To: Ministry of Primary Industries

Re: Submission to DIRA

We are a group of young dairy farmers based in Canterbury that was formed in 2016 to share ideas to make our businesses better. There are 8 of us and we range from sharemilkers to farm owners. Between us we employ 84 full time staff and milk 17,100 cows. Not all of us are Fonterra shareholders with some of us supplying Synlait and Mymilk, (Mymilk is a Fonterra subsidiary that doesn't require you to own shares for a period of time). We are all very passionate about and committed to the NZ dairy industry and want to ensure it prospers into the future, hence we feel very strongly that some things in DIRA must be changed. Our group would not exist in the retail/commercial world as we would be in competition with each other. While we do compete for some things (land, cows and people) we believe that we can achieve more together by sharing our innovations/ideas and concepts than we could individually. This ethos underpins the NZ dairy industry and has done so for the last 100+ years.

New Zealand is still a small producer of milk on the world stage. We believe it's imperative that we have a strong co-operative in Fonterra, not only for the benefit of the Fonterra shareholders, but also for the whole of New Zealand. Nationally Fonterra's market share has fallen to nearly 80% and is falling every year, so we believe DIRA has done what it was initially set out to do, but needs to be changed before we lose our global competitive advantage. We think competition for milk supply and processing is healthy as it promotes efficiencies, but strongly feel that DIRA should encourage competitors that are majority New Zealand owned. You only have to look as far as Australia to see what could happen to the New Zealand dairy industry if some changes aren't made to DIRA.

We are all from farming backgrounds of some description, and we passionately believe that we must control our own destiny. For us that means owning some or all of the company that sells our products and often owning the companies that supply crucial farm inputs and services. Our farming forebears had similar lines of thinking and we have inherited their foresight and planning in the form of our cooperatives. We would feel just as strongly about this if we produced wool or carrots as we do when supplying milk which is the core of our businesses. We believe the prosperity of the dairy industry is directly linked to the prosperity of Fonterra. Zespri and Tatua are examples of successful cooperatives that have helped generate significant wealth for their shareholders and New Zealand.

Fonterra has also generated significant wealth for its shareholders and New Zealand; we believe that the continuation of the current DIRA regulations would put that at risk. Our reasons are outlined below.

1. Open entry requirements

We believe it is unreasonable that Fonterra has to pick up everyone's milk regardless of where and how they farm. The creation of DIRA has meant Fonterra has needed to invest in processing factories to cope with the flood of milk, rather than focus on adding value to the milk that they already have by utilising it for certain products. Amending the open entry requirements will limit the inefficiencies that have developed in Fonterra over the years (having to build capacity for peak milk flows) and should encourage businesses to invest in the dairy industry only if there is demand for their milk.

We as dairy farmers are feeling a lot of pressure from the New Zealand public at the moment, and to us our reputation is very important. Allowing Fonterra to decide which milk they will pick up would, we believe, enhance the reputation of the dairy industry as a whole. For example, if the prospective supplier has a bad environmental history or farms in an area that may pose some reputational risk then Fonterra will not accept the milk. This may also ensure that environmental standards are reached quicker than relying solely on regional regulation.

What we propose:

We think that DIRA should be amended to let Fonterra decide whether or not to accept new supply. The rules for the criteria of accepting new supply can be added to the Fonterra constitution.

Anyone who is currently supplying Fonterra, or has contracts to supply in the future, should be exempt from any new changes to the updated DIRA.

Farmers should be able to exit Fonterra if they choose to.

2. Access to regulated milk

While we can see why this was initially set up (to promote competition), we believe this needs to be changed as we don't think this is benefiting New Zealand. Over the past 17 years there have been a number of other processors that have become established and bought milk from Fonterra at cost price, and then been in direct competition with Fonterra globally. Our issue with this is that the competing processors are majority overseas owned, thus the profits are leaving New Zealand to their overseas shareholders.

Because of the other processors access to regulated raw milk we feel Fonterra has had to build capacity to process the milk and essentially carry the risk associated with this all at the expense of the Fonterra shareholders.

We propose that legislation is changed so that Fonterra doesn't have to supply competitor's with cost price milk.

3. Base milk price calculation

We think that the current milk price regime works well. There must be transparency in the setting of the milk price, and the commerce commission should monitor this. All dairy farmers in New Zealand, not just Fonterra suppliers, rely on Fonterra setting a competitive milk price, and this must be maintained.

We propose for the milk price rules to stay as status quo, except we would like monthly updates of the predicted payouts instead of quarterly. This will give us more real time information to help us make more informed decisions within our businesses.

4. Milk for Goodman Fielder

We completely understand there must be domestic competition to look after New Zealand consumers. However, we think that the domestic competitors should at least be greater than 51% New Zealand owned, and be on a pathway to finding their own New Zealand supply base. From our understanding Goodman Fielder hasn't sought their own supply base in 17 years, and is reliant on milk from Fonterra, which is unacceptable.

We propose that Fonterra supplies milk to any processors that are selling in the New Zealand market that are greater than 51% New Zealand owned, and give them 5 years to find their own supply base. After 5 years Fonterra would cease supply.

5. Timeline for review of DIRA

We propose that DIRA should be reviewed in 5 years to assess the changes to the industry.

Happy to discuss or answer any questions that you may have

Please note: We do not wish to have our phone numbers and addresses below listed publicly

Kind regards

Tony Dodunski- Chair

s 9(2)(a) [redacted]

Tony Coltman

s 9(2)(a) [redacted]

Jeremy Duckmanton

s 9(2)(a) [redacted]

Jared Clarke

s 9(2)(a) [redacted]

Matt Ward

s 9(2)(a) [redacted]

Campbell Tait

s 9(2)(a) [redacted]

Will Grayling

s 9(2)(a) [redacted]

Josh Mcatamney

s 9(2)(a) [redacted]

DIRA Feedback

1. Next Generation Fonterra Sharholders Currently invested.

2. We/I wish to make the following points with regard to the Government's current review of the Dairy Industry Restructuring Act 2001 (DIRA).

3. It is important that Fonterra remain the dominant export oriented processor in the New Zealand Dairy sector. This was a key driver of the original reform in 2001, and remains importa t. In considering changes to DIRA the viability of Fonterra in the future must be kept front of mind.

Open Entry

4. It is important that any changes considered to the Open Entry/Exit provisi ns of DIRA protect the right of farmers currently supplying Fonterra through supply contracts w th its ubsidiary MyMilk to become fully shared up members of Fonterra in the future.

5. However it is important that Fonterra shareholders are able to act n the interests of their own co-op. Open entry as it currently exists, favours competitor processor to the detriment of shareholders who remain with Fonterra.

6. We/I believe that farmers should be entitled to leave Fonte ra if that is their wish (open exit), but that on leaving, they should no longer have a guaranteed right to return to the co-op (under DIRA).

7. We/I believe that it is in the spirit of our co op rative to keep small areas where there is no competition for milk viable and ali e so would be interested in any mechanism which enabled the DIRA protections to remain in pla e for such places, while allowing them to expire in areas with greater competition.

8. If such a regional approach to competition were taken, Fonterra would be able to exercise more commercial judgement i high competition areas, such as Canterbury, and one consequence of that would be that milk collection in the Mackenzie Basin would be able to be assessed on more commercial grounds (including reputational and environmental impact) on the co-op.

9. Were Open entry to be removed we would like to see continued guaranteed rights of supply to Fonterra o stay with currently shared-up supply numbers, allowing farm sales and succession to occur without risk of non-collection, and asset stranding.

Milk for large competitors

10. It is time to end the right of new entrant competitors to have milk supplied to them by Fonterra while they establish their own supply.

11. Fonterra farmers are not a bank and we need to be able to support our own investments, not guarantee the risks of our export competitors.

Milk for Goodman Fielder

12. We acknowledge that there is a reputational risk to simply stopping the guarantee of milk supply to Goodman Fielder, given that this helps supply the NZ domestic market. But it is time to wean them off this guarantee. A clear timeline for the end of this provision is needed.

13. We are also keen to see that the New Zealand domestic market continues to have a strong supply of New Zealand milk and do not want to see foreign milk being sold here.

Milk price

14. The existing requirement for quarterly milk price announcements creates some problems for ou businesses. We get hurt in our market for grain and winter feed with the market price being impacted directly after payout announcements. We believe more regular (monthly) m ndator announcements would smooth this impact.

15. We do not support the proposal to have the Commerce Commission set the milk pr ce, and want to see the existing method retained.

DIRA Review/Expiry

16. Taking all of the above into account (pathway for expiry of G odman Fielder obligation, changes to open Entry, repeal of large competitor supply obligation) we believe there should be a clear timeframe for regular review (every 5 years), especiall for those parts of open entry which are retained.

Attached email

DIRA Review Team
Agriculture, Marin and Plant Policy
Policy and Trade Branch
Ministry for Primary ndu tries
PO Box 2526
Wellington 61 0

Dear DIRA Review Team

Recently we held a Next Generations Farmers meeting to discuss and review DIRA. It was a well invested morning spent with many generational concerns for the future of Fonterra around DIRA;looking at it beyond the next 5-10 years but the next 40-50, as we will be the generation of shareholders that live the decision that is made today.
Amongst us we were either, Contract milkers, share-milkers , landowners, new shareholders in Fonterra, the next generation of family shareholders, and some of the establishing shareholders of Fonterra children and grandchildren. We also want to represent the future shareholder of Fonterra, our children's generation and

those to follow.

We all had different on farm systems, % of shares, % of land ownership and other industry investments.
As a group and we understood the impact DIRA has had, and why it was first introduced.

Our voice was quite clear that Fonterra/MPI needs to protect the future of Fonterra Shareholders and investments and listen to their voice during the DIRA review , WE (the shareholders) are the company and WE (the shareholders)are seeking a clear, protective, vision for our company to provide the best service for the next 40-50 years.

We would be happy to work along side the process and discuss any ideas, issues that may effect us as we are the ones living for and providing the product for many stakeholders in the dairy industry, beyond the farm gate and providing a service in protecting our national economy.

Please see our submission attached.

Kind regards

Mrs Victoria Trayner
s 9(2)(a) [redacted]

Mr Steve Reed
s 9(2)(a) [redacted]

Mr David Le Heron
s 9(2)(a) [redacted]

Mr Ben McKerchar
s 9(2)(a) [redacted]

Mr Darcy Bishop
s 9(2)(a) [redacted]

Mr Arno Luten
s 9(2)(a) [redacted]

Mr Stu Bailey
s 9(2)(a) [redacted]

Mr Sam Spencer-Bower
s 9(2)(a) [redacted]

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February 8, 2019

1 February 2019

DIRA review team
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Policy and Trade Branch
Ministry for Primary Industries
PO Box 2526
Wellington 6140
New Zealand

Dear Sir

Review of the Dairy Industry Restructuring Act 2001 and its impact on the dairy industry

The Commerce Commission is pleased to provide this submission on the Ministry for Primary Industries' discussion document. We have provided responses to the consultation questions you posed in the pro-forma that you published on your website as an enclosure to this letter. We think that you have summarised the complex issues of the industry and the regulation around it very well. We would be happy to discuss any of the issues with you if that should be helpful to your process.

We believe that the base milk price calculation and monitoring regime in the Dairy Industry Restructuring Act (DIRA) has performed satisfactorily in meeting its objectives. The current approach which sees Fonterra publish a milk price manual and set a predicted milk price which is reviewed by the Commission operates satisfactorily and at low regulatory cost. We see no need for the Commission to set the milk price nor do we require further legislative guidance to determine whether the monitored inputs are practically feasible. This is especially so as the milk price is not binding on Fonterra or its competitors. Further, implementation of such a change would potentially be costly and complex, likely to generate additional challenges and, in our view, provide little benefit to New Zealanders.

Fonterra had a substantial degree of market power in New Zealand in a number of domestic dairy markets when it was established. The DIRA was implemented to mitigate the risks of

Fonterra exercising this market power to the detriment of its suppliers and New Zealand consumers. DIRA places certain obligations on Fonterra regarding its collection of raw milk at the farm gate and to the supply of raw milk at the factory gate to other dairy processors.

In 2015/2016, we reviewed competition in the dairy industry for the Minister for Primary Industries. We refer to this in our responses to your questions and have provided a link to it in the response so that other readers can access it should they wish when you publish the responses to your consultation. We note that we have not done further work regarding the state of competition in the New Zealand dairy industry since concluding our review.

In our review, we concluded that the pros and cons of DIRA were finely balanced but that the regulation should remain in place. We considered that the level of competition alone in current or foreseeable market conditions was likely to be insufficient for one to expect efficient operation of the dairy industry without DIRA. We have outlined our primary rationale in the remainder of this letter.

The DIRA limits Fonterra's market power and reduces barriers to entry and expansion for independent processors. Our review found that some competition had developed at the farm gate, but that this varied across regions. We considered the open entry and exit provisions importantly safeguarded against Fonterra's ability to hinder the prospects of its competitors in regard to dealing with farmers. It also offered protection to farmers against Fonterra behaving unfairly towards them, though we noted that as a co-operative, Fonterra had little incentive to deal poorly with its farmer suppliers. We supported the retention of the open entry and exit provisions but noted that it might be worth exploring removing open entry for new dairy conversions.

We considered the Raw Milk Regulations reduced the likelihood that Fonterra would raise its prices above competitive levels through the requirement that it supplies raw milk to domestic processors. In consequence, we considered that this regulation kept prices of milk and dairy products lower than they would otherwise be through the supply chain. Sales between large-scale independent processors were limited and we recommended that options to facilitate the development of an effective factory gate market be explored with the aim of benefiting consumers through increased competition.

