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11 February 2021

Geoff Lewis
Inquiry Director
The New Zealand Productivity Commission
By email: Geoff.lewis@productivity.govt.nz

Dear Geoff

FONTERRA COMMENTS ON THE PRODUCTIVITY COMMISSION'S DRAFT REPORT: *NEW ZEALAND FIRMS: REACHING FOR THE FRONTIER*

1. Thank you for the opportunity to provide some comments on the NZPC draft report on 'frontier firms' in New Zealand. We see this as an important discussion: as a business strongly anchored in New Zealand and committed to the sustainability and prosperity of New Zealand and its people, we support research that can help unlock further progress for our Co-operative, the dairy industry and our economy.

2. We believe there is strong alignment between Fonterra and the concept of a frontier firm. Accordingly, we are interested in insights and findings that will help us be more productive and to deliver more for New Zealand. We also accept that like all businesses Fonterra has had successes and failures, including making investments that have not delivered according to perceived potential. However, in many aspects our business has been very successful in highly competitive global marketplaces and has delivered strong sustainable value to NZ. We think that it would provide useful insights for the Commission's final report to comprehensively cover the progress of a frontier firm such as Fonterra, including to understand fully the impact that Government regulation can have on its business.

3. We do, however, disagree strongly with the draft report's findings and recommendation with respect to the Dairy Industry Restructuring Act and reversing the changes made unanimously by Parliament in 2020. We believe that recommendation R9.2 (Draft Report, p.134) advocates a regulatory measure that is among the more detrimental things Government could do to handicap the innovation and value creation potential of Fonterra.

4. Below I set out our comments on the draft report. There are clearly limits as to the amount of detail that can be provided in this format: we would welcome the opportunity for further discussion with the Commission in coming weeks as this report is finalized and are very happy to provide further information if you have questions or if the final report would benefit from greater detail.

Productivity, Profit and Value

5. While there is plenty of useful content in the draft report and much with which we would agree, we do have questions about the way the report has sought to frame its research. In particular we think it would be useful to be clearer and more consistent about the relationship between productivity itself, and other measures or outcomes which at times seem to be used as proxies for productivity such as

competition or measures of company value. For example, we believe that relying on single data points such as share value are an inadequate proxy for measuring productivity or drawing conclusions about the relative performance of firms over the long term. For example, an interesting metric (particularly when making comparisons between privately held companies and co-operatives such as Fonterra) to explore would be Total Societal Impact (TSI) rather than the narrow – and arguably increasingly outdated Total Shareholder Return (TSR) model.

Qualities of successful Frontier Firms and Fonterra

6. We think there is a strong case that Fonterra is a successful frontier firm in a New Zealand context. The draft report suggests that "Exporting at scale is the way to reach for the global frontier" (Draft Report, p.2). The description of successful firms in Small Advanced Economies (SAEs) would seem to describe Fonterra well:

   Their frontier firms operate at the global frontier; in other words, they are world leading. Around each of them exists an ecosystem of many smaller businesses supplying complementary products or specialised inputs. Supporting them are researchers and innovators in both public and private employment, a pipeline of highly educated graduates and post-graduates, investment in enabling infrastructure and regulations, and investors with deep knowledge and understanding of the industry. (Draft Report, p. 2)

7. In addition to the thousands of businesses Fonterra supports across New Zealand from its commercial operations there are also other ways in which Fonterra supports NZ Inc in a way that appears to be characteristic of a frontier firm. For example, we partner with other companies, Crown Research Institutes, Universities and Central Government agencies on R&D. We employ and train thousands of highly skilled staff. We enjoy a collaborative partnership with the unions that represent our manufacturing workers. We use our scale to make significant community contributions including helping children and families with their nutrition needs through programmes such as Kickstart Breakfasts.

8. Our scale also allows us to contribute to "NZ Inc" through facilitating access to foreign markets for other New Zealand companies – for example, by building demand for dairy in China and more generally building the New Zealand provenance story, in which we have invested heavily and from which all New Zealand-origin dairy and other products benefit.

9. Our Co-op also provides input and support on New Zealand trade negotiations and broader trade policy issues. In the context of free trade agreement (FTA) negotiations, our unique commercial perspective informs New Zealand's FTA priorities for dairy. We provide direct commercial insights into market trends, consumer perceptions, growth in domestic consumption for markets across key products and future trade opportunities. We are also uniquely positioned to advise on technical disciplines, such as tariff quota administration and safeguards, given our in-market and trade policy expertise.

