, because container slots allocated for New Zealand exports could be reallocated to larger Australian exporters who suddenly need extra capacity and have the bargaining power to secure it from shipping companies, at New Zealand shippers' expense.

32.20 Ensuring and accelerating a migration to bigger ships is critical to countering these adverse prospects . This will require consolidation of New Zealand cargo to fewer hub ports capable of servicing those bigger ships.

Service quality

32.21 The ability of exporters and importers to connect effectively with distant markets depends on the performance of the entire supply chain in terms of cost, time, and above all, reliability and predictability.

32.22 To date there has been increasing service degradation off the New Zealand coast – the further consolidation of carrier services and increased transit times through introduction of slow and super-slow steaming programs. The resulting increase of 7 days in the shortest transit time to Europe is impacting viability of New Zealand chilled meat exports to this traditional market.

32.23 Consolidation and smoothing of demand will facilitate the introduction of new carrier services and capacity into New Zealand by underwriting a larger proportion of a capacity of each vessel .

32.24 The introduction of new capacity will have a number of service quality benefits, including:

(a) Introduction of shorter transit time options for most major regional markets;

(b) Creation of competitive tension in the ocean freight market to drive improved carrier performance.

Cost of distance to market

32.25 Hummels (2001) identifies two time-related costs for exporters and importers. They are:

(a) Inventory holding costs. For exporters, inventory holding costs include the opportunity cost of capital tied up in goods in transit. For importers, inventory holding costs include the cost of having to hold larger stocks of inventory to accommodate variations in the arrival time of imports. With imported goods, any additional inventory holding costs are likely to be inflationary, as importers pass on these costs to their customers. There is less scope for exporters to pass on these costs, as it would reduce the international competitiveness of New Zealand's exports. Assuming a weighted average cost of capital of 10% per annum, inventory holding costs equate to approx. 0.03% of the value of the cargo per day.

(b) Product loss of value. This captures any reason a newly produced good might be preferable to an older good. Examples include the spoilage or reduced shelf life of fresh meat and produce, items with immediate information content such as newspapers, and highly seasonal goods, for which demand is difficult to forecast, for example Christmas or Easter themed products, seasonal fashion apparel. For example, the Meat Industry Association notes the shelf life of chilled meat ranges from 70 to 90 days. If transit delays mean chilled meat has to be frozen down, its economic value could be reduced by up to 50%, as it is in essence a distressed product.

Avoid inefficient infrastructure spend

32.26 With co-ordination of demand of freight services New Zealand already has sufficient volume to efficiently use bigger ships, servicing the South East Asia route . This volume could be further increased by routing a greater proportion of Chinese and North Asian cargo via South East Asia. Currently, however, this cargo base is fragmented across a wide range of ports.

32.27 New Zealand operates 10 container ports, none of which are currently bigger ship capable. And most attract premiums from the carriers which serve them.

32.28 Fonterra depends on the port companies to drive productivity and invest rationally to ensure New Zealand attracts efficient shipping services to maintain its cost position on the global market. In recent years Fonterra has achieved efficiencies and reduced order lead times by moving away from its traditional model of "utilizing the closest port". **[**

].

32.29 Most other freight owners still maintain a closest port usage policy. Fonterra is the only scale shipper to move materially from this model; and has done so only recently.

32.30 Bigger ships are unlikely to call at more than 2 New Zealand ports on any single service.

32.31 New Zealand cannot afford to not invest in bigger ship capable ports; but New Zealand cannot afford to invest in too many ports becoming bigger ship capable, either.

32.32 The Bigger Ships Report identified Auckland, Tauranga, Lyttelton and Otago as having plans to invest in infrastructure to become bigger ship capable. Page 9 of Bigger Ships Report stated:

> *The amount of capital investment required for each port to become 7000 TEU ship capable is in the range of NZ $40 million to $200 million per port.*
>
> *In the shorter term (i.e. within five years), not all four ports would need to make this capital investment initially, for New Zealand to attract [bigger] ships. In fact, having all four ports investing simultaneously to become [bigger] ships capable within five years could deliver sub-optimal outcomes for New Zealand.*

32.33 The investment required at Port of Tauranga to become 7000 TEU ship capable is significantly lower than at Ports of Auckland (i.e. NZ $50 to $80 million, compared with NZ $200 million for Auckland to have comparable capability).