Yours sincerely

SJ Begg

Sue Begg
Deputy Chair

Chapter 2: Performance of the dairy industry

Section 2.1 2001 structural reform to enable the industry to drive strategic change

Please refer to [Section 2.1] of the discussion document.

(1) Do you agree with our description of the DIRA regulatory regime and its original policy rationale? Do you consider the original policy rationale is still valid?

We think that you have summarised the relevant issues well in your discussion document. Much of the original policy rationale remains valid in our opinion. We provided a detailed assessment of competition in the dairy industry in response to MPI's request in March 2016. We refer to this report as the 2015/16 review in this response for additional information and evidence supporting our responses to your questions in this consultation. The full report is published on our website at https://comcom.govt.nz/__data/assets/pdf_file/0018/62370/Final-report-Review-of-the-state-of-competition-in-the-New-Zealand-Dairy-Industry-1-March-2016.pdf

Section 2.2 Industry performance since the restructure

Please refer to [Section 2.2] of the discussion document.

(2) Are there any other dairy industry developments or industry performance indicators that are not captured in the discussion document or its supplementary material? Please provide details and supporting evidence.

[Intentionally Blank]

Chapter 3: The effects of the DIRA and other factors on industry performance

Section 3.1: Has the DIRA been effective at managing Fonterra's dominance in the market for farmers' milk, and is it still needed?

Please refer to [Section 3.1] of the discussion document.

(3) Do you consider the DIRA has been effective at achieving its core regulatory objective of preventing Fonterra from using its dominance to create barriers to farmers' milk and land flowing to their highest value uses? If not, please provide reasons and supporting information/evidence.

Yes. We concluded in our 2015/16 review of the dairy industry that DIRA has made it easier for other firms to operate in the New Zealand dairy industry. The DIRA has seen competition increase for farmers milk for processing and export, and ensured the supply of raw milk to producers of dairy products for sale in New Zealand.

(4) Do you think Fonterra is still dominant in the market for farmers' milk, at the national and regional levels?

DIRA has reduced barriers to entry and expansion for independent processors. Competition has intensified under DIRA regulation yet Fonterra still buys more than 80% of all raw milk produced in New Zealand. We found in our 2015/16 review that the level of competition Fonterra faces varies between regions, and that in most areas it still holds significant market power.

(5) Do you think the DIRA imposes unreasonable costs on Fonterra? If so, please provide supporting information/evidence.

In our review we determined that the adverse consequences for the industry and New Zealand consumers was greater than the reduction in the costs that might result if the DIRA were repealed.

(6) Are there ways for the costs imposed on Fonterra to be mitigated without impacting on the effectiveness of the DIRA regulatory regime? If so, please provide supporting information.

[Intentionally Blank]

(7) Are there any other regulatory tools that, in your opinion, would be more effective than the current DIRA provisions at managing Fonterra's dominance? If so, please provide examples and supporting information/evidence.

[Intentionally Blank]

(8) Are there other factors you consider need to be taken into account when considering the effectiveness of the DIRA regime and whether it is still needed?

[Intentionally Blank]

Section 3.2: Does the DIRA encourage industry growth?

Please refer to [Section 3.2] of the discussion document.

(9) Do you agree with our preliminary assessment of the extent to which the DIRA encourages industry growth? If not, please provide reasons and supporting information/evidence.

[Intentionally blank]

Section 3.3: Does the DIRA influence Fonterra's strategy?

Please refer to [Section 3.3] of the discussion document.

(10) Do you agree with our preliminary assessment of the extent to which Fonterra can influence milk supply volumes through price, notwithstanding the DIRA open entry requirements?

Yes.

(11) Are there other factors that you consider should be taken into account? Please provide detailed comment in support of your views.

We concluded in our 2015/16 review that there was no evidence that the open entry and exit provisions were imposing material costs on Fonterra. We reached this conclusion at a time when the volume of milk being supplied was increasing. We consider it possible that the balance between costs and benefits of the open entry and exit requirements could change if milk supply is static or declining.

(12) Do you consider that the DIRA provisions governing Fonterra's base milk price calculation and Commerce Commission monitoring may be preventing or disincentivising Fonterra from deviating from the base milk price calculation for strategic or commercial reasons?

Fonterra has deviated from the base Milk Price in recent years. Fonterra's final milk price for the 2013/14 season reflected a 55 cent downward adjustment from the Manual-consistent milk price. Fonterra reduced the final 2017/18 milk price by 5 cents relative to the Manual-consistent milk price.

(13) If the DIRA is not driving Fonterra's business and investment strategy, what is? Please provide detailed comment in support of your views.

[Intentionally Blank]

Section 3.4: Does the DIRA impact on the industry's environmental performance?

Please refer to [Section 3.4] of the discussion document.

(14) Do you agree with our preliminary analysis of the DIRA's impact on the industry's environmental performance? If not, please provide your reasons and supporting evidence.

[Intentionally Blank]

(15) Do you agree with our view that environmental issues are best dealt with through the Resource Management Act and not the DIRA regime?

[Intentionally Blank]

(16) Are there other environmental issues that you consider should be addressed either through the DIRA review or some other means?

[Intentionally Blank]

Section 3.5: Does the DIRA incentivise inefficient entry by large dairy processors?

Please refer to [Section 3.5] of the discussion document.

(17) Do you agree with our preliminary analysis of the impact the DIRA has on new processor entry? If not, please provide your reasons and information/evidence in support of your views.

[Intentionally Blank]

(18) Do you consider that large dairy processors should continue to be eligible to purchase regulated milk from Fonterra under the Raw Milk Regulations or not? Please provide detailed comment in support of your views.

In our 2015/16 review we recommended that the Minister consider a staged approach to deregulating the supply of raw milk. We suggested reducing independent processors' entitlement to DIRA milk, and allowing changes to the terms and conditions for the supply of DIRA milk.

Section 3.6: Does the DIRA promote sufficient confidence in the base milk price calculation?

Please refer to [Section 3.6] of the discussion document.

(19) Do you consider that greater confidence in the base milk price calculation outcomes could be achieved if additional legislative guidance on the term "practically feasible" were to be provided for in the DIRA? Please provide detailed comment in support of your views.

We assess the practical feasibility of the estimates Fonterra uses in its milk price manual and calculations. We have published our interpretation of what practical feasibility is and our approach as to how we test it since Part 5A was introduced. Our interpretation and approach has not changed materially over that time. We consider our interpretation works and does not need further guidance. In our view the Act does not require clarification in this regard.

The scope and cost of our review work has reduced over time as issues have been concluded. It is our view that legislative guidance to define practical feasibility might cause us to have to reconsider issues which we have previously concluded. Given the stability of the regime since DIRA was introduced we think that providing additional guidance is unnecessary and may drive significant additional cost.

(20) Do you consider that the base milk price should be set by an independent body (e.g., the Commerce Commission)? If so, please provide supporting information.

No, we consider that the current arrangements are satisfactory. The monitoring regime that we operate provides independent assurance of Fonterra's processes, and delivers increased transparency over Fonterra's farm gate milk price setting at a low regulatory cost.

There is not evidence of a problem sufficient to justify alternative of a price control regime through which we, or another regulator, would set the milk price for Fonterra. If a regulator were to set a non-binding milk price then we cannot see what benefit there would be from the introduction of such a process but it would create transitional and ongoing costs for the independent body and for the industry. The independent body would have to collect the information for the calculations from Fonterra so it is unlikely to result overall in improved outcomes for businesses or consumers.

Section 3.7: Does the DIRA support competition in New Zealand consumer dairy markets?

Please refer to [Section 3.7] of the discussion document.

(21) Do you agree with our preliminary analysis of the DIRA impact on the domestic consumer dairy markets? Please provide your reasons and information/evidence in support of your views.

We found in our 2015/16 review, that without DIRA regulation, Fonterra would be able to increase the price of raw milk it sells to other domestic processors (in the factory gate market). This would likely result in higher prices for dairy products in shops. We considered that the pathway to deregulation would be smoothed by facilitating the development of a factory gate market for non-DIRA milk. We remain concerned that an immediate move to deregulation would risk sharp increases in the retail prices of milk and dairy products. We are also concerned about the potential impacts on consumer choice if the regulation were abandoned abruptly.

(22) Are there any other factors that should be taken into account regarding the domestic consumer dairy markets? Please provide your reasons and information/evidence in support of your views.

[Intentionally Blank]

Chapter 4: Options for change

Section 4.1: DIRA open entry requirements

Please refer to [Section 4.1] of the discussion document.

(23) Are there any other options for the DIRA open entry requirements that you think should be considered? Please provide sufficient detail when describing any alternative options as well as reasons for considering these.

[Intentionally Blank]

(24) What costs and benefits would each of the options for the DIRA open entry requirements create for your business? Please provide quantitative information if possible.

[Intentionally Blank]

(25) How well do you think each of the options for the DIRA open entry requirements would perform against the principles of good regulatory practice of promoting certainty and predictability of regulatory outcomes, transparency, cost-effectiveness and timeliness of regulatory processes?

[Intentionally Blank]

(26) What is your preferred option for the DIRA open entry requirements? Please provide your reasons and information/evidence in support of your views.

We support Option 4.1.3 We proposed a variant of this option for consideration by the Minister in our 2015/16 review. In particular, we suggested that MPI consider removing open entry for new dairy farm conversions. We consider that open entry for new conversions contributes little to competition in the farm gate market, but accept this may impose costs on Fonterra.

Section 4.2: Access to regulated milk for large dairy processors (except Goodman Fielder)

Please refer to [Section 4.2] of the discussion document.

(27) Are there any other options for access to regulated milk for large dairy processors that you think should be considered? Please provide sufficient detail when describing any alternative options as well as reasons for considering these.

[Intentionally Blank]

(28) Do you consider that the proposed 30 million litres threshold is too high or too low? If so, what would you consider the right threshold to be, and why?

[Intentionally Blank]

(29) What costs and benefits would each of the options for access to regulated milk for large dairy processors create for your business? Please provide quantitative information if possible.

[Intentionally Blank]

(30) How well do you think each of the options for access to regulated milk for large dairy processors would perform against the principles of good regulatory practice of promoting certainty and predictability of regulatory outcomes, transparency, cost-effectiveness and timeliness of regulatory processes?

[Intentionally Blank]

(31) Do you have a preferred option for access to regulated milk for large dairy processors? Please provide your reasons and information/evidence in support of your views.

[Intentionally Blank]

Section 4.3: Options for the base milk price calculation

Please refer to [Section 4.3] of the discussion document.

(32) Are there any other options for the base milk price calculation that you think should be considered? Please provide sufficient detail when describing any alternative options as well as reasons for considering these.

[Intentionally Blank]

(33) What costs and benefits would each of the options for the base milk price calculation create for your business? Please provide quantitative information if possible.

[Intentionally Blank]

(34) How well do you think each of the options for the base milk price calculation would perform against the principles of good regulatory practice of promoting certainty and predictability of regulatory outcomes, transparency, cost-effectiveness and timeliness of regulatory processes?

The current regime has performed well against these measures of good practice and it continues to do so. We agree with your initial assessment of Options 4.3.2 and 4.3.3.

(35) Do have a preferred option for the base milk price calculation? Please provide your reasons and information/evidence in support of your views.

We prefer Option 4.3.1 on the basis of the information we have provided in response to your questions.

Section 4.4: Options for access to regulated milk for Goodman Fielder and smaller processors

Please refer to [Section 4.4] of the discussion document.

(36) Are there any other options for access to regulated milk for Goodman Fielder and smaller processors that you think should be considered? Please provide sufficient detail when describing any alternative options as well as reasons for considering these.

[Intentionally Blank]

(37) What costs and benefits would each of the options for access to regulated milk for Goodman Fielder and smaller processors create for your business? Please provide quantitative information if possible.

[Intentionally Blank]

(38) How well do you think each of the options for access to regulated milk for Goodman Fielder and smaller processors would perform against the principles of good regulatory practice of promoting certainty and predictability of regulatory outcomes, transparency, cost-effectiveness and timeliness of regulatory processes?

There is a risk that Option 4.4.5 reduces transparency, and creates uncertainty for independent dairy processors in light of the potential for dissatisfaction and challenges to Fonterra's transfer pricing practices under a new arrangement.

(39) Do you have a preferred option, or a combination of options, for access to regulated milk for Goodman Fielder and smaller processors? Please provide your reasons and information/evidence in support of your views.

We support the gradual and careful implementation of any changes along with monitoring of how these impact on the trading of raw milk between industry processors. Please refer to our response to Question (21).

Section 4.5: Options for the DIRA review and expiry provisions

Please refer to [Section 4.5] of the discussion document.

(40) How best do you consider "market dominance" could be measured? For example, are there certain criteria (other than a market share threshold) that could be provided for in legislation as a trigger for review and/or expiry of the DIRA?

Market share thresholds are simple measures and though they are imperfect proxies for measures of competition we support their continued use to trigger future competition reviews. Market dominance is best assessed through a full review such as that we conducted in 2015/16 at MPI's request. This allows the nuances of the geographic and other restrictions on raw milk sales and trading to be considered fully, and also for variance in market concentration in each relevant market to be properly taken into account.

Changes in market share having the potential to trigger a competition assessment in this way satisfactorily addresses the shortcomings of the crude measurement of market shares as a trigger to deregulation, which was the case before 2011.

(41) Are there any other options for the DIRA review and expiry provisions that you think should be considered? Please provide sufficient detail when describing any alternative options as well as reasons for considering these.

[Intentionally Blank]

(42) What costs and benefits would each of the options for the DIRA review and expiry provisions create for your business? Please provide quantitative information if possible.