10. Through our local subsidiaries, we are also members of key trade-related organisations across different countries, including Eucolait (the European dairy processors association), IDFA (the US dairy processors organisation) and the Federation of Malaysian Manufacturers, where we contribute to better outcomes on issues such as non-tariff barriers to New Zealand exports. Given the broad nature of our export markets and our network, we are often an "early warning system" for the New Zealand Government and other New Zealand dairy exporters on barriers faced in overseas markets (subsidies in the EU, US and Canada are a good example).

11. From a food regulatory perspective, our Co-op is also actively involved in working with the New Zealand government to shape the global regulatory environment. We provide expert advisers to participate in standards development processes in international organisations such as the Codex Alimentarius Commission and the International Standards Organisation. We also work with MPI and colleagues and stakeholders in offshore markets to monitor and influence the development of country-

specific standards that could impact on exports of dairy products out of New Zealand. We are also closely engaged in regional and international trade associations such as the International Dairy Federation and Food Industry Asia, where we aim to ensure that the positions and activities of these bodies support agricultural and food production processes that are used in New Zealand.

12. Given this alignment between the role Fonterra plays in the NZ primary sector and broader economy and the report's focus on such frontier firms, we believe the report has the opportunity to usefully test thinking about frontier firms against the Fonterra example. Such analysis could examine where and why Fonterra has succeeded to the degree that we have, but also why our business has not done better. Such analysis could place the report in a position to advocate for the changes that might unlock further productivity within Fonterra's business and important lessons for other existing or potential NZ frontier firms.

The role of regulation in the dairy sector

13. Unfortunately, while the main thrust of the draft report is encouraging from a Fonterra perspective, perhaps the most surprising of the findings and recommendations are those in section 9 with respect to the analysis of the dairy sector and the role played by the Dairy Industry Restructuring Act (DIRA). These points culminate in recommendation R9.2 (Draft Report, p.134) which from our perspective advocates a regulatory measure that is among the most detrimental things Government could do to handicap the innovation and value creation potential of Fonterra. R9.2 also appears to contradict directly many of the key points made in the draft report about the importance of regulation enabling innovation, rather than the other way around (Draft Report, p. 127).

14. Where the draft report focusses on the dairy industry, we are particularly disappointed in the poorly informed analysis that characterizes this section. It seems to be a significant missed opportunity that the Commission has not sought to understand in detail the actual productivity characteristics of the industry and a company such as Fonterra – as a frontier firm as set out by the Commission – and then made recommendations based on what could be done better, or what the NZ economy could learn from the dairy sector's experience.

15. The misalignment between the rest of the draft report and the dairy sector recommendations seems to arise because the analysis of the dairy sector does not measure or account for productivity in the sector and instead rests its analysis of success on what we would argue are inadequate and partial measures of value and performance – measures that also tend to overlook the core ways Fonterra delivers value.

16. This challenge is compounded by an apparent assumption that greater domestic competition can and should be equated with greater productivity within the NZ dairy sector. We agree that fair and healthy competition between dairy processors is an important policy outcome, but it is not the only policy goal. In fact the ability to compete at scale in competitive global dairy markets sits behind both the original desire to form Fonterra (and thus the passage of DIRA in 2001), and subsequent amendments to DIRA including those made in the second half of 2020.

The impact of DIRA

17. In creating a guaranteed buyer for milk, the DIRA regulations incentivised land-use change into dairy, and then de-risked the establishment of Independent Processors by forcing Fonterra to carry enough processing capacity to take suppliers back should the new business falter or fail. This had several impacts:

    - Fonterra was forced into the position of allocating scarce capital to cover growth in milk volumes with a particular focus on managing peak milk at the height of the production season. This constrained Fonterra into a particular asset footprint explicitly built towards a supplier demand rather than a more optimal customer led footprint.

- Furthermore, given the nature of consenting and construction in New Zealand, Fonterra was at times forced to anticipate large future milk growth which it had no ability to meaningfully control. In some cases, this did not eventuate (Central North Island forestry conversions to dairy in the late 2000s are a good example, the lack of progress on the Hunter Downs Irrigation Scheme in South Canterbury is another) leaving Fonterra with an even further constrained asset footprint.
- Capital-constrained or highly indebted Fonterra suppliers, often under pressure from their banks, were encouraged to supply new companies by the promise of a competitive milk price, a debt-reduction/capital injection to their farm businesses through selling Fonterra shares, and a guaranteed ability to return to Fonterra should the new company not meet the farmer's expectations. This compounded the capital risk sitting with remaining Fonterra shareholders.