32.34 The Government recently committed NZ $750 million over the next three years to support KiwiRail's 'Turnaround Plan' – a targeted investment programme which aims to turn KiwiRail into a sustainable rail business within 10 years. Key features of the plan include targeted investment on key routes, and adding new locomotives and wagons to the fleet: refer Office of the Minister of Transport (18 May 2010). Press Release: "Government Investment for Rail Turnaround". http://www.beehive.govt.nz/release/government+investment+rail+turnaround.

32.35 Kotahi Logistics will consolidate cargo demand to ports with viable bigger ship potential; providing a sustainable demand signal for ports and other infrastructure providers to enable investment decisions (within and outside the port gate) – "letting the market decide" but on a shorter timescale.

32.36 Such consolidation of cargo will provide a scale view of demand upon which ports, KiwiRail and TransitNZ can base future infrastructure investment decisions with a reduced risk profile.

32.37 KiwiRail acting rationally, as a priority, will ensure the funding is targeted at those parts of the rail network that will support a bigger ships future.

Reduced shipping costs

32.38 New Zealand's ocean freight export market is dominated by a few major cargo owners with a broad range of individual smaller players. The market is characterised by a lack of coordination between cargo owners and volatile weekly demand profiles, exposing carriers to a continual feast and famine cycle alternating between excess demand and underutilisation. Carrier response has been to mitigate the under-utilisation risk by rationalising capacity, offering reduced flexibility for cargo owners while enabling successive demand/supply related rate increases.

32.39 Ex-New Zealand ocean capacity has been significantly eroded over the last 2 years.

32.40 Standard service capacity has been reduced by 35% (~270,000 TEU per annum) though reduced standard capacity partially compensated by increased use of extra loader vessels (~40-50k TEU p.a.) – weaker origin and destination port coverage, premium priced, lumpy supply.

(a) Services have consolidated through proliferation of Vessel Sharing Agreements (code sharing on ships) offering less choice in capacity and service options.

(b) MSC maintain the only single carrier service of any scale with all others sharing a reduced number of ships.

(c) North Asia is a good example of consolidation through Vessel Sharing Agreement: 2 services to 1; overall reduction of ~1700 usable slots a week while New Zealand export demand on this route increased significantly.

(d) Proliferation of additional charges being imposed on smaller exporters and importers

(e) New Zealand exporters left with little choice due to limited capacity alternatives

32.41 The introduction of new standard service capacity is critical to countering these adverse market conditions. Acting independently, freight owners lack the scale and demand stability to achieve this.

32.42 The benefit centres on the combination of Fonterra import/export ocean freight volumes with complementary New Zealand exporters and importers.

(a) Fonterra will work with other major New Zealand exporters to pool cargo and operations to reduce costs and present a stable demand profile for ex-New Zealand ocean freight. This will encourage the introduction of new ocean capacity, increasing competition amongst carriers and improve vessel utilisation.

(b) Alignment with New Zealand (and Australian) importers will further allow matching of north and southbound cargo flows, delivering even higher levels of utilisation. In support of GDT expansion and global sourcing, this entity will build on the scale and capabilities developed in New Zealand to deliver international import/export solutions.

32.43 Value will be created through:

(a) Creating and leveraging balanced north and southbound flows combining Australasian import and export cargo flows to disrupt carrier ability to maintain constrained capacity profiles through the potential introduction and support of new players to the Australasia-Asia trade.

(b) Combining multiple, volatile, seasonal transport demand profiles to deliver a smooth and predictable weekly demand curve; allowing access to attractively priced “take or pay” arrangements with the ocean carriers for a significant portion of the combined volume.

(c) Improved utilisation of vessels by export flows across multiple freight owners and seasonal profiles to reduce the occurrence of empty slots;

32.44 Sustainable savings will be achieved by driving down the underlying cost to serve through improved asset utilisation and the introduction of shared risk procurement models and then extracting the value created rather than simply leveraging the increased buying power afforded by increased volume.

Value for New Zealand Freight Owners	**Value for Ocean Freight Providers**

• Improved service performance
• Reduced ocean freight costs
• New revenue generation
• Influence on ocean freight industry & capacity
• Influence of domestic transport and port infrastructure investment
• Increase of competitive tension between carriers
• Improved sustainability of ocean freight offerings
• First mover advantage from our privileged position
• Reduced vendor management cost
	• Value extraction through value creation not simply scaled buying power
	  o Asset Utilisation Focus
	• Square demand curve
	• Shared Risk Models
	  o Take or Pay purchasing
	• Reduced customer management resource requirement

Reduced carbon footprint

32.45 Bigger ships are more fuel efficient (and therefore more carbon efficient) than smaller ships because less fuel is required to transport each TEU of cargo. A reduction in the carbon profile of shipping is particularly important for New Zealand because:

(a) Geographically, New Zealand is far from many of its key international export markets. Accordingly, the carriage of New Zealand exports to overseas markets is more carbon intensive than goods not travelling as far. This may affect the demand for New Zealand products in an environment where parties focus on food miles only, rather than the overall carbon footprint of the total supply chain.