[Intentionally Blank]

(43) How well do you think each of the options for the DIRA review and expiry provisions would perform against the principles of good regulatory practice of promoting certainty and predictability of regulatory outcomes, transparency, cost-effectiveness and timeliness of regulatory processes?

Automatically expiring DIRA (Option 4.5.4) at a set future date may be undesirable as one would not know whether the market conditions at that time would result in good outcomes for farmers, processors or consumers. It would result in better outcomes to review the market's operation and the impacts on consumers and participants before considering repealing the act.

(44) Do you have a preferred option, or a combination of options, for the DIRA review and expiry provisions? Please provide your reasons and information/evidence in support of your views.

In our 2015/16 review we recommended that the Minister should consider the following combination of measures:

1. resetting the market share thresholds in the North and South islands to 30%;
2. resetting the time limited provisions of the DIRA to the 2021/22 season;
3. not including any additional or alternative expiry triggers to the DIRA; and
4. as a transition pathway to deregulation, exploring amendments to the Raw Milk Regulations (including the Goodman Fielder provisions) in order to facilitate better functioning factory gate markets

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To: Ministry for Primary Industries

Submission on: Review of the Dairy Industry Restructuring Act 2001 and its impact on the dairy industry

Discussion document 2018/13

From: Dairy Holdings Limited

Date: 8 February 2019

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SUBMISSION

REVIEW OF THE DAIRY INDUSTRY RESTRUCTURING ACT 2001 AND ITS IMPACT ON THE DAIRY INDUSTRY

Discussion Paper No 2018/13

1. INTRODUCTION

1.1. Dairy Holdings Limited welcomes the opportunity to submit to the Ministry for Primary Industries (MPI) on the Review of the Dairy Industry Restructuring Act (DIRA) 2001 and its impact on the dairy industry.

1.2. The comments within this submission come from consultation within the Dairy Holdings Limited Management Team and with the Chairman of the Company's Board of Directors.

1.3. This submission has been prepared with the assistance and support of Federated Farmers of New Zealand (the Federation), of which Dairy Holdings Limited is a member. While many of the submissions of Dairy Holdings Limited align with the Federation, there are a number of areas where we have reached different conclusions. We therefore encourage our full submission to be read and considered.

1.4. We reserve the right to be heard in support of our submission and we would be happy to appear to clarify any points if this is required.

2. SUMMARY OF RECOMMENDATIONS

Dairy Holdings Limited recommends that:

- The DIRA should remain, but with some changes to manage the evolving nature of the dairy industry. The DIRA is approaching the end of its useful life now that the larger pools of milk in New Zealand have choice around who to supply, and the Independent Processors are well established in a commercial sense.
- Fonterra have discretion to accept supply but provided:
  - o This discretion does not apply to the sale and purchase of existing farms.
  - o A decision by Fonterra not to receive supply, or not to receive growth in supply, from a location or region is signalled at least ten years in advance for existing Fonterra dairy farms.
  - o This discretion for new conversions applies one year after the DIRA amendments take effect.

- Amend the eligibility provisions in the Raw Milk Regulations to exclude supply to large dairy processors.
- No change to the regulation of the base milk price.
- Adopt Option 4.4.3 providing for a continuation of the current protections for smaller independent processors and a reduction over time in Goodman Fielder's eligibility to access regulated milk.
- Supports Option 4.5.2 providing for periodic five yearly reviews.

3. GENERAL DISCUSSION ON THE DIRA

3.1. **Competition policy.** The DIRA is competition policy that circumvents the normal route for other competition policy, which is via the Commerce Act 1986. Dairy Holdings Limited recognises that without DIRA Fonterra would not have been able to be formed and if DIRA were to fall away the dairy industry would be exposed to the broader competition provisions of the Commerce Act.

3.2. Dairy Holdings Limited considers that the DIRA has worked. DIRA enabled the formation of New Zealand's largest company, now owned by 10,000 farmers and their families, which employs 22,000 people in New Zealand and overseas. Fonterra's annual revenue exceeds $20 billion and it exports to 140 countries, contributing 25 percent of New Zealand's total goods exports. Farmers have been able to freely come and go from the Co-op, allowing new and existing processors certainty of supply and pushing Fonterra to work for its shareholders. New Zealand's consumers have choice on all standard dairy products, and they continue to buy them.

3.3. Fonterra shareholders can, generally, choose to leave Fonterra and supply an independent processor (IP) with the minimum required period of notice, due to the annual contract period requirements as set out in the DIRA. This allows farmers to manage their business and suit their philosophy on an annual basis. This 'freedom' has also encouraged Fonterra to offer different terms and conditions in areas where there is real competition, such as My Milk in the South Island.

3.4. IPs with own-supply have been advantaged by the DIRA, both at start-up (through the Raw Milk Regulations[1]) and through the requirement in the DIRA that obliges Fonterra to accept all supply, with few exceptions. This allows IPs to terminate a contract with their suppliers at the end of the term, with no redress, and no worry that the farmer would be left with stranded assets. They are also not required to be as transparent as Fonterra with regards to what new supplying farmers will get paid for their milk, and for the term of the contract, with many farmers being locked in for three years or more.

[1] Dairy Industry (Raw Milk) Regulations 2012

3.5. IPs with no own-supply or less than 30 million litres have been advantaged by the DIRA because they have continued access to raw milk via the Raw Milk Regulations.

3.6. Goodman Fielder, the only major countrywide, year-round supplier of the domestic market, has, because of the DIRA, continued to offer New Zealand consumers a choice, a very important quid-pro-quo for enabling the establishment of Fonterra.

3.7. As the DIRA is concerned with local competition, it is silent on what any dairy processor (Fonterra and IPs) do with the milk, allowing all processors to work in the market that gives them the highest return.

3.8. **Higher value products.** The observations of the Dairy Industry s performance in the Discussion Document are noted and generally agreed with. We agree that a number of large-scale dairy processors have established in New Zealand since 2004 and most have focused on higher value products. However, the Discussion Document provides no comment on the relative perfo mance of these new dairy processors. We note that many of these new processors have had limited initial financial success and most have been re-cap talised on a number of occasions. We also note that the new processors that have focused on commodity products appear to have been more successful at least in the formative years.

3.9. This observation regarding new dai y processors and their varying success highlights the challenge with supplying higher value products. The Discussion Document suggests that Fonterra has not been successful in the high value products space. Dairy Holding agrees with this observation but notes that this challenge has been in part due to the rapid growth in New Zealand milk volumes, even receiving commodi y milk prices.

3.10. **Milk growth.** Over the past two decades, the lending to dairy farm businesses has increased considerably as noted in the Discussion Document. This increased lending has, n Dairy Holdings view, been the result of the farm gate milk returns in New Zealand moving to more closely match dairy prices received by farmers internationally. This one-off adjustment occurred following the removal of export subsidies and increased free-trade following the World Trade Organisation Uruguay Round in the 1990’s. The subsequent milk growth was not due to the DIRA, but rather due to the resulting land use change as farm gate milk prices lifted to a new sustainable level.

3.11. **Champion of the world.** The intention of the DIRA was to allow Fonterra to be the global champion of the New Zealand dairy industry. Dairy Holdings Limited considers that Fonterra’s performance has not been at the required level in the past five years – just like many new dairy processors and Westland Milk Products Limited that have changed from ingredients businesses and moved to focus more closely on consumer and food service dairy products. While milk supply growth has been put forward as a reason for this poorer performance, the reality is that higher value dairy products require different capability and can be more challenging. While Dairy Holdings Limited agrees with Fonterra's strategy to move up the value chain, we note that dairy businesses that have focused solely on commodities over the past decade have been just as successful as businesses that have been focused on higher value products, but without the need to be re-capitalised.

3.12. **Has the DIRA led to this 'tsunami' of milk?** In Dairy Holdings view the wave of milk growth in New Zealand has not been largely due to the DIRA. Milk growth was happening in New Zealand at around 4% cumulative average annual growth throughout the 1990's and this continued in the next decade primarily due to the one-off change in farm gate milk prices following international trade reform. While Fonterra has been required to take all milk, it has been required to price the milk in a transparent manner and farmers have responded based on international milk prices.

3.13. We do consider that the DIRA could have also contributed to increased cow numbers and environmental pressures by requiring Fonterra to pick up milk with open entry, but also know that there are other parts of government policy which should manage these pressures through the Resource Management Act and the resulting rules from regional and district plans. Some parts of the country are applying these rules more vigorously than others and the whole of the dairy sector is working with regional councils on getting sensible outcomes for both farmers and the environment.

3.14. With the benefit of hindsight, Fonterra could have been clearer about what regions it was willing to accept milk from and what regions it may have been less willing to receive supply from; and reflect this signal in the milk price paid. We note that new dairy processors establishing their own supplying farms have been more discerning about the location. However, we contend that this has had more to do with milk transportation costs than environmental considerations until very recently.

3.15. **Should it go or should it stay?** Dairy Holdings Limited suggests that a well-working DIRA would be better than relying on the Commerce Act. We also consider that the industry is mature enough to manage some changes to the DIRA.

4 OPTIONS FOR THE DIRA OPEN ENTRY REQUIREMENTS

4.1. Chapter 4.1 of the discussion document puts options for DIRA open entry requirements.

4.2. Dairy Holdings Limited understands the purpose of the open entry requirements within the DIRA – they were set in place to allow farmers to enter and exit Fonterra with some ease. This in turn set Fonterra the incentive to perform well relative to the milk price determined through the Milk Price Manual.

4.3. The tension on the price of shares (now bought and sold independently of Fonterra following the Trading Among Farmers constitutional changes) and the milk price gives farmers information to base their business decisions on. This includes cow numbers, degree of supplementary feeding, both of which in-turn effect milk production, processor of choice (if available) and whether dairying is the best use of their land.

4.4. Farmers have generally voted with their feet (by changing supplier or not), where competition has been available or where land-use change is a more viable option.

4.5. Dairy Holdings Limited has supported these provisions over the li etime of the DIRA because we know that it offers all farmers certainty that their milk will be picked up if the conditions of supply have been met. This has been regardless of where they live and who they supply, given that Fonterra is required to pick up milk even if a farmer has previously been supplying an IP.

4.6. Dairy Holdings Limited is aware of the call for an end to the open entry clauses.

4.7. Dairy Holdings Limited is concerned that the removal of open entry could impact farms being sold, farms in areas that may be regarded in future as being less desirable and farms that have future productivity growth.

4.8. **Sale and purchase of farms**. When a farm changes hands, the new owner is regarded as a new supplier to a dairy factory because supply is tied to the owner, not to the farm location The new owner must meet the terms and conditions of the supply before being accepted, and if these are met Fonterra, if approached, must accept this milk. The ame is not true of any of the IPs, where supply is often tied to the farm location and a transfer to a new owner can be refused on the basis that it doesn't 'want/need' this new supply, without giving a reason and little redress.

4.9. If this obligation to accept this 'new' milk on Fonterra is removed Dairy Holdings' concern is for the value of the land/farm and for those Fonterra <u>and</u> IP suppliers who take for granted that Fonterra will pick up the milk on the sale of their dairy farm if an IP doesn't.

4.10. It is likely that, if Fonterra were no longer obligated to accept all milk offered, unless Fonterra's collection policy was able to be clearly communicated, then dairy land values would drop for all farms irrespective of whether they supplied Fonterra or an IP.

4.11. Fonterra would be required by supplying farmers to clearly articulate where its future supplying farms will be located, as would IP's. However, if this doesn't occur regulation in this regard may be appropriate.

4.12. **Farms in future less-desirable areas**. Dairy Holdings Limited is concerned for farms in areas that may in future be less desirable for various reasons.

4.13. These future less-desirable areas could be for reasons of remoteness, or because of future land use change where milk supply volumes in an area reduce, or where local environmental pressures need to be more aggressively managed.

4.14. In all these situations where any such change is proposed, this needs to be openly communicated and signalled with enough time for farmers to adjust and adapt. As a minimum, a clear signal regarding a decision by Fonterra not to accept supply from a location should be required to be announced at least ten years in advance of ceasing to pick up supply.

4.15. **New conversions and milk growth.** Dairy Holdings Limited considers that Fonterra should have discretion to accept new supply from land which has been converted to dairying, from a defined date, which Dairy Holdings Limited suggests could be from the season after the DIRA has been amended.

4.16. We consider that a new conversion be defined as a milking platform where greater than 50 percent of the land is new to dairy.

4.17. Dairy Holdings Limited also holds the view tha Fonterra should be provided the discretion as to whether or not it accepts increased milk supply from existing supplying farms, from a defined date. As set out in paragraphs 4.12 to 4.14 any such discretion needs to be openly communicated to farmers with sufficient time for them to adapt.

4.18. Having this specified within the DIRA would give Government some comfort that so called 'sensitive' land could be shielded from dairying, while giving farmers clarity on the type of activity that can be carried out on land.

4.19. **What would this look like**. In summary, Dairy Holdings Limited considers that Fonterra should have discretion to accept supply, but on the above bases.

4.20. Otherwise, Fonterra must continue to accept supply from farms supplying Fonte ra on a share-backed basis (full or part), provided the supply meets the normal terms and conditions of supply.

4.21. **MPI'S OPTIONS ON OPEN ENTRY**

4.22. **4.1.1 Status Quo.** Dairy Holdings Limited **rejects** this option.

4.23. **4.1.2 Repeal the DIRA Open Entry Requirements.** Dairy Holdings Limited **rejects** this option. Farmers run the risk of having stranded assets, as per the arguments set out above.