18. These combined factors have imposed significant cumulative costs on Fonterra and our shareholding farmers. In significant cases it has meant that available capital has had to be invested in peak manufacturing capacity rather than value-add manufacturing production. It has meant our business needs to carry spare manufacturing capacity for farmers who could return to Fonterra. By being obligated to invest in large processing assets with a long capital life, DIRA has contributed to a legacy issue for Fonterra, in that we need to continue to efficiently process milk through this capacity to protect the value of those investments.

19. The regulatory distortion of creating a guaranteed buyer for milk, transfers risk away from the entities best placed to manage the risk of land-use change and new processing capacity—the new entrant processors and their suppliers—to Fonterra and our shareholding farmers. As a matter of both New Zealand economic history (e.g. NZ's experience with 'supplementary minimum payments' in the late 1970s, with in that case the government as the guaranteed buyer, is synonymous with lowering, not increasing, agricultural productivity) and economic theory, inefficient allocation of risk is likely to lower not increase productivity over time as the investment decisions by entities subsidised by the risk transfer are distorted. We would argue it is important that the Commission addresses these distortions in arriving at any final recommendations.

DIRA and Fonterra strategy

20. These factors above have combined to mean that Fonterra's business strategy has been handicapped by a need to remain significantly supply led with resultant capital challenges.

21. The major policy goal which brought about DIRA in the first place is the desire for a large NZ dairy company to be able to compete in global dairy markets at scale. This is the goal that Parliament supported unanimously in 2020 when it decided that the open entry obligation on Fonterra should end on 1 June 2023. This significant change will allow us to deploy capital over time away from our supply-led legacy and will help contribute to Fonterra's strategy of moving to a strong global customer-led model. In this way we would argue that the 2020 DIRA reforms are in fact an excellent example of enabling-legislation that is designed to allow Fonterra to be more innovative, and to focus its capital and business model on demand-driven value creation. We would expect this in turn will help make us more productive and deliver enhanced value for New Zealand.

22. If, however, New Zealand were to adopt the recommendations in the draft report, it would be likely to accelerate a trend towards industry-wide over-capacity which in turn could lead to industry-wide low returns as milk growth drops. This could result in a long period of stagnation in the sector – as we have seen with the red meat processing industry. Eventually players might capitulate and close plants. While this would "fix" the over-capacity problem, it would itself have serious negative consequences for the individuals and communities affected. Such an outcome would also be likely to directly challenge the initial raison d'etre of DIRA: to ensure NZ had a dairy business of sufficient scale to compete internationally. It also creates a catch-22 situation for Fonterra: having been obligated to

invest capital in assets required because of regulation, regulation would now be being used to undermine their economic value and that of Fonterra.

DIRA and competition

23. Competition is clearly important, but it is important to distinguish competition from competitors. Competition is a process of rivalry to offer suppliers and customers better products and prices. Individual firms may adopt different strategies; some will succeed, and others will fail. Entry by competitors cannot be subsidised (by transferring risk to Fonterra suppliers) indefinitely without losing the original purpose of the DIRA framework. That framework both created Fonterra and established expiring competition metrics. Had the original balance between domestic and global competitiveness struck in 2001 been adhered to the original DIRA competition provisions would have fallen away by now (NI trigger: 87.5% Market share, SI Trigger: 65m kgMS to IPs).

24. In amending the Act over time Parliament has considered these arguments. Regular amendments of DIRA have raised the market share triggers (from those envisaged in 2001), as well as introduced other mechanisms to ensure market transparency and domestic competition such as the milk price manual. However in its latest update of DIRA in 2020, Parliament unanimously concluded that it would be appropriate to remove the open entry requirement on Fonterra from June 2023, whilst maintaining (or indeed strengthening) other controls on Fonterra such as the milk price setting process, and ensuring regular ongoing parliamentary reviews of the regime as a whole. We accept that after similar detailed and careful analysis the Commission might disagree with this conclusion. However, the draft report does not appear to undertake much analysis to support this conclusion.

25. DIRA has been very successful in creating domestic competition in the New Zealand dairy industry. Our market share has reduced from 96% in 2001 to around 80% today. As the draft report notes:

    Competition affects all three forces that shape an economy's productivity growth: reallocating people, physical resources, and finance from lagging to leading firms; pushing out the technology frontier; and diffusing technology from leading to lagging firms. (p. 128)

26. However, what the draft report doesn't cover is that in constraining Fonterra, the forces the Commission points to have been distorted, not simply in the favour of independent processors and to the detriment of Fonterra and our shareholders, but against other primary sector players (the risk of undertaking dairy is substantially less than alternative uses given the guaranteed buyer). At the same time, by the very nature of our business (with 95% of our product being sold internationally) Fonterra remains subject to strong competitive discipline in our international markets.