(b) Any future international carbon trading or taxation scheme that covers the international ocean freight industry would increase shipping costs for exporters and importers. Whilst maritime greenhouse gas emissions are not yet covered internationally by the likes of the Kyoto Protocol, there is increasing pressure on the United Nations and the International Maritime Organization to introduce emissions tax or trading schemes for ocean freight (United Nations' Economic and Social Commission for Asia and the Pacific, 2007).

32.46 KiwiRail has advised the rail network currently has sufficient below-rail (i.e. track) capacity to move larger volumes of freight to and from New Zealand ports. The current line utilisation ranges from between 15% to 67% of capacity on the main segments of the network: refer page 63 of Bigger Ships Report.

32.47 There is also sufficient current track capacity at the ports to handle significantly more freight train services than the numbers currently operating. The key rail capacity constraint at ports is related to the productivity of cargo handling (i.e. how quickly trains can be loaded or unloaded at the port). Current rail capacity at ports can be increased up to its theoretical track capacity with improved train turn-times at ports.

Consolidation of Domestic Freight
Transportation

32.48 Migration from closest to best port will require cost effective intermodal transport alternatives (road, rail or coastal shipping) i.e. the cost incurred by the longer distance domestic leg must be less than the ocean freight premium charged for the closest port. At present:

(a) New Zealand's landside transport infrastructure is poorly utilised - Significant proportion of all truck and rail wagon movements occur to reposition equipment without revenue generating cargo loads.

(b) New Zealand import flows run primarily from North to South e.g.: Auckland – Palmerston North and Christchurch – Dunedin.

(c) New Zealand export flows tend toward intra-regional movements (closest port) however Fonterra also maintains significant South to North flows e.g.: Whareroa to Auckland, Clandeboye to Christchurch.

(d) Most New Zealand cargo movements are highly time sensitive i.e. must move on a specific day. In contrast, Fonterra typically has flexibility of **[ ]** in transport timing.

32.49 Fonterra is KiwiRail's largest single freight owner customer moving 1.8M MT of finished product per annum (Toll is slightly larger but a freight forwarder rather a freight owner). Main Routes are:

(a) Whangarei – Auckland

(b) Auckland – Hamilton – Tauranga (Golden Triangle)

(c) Auckland/Hamilton – Palmerston North (Main Trunk)

(d) Whareroa – Palmerston North – Napier

(e) Whareroa – New Plymouth

32.50 **[ ]** – but half Fonterra's current rail spend is to ship empty containers around New Zealand (up to 90000 long haul truck trip equivalents per annum in the North Island alone). This is a waste of capacity that could be used to service contra domestic flows, allowing better utilisation of KiwiRail's existing assets and moving cargo off road and onto rail.

32.51 Kotahi Logistics will work with KiwiRail and major New Zealand importers and distributors to fill empty capacity. That opportunity is presently constrained by a lack of efficient road/rail interchange points at hub locations.

Inland Ports

32.52 Multi-user inland port and freight interchange facilities are required to enable cargo consolidation to hub ports, overcome resource constraints inside the port gate and enable the efficient movement of freight between road and rail.

32.53 Likely first phase locations are:

(a) **[ ]**

(b) **[ ]**

(c) **[ ]**

32.54 Kotahi Logistics will explore with ports and other infrastructure investors opportunities to build and operate multi user campus facilities to offer:

(a) Empty Container Depots

(b) Container Transfer

(c) Cross Docking

(d) Container de-van and pack

(e) Port gate in

(f) Efficient road and rail links between ports and the hinterland.

32.55 Without coordinated demand for freight services there is the risk that multiple parties may build duplicate inland port facilities that due to scale limitations will not deliver efficiencies and levels of service reliability achieved internationally. Again, the Kotahi proposal reduces the prospect of such duplication.

33 DETRIMENTS

33.1 The Kotahi proposal, in essence, involves establishing a collective of exporters and importers to ensure more secure and more efficient supply chains to overseas markets.

