THE DOMINION POST

Synlait a saviour?*

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By Tony Baldwin

As a consultant to the industry, Alex Sundakov promoted the 2001 dairy reforms with zeal. Last week, he argued that the arrival of Synlait – an ambitious new Canterbury dairy company – "closes the debate" on the 2001 reforms and "completes the evolution of the dairy sector".

If Synlait's birth is the industry's apex, it has some serious problems.

Alex claims that Synlait will cause a competitive market for raw milk in New Zealand, with an independent milk price. This is unlikely. Synlait currently accounts for less than 0.5% of total milk production. It aims to grow to 1%.

Synlait will eventually provide some competition in the small geographical area of Rakaia. However, for several years, its internal milk costs, profits and any dividends will remain private. It will not necessarily pay or publish an independent milk price, even to future suppliers. Payments can be delivered in other ways.

To say that Synlait will create competitive pressure on Fonterra is like arguing that telecommunications minnow, Woosh, would discipline Telecom in a market without TelstraClear or Vodaphone.

Alex's assertion that Synlait will provide a commercial benchmark for Fonterra is also tenuous. For several years, Synlait will be a private company with no public accounts. If Synlait were to list its shares sometime in the future (unlikely within the next five years), Fonterra's highly administered share price would gain some point of reference. However, the scope and mix of the two businesses is so significantly different that any comparison would have limited relevance.

* This is Tony's title for the article

In another overstatement, Alex claims that Synlait's arrival will lead to the removal of the regulatory restraints on Fonterra. Even if Synlait achieves extremely high growth over a sustained period, it is likely that another significant new player would have to enter the raw milk market east of the Southern Alps to trip the thresholds for removing the restraints on Fonterra in the South Island. In the North Island, Synlait will have no impact on the thresholds, which are some distance from being threatened. In any case, it is not clear that removing the restraints would necessarily benefit Fonterra's shareholders or the industry.

Of greater concern is Alex's implication that Fonterra's formation, and its associated legislation, represented an optimal reform package for enhancing economic performance. If only this were true. In reality, the 2001 reforms were driven by politics and expedience.

The previous industry structure is now widely accepted as inefficient and dysfunctional, distorted by years of government intervention, co-operative politics, poor governance and centralised control.

It was clear in 2000 that realigning dairy resources to unlock their full potential would take time, under any reform scenario. The key question was, how and at what rate to expose the industry to normal commercial drivers, particularly capital market and competition law disciplines.

Shareholders' ability to re-allocate funds from low to high performing businesses is pivotal to an economy's strong performance. Since the 1890s, dairy co-op equity has been highly immobile.

Competition is also critical. To become a near-monopoly like Fonterra, a company would normally have to prove to the Commerce Commission that, despite the loss in competition, resources will be used more efficiently in the economy. It is a tough but well designed test.

For 100 years, governments have protected the dairy industry from both sets of pressures. Today's structure would have looked quite different if it had evolved in a more open environment. Almost certainly, we would not now have the current near-monopoly exporter of low value commodities.

Alex argues that the Commerce Commission was not capable of dealing with the industry's 2001 merger. This is nonsense. A Commission authorisation was possible if the proposal had strong safeguards, to ensure mobility of capital and effective performance pressures. However, it would have forced leaders to confront farmers' traditional 'no go zones', such as tradable shares and real price signals.

Keen to avoid these core issues, they found an easier path through the Government. As Fonterra's lame capital structure review last year shows, the 2001 reforms still allows leaders to side-step the 'sacred cows'.

For Alex Sundakov to imply that the reform's legislation and outcomes are optimal is simply not credible.

After 100 years of cryogenic suspension, initiatives like Synlait and Open Country Cheese are welcome signs of incremental thawing at the industry's extremities. Any fresh pulse of independent commercial thinking in this deeply conservative and collectivised industry is positive. However, it is well short of where the wider industry needs to be.

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