Competition in the NZ dairy industry

27. DIRA has clearly been successful in ensuring NZ consumers have access to a wide variety of competitively priced dairy products. In terms of tilting the competitive playing field to discriminate in favour of new entrants (e.g. through guaranteed raw milk supply at cost and forcing Fonterra to carry the milk supply risk for new entrants through the open entry provisions) DIRA has likewise ensured a number of private and public companies have been formed since 2001, largely through foreign investment. As noted, however, we think the draft report fails to address the cost to Fonterra of the regulatory constraints of DIRA as Fonterra's milk supply share has inevitably decreased over the past 20 years. In particular we think the Commission should take into account:

    - While clearly there has been a significant rise in the number of dairy processing companies operating in NZ, what is less clear is whether these new companies have brought genuine innovation into the NZ dairy sector. While a number of Independent Processors in New Zealand have established valuable businesses, beyond the obvious branding and marketing success to date of The a2 Milk Company, it is less clear others have done so using products, processes, markets or approaches that are different to those already employed by Fonterra or other legacy

NZ dairy companies. We would welcome further detail from the Commission on this: the examples cited in the report (OCD, Synlait, Miraka) could equally be used to describe Fonterra's business – in fact in several cases Fonterra's success in these areas is industry-leading (we outline further details about Fonterra's performance below).

- There are risks in narrowing the scope of analysis to focus on early-growth phase market capitalisation of relatively new dairy industry players without at the same time seeking to understand the much *more* complex and internationally competitive story of Fonterra.

Innovation and the Dairy Sector

28. While arguing about the need for new investment to provide innovation, the draft report appears to overlook Fonterra's successful innovation story – innovation that has occurred despite the regulatory constraints outlined above. We are one of New Zealand's largest private sector investors in R&D with an annual budget of more than $98m (FY20) and a track record of bringing significant value-driving innovations to market.

29. In addition to our annual central R&D spend, we invest in innovation across our business, in collaborations with other research bodies, through joint ventures with other parties such as the Pastoral Greenhouse Gas Research Consortium (PGgRC), and on behalf of the industry as a whole. In particular, our farmers' contribution to DairyNZ accounts for most of DairyNZ's R&D spend, which benefits the New Zealand dairy industry as a whole.

30. Further, we think it is risky to measure R&D simply by expenditure, as a lot of R&D expenditure can be wasted. What is more important is R&D outcomes. Our R&D investments and their outcomes keep us competitive with other global food companies. For example, Sysco, the world's largest food distributor, has named our Anchor Food Professionals Culinary Cream in its top 10 most innovative products. Our cream scored the highest innovation score and purchase intent in the history of their innovation platform. This is because the cream is already reduced and saves chefs time in getting the right consistency and thickness. It was formulated at our R&D Centre in 2007 and is the only cream of its kind on the market (so we take real care to protect the intellectual property behind this innovation).

31. In 2008 we launched our IQF mozzarella using world-leading patented technology developed at our R&D Centre and supported by Transforming the Dairy Value Chain – a Primary Growth Partnership (PGP) programme between the Ministry of Primary Industries, Fonterra and DairyNZ. It has features that bind the topping to the base and provide colour and texture and extra stretch – a key part of the pizza experience. It's snap frozen at peak maturity to capture freshness and its authentic taste, and pre-shredded for ease of use. In September 2018 we commissioned a new $240 million plant to help meet growing demand – the single largest foodservice investment in New Zealand's dairy industry history, doubling our Co-op's capacity to produce this revolutionary mozzarella, which is made from milk in one day instead of the usual two to three months taken by conventional mozzarella processes.

32. Another example is our complex milk lipids made at our Edgecumbe site. We add complex lipid ingredients to our maternal, infant and older adult products generally for cognitive benefits and also mobility (joint and muscle). Complex milk lipids can also be used for gut health and we are actively exploring new applications and benefits.

33. Our milk "finger-printing" technology developed in 2015, which led to our research and development arm winning the Innovation Excellence in Research award at the 2015 New Zealand Innovators Awards. The milk finger-printing technology cuts some testing costs by more than 99 per cent and significantly reduces the time required for processing results. Instead of some tests taking days or weeks we can test hundreds of samples in seconds, cutting processing times and cost. However, its benefits go far beyond ensuring a quality, safe supply of dairy nutrition. The composition of milk varies

seasonally, and between farms and regions. This means milk from one of our farms may be better suited to one specific product rather than another. Milk finger-printing provides information about each farm's milk so rapidly that when combined with our sophisticated tanker scheduling system, we can now send our milk to the manufacturing site that will get the most value out of every drop. The development of milk fingerprinting was partially funded by Transforming the Dairy Value Chain – a PGP programme between the Ministry of Primary Industries, Fonterra and DairyNZ that aims to create new products, increase on-farm productivity, reduce environmental impacts and improve agricultural education.