33.2 To the extent that Kotahi Logistics confines its activities to carriage of goods by sea to and from New Zealand (as defined for the purposes of section 44(2)), all such services - and any detriment arising from their actual or deemed competition consequences - are expressly exempt from Part 2 of the Commerce Act and present consideration.

33.3 To an extent that any non-exempt activities related to carriage of goods by sea or other landside services affect markets within New Zealand, those activities will be subject to all of the provisions of Part 2. In particular, some aspects of the arrangements proposed to be entered into by Kotahi Logistics and its limited partners – initially Fonterra and Silver Fern Farms – may breach sections 27, 29 and 30 of the Commerce Act.

33.4 Exposure to sections 29 and 30 arises primarily because Fonterra and Silver Fern Farms (and other firms which agree to use Kotahi Logistics' services) are notionally "competitors" in relation to their individual acquisition of the services that Kotahi Logistics will procure and provide.

33.5 With section 29, it is only an exclusive aspect of a supply arrangement to which limited partners (but not necessarily other customers) must agree that is problematic. Such exclusionary arrangements are no longer per se unlawful, if it can be proved that the particular arrangement in practice does not have the purpose or effect of substantially lessening competition. While no single exclusionary arrangement will likely have that effect, at some stage the aggregation of several such arrangements entered into by several limited partners might.

33.6 With section 30, the situation is different and more complicated. Any arrangement between competitors which if found to have for purpose or effect of providing for the fixing, controlling or maintaining of price, is deemed to substantially lessen competition irrespective of actual effect. The issue here is whether either or both of the section 31 and section 33 exceptions operates to oust the section 30 deeming provision.

33.7 Section 31 contains an exhaustive list of exceptions for joint ventures. Unhelpfully those exceptions differ according to whether the joint venture is unincorporated or incorporated, or for the provision of goods or services. The exceptions apply in graduated fashion – in particular, services supplied by an unincorporated joint venture must additionally be shown to be "made available as a result of the joint venture" to quality for the exception.

33.8 The limited partnership concept – introduced to the statute book but not the Commerce Act 22 years after those exceptions – seems to straddle both the unincorporated and incorporated species of joint venture. But, put simply, the section 31 and section 33 exceptions for joint buying arrangements are unlikely to be sufficiently broad to protect all of the landside activities which Kotahi Logistics contemplates providing to its limited partners (and others), from the deeming rule.

33.9 Even if those exceptions were sufficient to oust the deeming provision, the section 27 test of substantially lessening competition still would apply. Section 27 involves disjunctive "purpose" and "effect" limbs; and the latter is difficult to apply hypothetically. In essence, legality of the particular arrangement depends upon how much the affected market is constrained, relative to how that market would operate without that arrangement. With both of the exclusive dealing and collective buying arrangements of the kind the Kotahi proposal contemplates, the particular issue is the extent to which affected markets are foreclosed to other buyers and sellers. The greater that market foreclosure, the greater the risk.

33.10 Duration is also relevant, with arrangements that are intended to endure long term or permanently seen as more harmful to competition than (say) 5 year arrangements.

33.11 Practically speaking, the issue here is that Kotahi Logistics will become a significant acquirer of shipping and related services and intermodal transport services within relevant New Zealand markets as it will be procuring those services on behalf of firms that themselves are major users of such services. Suppliers of those services who are unable to secure Kotahi Logistics' custom may effectively have a large portion of demand foreclosed to them.

33.12 Similarly, other users of those services – who cannot match Kotahi Logistics' coordinated demand – may be disadvantaged vis a vis those who acquire through Kotahi Logistics, especially in times of shortage.

33.13 Whether or not the substantially lessening competition line is crossed in relation to a particular service at a particular time will depend on various factors, including availability of alternative supply, "depth" of demand, barriers to entry or expansion, and prevailing industry practice. But, speaking very generally, the more successful Kotahi Logistics becomes in attracting further limited partners and customers to use its services on an exclusive basis, the greater the risk that the section 27 threshold will be crossed and section 29 defence negated.

33.14 Against that, as discussed in paragraph 5.18 above, those long term potential effects are mitigated by the ability of limited partners to terminate their Services Agreements and exit the Limited Partnership effectively on a yearly basis.

33.15 Importantly, any lessening of competition, or deemed lessening, gives the Commission jurisdiction to grant authorisation. Such lessening or deemed lessening may occur without actual detriments.

34 BALANCING OF PUBLIC BENEFITS AND DETRIMENTS

34.1 NERA have been asked to consider the public benefits and detriments likely to come from the Kotahi proposal. NERA's Broad Review of Benefits and Detriments is appended to this application.