4.24. **4.1.3. Amend the DIRA open entry requirements to allow Fonterra to decline to accept applications from new and existing farmers if Fonterra considers their supply is unlikely to comply with Fonterra's terms of supply.**

4.25. Dairy Holdings Limited **agrees** with this option, but on the conditions set out above.

5. OPTIONS FOR ACCESS TO REGULATED MILK FOR LARGE DAIRY PROCESSORS (EXCEPT GOODMAN FIELDER)

5.1. Chapter 4.2 of the discussion document puts options for access to regulated milk for large dairy processors (except Goodman Fielder).

5.2. Dairy Holdings Limited understands the intent of providing some milk at a regulated price to all IPs that are starting up in business. They need certainty of supply, and farmers might not supply them until the new business has shown its ability.

5.3. **RECOMMENDATION**

5.4. That Option 4.2.2: Amend the eligibility provisions in the Raw Milk Regulations to exclude large dairy processors, be adopted, as per the proposal

6. OPTIONS FOR THE BASE MILK PRICE CALCULATION

6.1. Chapter 4.3 of the discussion document puts options for the base milk price calculation.

6.2. Dairy Holdings Limited acknowledges that a base milk price is a key foundation for the DIRA. The price paid by Fonterra to farmers for their milk drives the profitability of both Fonterra and independent processors and it will also influence prices paid by consumers for dairy products.

6.3. We agree that Fonterra's market dominance means its milk price has had a strong influence on the milk prices dairy processors have to match or better to maintain supply from farmers.

6.4. Dairy Holdings Limited supports light-handed regulation and the DIRA is no exception. We believe the approach of DIRA to the base milk price calculation remains appropriate.

6.5. Utilising the Milk Price Manual to set the Fonterra Farm gate milk price remains a very transparent way of assessing dairy processing performance. While all processors have being paying a milk price based off the Fonterra milk price, this has meant that the resulting earnings before interest and tax for any processor provide an indication of relative efficiency and competitiveness compared with Fonterra.

6.6. Utilisation of a standard approach to developing the Fonterra farm gate milk price has also enabled a number of milk price derivatives to be developed in the financial markets to enable farmers and processors to manage milk price risk. If this standardisation relative to international dairy commodity prices was removed, then the milk price hedging market would almost certainly cease to exist and the volatility that many dairy farmers are exposed to would increase.

6.7. Dairy Holdings Limited does not believe there is a need for substantial change from the current approach to regulation of the base milk price.

6.8. **MPI'S QUESTIONS**

6.9. **Q19. Do you consider that greater confidence in the base milk price calculation outcomes could be achieved if additional legislative guidance on the term 'practically feasible' were to be provided for in the DIRA? Please provide detailed comment in support of your views.**

6.10. Dairy Holdings Limited believes that the current approach provides sufficient confidence in the milk price calculation. We would not be averse in principle to consideration of additional guidance on the term 'practically feasible' but, as mentioned in the discussion paper, this is unlikely to be straightforward and if not done carefully would have risks of unintended consequences.

6.11. **Q 20. Do you consider that the base milk price should be set by an independent body (e.g., the Commerce Commission)? If so, please provide supporting information.**

6.12. Dairy Holdings Limited does not think such a change is necessary or desirable. We agree with the discussion paper's comment that such an option would likely have significant risks and costs.

6.13. **RECOMMENDATION**

6.14. That the **status quo** be retained for the base milk price calculation.

7. ACCESS TO REGULATED MILK FOR GOODMAN FIELDER AND SMALLER PROCESSORS.

7.1. Chapter 4.4 of the discussion document puts options for access to regulated milk for Goodman Fielder and smaller processors. Dairy Holdings Limited will consider Goodman Fielder and smaller processors separately.

7.2. Dairy Holdings Limited believes that where it's required the DIRA and Raw Milk Regulations must adequately balance the interests of New Zealand dairy farmers and New Zealand consumers.

7.3. **Smaller processors**. There has been no known movement of these IPs to enter either the factory gate or the farm gate market for milk supply. This is due to the new 2012 Raw Milk Regulations which allowed this continued access.

7.4. While we have been disappointed that more IP's have not taken advantage of the 20% Rule in section 108 of the DIRA, whereby Fonterra shareholders are allowed to allocate up to 20% of their weekly production to IP's, we note that managing farm supply curves is challenging for many smaller IP's.

7.5. **RECOMMENDATION**

7.6. That small IPs (under 30 million litres of own supply or no supply) continue to have access to Regulated Milk.

7.7. **Goodman Felder**. Given that the clear majority of milk and milk products sold in New Zealand retailers is either Fonterra's own brands or manufactured with milk from Fonterra there is clearly potential for a lack of competition in the domestic milk product market that has to be addressed.

7.8. In acknowledging this ongoing risk the preliminary analysis in the discussion document notes, correctly, that the only other significant player in the domestic market is Goodman Fielder with access to Fonterra milk and that other players who have access to their own milk supply have so far shown little willingness to participate in the local market.

7.9. In the same part of the discussion document we note that it was assumed on the introduction of the DIRA that Goodman Fielder would over time seek its own supply of milk and therefore reduce its reliance on Fonterra milk.

7.10. It is disappointing that Goodman Fielder have made no move to secure their own direct supply.

7.11. **Responding to MPI's Options:**

Option 4.4.1 Status quo retain the existing provisions in the raw milk regulations as they apply to Goodman Fielder.

Option 4.4.2 Amend the Raw Milk Regulations to update the terms on which Goodman Fielder can access regulated milk from Fonterra

Option 4.4 3 Amend the Raw Milk Regulations to gradually reduce Goodman Fielder's eligibility to access regulated milk over time

Option 4.4.4 Amend the Raw Milk Regulations to remove limits on the amount of regulated milk available to dairy processors supplying New Zealand consumer markets

Option 4.4.5 Amend the Raw Milk Regulations so that the terms on which dairy processors supplying New Zealand consumer markets can access regulated milk mirror the terms on which Fonterra supplies its own New Zealand consumer business

7.12. **Recommendation**: That policy changes be made to ensure that New Zealand consumers are protected from the risk of lack of competition by adopting Option 4.4.3. This will provide a continuation of the current protections for smaller IP's and a reduction over time in Goodman Fielder's eligibility to access regulated milk.

8. OPTIONS FOR THE DIRA REVIEW AND EXPIRY PROVISIONS

8.1. Chapter 4.5 of the discussion document puts options for the DIRA review and expiry provisions.

8.2. As we stated in the introduction, a well-working DIRA would be better than relying on the Commerce Act. It therefore comes down to what a 'well-working' DIRA would look like.

8.3. We suggest that giving some discretion for Fonterra to refuse milk, as discussed in Section 4, would go some way to providing a more permanent DIRA

8.4. However, some sort of check will need to be made to make sure that any changes made now are working.

8.5. Setting a time period for a review of how the industry is working is sensible. The dairy industry is New Zealand's second biggest exporter and reviewing it would be required, regardless of the DIRA. Having the DIRA puts some rules around what is reviewed, sets a track record and is something to benchmark against.

8.6. Reviewing it at five yearly intervals is almost business as usual given there have been around three reviews since its inception.

8.7. Allowing for no review or possibility of expiry (as per Option 4.5.1) would not be acceptable to Dairy Holdings Limited.

8.8. **RECOMMENDATION:**

8.9. That Option 4.5.2, requiring periodic reviews of competition in the dairy industry to determine if the regulatory regime should be retained, repealed or amended, be adopted Dairy Holdings recommends that the reviews be held at five yearly intervals.

9. ABOUT DAIRY HOLDINGS LIMITED

9.1. Dairy Holdings Limited is a growing dairy business that provides our customers with the highest quality food from 100% pasture.

9.2. Dairy Holdings Limited is a large farming business operating 75 farms in the South Island. These are a mix of dairy and grazing blocks.

9.3. Producing 17.5m Kg MS from 50,000 cows, Dairy Holdings Limited is the largest supplying shareholder of Fonterra.

9.4. Dairy Holdings Limited is owned by three New Zealand family groups being the Armer's, Turley's and Wallace Group.

DairyNZ
Profitability. Sustainability. Competitiveness.

Annie Hindle
DIRA Review Team
Agriculture, Marine and Plant Policy
Policy and Trade Branch
Ministry for Primary Industries

By email: dira@mpi.govt.nz 8 February 2019

Dear Annie,

Review of the Dairy Industry Restructuring Act 2001

Thank you once again for the recent discussions that you have had with me and the DairyNZ policy team regarding the current review of the Dairy Industry Restructuring Act (DIRA). DairyNZ welcomes the review process, and the opportunity to provide feedback on whether the DIRA's regulatory regime is continuing to operate in the long-term interests of dairy farmers, consumers, and the wider New Zealand public.

Our role

DairyNZ is the industry good organization representing New Zealand's dairy farmers. Our purpose is to secure and enhance the profitability, sustainability, and competitiveness of New Zealand dairy farming. Our work, which is funded by a levy on milksolids and government investment, includes:

- Research and development to create practical on-farm management tools
- Leading the adoption of best practice farming
- Promoting careers in dairying; and
- Advocating for farmers with central and regional government.

Our approach to the DIRA review process

Against this background, our approach to the current review is to ensure that any proposed changes to the DIRA are evidence-based, promote effective competition, drive productivity improvements, and support the sector's ongoing transition into high-value consumer product markets. It is also important that the DIRA contributes to the delivery of improved environmental outcomes for the benefit of all New Zealanders.

DairyNZ's emphasis is therefore on ensuring the DIRA provides a strong platform from which the dairy sector can achieve the social, economic, and environmental objectives outlined in the Dairy Tomorrow Strategy (https://www.dairytomorrow.co.nz). Our farmers, fellow industry organisations, and processing companies will provide more detailed insights into how the DIRA is currently influencing the level and intensity of competition within the domestic dairy market, and opportunities for improvement.

Key comments

The Cabinet Paper approving the DIRA Review Discussion Paper for release indicates that the main purpose of this consultation process is to test whether the Ministry has accurately identified he regulatory challenges that are of key concern to dairy market participants and the wider public. We have therefore provided some provisional observations which we look forward to discu sing in due course.

Dairy sector performance

According to the Discussion Paper the Ministry's preliminary analysis suggests that:

- The DIRA is an effective tool in managing Fonterra's continuing dominant market position, which is estimated to be 80.5% of the national market share based on 2018 data;
- The regulatory arrangements imposed by DIRA provid high-levels of business certainty (at relatively low cost) that cannot be replicated by the Commerce Act's general section 36 powers for dealing with anti-competitive behavior. Consequently, the DIRA remains the most effective tool for safeguarding competit on in the dairy sector; and
- There is no evidence the DIRA is constraining dairy sector growth.

  <u>**BUT**</u>
- The DIRA may be preventing Fonter a from effectively managing its farmers' environmental performance, thereby creating reputational risks for Fonterra, its farmers, and the wider dairy sector.

We broadly agree with thi analysis, which is consistent with several key findings arising out of the Commerce Commission s 2016 report on *The State of Competition in the New Zealand Dairy industry.* However, we do cons der that it is essential for the current review process to test the robustness of the datasets underpinning these initial findings. The economic analysis that the Ministry commissioned *Frontier Economics* to undertake prior to the commencement of the public consultation process on the drivers and current state of dairy market performance is an important first step. Our e pectation is that dairy farmers and processing companies will have valuable perspectives on the reliability of this analysis and will provide additional data that will assist the Ministry in refining its understanding of the challenges associated with the current DIRA regime.

Impact on business strategy

The DIRA Discussion Paper asks a broad suite of questions regarding the impact the DIRA may be having on Fonterra's corporate strategy, with specific reference to Fonterra's:

- Base milk price calculation,
- Terms of supply,
- Shareholding requirements,
- Dividend policy, and
- Competitive position in the global market place

While we understand the rationale for framing these questions, we consider they are most appropriately addressed by Fonterra and its farmer suppliers in the first instance.

The Discussion Paper also highlights longstanding concerns regarding the unintended consequences associated with the DIRA's open entry requirement. In particular, whether the obligation for Fonterra to collect milk from all new suppliers is driving the continuation of a commodity-based dairy sector. The Paper concludes that, from a regulatory perspective, there is nothing in the DIRA to prevent Fonterra from proactively adjusting its milk price over multiple seasons to reduce milk volumes and create headroom for increased investment in value-add processing initiatives. Consequently, the Paper suggests there is no evidence the DIRA is inhibiting Fonterra's ability to transition to high-value add dairy processing. However, the paper then goes on to list the sizable management and logistical reasons why milk price adjustments are difficult to implement in practice.

In many respects the discussion regarding the efficiency and effectiveness of the open entry requirements raises issues that go to the heart of the current review process. At firs analysis the DIRA bears all the hallmarks of a well-functioning competition policy instrument. However, in practice it fails to provide Fonterra with the right level of management flexibili y that it requires to respond to challenges in a rapidly changing global market place. We agree with the Ministry's analysis that striking the right balance between regulatory control and management flexibility is a highly complex issue, and there is unlikely to be a single solution.

DIRA's impact on the dairy sector's environmental performa ce

The Discussion Paper notes that dairy sector growth has delivered significant economic benefits for New Zealand. However, the rising international demand and high prices for dairy products, coupled with the lack of other comparable returning land use options, has led to an increase in the size of the national herd and the expansion of dairy farming into new areas. There is a suggestion that the DIRA's open entry requirements may h ve contributed to this expansion and produced adverse environmental outcomes as a result.