34. We would argue that Fonterra could have made a larger contribution to R&D and innovation in the absence of DIRA's open entry requirements and the attendant volume pressure to our business from our obligation to accept all supply. As discussed, open entry has required investment in sufficient processing capacity to meet all potential new supply, thereby crowding-out investment in higher value producing plant or R&D.

35. The Commission notes that we are no longer in an environment of substantial milk growth. Both environmental regulations, and the 2020 changes to DIRA, have altered the attraction of land-use change with respect to dairy. We agree with the Commission's suggestion (p.132) that the industry focus must now be to grow value rather than volume. Where we would differ with the Commission view is the apparent suggestion in the draft report that the only way to get further value is through more domestic competition. This view does not allow for the possibility that Fonterra itself will now be much freer to continue to accelerate its climb up the value chain. We would not suggest it is axiomatically true that what is commercially beneficial to independent dairy processors is good for the productivity of the NZ dairy sector (and of course nor is it necessarily true that what is good for Fonterra is good for the NZ dairy sector!). In summary we think there is a strong case for the Commission to engage in analysis of actual behaviour, productivity and regulatory settings in the dairy sector rather than consider recommendations which would perpetuate the very market settings which have led to the present productivity in the sector.

Understanding Fonterra's business and how it creates value for New Zealand

36. As noted above, we believe the draft report inadequately analyses Fonterra's business and fails to take into account the value the company creates – for its shareholders and also for New Zealand. As also noted above, in advocating for regulatory change to re-handicap Fonterra's business back into being a supply-driven company, the draft report also challenges the idea that there are significant benefits in Fonterra's scale. We provide further comment on these points below.

37. As with other companies, co-operatives such as Fonterra exist to deliver value: to their shareholders and, certainly in the case of Fonterra, beyond this to other stakeholders. Fonterra creates value in a number of ways: through the highest sustainable milk price it seeks, and then pays to its shareholders which then circulates through the wider economy (analysis supports that 50 percent of Fonterra pay-out is spent in NZ's regional economy); through increases to its share price; through the well-paying skilled jobs it creates in New Zealand and its strong relationship with the Dairy Workers' and E Tu unions; through its contribution to innovation clusters and education (such as those clustered with Fonterra's Research and Development Centre in Palmerston North), though its leadership and advocacy for sustainability solutions to address environmental challenges facing the dairy sector (such as its leadership role in the first and second generation Clean Streams Accords), and through its market penetration activity that opens, secures and maintains NZ presence in key offshore markets to the benefit of a diverse eco-system of NZ Inc companies.

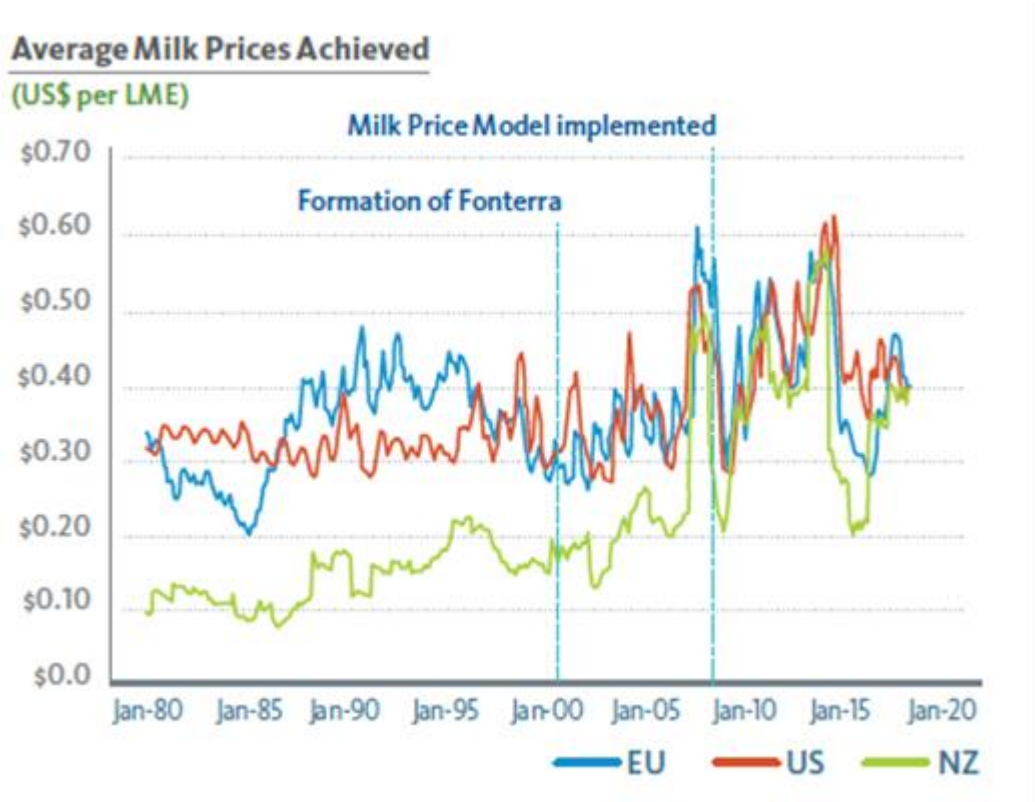
38. Fonterra does not apologise for its focus on paying the highest sustainable milk price to its shareholders. We believe it is in New Zealand's broader interests for regional economies to benefit from this significant economic injection each year. While we accept that milk price or farmer pay-out is not necessarily an analogue of productivity, we believe it is an important component and is arguably

