MEDIA RELEASE

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Analysis shows Fonterra artificially boosts milk price

The Independent Dairy Processors Group (IDPG) made a joint submission today to the Primary Production Select Committee on the *Dairy Industry Restructuring Amendment Bill* ("the Amendment Bill").

Central to the submission was quantitative analysis of Fonterra's milk pricing conducted by Deloitte Corporate Finance.

This analysis shows the Fonterra farm gate milk price is between **40 - 50 cents per kilogram of milk solids** (kg MS) higher than Fonterra's own commodity business or independent processors can pay and still make a sensible return on capital.

The Deloitte analysis suggests that Fonterra funds an artificially high farm gate milk price via a cross-subsidisation of approximately **$600 million per annum** from its distributable profits. In turn, this results in the profit of Fonterra being substantially lower than that of a group of international peers. This also artificially lowers Fonterra's share price.

The fact that Fonterra is setting an artificially high farm gate milk price is not disputed: a recent Cabinet Paper obtained by the IDPG under the Official Information Act indicates that the Ministry of Agriculture and Forestry's (MAF) own analysis showed overpricing by Fonterra was **30 cents** kg MS in each of the past two years.

The IDPG understands the MAF calculated figure was based on a superficial analysis using data supplied by Fonterra, and believes this is likely to understate the magnitude of the overpricing.

Castalia[1], who advised MAF on the competition policy implications of Fonterra's milk price manual, concluded "Fonterra's current approach to setting the raw milk price creates a barrier to entering the market for processing raw milk".[2]

Fonterra's farmers are not affected by the anti-competitive pricing system: they still get the same total payout, it is just that the milk price is too high and dividend too low.

At the heart of the anti-competitive pricing problem is Fonterra's decision to change the way it sets its farm gate milk price. Prior to 2006, Fonterra set its farm gate milk price based on what an actual Fonterra commodity business could pay for raw milk while achieving a sensible return on capital. However, after 2006 the farm gate milk price was based on what a 'notional' or imaginary super-competitor could pay.

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[1] See: http://www.castalia-advisors.com/

[2] Castalia, *The Hypothetical Efficient Competitor and Fonterra's farm gate milk price: Report to the Ministry of Agriculture and Forestry* (July 2011) page i

The Deloitte analysis shows the notional competitor cherry picks the best features of Fonterra (i.e. scale and a low cost of capital) and independent processors (i.e. modern efficient plant and an optimum product mix) to produce what is, in effect, a “super-competitor” that **does not exist**.

Rather than resolving this problem, the Amendment Bill has the effect of Parliament sanctioning the super-competitor and permanently locking in an artificially high farm gate milk price.

Fonterra’s artificially high farm gate milk price is having a dramatic negative effect on the industry. As well as stifling competition, it is sending farmers distorted pricing signals about milk potentially leading to overpriced dairy farm land, accelerated rates of dairy conversion and over production on existing farms.

Milk production in New Zealand has increased by 10% over the past season.

It is also sending Fonterra’s farmer shareholders and the investment market incorrect pricing signals about the value added by dairy processors, including Fonterra’s own dairy processing and value added businesses.

In its submission, the IDPG strongly urged the Primary Production Select Committee to correct the Amendment Bill to ensure Fonterra returns to setting its farm gate milk price based on the actual performance of its commodities.

Dr John Penno, spokesperson for the IDPG stated “It’s just common sense that Fonterra should be paying for milk based on the earnings of that milk. Allowing them to make internal transfers from returns on capital to subsidise milk price makes no sense for anyone”.

Dr Penno also noted that Castalia came to a similar conclusion when it advised MAF, finding “A pricing approach that used Fonterra’s actual costs (rather than hypothetically efficient costs) would enable efficient entry and promote outcomes that are more consistent with a workably competitive market”.

The IDPG is a group representing Open Country Dairy, Synlait and Miraka with collective export revenues of $1.3 billion.

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For more information please contact:

Michael Wan
Marketing and Communications Manager
Synlait Milk
P: +64 27 288 8253
E: michael.wan@synlait.com