We broadly agree with the Discussion Paper's analysis that there is likely to be a causal relationship between the DIRA's open entry requirements, dairy sector expansion and the potential for this expansion activity to impact on environmental outcomes in some catchments. We also share Fonterra's concern , as outlined in the Paper, regarding the reputational risks associated with its mandatory obligation to accept supply from farmers who have poor track records in relation to their on-farm pract ces and/or may not meet the environmental performance requirements outlined in its terms of supply agreement. We think it is essential that all dairy farmers _can_ and _will_ operate at industry-agreed Good Management Practices.[1] Consequently, we think it is timely to address the potent ally dis ortionary impacts that the open entry requirements may be having on Fonterra's abilit to manage its environmental footprint.

We also agree in principle that environmental outcomes are generally best addressed through the Resource Management Act (RMA), with the DIRA focusing on the efficient operation of the dairy market. However, the question as to which regulatory lever the Government should pull when dealing with a competition policy provision that appears to be having adverse environmental outcomes is less clear-cut. We would appreciate more guidance from the Ministry on the specific range of amendments (to either the RMA or the DIRA) that it is exploring in relation to this issue, and

[1] Please see *Good Management Practices: A guide to good environmental management on dairy farms* available at https://www.dairynz.co.nz/media/4106341/Good_management_practices_April_2016.pdf

the criteria for determining the most appropriate regulatory vehicle for implementing the required changes.
The Discussion Paper also invites feedback on the environmental issues that should be addressed either through the DIRA review or some other means. The Paper touches on the large number of policy processes that are currently underway, including the Essential Freshwater Programme, the Zero Carbon Bill, and the proposed National Policy Statement for Indigenous Biodiversity. The forthcoming review of the Biosecurity Act will also examine the role that biosecurity plays in securing international market access and safeguarding the competitive position of New Zealand's dairy farmers and processing companies. Our recent experience suggests that the policy intersects between these various workstreams are not well-understood. This raises the risk of policy fragmentation, and we are concerned about the impact that this could have on the quality of ou farmers' business environment. This is an issue that we are keen to engage with the Ministry of Primary Industries and Ministry for the Environment on as soon as possible.

Does the DIRA incentivize inefficient entry by large dairy processors

We agree with the Discussion Paper's assessment that it is timely to revisit whether the original rationale for providing large dairy processors with access to Fonterra milk during their initial establishment stage still stands. We look forward to discussing this issue in more detail with the Ministry in due course. This review must examine whether exist ng DIRA regulations, in any way, undermine the global competitiveness of our New Zealand dairy industry. We regard this as something critical to our future in a global market place that is acing on-going change and potentially more competition.

Access to farm performance data

Efficient markets require high-quality inform tion flows. The dairy sector is no exception, with increasing demands (e.g. from National Animal dentification and Tracing, processors and national and regional government) for access to fa mer-provided data. This is an important issue which may be technically outside the scope of the current DIRA review. We would however like to draw the Ministry's attention to the recent New Zealand Animal Evaluation Limited submission on the Dairy Herd Improvement Regulatory Review (located at Appendix 1) which raises several issues of relevance to the DIRA review process.

Thank you once again for the opportunity to contribute to the review process. Please contact our National Policy Manager, Kay Brown on s 9(2)(a) or kay.brown@dairynz.co.nz, if you have any questions regarding this submission. We are looking forward to receiving confirmation of the review outcomes and the Ministry's draft policy recommendations in the near future.

Dr Tim Mackle
Chief Executive
DairyNZ

Appendix 1: DairyNZ Submission on Dairy Herd Improvement Regulatory Review Process

DairyNZ

Profitability. Sustainability. Competitiveness.

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12th November 2018

By Email: info@mpi.govt.nz

To Whom It May Concern

Re: Dairy Herd Improvement Regulatory Review

Please find below our submission in relation to: **Dairy Herd Improvement Industry Review of Regulation (MPI Discussion Paper No: 2018/10)**

This submission has been prepared jointly by DairyNZ and New Zealand Animal Evaluation Limited (NZAEL), and represents the views of both organisations.

Should you have any questions, please contact

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Yours sincerely

Warren Larsen
NZAEL Chairman

David McCall
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Our Role

DairyNZ is the industry good organisation representing New Zealand's dairy farmers. Funded by a levy on milk solids and through government investment. Our purpose is to secure and enhance the profitability, sustainability and competitiveness of New Zealand farming. DairyNZ's work includes research and development to create practical on-farm tools, leading on-farm adoption of best practice farming, promoting careers in dairying, and advocating for farmers with central and regional government. DairyNZ invests approximately $6.3 million per year of farmer's levy in genetic gain through NZAEL and research programmes.

New Zealand Animal Evaluation Limited (NZAEL), a wholly owned subsidiary of DairyNZ establishes and maintains policies for the dairy sector's National Breeding Objective which includes developing a breeding goal for genetic improvement of New Zealand dairy cattle for the benefit dairy farmers. The National Breeding Objective is quantified as Breeding Worth (BW), which is calculated by NZAEL for all dairy cattle. NZAEL functions include

- defining, maintaining, estimating, publishing, and periodically reviewing a national BW index for artificial breeding sires to assist farmers when making breeding decisions. This index compares the expected ability of males and females to breed efficient converters of feed into farmer profit as replacements and is based on traits including but not limited to milkfat, protein, volume, liveweight, fertility, somatic cell score, body condition score and residual survival and their relative economic values;
- managing, on behalf of DairyNZ, the Core Database pursuant to Dairy Industry (Herd Testing and New Zealand Dairy Core Database) Amendment Regulations 2014;
- identifying traits that influence the breeding goal and deciding the relative importance of each of the traits in BW;
- overseeing, and having input into the research portfolios relating to the breeding goal;
- providing genetic evaluations and estimating breeding values (BV) for dairy animals;
- providing advice on setting standards for and monitoring data quality for inclusion in genetic evaluations for dairy animals;
- collecting, holding, analysing, manipulating, processing, evaluating, disclosing, distributing, and publishing any data which directly or indirectly relates to dairy cattle by any means required;
- contracting reviewers and other relevant third parties to report on existing or proposed genetic trait evaluations and/or on existing or proposed economic valuation of genetic changes in the traits of dairy cattle;
- consulting with farmers and with any other parties considered to have a relevant interest in the genetic improvement of dairy cattle and/or development of the dairy industry within this area in New Zealand or overseas.

Together DairyNZ and NZAEL have key roles to maintain and enhance the competitiveness of the New Zealand dairy industry by identifying animals that will optimise profit and lead to better environmental and animal welfare outcomes. We are acutely aware that New Zealand dairy farmers are in a race against international competitors to accelerate rates of genetic gain and are competing with major genetic improvement investments in Europe, North America, Asia and Australia. There is increasing evidence that under current data constructs we are falling behind those international competitors.

Contribution of data to genetic improvement

Genetic improvement of NZ dairy cattle contributes $300 million per annum profit to New Zealand dairy farmers with significant spill over benefits to the NZ economy. This value relies on access to high quality data relating to individual animals' pedigree, conformation and behaviour (e.g. parentage, breed, udder quality, temperament etc.) and their performance (e.g. fertility, milk yield, body condition score etc.) combined with statistical techniques to estimate their genetic merit. These estimates of genetic merit are then combined with economic information to identify the most profitable (highest BW) animals. Without quality data, genetic variation, heritability, and genetic trade-offs between traits cannot be estimated and the accuracy and breadth of indices are compromised.

Challenges with the current construct

The **current fields defined as Core Data are not sufficient to calculate BW**. Data currently excluded but required to calculate BW include:

- Body condition scores
- Liveweight
- Traits Other than Production (TOP) scores, specifically TOP scores for milking speed, overall opinion, legs, udder overall and dairy conformation

These non-core data are available based solely on ag eements between NZAEL and Certified Herd Testers.

At present, data can only be supplied to the Core Database by Certified Herd Testers, yet Core Data and data required for animal eva uation exists outside of these Certified Herd Testers The current construct works for companies with sufficient incentives to provide both Core Data and non-core data, but not for those with limited incentives or ability to supply data to Herd Record Providers or D GAD This means that this non-core data collected by farmers and required for animal evaluation cannot be accessed or utilized by NZAEL.

Technological advancement means genotypes, animal health, environmental impact, high-throughput "-omic" data and data llected by automated sensor technologies will be needed to calculate BW soon **We need a forward-looking and commercially balanced construct that encourages investment in new technology and data utilisation for the National Breeding Objective.**

SECTION 5 - THE LIST OF REGULATED (CORE) DATA IS OUT OF DATE

Q1: Have we correctly described the issue?

The Discussion Paper correctly identifies that the list of Core Data is out of date in that it doesn't include all the data required for the national animal evaluation process to calculate BW. However, there are four important areas that are not covered in the document. These are:

1. farmer and breeding company access to cow genetic indices
2. usage and access to single nucleotide polymorphism (SNP) data required for parentage verification
3. usage and access to farm performance data
4. use of commercially funded genotypes in animal evaluations.

While the purpose of animal evaluation is to maintain and accelerate rates of genetic gain, this is not a simple function of animal evaluation alone. The rate of gain also depends on:

- animal breeding companies and bull breeders identifying the best cows to mate to produce the next generation of elite sires. This "cow to bull" selection pathway contributes about 37% of the estimated $300 million per annum. Therefore, any inefficiencies or barriers significantly impact rates of genetic gain;
- farmers using these elite sires widely – supported by the AI companies endorsing the national breeding objective and competing to deliver the highest genetic merit bulls;
- farmers identifying their best cows and replacement heifers and using these to increase the genetic merit of their herds.

This process is supported by investment in research, information systems, farmer support and breeding by companies and farmers. Without this, the effort in collecting Cor Data and calculating BW has less impact. Changes to the arrangements for Core Data must consider the impacts on the wider genetic improvement system for dairy cattle, n t just the accuracy and relevance of genetic indices.

Access to cow genetic indices including Breeding Worth

The original Business Case for the DIGAD identified the value that was being lost to the dairy sector through fragmentation of indices. Since the DIGAD was established this fragmentation has continued, at least partly due to the inability of LIC and CRV Ambreed to reach commercial terms on the supply of cow BW and breeding values from LIC to CRV. CRV Ambreed access to cow BW and breeding values are required to inform their contract matings to produce elite sires (cow to bull pathway) and to provide CRV's herd recording clients with BW and breeding values for their cows

As part of the DIGAD negotiations between DairyNZ and LIC, it was agreed that LIC retained the commercial rights to cow BW, and LIC u dertook to reach commercial terms with other users. These important agreements have not been achieved – and consequently, genetic gain has been compromised.

This construct has proved to be sub optimal because the parties have been unable to reach commercial agreemen for routine supply of the cow genetic indices. This has two important implications for genetic gain.

- Farmers that supply data to the DIGAD via CRV are not routinely receiving the full genetic selection benefits of these indices despite paying for and supplying data and funding the operations of the DIGAD and NZAEL through their DairyNZ levy. This is a disi centive to participate in herd testing and data supply.
- B eeding companies that need to identify elite females as parents for the next ge eration of high genetic merit bulls are not routinely purchasing Elite Cow Lists from LIC.

This situation will be exacerbated in 2019 when CRV starts supplying Core and other data directly to DIGAD rather than through LIC. At that point, indices for CRV enrolled cows will not be supplied to LIC unless CRV and LIC reach commercial agreement, further reducing the information flow to breeding companies and herd record providers and the rate of genetic gain.

DairyNZ does not have a solution that continues the previous arrangements produced by DIRA and the agreement between LIC and DairyNZ. The onus has been on the commercial players to reach agreement – but this has not happened. **A new construct is required which in our view - and based on close observations of the last decade - will only be achieved through government leadership.**

Access to SNP data for parentage verification

Parentage errors are biasing the national evaluation system. We have demonstrated that an increase in the number of animals with DNA-verified parentage will reduce bias and increase the accuracy of estimated breeding values and BW. Therefore, increasing the use of parentage testing will increase genetic gain.

At present, there are two main providers of parent verification technology for NZ dairy cattle. These two providers use a different selection of SNPs, and farmers are provided only the parentage result (i.e. the ID of the likely sire and dam) while the underlying SNP data remains with the provider. Both factors contribute to a market environment where farmers face large financial costs if they change parent verification providers, as they must re-genotype their cows (i.e. potential dams of calves) with the new provider. This creates a barrier to providers who wish to enter the industry because this cost limits farmers' ability to consider new providers.

NZAEL proposes establishing a standard set of SNPs as 'parentage SNPs'. Accredited parent verification providers would be required to both use these SNPs for their parent verification process and supply these SNP genotypes to other providers under farmer direction.

This practice is common place internationally, with a selection of 550 SNPs identified as an international set of standard parentage SNPs. NZAEL's preference would be to align with international standards following initial validation to ensure these selected SNPs are appropriate for parent verification in NZ cattle.

Technically, it is the parentage not the SNP data that is required for AE. If DNA providers cannot agree to exchange SNP data, an alternative approach is that parentage SNPs are designated as Core Data with the Access Panel able to release these with farmer permission.

Access to farm performance data

There is increasing demand for farmer-provided data for use by NAIT, processors and government. Barriers to sharing and re-use of these data remains a rub point with farmers. In the future, data held in DIGAD could be valuable to farmers and to parties to whom they need to supply data. For example, antibiotic treatment records for mastitis cases being supplied to milk processors.

NZAEL's preferred position is that farmers provide these data via their herd record provider, who then has an arrangement with the next user (e.g. a milk processor) to share the data with farmer permission. However, there are likely to be blockages to this flow because the herd record provider has competing relationships with an existing milk processor or because providing data and linkage is not a priority for the HRP. Given that the data are held in DIGAD, it makes sense that the farmer should be able to authorize its release to the milk processor. The connection to the DIGAD and data processing costs would be met by the end user.