as significant as share price. Unfortunately, the Commission's draft report, and the analysis undertaken by its consultants, focusses almost exclusively on share price as a proxy for productivity and thereby misses one of the key value-deliverers of the Fonterra business.

Milk Price and Innovation

39. The criticisms of 'high' milk price in the draft report are worth further analysis: that having a 'high' milk price stifles innovation, and secondly that strong milk prices become capitalised in the value of shareholders' farms which is bad for New Zealand.

40. On the first point, the milk price paid to New Zealand farmers is broadly at par with that paid to farmers in our two largest competitors in global dairy markets: the EU and the US. Interestingly, as the graph below shows, since the formation of Fonterra this gap has narrowed – a fact which we would argue is direct evidence of the success of Fonterra since 2001 in terms of the total economic return to the New Zealand economy. It also suggests, that in comparing New Zealand dairy companies to successful food companies in other countries, we need to discount the idea that a low milk price is an important factor in their success or in their ability to invest or innovate.



41. In its submission to the 2018 DIRA Review Terms of Reference, small dairy co-operative Tatua, which has a track record of paying a high milk price compared to other processors in NZ, yet has been highly successful in exploiting high-value niche markets through its innovative products, argued with respect to the Fonterra milk price that:

Tatua believes that a strong Fonterra Co-operative is good for New Zealand. The co-operative model provides an essential risk management function for the whole dairy sector, because it passes the effects of market volatility onto the farming sector which has the greatest financial value and resilience. In the absence of a dominant Fonterra Co-operative, and Fonterra reference milk price there is a real risk that long term farm returns would diminish, resulting in an erosion of farm resilience, and at the extreme, failure of the farm gate milk price in some regions.

In the absence of a co-operative Fonterra, milk producers supplying independently owned processors would likely bear the impact of global market and foreign exchange downturns, but not necessarily obtain the full rewards of positive market performance. In dairying regions with no or little farm-gate milk competition this could lead to an erosion of long term returns and reduced on-farm resilience. (Tatua submission 2018)

42. The second question about asset price inflation due to high milk prices is a complex one in a New Zealand context. Any company shareholders, whether holding assets in productive businesses such as farms or in shares, are typically happy at strong asset growth. It is clear that Fonterra has created significant asset value for its shareholders in the past 20 years. The draft report argues this is "undesirable" (p 132) which from some perspectives is understandable - for example it makes farmer succession more challenging, although new models of ownership such as equity partnerships are evolving in NZ to address this. It does not, however, provide any comparative analysis as to the genuine costs or benefits of this compared, say, to the alternative of greater proportions of the available value chain being captured by private shareholders who may or may not live in New Zealand. While we understand that the independent processors in New Zealand are motivated to pay as little for their milk as possible in order to maximise returns to their shareholders, we would argue care needs to be taken in inferring that this is also to New Zealand's overall economic benefit: whether measured through productivity or otherwise. It would certainly seem to be harmful to rural and regional New Zealand for the industry to be led by companies focussed on minimising their milk costs.

43. On the other hand, the attraction of our co-operative model is that it is successful in capturing a greater proportion of the global value chain of the dairy business within the New Zealand economy than would be the case if the market was dominated by private or public corporates.