34.2 NERA have identified the following benefits (both generic and specific to particular markets):

(a) By aggregating and co-ordinating demand for freight across all modes, Kotahi Logistics will generate a "flatter" demand profile and economies of scale. This will:

(i) increase the utilization of freight assets, thus lowering transport costs;

(ii) reduce risk for freight carriers; and

(iii) increase the attractiveness of New Zealand to ocean carriers and potentially give Kotahi Logistics countervailing power against ocean carriers.

(b) Reduce the number of empty return legs by balancing import/export flows;

(c) Aggregate freight volumes at certain points, which will assist in:

(i) underwriting new investments in transport capacity; and

(ii) attracting larger ships to New Zealand Ports.

(d) Reduce the risk of New Zealand becoming a spoke to Australian port hubs, by facilitating and speeding up required investment in New Zealand ports; and

(e) By switching domestic transport away from trucking and increasing the utilisation of truck movements, carbon emissions will potentially be reduced.

34.3 NERA have quantified the benefits of larger ship visits and better utilisation of domestic transport assets, net of the costs of the required port investment to enable larger ships to visit and the cost of additional resources required for domestic container transport. Estimated over an eight-year period, the 2012 present value of the net benefit is:

(a) $78m to $204m if Kotahi brings forward large ship visits to New Zealand by three years; or

(b) $814m to $959m if Kotahi avoids New Zealand ports becoming spokes to Australian hubs.

34.4 In addition NERA estimates that the Kotahi proposal is likely to result in better utilisation of domestic transport assets, having further present value benefits of $**[ ]**m.

34.5 NERA have identified a possible allocative efficiency detriment of Project Kotahi, insofar as it potentially allows Kotahi Logistics to exercise buyer power over suppliers of transport services. However, the extent to which this is a detriment is limited because:

(a) the extent of aggregation in domestic transport markets is very small, and therefore any price effect would likely be immaterial; and

(b) Kotahi Logistics' ability to exercise buyer power against domestic and international freight companies will be constrained, because it will be in Kotahi Logistics interests to ensure these companies remain in business and have incentives to invest.

34.6 Accordingly, NERA concluded that there will not be any material level of allocative efficiency detriment from Project Kotahi. Similarly, since participants in Kotahi Logistics continue to compete in their output markets, there will be no material impact on the broad competitive pressures on participants to be productively and dynamically efficient.

PART 8: IDENTIFICATION OF INTERESTED PARTIES

34.7 The parties primarily interested in this application are the shipping lines from which Kotahi Logistics will be acquiring freight services on behalf of its limited partners and other customers. The shipping lines currently servicing New Zealand are set out in Appendix B.

34.8 Other interested parties include the ports and other parties referred to in the Bigger Ships Report and Freight Futures Report and in Appendix B.

35 PART 9: CONFIDENTIALITY

35.1 The Applicant claims confidentiality for this Application pursuant to section 100 of the Commerce Act and section 9(2)(b) of the Official Information Act 1982. A Public Version will be provided separately which will identify confidential information by enclosing it in bold square brackets (i.e. **[ ]**) (the *Confidential Information*). The Confidential Information is commercially sensitive and valuable information which is confidential to the Applicant and disclosure would be likely to unreasonably prejudice the commercial position of the Applicant.

35.2 The Applicant requests it be notified of any request made under the Official Information Act for release of Confidential Information, and that the Commission seeks its views as to whether the Confidential Information remains confidential and commercially sensitive at the time responses to such requests are being considered.

DECLARATION

THIS NOTICE is given by Joe Coote, Director, Group Supply Chain, Fonterra.

I hereby confirm that:

- all information specified by the Commission has been supplied;
- if information has not been supplied, reasons have been included as to why the information has not been supplied;
- all information known to the applicant(s) which is relevant to the consideration of this application/notice has been supplied; and
- all information supplied is correct as at the date of this application/notice.

I undertake to advise the Commission immediately of any material change in circumstances relating to the application/notice.

Dated this 13 day September of 2011

Director, Group Supply Chain

I am an officer of the company and am duly authorised to make this application/notice.

Authorised signatory D. A. MATTHEWS
GENERAL COUNSEL.

WARNING

It is an offence to attempt to deceive or knowingly mislead the Commission in respect of any matter before the Commission. Any person who does so is liable upon summary conviction to a fine of up to $10,000 (for an individual) or $30,000 (for a body corporate). Refer to sections 103(2) and (4) of the Act.