synlait™
making more from milk

26 July 2018

Ms Inna Koning
Principal Adviser
Ministry for Primary Industries

By email: inna.koning2@mpi.govt.nz

Dear Inna,

TERMS OF REFERENCE FOR THE REVIEW OF THE DAIRY INDUSTRY RESTRUCTURING ACT 2001 (DIRA) AND ITS IMPACT ON THE DAIRY INDUSTRY: INITIAL COMMENTS

Thank you for meeting with us back in May 2018.

We have now had an opportunity to discuss internally our initial thoughts on the DIRA review, as set out below.

Executive Summary

We are of the view that now is an important time to review DIRA and the implications that DIRA has had, both good and unintended.

We have focused our initial thoughts on three key areas:

- Setting a realistic farm gate milk price
- Sustainability and environmental impact
- Removal of out of date DIRA practices

A. The Farm Gate Milk Price is too High

There are short comings with the current method for calculation of the farm gate milk price that we believe can be corrected. These shortcomings come in a large part from the lack of transparency and oversight in Fonterra setting the milk price. This has led to results that are inconsistent with the statutory purpose of DIRA as set out below and we believe should be considered through the DIRA review.

Independent processors must pay the 'market price for milk' to ensure that they do not lose their farm suppliers over time. Consistently paying below this market price will likely see farmers leave independent processors. The 'market price for milk' is determined in New Zealand by the farm gate milk price calculated by Fonterra applying the milk price model. While DIRA sets out how the milk price model is intended to be applied, Fonterra has consistently demonstrated that they are able to make changes to the assumptions used to effectively increase the milk price at the expense of their value-added business performance.

This was recently reinforced by the Chairman of Fonterra, John Wilson, in an article published in the Farmers' Weekly on 11 June 2018, where the article stated –

> *"But Wilson also pointed out that 46 cents has migrated across from earnings to the milk price by several tweaks to the MPM."*

Synlait Milk Ltd
1028 Heslerton Road
RD13, Rakaia 7783
Private Bag 806
Ashburton 7740
New Zealand
P +64 3 373 3000
www.synlait.com

In the case of Synlait these "tweaks" effectively increase our cost of milk. As an example, on 23 May 2018 Fonterra lifted their 2018 milk price to $6.75/kgMS from the previously announced milk price of $6.55/kgMS (on 21 March 2018) pointing to increases in commodity prices. Analysis undertaken by ourselves and other analysts could not justify this 20 cent lift by changes in commodity prices alone. Therefore, several other variables within the MPM must have been "tweaked" to support this lift. As Fonterra provides no transparency there was no explanation given for the tweaks. Even assuming that these tweaks were appropriate, how was it that they were not known only two months earlier when the previous milk price was announced.

The key areas that lead to concern in calculating the milk price are:

- The conceptual model for the notional producer enjoys a "super-competitor" mix of characteristics not shared by anyone in the New Zealand milk processing sector and that are not practically feasible.
- The asset beta used is too high for the industry leading to an estimate of risk for the cost of financing milk processing operations that is too low.
- The continued lack of transparency regarding the components of the milk price calculation heightens the uncertainty around the milk price each year. This has led to a continual concern, widely held, that Fonterra is able to manipulate its competitive position through over valuing milk price and undervaluing the Fonterra share price. Fonterra has openly confirmed this in recent times. In May this year Duncan Coull, Fonterra Shareholders' Council Chairman, openly stated in a RadioNZ interview that:

> *"...[question we're asking is] whether Fonterra has performed or not – it's a very complex organisation. I'll give you one example where over the last 8 years, given the milk price regime - which is part of DIRA, which I think is one of the most important things and protections we have as a farmer - has shifted 40c from our earnings - or dividend streams - into our milk price. So, right now, today, like for like, in the absence of such a milk price setting arrangement, you could argue our dividend would be sitting at 70 - 80 cents. [inaudible].. what has Fonterra delivered for us as farmers, and as an extension of our own farm business, and what does it mean for us and what does it mean going forward."*

The flow on effect is that the shortcomings in the calculation of the farm gate milk price gives rise to an inflated milk price that drives the following unfavourable behaviours:

- More land in New Zealand is moved into dairy and more milk has been produced than perhaps should have been. This gives rise to significant sustainability and environmental issues that we are all aware of and have referred to below.
- The inflated milk price artificially encourages farmers to invest in dairy farming (over other land uses), potentially putting themselves under financial stress by taking on higher debt.
- Fonterra has been forced to invest more capital in commodity processing than is economically efficient. There is a lack of incentive to invest in value add.
- The lack of transparency and ability of Fonterra to increase the farm gate milk price annually creates a barrier to entry by new processors.