Measuring the success of the Fonterra Co-operative

44. We acknowledge that we cannot cherry pick the measures by which Fonterra's success or failure is measured. However, we are concerned that there is high reliance in the draft report in benchmarking Fonterra's progress against aspirational claims made in the political context of building a case in 2000-2001 around the formation of Fonterra as the draft report does on page 131. (Interestingly even Fonterra arch-critic Peter Fraser in his polemic against Fonterra's then-performance in 2019 discounted the importance of the "hype" of the claims surrounding Fonterra's formation in 2001!) (Peter Fraser, Apocalypse Cow, 2019).

45. We would argue that an assessment of the performance of a co-operative such as Fonterra should account for the total benefits, including to their farm productivity, obtained by its shareholders relative to what they could achieve through other supply routes. In their influential report on co-operatives in New Zealand, Evans and Meade state:

    It is not strictly meaningful to consider cooperative performance in isolation, since cooperatives represent an extension of the production process beginning with their owner-suppliers (or customers). Thus, from the perspective of the cooperatives' owner-patrons, an assessment of cooperative performance should not consider just the cooperative portion of the productive entity. It should account for the total benefits derived by these owner-patrons relative to what they would achieve from alternative supply and investment routes. Care must be paid to the fact that cooperatives are often modelled as having a zero-profit objective, with patrons securing their returns not on capital investment but via patronage returns. Hence simple comparisons with the profitability of profit-maximising IOFs will be skewed. Moreover, comparisons of cooperatives and IOFs should allow for the various "ancillary services" provided by cooperatives, such as member education and political representation, which increase cooperative production costs and affect efficiency assessments (Evans and Meade 2006).

46. Fonterra's current roll-out of bespoke Farm Environment Plans to all its shareholders at no direct cost to ensure these farms can operate successfully within environmental regulation in their location is a perfect example of such ancillary services.

47. With respects to the link between productivity, innovation and business success, we think there is an opportunity for the draft report to better reflect Fonterra's track record of delivering value-add from

sophisticated management of its base-ingredient portfolio, advanced ingredients and from its strong performing food service business.

48. Our Co-op's export product mix has increasingly moved to value add. In 2017/18, 45% of our raw milk was directed to value-add products, up from 42% in 2016/17. Value add investments are typically longer-term plays and take time to deliver higher returns. In addition, our size/scale and the volume of raw milk collected means we could never be a solely value add business, and commodities provide flexibility to allow for variation in year-to-year volumes. Value add products often only use a proportion of the components in a litre of raw milk collected and the remaining components need to be optimised. We see this in the United States and Europe where industry sells fat as butter and cheese in the domestic market, and then exports the skim milk powder and whey powder by-products. However, as the figures above show, we are seeing a shift in the make-up of Fonterra's exports to more value add.

49. It is also important to clarify that value add includes not only our consumer and foodservice business (which is the area most commonly understood to involve value add), but also advanced ingredients and logistics and other services, such as price risk management services, available to customers in connection with our products.

50. Advanced ingredients are differentiated products that attract premium prices over base ingredients through superior product performance, differentiated offerings (such as non-GMO or grass-fed milk) or claims that are backed by science. We have a continuous innovation pipeline of new, value-add ingredients – giving our customers new ways to differentiate their products with consumers. Examples include low lactose instant whole milk powder (which offers lactose intolerant people the chance to enjoy dairy), pastry butter (designed for exceptional performance in pastry and bakery applications), extra-stretch cheese, our SurestartTM range of science backed ingredients for infant and maternal nutrition and our SureproteinTM range of high protein ingredients for sports and active lifestyles and medical nutrition applications. When we first started reporting Advanced Ingredients separately in 2017, sales had increased 9% on the prior year and comprised 19% of our total external sales volume.

51. Building on this, in 2018 we launched three dedicated business units focused on medical nutrition, sports and active lifestyle and paediatrics to further strengthen our focus on advanced ingredients solutions. Our functional Whey Protein Concentrate technologies are enabling high quality dairy proteins to be delivered for the first time in a more palatable format at the concentrated levels required by ready-to-drink Medical Nutrition products. Medical and active ageing nutrition are fast-growing sectors, as lifespans increase and as lifestyle-associated diseases emerge as the key global cause of death. The global medical nutrition industry is valued at $17.5 billion today and is expected to grow to almost $24 billion by 2020.

52. On the consumer products side, we have grown our cream cheese production through a new investment in Darfield and expanded our Clandeboye mozzarella plant to service growing demand for higher-value dairy products, primarily in China. Already, our cheese tops around 50% of pizzas sold in China, one of the fastest growing pizza markets in the world. Since entering the Chinese consumer UHT liquid milk market in 2014 sales have increased 630%, over the last 10 years our sales of consumer creams have increased 780%, and since 2011 our mozzarella sales have increased 50%.