Access to genotyping and genomic prediction

We acknowledge that both CRV and LIC have made significant co-investments with government to collect phenotypic data and genotypes and develop genomic prediction systems. We want that investment to continue, and it would be in the interests of the sector for new commercial companies to invest further in genotyping and phenotyping.

DairyNZ is currently investing in developing a new approach to bring genomic data into the BW calculations. Both CRV and LIC are collaborating in this project, and funding has been sought from MPI through a PGP. If successful, this approach will require either genotypes or genomic BVs to be supplied to NZAEL by the companies.

To protect those historic investments against free-loading and encourage on-going participation, we propose a model where genotype or sequence data is made available for the NZAEL animal evaluation function and research only. In the construct proposed in answer to Question 2, the required genomic data would be designated as required for the calculation of BW but not available through the Access Panel.

A Consortium (modelled on overseas experience) is envisaged as the business model to fund efficient collection of genotypic (and potentially phenotypic) data. This would include provision for new members to join in through a substantial contribution of genotypes and data, an investment, or a one-time fee. If new phenotyping technologies offer potential for increased genetic gain with a cost or IP structure that inhibits data sharing, a similar Consortium model could be used. The Information Herds concept being tested by NZAEL could follow this option to protect and incentivise genotype and phenotype collection and provision.

Q2: Of Options (i), (ii) and (iii) above which do you prefer?

Under the current construct, there is a risk that

- **All data that is collected and required for Animal Evaluation are <u>not supplied</u> to the Core Database**. This is because there is a requirement in the current Regulations that Core Data **<u>must be sent only by Certified Herd Testers</u>**. This precludes companies collecting and holding data required for animal evaluation from submitting data to the Core Database unless they develop data sharing and transmission agreements with Certified Herd Testers on a case-by-case basis.
- **New types of data required to keep pace with technology developments or data needs for Animal Evaluation are not available or utilised.** This is because there are regulatory or commercial hurdles to accommodate new technologies.

We agree that ***Option (iii) Provide a mechanism that provides flexibility for core data to be redefined without requiring formal regulatory amendment*** provides the optimal construct to meet the animal evaluation needs of the New Zealand dairy industry now and in the future. However, with any change in regulatory construct, we emphasise that a regulatory framework is still required to ensure Core Data is supplied to the Core Database.

Our recommendation on this mechanism has 3 steps:

1. NZAEL approve a business case for new Core data fields after consultation with the sector. Where necessary, this business case should include any need for compulsory collection or supply of data.
2. The Access Panel designate new fields as Core Data based on the NZAEL submission.
3. The Minster or Director General of MPI approve the Access Panel decision where this brings new data under the control of the Access Panel or requires compulsory data collection or supply.

The criteria for Core Data field expansion would require a business case that includes "*demonstrated or estimated value to the New Zealand dairy farmer via an increased rate of genetic gain in the national dairy herd*" and consideration of the costs and investments for other participants in the sector.

This option maximises agility to respond to product and technology dev lopment, market conditions, consumer needs, and data requirements balanced by commercial onsiderations. We must be able to update Core Data fields within 3-6 months.

Our current view is that the mechanism proposed in Option (ii) should be used to develop the business case for all fields required for Animal Evaluation (e. all data required for the calculation of BW), to be designated as Core Data an under the control of the Access Panel.

For your reference, and in addition to existing Core Data fields, the following data is currently required to calculate BW:

- Body condition score measurements undertaken by Certified Traits Other than Production (TOP) Inspectors or Asur Quality
- Static liveweight and TOP liveweight measurements
- Traits Other than Producti n (TOP) scores, specifically TOP scores for milking speed, overall opinion, legs, dder overall and dairy conformation

Data also required inc udes date, inspector, animal and herd identifier data for those measurements.

We also see that:

- increasing consumer focus on the animal health and welfare of animals, improving the environmental outcomes of dairy cattle e.g. lower nitrate leaching and reduced methane production, and technological advancements, and;
- probable integration of genomic breeding values or genotypes into NZAEL estimates of genetic merit

will mean that additional Core Data will be required to calculate BW in the foreseeable future.

Expansion of Core Data fields under the current Access Panels arrangements where all Core Data is available to applicants who meet a relatively low test of 'not harming' the NZ dairy sector creates tension between data suppliers and potential applicants.
This tension reduces investment in data collection and innovation by current and potential data suppliers, and may have a detrimental outcome. There is also a risk that the commercial players back away from the NBO and BW as a marketing strategy and shift their investment

to differentiate their commercial products from BW and undermine the NBO. Australia took this path at considerable cost to the dairy sector there due to low genetic gain and the subsequent cost to government and the sector of reversing the damage by creating DataGene.

To mitigate this risk, DairyNZ proposes that Core Data is segregated into two sets:

1. Core Data – Data required to calculate BW supplied under compulsion, which the Access Panel has control over and would require Ministerial/Director General approval.
2. Core Data (Restricted) - Data required for animal evaluation that the Access Panel does not control access to. Rather, these data are supplied and used specif cally for national animal evaluation and research purposes e.g. genotype or sequence data

This construct (or similar) would allow the flexible expansion of data required fo anim l evaluation purposes, but reduce the risk of companies not participating and investing in improving the national genetic evaluation system.

An expanded list of Core Data fields would promote the expansion of industry good research into novel areas, promote collaboration between research organisati ns provide greater value from maintaining the Core Database, and increase the outputs and impacts of industry good research.

We would also propose that the Manager of Core Data ase:

- Adopts ICAR Standards or develop its ow Standards for Core Data not covered by ICAR Standards or existing NZ Data Stan ards
- List Core Data fields and associated Data Standards on the DairyNZ Website

We further propose that regulations would refe to a webpage that stated the current list of Core Data fields as approved by an independent Panel.

Q3: Under option (ii) are you able to provide an estimate of costs or lost revenue to herd testers?

Costs will only increase where new data is to be collected. This might include, for example, puberty data in yearling he fers to support the calculation of the fertility BV. This is a possible outcome of cur ent research at DairyNZ. The process of bringing new data fields into Core data will require a business case and consultation with the sector and with the Access Panel.

The constructive tension that this creates for NZAEL to justify expansion of data collection, the ability of the data providers to refuse to collect those data, and the ability of NZAEL to negotiate ost-sharing of data collection should mitigate against cost increases that are not justified or important data not being collected.

Q4: Are there other options that should be considered?

Our view is that ***Option (iii)*** is optimal, but that it requires some finessing of detail as described above.

HERD TESTING TECHNOLOGIES ARE CHANGING

Q5: Have we correctly described the issue?

Yes. We agree with the need to enable organisations other than Certified Herd Testers to supply data to the DIGAD. The question of compulsion to record and/or supply data is under-emphasised. Currently Herd Testers are compelled to supply data not directly related to herd testing (e.g. calving date) where this is necessary for animal evaluation.

As an example of data that is collected but not supplied, the unrecorded use of hormona reproductive treatments is probably leading to poor estimates of reproductive performance especially in young cows. It is likely that these data will be collected routinely by ve s in future, but these data may not be transferred to a farmer's herd records. In this case it wou d be beneficial to be able to compel the data to be sent to the DIGAD.

NZAEL supports the ability of the Access Panel in designating Core Data to include compulsion to collect and supply.

Q6: Under Option (ii) are there any arrangements that could provide for a new class of person to provide data?

We support ***Option (ii) Provide for a new class of persons to provide data.***

We propose that **<u>Certified Data Providers not just Certified Herd Testers</u>** could provide data to the Core Database. The current approach allows only a Certified Herd Tester to provide data to the Core Database, creating an unnecessary barrier for companies who may not provide herd testing services but provide other important measurement services and collect data that could accelerate rates of genetic gain in the national dairy herd.

The current focus on herd testing p oduces on y a small subset of the data required to estimate genetic indices and requires other potential Core Data providers (e.g. organisations with animal treatment, pregnancy or par ntage, data etc.) to negotiate data transfer agreements and arrangements with Certified Herd Testers as a "pass-through" to the Core Database. Our preference i that al data comes via Herd Record Providers as this is most efficient and farmers would have all their cow related data in one place. However, we recognise that commercial pressures and investment decisions mean that this may not always be possible, so the DIGAD should be able to receive data directly.

Certified Data P ovide s could be classed as follows:

- Cer ified DNA Parentage Verification and Genotype Providers – these could provide p rentage information and genotypes directly to Herd Record Providers and/or direct to he Core Database
- Certified Phenotype Providers (e.g. liveweight, body condition score, Traits Other than Production, milk volume, fat and protein yield and other milk composition traits, somatic cell score and animal health treatment). These providers could provide phenotypic data directly to Herd Record Providers and/or direct to the Core Database. Note: Certified Herd Testers would become a class of these providers.
- Certified Herd Record Providers - these would provide birth, mating, calving, fate, breed composition, death, sale, purchase and cow and herd movement information direct to the Core Database. They would receive male and female genetic indices.

We envision that these organisations would be Certified by an Internal Committee of Animal Recording (ICAR) process or an NZAEL-led certification process. Ongoing compliance would be assessed by Telarc (or equivalent organisation) and NZAEL.

Q7: Are there other options that should be considered?

No.

SECTION 6 - THE ACCESS PANEL

Q8: Do you consider that the statutory criteria by which the Access Panel dete mines access to data should be retained or amended?

We consider the current criteria of **beneficial or not harmful** to be too broad, oo low, and not sufficiently objective and transparent. We would prefer applications evaluated against a narrower and higher standard of being **beneficial** using a published framework t at guides Access Panel decision making to provide objectivity and external visibili y regarding areas of data usage and the beneficial impact(s) of data usage.

Q9: Which of the above options do you prefer and why?

We recommend *Option (ii) Retain the current criteria with published guidance*. A published framework will provide greater objectivity.

Q10: If the criteria were amended or added to, what factors would be useful criteria to assess applications against?

Assessment criteria could include benefits in the following areas:

- Financial
- Environmental/sustainab ity
- Science/knowledge creation
- Product development
- Animal health and w lfare
- Farm and anim l performance
- Social

We also recommend that Core Data applicants must provide examples or estimates of beneficial value in each of these areas for an application to be approved.

As set out in answers to Question 1, applications under which farmers effectively seek ac ess to their own data for purposes related to DNA parentage verification or on-supply to thi d parties should be granted. However, the Access Panel should be satisfied that genuine mark t failure exists, and that this is preventing the preferred flow of data via Herd Record Providers or DNA parentage verification suppliers.

Q11: Are there any other options that should be considered?

No.

Functions of the Access Panel

Q12: Do you consider the Access Panel should carry out additional functions?

Yes

Q13: Which of the above options do you prefer and why?

NZAEL supports Option (ii).
We suggest that the functions of the Access Panel should include the current functions:

1. Evaluating applications for access to data in the Core Database (the Panel must take into account criteria set out in the Regulations in making a decision).
2. Determining other circumstances under which the manager of the Core Database must make data in the Core Database available (including, for example at the request of persons who have supplied the information from which that data results).
3. Appointing an auditor to evaluate compliance by the Manager of the Core Database and LIC with requirements regarding the maintenance and provision of access to data as set out in the Regulations.

And additional functions, including:

4. Determining what is regulated Core Data
5. Determining what data must be supplied for the pu pos s of calculating BW, but not under the Panel's control on access
6. Providing guidance to the Manager of the Core Database on waiving per animal fees when access requests will produce indust y good outcomes aligned with the Core Data Application

We believe that having an independent panel ultimately determining what is Core Data to be beneficial and will remove potential confli ts of interests.

Q14: Are there any other functions that should be considered?
No

Access Panel membership

Q15-Q18
We believe that the memb rship of the Panel should be reviewed to ensure their ability to assess applicat ons based on areas covered under 6.1.1 above, and/or if the functions of the Access Panel a e expanded.

6.1.4 Continued Access Panel oversight of LIC's copy of the Core Database

Q 9: Do you support Option (i) or (ii)?

We support ***Option (ii) Remove Access Panel oversight of core data held by LIC at a defined point in time after DairyNZ is able to receive core data direct from other organisations.***

We note that LIC (and CRV) is likely to apply to the Access Panel for the Core Data that LIC or CRV itself does not hold to recreate a complete Core Data set. In this situation, we see it as the role of the Access Panel to put sufficient conditions on LIC regarding the use of this data to protect and prevent the risk of third parties circumventing the Access Panel.

Q20: Should Access Panel oversight of LIC's copy of the Core Database be removed after 12 months or 24 months?

We believe 12 months is sufficient so long as the Access Panel places sufficient controls on LIC's use of the Core Data supplied from the DIGAD after this time.

MONITORING AND REPORTING

Access Panel annual reporting

Q21-23

We support the Access Panel primarily reporting to milksolids levy payers via its annual report and on the web but also reporting to the Minister of Agriculture. We believe that this reporting should be more informative and include:

- Number of successful and non-successful applications
- Specific criteria for which applications were granted

<u>Manager of the Core Database annual reporting</u>

Q24-26

We support *Option (ii) Establish reporting requirements and enabl publication of some high-level information*.

We suggest that this information should include a summary of the:

- Number of successful applications
- List of successful applicants
- High level summary of each of th successful applications with non-confidential information. Note: We would propos that these summaries would be published only when 12 months had elapsed after data was delivered
- Benefits realised from past Core Data Extracts

CERTIFICATION OF HERD TESTERS AND ASSOCIATED OBLIGATIONS

Q27: What are your views on Options (i), (ii) and (iii) above.