Independent Panel to set the Milk Price

We believe the setting of a realistic farm gate milk price can only be established by setting up an independent regulated panel to set the milk price annually. This body should comprise a range of members across the industry including processors and academics. We will explore this further in our submission.

Synlait Milk Ltd
1028 Heslerton Road
RD13, Rakaia 7783
Private Bag 806
Ashburton 7740
New Zealand
P +64 3 373 3000
www.synlait.com

synlait™
making more from milk

B. Sustainability and Environmental Impact

More than 85% of the dairy industry's environmental impact comes from on-farm activities. This coupled with increasing intensification of dairy has resulted in raised GHG emissions and nitrate leaching to waterways.

Changing farm practices and farm systems to be more sustainable is challenging. The right incentives and support is required for farmers to make the rapid change in sustainability practices that our communities are now expecting. It is currently falling upon processors to incentivise farmers toward more sustainable practice. In our experience, we are seeing that, not all processors are equipped to create the incentives required because there is not enough inherent margin in their businesses and/or because they do not align philosophically with a focus on environmental sustainability.

In our view this position will not change without intervention by Government.

Sustainability and Environmental Approach at Synlait

At Synlait we have adopted a number of practices to promote sustainability. These are funded by Synlait and come at a cost in addition to what Synlait pays to our farmers as a "base milk price" before premiums.

Synlait's Lead With Pride (**LWP**) programme is our key enabler in setting bold targets for reducing on-farm environmental impact. The LWP programme, launched in 2013, incentivises farmers to address their environmental impacts. Farmers who supply Synlait and meet the LWP requirement, which is independently audited annually by AsureQuality, receive a premium on their milk price.

In using this programme, over the last 5 years, Synlait has succeeded in driving change across 27% of its supply base.

We are now committed to substantially boosting the LWP incentive from 1 August 2018. We anticipate that 85% of our supply base will be LWP certified by 2024, thus demonstrating best practice in addressing on-farm environmental impact. This is a direct cost to Synlait in promoting sustainability with our farmers.

The opportunity to take this further

We believe that once the milk price is set at a proper level processors will have capital to invest in new plant, and improvements to current out dated plant, improving the environmental impact of dairying off-farm.

We also recommend that processors should be compelled to invest a proportion of their improved margins in reducing on-farm environmental impacts, where most of the environmental impacts occur.

C. Removal of out-of-date DIRA practices creating inefficiency

In our view there are measures under DIRA that were beneficial when DIRA was established in 2001 and have helped the dairy industry transition. However, we believe these measures are now inhibiting the further development of the dairy industry in New Zealand and should be transitioned out by 2021, as follows:

- **Remove requirement for Fonterra to supply milk to new entrants (up to 50 million litres):** The requirement for Fonterra to supply milk to new entrants has stopped new entrants establishing their own milk supply, thereby creating more of a market for milk supply.

- **Remove requirement for Fonterra to supply milk to Goodman Fielder (up to 250 million litres):** Goodman Fielder has had ample time to build its own milk supply since DIRA was introduced in 2001. This concession should now be transitioned out.

Synlait Milk Ltd
1028 Heslerton Road
RD13, Rakaia 7783
Private Bag 806
Ashburton 7740
New Zealand
P +64 3 373 3000
www.synlait.com

- **Remove requirement for Fonterra to collect all milk:** Farm conversions occur in areas uneconomic for processors to collect from; but Fonterra is mandated to collect the milk (in many cases). This creates inefficiencies. It would be more effective if Fonterra was only required to collect from farms that met high standards of compliance in animal welfare and environmental standards.

We will prepare a detailed submission in response to the public consultation document when released and look forward to working with you further on the DIRA review. If you wish to discuss, please contact Deborah Marris.

Yours sincerely

John Penno
CEO and Managing Director

Synlait Milk Ltd
1028 Heslerton Road
RD13, Rakaia 7783
Private Bag 806
Ashburton 7740
New Zealand
P +64 3 373 3000
www.synlait.com