53. Building on these consumer product developments, our foodservice business, Anchor Food Professionals, is now New Zealand's sixth biggest export business, having generated more than $2 billion in annual revenue over the past year (for example larger than the entire New Zealand wine industry). While COVID is having a significant short-term impact in some markets, globally, people are increasingly eating out and we are taking advantage of what we see as a long-term trend. Anchor Food Professionals is currently growing around 10 times faster than the total global foodservice market.

Scope for more investment in value added production

54. However, as noted above, we don't disagree that we could have invested more in value added production in the past decade, but again, it is important to understand the role the now removed DIRA open entry provisions have played. During the period of highest dairy growth in New Zealand (between the 2008/09 and 2014/15 seasons), the requirement that we accept all milk required us to have assets on the ground to process large volumes of milk during the peak of the season and those assets had to make products that were already in demand. As with any corporate, the amount available for capital investment in any year is limited and at the time, with high milk growth, the most predictable demand (with consistent demand from China) was for milk powder which could also be produced efficiently and quickly. For example, approximately 30 - 40% more whole milk powder can be produced per hour than nutritional powders. We therefore invested more than NZ$1 billion in whole milk powder plants over this time.

55. In summary, Fonterra believes it has a strong and in most cases market-leading story to tell in most of the areas cited by the draft report as strengths of other New Zealand dairy companies: whether it be efficient manufacturing and exporting commodities, or developing "business-to-business (B2B) and high-end brands and distribution channels." (page 131). We think this also reinforces that it is arguable that new investment in the NZ dairy sector has led to significant innovation in either products or business practices (although factors such as the foreign investment, a significant characteristic of all the new dairy investments in New Zealand, certainly means there has been innovation in corporate form as the draft report notes).

56. It could be argued that some of the smaller companies have been able to bring a degree of specialisation that Fonterra cannot because of the New Zealand seasonal milk curve which makes large scale manufacturing of base products essential at peak production. However, a diverse portfolio of products and markets is an important risk mitigation tool for Fonterra in volatile international markets (as demonstrated during the 2020 COVID crisis). It should also be understood that many of the smaller milk companies within New Zealand typically exchange milk components among themselves to allow any specialisation they undertake to occur.

Next Steps

57. As noted above we are keen to engage with the Commission to ensure the final version of the Frontier Firms report is as well-informed, insightful and useful as possible. We appreciate there is limited time before the final version of the report will be published in March 2021 but stand ready to discuss any of the above points with the Commission team and to provide further information of evidence to the above points as needed.

58. In addition to ensuring it has all the information useful about Fonterra and the NZ dairy sector, on the basis of the points outlined above, we believe it would be useful for the Commission to undertake further analysis on:

    - Actual analysis of Fonterra's productivity as a firm. The consultant's report that underlies the Commission's dairy sector analysis mentions "productivity" only once. As noted above, unsourced claims made in the political context of the effort to form Fonterra two decades ago (growth of 15% p.a.) are used as the sole yardstick against which to assess Fonterra's success. This seems to be counter to the cautions set out elsewhere in the report on how to read firms success against productivity.

    - Deeper analysis on the dynamic relationship between productivity and competition in the dairy sector; a contested area the Commission could add helpful analysis and evidence to. Having little analysis about Fonterra, the draft report moves on to consider competition in the dairy sector – thereby suggesting competition can be read as a direct substitute for productivity. As noted above, this approach seems to mistakenly assume that using regulation to constrain Fonterra is cost-free or at least cost neutral compared to encouraging more competition.

- Interestingly the draft report suggests that at the macro-level NZ's low ranking for "simplification and evaluation of regulations" might be a reason for our low productivity (Draft Report, p.21) – but then suggests more of the same for the dairy sector without analysis of the regulatory settings that dairy has operated under in the last two decades. Indeed, other parts of the report (an inquiry into why NZ isn't seeing greater productivity despite world's best competition settings at the macro-level) would seem to suggest the analysis of the dairy sector is questionable. The basic conclusion of the dairy section of the report is that DIRA has produced a set of outcomes which are sub-optimal, but that reverting the 2020 changes to let that continue will produce a different outcome. Perhaps enabling domestic competition has come at a cost to productivity and global competitiveness? Afterall, Fonterra is not free from competitive discipline – it operates in a highly competitive global market. Considering only domestic manufacturing competition meaningfully hobbles the dairy analysis.

59. I look forward to further discussion and consideration of these issues.

Yours sincerely

Simon Tucker
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