We support the inclusion of all three options.
Option (i) Increasing decision-making clarity for the appointment of certification bodies
Option (ii) In reasing decision-making clarity for the revocation of approval of certification bo ies
Option (iii) Including an obligation on the certification body to advise the Director-General if its ability to certify may change

Q28 Other issues in relation to certification?

As indicated under Q6, we see that Certified Data Providers not just Certified Herd Testers would be compelled to provide Core Data to the Core Database. Certified Data Provider obligations would include adhering to data standards, audits and ensuring they are compliant. The Certification protocol for those other types of Certified organisations may or may not include Director-General of MPI involvement, but we see it as important that a certifying body independent of NZAEL or DairyNZ is integral in that process.

8 February 2019

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Danone response to MPI Discussion Paper 2018/13

1 Danone Nutricia (**Danone**) welcomes the opportunity to provide a response to the Ministry for Primary Industries discussion paper on the proposed ch nges to the Dairy Industry Restructuring Act 2001 (**DIRA**) and the Dairy Industry Restructuring (Raw Milk) Regulations 2012 (**the Raw Milk Regulations**).

2 Danone is one of the world's leading food companies and the global leader in dairy with a turnover of €29.3 billion (NZD $48.5 billion). Ag iculture is at the core of our business and we work with 140,000 farmers around the world, including in New Zealand.

3 New Zealand is a strategic manufacturing and supply point for Danone. Since acquiring spray drying facilities in Balclutha and a blending and packing plant in Auckland, Danone has invested NZD $85 million in doubling pr duction apacity and enhancing capability to create world-class infant milk formula (**IMF**) operations. Today we source raw milk direct from 20 farms and manufacture our international brands including Aptamil, Karicare and Cow & Gate for export to the Asia Pacific region. We currently employ 420 people in New Zealand.

4 The DIRA egulations are critical for our continued growth and investment in New Zealand.

5 This submission briefly sets out Danone's comments on the main issues raised in the MPI Dis ussion Paper 2018/13 (**Discussion Paper**). In summary:

   a We strongly agree that the DIRA is still needed if the raw milk market in New Zealand is to function properly.

   b We strongly agree that environmental concerns need to be addressed. This is best done by using appropriate and existing legislation to address the environmental issues arising from the dairy industry. The DIRA is not the appropriate regulatory regime for these wide environmental issues.

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c The open entry and exit requirements in the DIRA are critical. Allowing Fonterra to refuse to accept applications from farmers on environmental grounds would add unnecessary complexity and raise the raw milk supply beyond competitive prices.

d The Base Milk Price should be set by an independent body to ensure transparency and confidence.

e Regulated access to raw milk for independent processors is important to s pport competition and innovation.

f The DIRA should be subject to regular periodic review. Applying a ma ket threshold trigger is unnecessarily complex.

6 The following comments are grouped in accordance with the Discussion Paper's specific questions.

Have the anticipated benefits of the 2001 industry restru ture been realised? (Questions 1 and 2)

7 The purpose of the 2001 reform was to provide both certainty and opportunity for the dairy sector in New Zealand. The DIRA has provided a set of r gulatory safeguards to ensure the dairy market operates efficiently.

8 To that end to date, the DIRA has been effe tive at achieving its core regulatory objectives. If the New Zealand dairy market in New Zealand is to continue to grow and develop, the DIRA remains a critical mechanism. Without it, fur her investment and capacity building in high value dairy processing, such as IMF, will b at risk.

Is the DIRA still needed? (Questions 3-8)

9 We consider that the DIRA is still needed. It would be premature to reduce regulation while competition has been ncreasing and investor confidence is growing.

10 Fonterra is stil dominant at both the national and regional level. Independent processors and farmers still need regulatory protection to have the certainty and confidence to invest in supply ar angem nts and in capability improvements.

11 The current form of regulation enables a degree of workable competition in dairy markets. The DIRA prevents Fonterra from taking advantage of its market power to create barriers to developing an efficient farming sector in New Zealand.

12 The following obligations regulate Fonterra's activities:

a open entry and exit for farmers;

b regulated provision of raw milk to independent processors; and c default milk pricing.

13 These regulations have enabled the independent supply of raw milk to Danone's Balclutha facility, and are critical for the continued growth of Danone's New Zealand operations. Whilst Dan ne doesn't source regulated milk, the entry and exit provisions allow us to compete for supply from farmers within the region around Danone's facility. The pricing regulations make pricing more transparent and mitigate tactical overpricing by Fonterra.

14 If these mechanisms are removed or watered down, there is a significant risk tha Fonterra will be able to use its market power to raise the farm-gate price and to lock farmers int exclusive long-term contracts, thereby driving prices artificially high for competitors or excluding them from raw milk supply altogether. This would stagnate growth and reduce the incent ves or new entrants drawing from the current NZ milk supply for processing.

15 DIRA provides valuable protections that overseas ma kets suggest are still required again dominant incumbents. For example, pharmaceutical company, Pfizer entered into contracts that induced the long term supply of a drug, for which it previously held a patent, in order to prevent competitors obtaining market access once the patent expir d Similarly, in the UK, the National Grid entered into a number of long term supply agreements to preven competitors from gaining access to the gas meter market when it was de-regulated.

Does the DIRA encourage growth? (Questions 9-13 and 17/18)

16 The DIRA has enabled but not dr ven growth. It has provided the regulatory protection for farmers to enter into raw milk supply arrangements with Danone. This has given Danone the certainty and ability to develop high quality processing facilities and brands from New Zealand.

Open entry requirements (Questions 14-16 and 23-26)

17 Agriculture is centre stage in relation to some of the major challenges, from economic development and climate change, a d from sustainable diets to biodiversity issues.

18 Danone w lcom s the Government's efforts to combat climate change and achieve carbon neutrality G obally, Danone has pledged to become carbon neutral by 2050. We are currently w rking o regenerative agriculture models that help farmer suppliers protect and invest in their uture in reducing carbon emissions.

19 We agree new levers to address poor farming practices are necessary. However, we do not agree that the open entry requirements should be amended to allow Fonterra to refuse entry to farmers whose operations do not meet environmental standards. Accordingly, we support option 4.1.1 as set out in the Discussion Paper, with the exception that Fonterra should be able to refuse to accept applications from shareholding farmers with new dairy conversions, as previously set out in our 2016 submissions.

20 The DIRA is not the appropriate regulator of environmental standards. There is appropriate existing legislation, including the Resource Management Act 1991, and bodies independent of the indust y itself, that can better deal with the environmental issues arising from the dairy industry.

21 The Ministry for the Environment and local government bodies have the necessary experience and expertise in environmental issues, both small and large scale, and the dairy industry should defer to that experience.

22 We consider the open entry provisions have been critical to Danone's g owth in New Zealand. If the open entry provisions were amended such that our ability to source for raw milk supply at competitive prices was hindered, our ability to expand our local operations and realise our export potential from New Zealand would be compromised. This would repr sent a risk for our New Zealand IMF operations. In such circumstances, we would seriously consider our company's future New Zealand expansion and investment in New Zealand. We expect the other processors would find themselves in similar situations, resulting in a less compet tiv market. Notably, the Commerce Commission has already identified this risk in its 2016 review, which concluded that no changes to the requirements were necessary, and with which we agree.

23 Amending the open entry provisions would also create an additional burden on prospective farmer-shareholders (who would need to prove their compliance with the standards imposed) as well as on Fonterra (which would need to review every application in detail and verify its accuracy).

24 In addition, the discussion paper sugg sts that Fonterra would be responsible for setting the specific environmental standards that farm r-shareholders must meet, with any amendments to the DIRA specifying only the types of standards that could be imposed. Danone is concerned that, if Fonterra is responsible for both prescribing and enforcing the standards, such a system could be open to gaming and therefore more oversight from the regulator would be required to prevent this from happening.

25 If the Government concludes that the open entry and exit provisions in the DIRA should be amended, the standards should be prescribed by the Government, by way of regulations under DIRA, in con ultation with the industry (including existing and prospective farmer-shareholders), not by Fonter a.

26 Finally, a prospective farmer-shareholder whose application is declined would have limited recourse. The discussion paper suggests that the matter could be investigated by the Commerce Commission in accordance with the existing dispute resolution provisions in the DIRA. However, the Commission's decision could only be challenged by way of judicial review. This is expensive and lengthy, and not tenable to many farming operators.

27 Any concerns about reputational risk to Fonterra by maintaining the open entry provisions may be dealt with by Fonterra in other ways. Fonterra could manage any reputational concerns by taking an active, hard-line and public approach to issues of non-compliance. Any reputational risk ould be addressed as soon as a farmer-shareholder, with a history of poor farming practices i accepted into the collective.

28 The risk of reputational damage to Fonterra by maintaining the status quo is limited and could be mitigated by Fonterra itself. Amending or repealing the open entry and exit prov sions, conversely, would likely have a profound and long-term effect on the competitiveness of the industry that could not be remedied without further Government intervention.

Base Price Milk calculation (Questions 19-20 and 32-35)

29 The Base Milk Price (**BMP**) effectively sets the market rate for raw milk so that Fonterra's pricing can be assessed by farmers. The BMP is meant to allow transparency so that Fonterra's price can be assessed by farmers, and should be set at a level tha inc ntivises Fonterra to act efficiently, while providing for contestability in the market for the purchase of raw milk.

30 The DIRA takes a 'light-handed' approach when i comes to setting the BMP. Based on the DIRA, Fonterra can set the BMP with a wide discretion as o the factors that it can take into account. While the DIRA provides for Commerce Commi sion oversight, Fonterra is not required to change its approach if the Commission finds that its assumptions in setting the BMP are not consistent with the legislative purpose.

31 Fonterra could essentially set the BMP and then rely on market discipline. This is undesirable. The intention is to create a light-handed regime, but this undermines the the effectiveness of the BMP as a regulatory tool. Fonte ra may be incentivised to pay more for milk in order to attract and retain milk supply at the cost of potential competitors.

32 The BMP is meant to set a notional benchmark price independent of Fonterra's actual pricing. Transferring the responsibility for setting the price to an independent body ensures that farmers, consumers and processors can be confident of the BMP figures. An independent entity should set th BMP o ensure that it is accurate and set appropriately.

Access to regulated milk under the Raw Milk Regulations (Questions 27-39)

33 A already mentioned, we support access to regulated milk supply for new entrants or smaller processers, particularly to support the diversification, investment and innovations, of value-added consumer goods.

34 We also acknowledge that Goodman Fielder and Fonterra are the two main consumer goods players in the domestic market and therefore it remains important to ensure access to regulated milk for Goodman Fielder as a back up to its contractual arrangements, and to encourage new entrants.

Options for change (Questions 23-26 and 40-44)

35 The DIRA should be amended to require periodic review of the dairy industry. Each review should determine whether the DIRA is still required and is still fit for purpose.

36 We suggest a period of five years between reviews. The five-year period strikes a balance between affording the dairy industry with sufficient certainty while assuring stakeholders that regulation will not continue unnecessarily.

37 Amending the DIRA to require a review of competition in the dairy industry when a set market threshold is reached, is unnecessarily complex and does not give any significant advantage over the periodic review option. A clear and un-contestable proxy for market share would need to be identified for this option. There is also a risk that using a market share trigger could create an expectation that de-regulation is required at the point a review is initiated.

Yours faithfully

Ailish Hanley

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8 February 2019

DIRA Review
Ministry for Primary Industries
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To whom it may concern

Environment Canterbury submission on the DIRA review

This submission follows our earlier letter to the Ministry for Primary Industries (the Ministry) signalling Environment Canterbury's interest in the review of the Dairy Industry Restructuring Act 2001 (DIRA). We are again focusing on the open entry provisions, specifically the requirement for Fonterra to accept milk from new shareholders and to accept any quantity of milk from its shareholders.

As noted in the Ministry's discussion document, the growth of the dairy industry has had considerable economic benefit to New Zealand, in luding to Canterbury, but this growth has also had negative effects on our environment, through increased greenhouse gas emissions, nitrate leaching, and the expansion of dairy into increasingly marginal land areas. Environment Canterbury is concerned about all three of these issues, and we consider that these effects need to be taken into account in the review. In our view there is a strong case for DIRA to be amended to reduce the influence that DIRA is having, even if only at the margins, on these issues.

Responding to environmental challenges requires aligned policies

New Zealand faces significant environmental challenges, particularly around land use. In Canterbury we know these challenges very well. Responding to them requires a range of targeted policies and tools, such as those delivered nationally and regionally through the Resource Management Act 1991. Notably they include the requirements on regional councils to implement the National Policy Statement for Freshwater Management. Given the significance an magnitude of these requirements it is important to ensure that other policies align with, or at least do not hinder, efforts to address these challenges.

In 2009 the Canterbury Water Management Strategy set long-term targets for Canterbury. Since then we have been working collaboratively with territorial authorities, Ngāi Tahu, industry and community groups towards meeting these targets. In 2012 we imposed strict nitrate discharge limits for the first time, which essentially took the form of not allowing any increase above 2009 – 2013 average nitrate losses. These rules have had a direct impact on the number of dairy conversions. We are now moving towards lower (i.e. tougher) nitrate limits that reflect industry-agreed Good Management Practices, as well as the recommendations of local water management zone committees.

Environment Canterbury agrees with the Ministry's preliminary analysis that the primary driver for the growth of the dairy industry (and subsequent negative effects) appears to be the incentives created by growing international demand for dairy products and associated high prices for commodities. This should not, however, discount the need to examine and address secondary drivers, especially where government may have increased control over these[1]. To respond to key environmental challenges, we need to look critically at any policies that unintentionally contribute to negative land use outcomes.

DIRA open entry provisions are likely to influence land use outcomes

Under the DIRA open entry provisions Fonterra is required to accept milk from new shareholders and to accept any quantity of milk from its shareholders. In Environment Canterbury's view, these provisions are likely to influence landowner decision making, at least at the margin, meaning increased cattle numbers and milk production above what would otherwise be the case. If that is not the case, then one might reason bly question whether these provisions now serve any purpose. We appreciate that the initial rationale for these provisions was to counter Fonterra's monopoly. But if these pro competitive requirements do not still influence land-owner investment decisions then they serve no ongoing purpose. And if they do influence land-owner decisions on matters such as herd size and milk production then it is reasonable to conclude that these same provis ons have negative environmental impacts.

Accordingly, we consider that DIRA open entry provisions impact negatively on the dairy industry's environmental performance (and our ability as a regional council to respond to land use challenges such as water quality) We ask that the Ministry work to remove those incentives created through DIRA tha conflict with Government goals for a sustainable land-based sector and the outcomes sought through the Government's Essential Freshwater work programme.

The Ministry's discussion document notes that Fonterra can and does influence farmers' milk supply decisions through its price signals. Environment Canterbury can also attest that Fonterra takes its environmental responsibilities seriously and works to address the environmental impact of its shareholder suppliers. But in this respect, it is important to observe that Fonterra lacks the most obvious and straight-forward means of limiting the environmental impact of its shareholders i.e. being able to set or negotiate for agreed contract volumes. This is of course precisely the contractual mechanism that is available to milk purchasers other than Fonterra, such as Synlait and Westland Milk. What stands in the way of this arrangement in Fonterra's case are precisely the so-called "open entry" provisions of DIRA.

For these reasons Environment Canterbury sees merit in the removal of the open entry provisions – at least in the South Island. We note that the original automatic expiry provisions

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[1] A comparable examination is usefully being undertaken across the tax system by the Tax Working Group, which has sought to identify 'whether there are areas of our income tax system that unintentionally favour environmentally-damaging activities' (page 50, *Future of Tax Submissions Background Paper*, Tax Working Group, 2018).

were triggered in 2015, when other dairy processors collected more than 20 percent of milk solids in the South Island. The rationale for the 2018 DIRA amendments – that a fuller review be performed before provisions expire in the South Island, may have seemed justified at the time, and we acknowledge that the Commerce Commission found in 2016 that competition was not yet sufficient to warrant the removal of the DIRA provisions. However, the Commission's findings did not consider any environmental impacts of retaining DIRA provisions (being outside the scope of the Commerce Commission's jurisdiction and expertise), and we argue that these should carry weight in future decisions on the open entry provisions. Further to this, we consider there is value in the Ministry testing regional deregulation of the open entry provisions. The Commerce Commission highlighted that this could enable the Ministry to experiment with deregulation before adopting the preferred pathway nationwide. As the region with Fonterra's lowest market share and a re atively competitive farm gate market, and with some of the most pressing land use challenges, removing the open entry provisions in Canterbury alone should be considered by the Ministry.

The Commerce Commission also recommended in 2016 that a staged approach to transition pathways to deregulation was appropriate. Regardless of what changes are made to the open entry provisions, we would like to see an approach to the DIRA review and expiry provisions that provides clarity and certainty. Perpetual reviews create regulatory instability and uncertainty, and constrain the ability for parties inc uding regulatory agencies like Environment Canterbury, to plan ahead. This too has an adverse impact on the environment.

Thank you for the opportunity to make this submission. For all enquiries please contact Cam Smith, Team Leader Regional Leadership and Policy, s 9(2)(a) , cam.smith@ecan.govt.nz.

Yours sincerely

Steve Lowndes
Chair

CC: Cr David Caygill

SUBMISSION

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FEDERATED FARMERS OF NEW ZEALAND

To:	Ministry for Primary Industries
Submission on:	Review of the Dairy Industry Restructuring Act 2001 and its impact on the dairy industry Discussion document 2018/13
From:	Federated Farmers of New Zealand
Date:	8 February 2019

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SUBMISSION

REVIEW OF THE DAIRY INDUSTRY RESTRUCTURING ACT 2001 AND ITS IMPACT ON THE DAIRY INDUSTRY

Discussion Paper No 2018/13

1. INTRODUCTION

1.1. Federated Farmers welcomes the opportunity to submit to the Ministry for Primary Industries (MPI) on the Review of the Dairy Industry Restructuring Act (DIRA) 2001 and its impact on the dairy industry.

1.2. To inform our submission we surveyed our dairy farming membership and placed a link to the survey in our weekly e-newsletter, the Friday Flash, which goes to all who register to get the newsletter – not all will be members. We also asked our contacts within the six major non-Fonterra processors to pass this survey on to their suppliers in order to gain their views. We received responses from 338 people. The responses were anonymous.

1.3. The comments of farmers within this submission come from this important consultation.

1.4. After a general discussion on the DIRA review set out in section three of this submission, the remainder of the submission (sections 4 to 8) will discuss each of the 'Options for Change' within Chapter 4 of the discussion document.

2. SUMMARY OF RECOMMENDATIONS

Federated Farmers recommends that:

2.1. The DIRA be amended to allow Fonterra to have discretion over accepting suppliers, based on the following provisions:

2.1.1. Fonterra's supply footprint is protected, which includes those Fonterra-supplying farm properties which change hands during sale and purchase, thus becoming 'new' suppliers (paragraphs 4.1 – 4.57).

2 1.2. New conversions: Fonterra be given discretion to accept supply from land that has been converted to dairying (paragraphs 4.22 – 4.28)

2.2. Option 4.1.3 (Amend the DIRA open entry requirements to allow Fonterra to decline to accept applications from new and existing farmers if Fonterra considers their supply is unlikely to comply with Fonterra's terms of supply) be adopted (paragraphs 4.61 – 4.75)

2.3. The current dispute resolution route via the Commerce Commission be communicated to farmers, the costs advertised and a time limit on resolution of farmer-Fonterra disputes be set at 10 working days.

2.4. Option 4.2.2: (Amend the eligibility provisions in the Raw Milk Regulations to exclude large dairy processors), be adopted, as per the proposal (paragraphs 5.1 – 5.9) .

2.5. Option 4.3.1 (Status quo) be retained for the base milk price calculations (paragraphs 6.1 – 6.18).

2.6. Small IPs (under 30 million litres of own supply or no supply) have access to Regulated Raw Milk (under the Raw Milk Regulations[1]) for a maximum of 3 years (paragraphs 7.1 – 7.11).

2.7. Policy changes be made to ensure that New Zealand consumers are protected from the risk of lack of competition by adopting a composite of option 4.4.2 and with consideration to also exploring option 4.4.3 (paragraphs 7.12 – 7.24).

2.8. Periodic reviews of competition in the dairy industry to determine if the regulatory regime should be retained, repealed or amended, should be adopted (Option 4.5.2). The Federation recommends that the reviews be held at five yearly intervals (paragraphs 8.1 – 8.13).

3. GENERAL DISCUSSION ON THE DIRA

3.1. **Competition policy.** The DIRA is competition policy that replaces the normal route for other competition policy, which is via the Commerce Act 1986. Federated Farmers recognises that without DIRA Fonterra would not have been able to be formed and if DIRA were to fall away the dairy industry would be exposed to the broader competition provisions of the Commerce Act.

3.2. Federated Farmers considers that the DIRA has, on the whole, worked. DIRA enabled the formation of New Zealand's largest company, now owned by 10,000 farmers and their families which employs 22,000 people in New Zealand and overseas. Fonterra's annual revenue exceeds $20 billion and it exports to 140 countries, contributing 25 percent of New Zealand's total goods exports. Farmers have been able to freely come and go from the Co-operative, allowing new and existing processors certainty of supply and pushing Fonterra to work for its shareholders New Zealand's consumers continue to have choice on all standard dairy products.

3.3. Fonterra shareholders can, generally, choose to leave Fonterra and supply an independent processor (IP) with the minimum required period of notice, due to the annual contract period requirements as set out in the DIRA. This allows most farmers to manage their business and suit their philosophy on an annual basis. This 'freedom' has also encouraged Fonterra to offer different terms and conditions in areas where there is real competition, such as My Milk and higher than average milk price payments to some suppliers.

3.4. IPs with own-supply have been advantaged by the DIRA, both at start-up (through the Raw Milk Regulations) and through the requirement in the DIRA that obliges Fonterra to accept all supply, with few exceptions. This provides farmers with the safety net of being able to return to Fonterra in the future if they choose to shift their supply to an IP and allows IPs to terminate a contract with their suppliers at the end of the term, with little redress, and no worry that the farmer would be left with stranded assets. IPs are also not required to be as transparent as Fonterra with regards to what new supplying farmers will get paid

[1] Dairy Industry (Raw Milk) Regulations 2012

for their milk, and there is no requirement to provide suppliers with annual supply contracts, with many farmers being locked in for three years or more.

3.5. IPs with no own-supply or who collect less than 30 million litres have been advantaged by the DIRA because they have continued access to raw milk via the Raw Milk Regulations.

3.6. Goodman Fielder, the only major countrywide, year-round supplier of dairy products for the domestic market, has, as a consequence of the DIRA, continued to offer New Zealand consumers a choice, a very important quid-pro-quo for enabling the establishment of Fonterra. We note that Synlait is to also contribute to the South Island liquid milk market, without the use of milk bought via the Raw Milk Regulations.

3.7. As the DIRA is concerned with local competition, it is silent on what any dairy processor (Fonterra and IPs) actually does with the milk, allowing all processors to work in the market that gives them the highest return.

3.8. **Champion of the world.** The intention of the DIRA was to allow Fonterra to be the global champion of the New Zealand dairy industry. Federated Farmers considers that Fonterra has achieved this under the DIRA. While critics suggest that Fonterra has failed in this expectation by exporting what they consider to be too great a proportion of commodities over value-add product, we believe the critics fail to acknowledge the sheer volume of milk that must be processed.

3.9. Even when production is down, as stated in the MPI discussion document where the excess world supply (relative to demand) led to a drop in the milk price in 2013/14 and a decrease in production on farm (because farmers react to price signals), Fonterra still has to process a significant volume of milk.

3.10. Using 2017 figures, Fonterra must find customers for 21.3 billion litres of milk while its nearest New Zealand competitor (Open Country Dairy) has to shift just 1.5 billion litres of milk.[2] Converting all 21.3 billion litres of milk into value-add products is likely to be near impossible and then there is the bi-product that needs to be sold.

3.11. In contrast, the other smaller processors are able to better tailor their intake with their sales. This is not currently an available option for Fonterra due to the DIRA's policy on Open Entry.

3.12. We do consider that the DIRA, in enabling dairying to be a more profitable use of land, has contributed to increased cow numbers and environmental pressures, which must be managed. We also know that there are other parts of government policy which should manage these pressures through the Resource Management Act (RMA) and the resulting rules from regional and district plans. Some parts of the country are applying these rules more vigorously than others and the whole of the dairy sector is working with regional councils on getting sensible outcomes for both farmers and the environment.

3.13. **Should it go or should it stay?** While many farmers consider there are many parts (if not all) of the DIRA that should fall away, Federated Farmers suggests that a well-working DIRA would be better, and more efficient, than relying on the Commerce Act. We also consider that the industry is mature enough, having

[2] Frontier Economics. 2018 DIRA Review: Analysis of industry performance. August 2018, p 27

read the submissions made on the terms of reference for the review and which the current discussion document is based on, to manage some changes to the DIRA.

4. OPTIONS FOR THE DIRA OPEN ENTRY REQUIREMENTS

4.1. Chapter 4.1 of the discussion document puts options for DIRA open entry requirements.

4.2. Federated Farmers understands the purpose of the open entry requirements within the DIRA – they were set in place to allow farmers to enter and exit Fonterra with some ease. This in turn set Fonterra the incentive to perform well so that all dairy farmers would want to supply Fonterra, while attempting to keep the milk price within that 'goldilocks' spot that meant that it was not flooded with uneconomical milk.

4.3. The tension on the price of shares (now bought and sold independently of Fonterra) and the milk price gives farmers information to base their business decisions on. This includes cow numbers, milk production processor of choice (if available) and whether dairying is the best use of their land.

4.4. Farmers have generally voted with their feet (by changing supplier or not), where competition has been available or where land-use change is a more viable option.

4.5. Federated Farmers has supported these provisions over the lifetime of the DIRA because we know that it offers all farmers certainty that their milk will be picked up if the conditions of supply have been met. This has been regardless of where they live and who they supply, given that Fonterra is required to pick up milk even if a farmer has previously been supplying an IP.

4.6. However, we have certainly been aware of the many farmer voices, members and non-members of Federated Farmers, and suppliers of all processors, over the duration of the DIRA who have called for the end of the open entry clauses. Because Federated Farmers is a membership-based organisation, we have had to take note of this.

4.7. The review of the DIRA in 2017 when the previous market share triggers were met and the subsequent 2017 DIRA Amendment Bill was announced gave Federated Farmers the impetus to consider the 'what-if' scenario of removing Fonterra's obligation to pick up all supply if its terms and conditions were met.

4.8 Federated Farmers' concerns are for those farmers who are not aware of the full implications the removal of open entry could have on their businesses, especially those who had not been in the sector before Fonterra came into existence.

4.9. Of particular concern was the effect this could have on the sale and purchase of farms, those dairy sheds that had been put on hold via other land use until conditions changed, and where farms were 'over the big hill', at the 'end of the valley' or just too far away but who were currently Fonterra suppliers and paying no transport differential.

4.10. **Sale and purchase of farms**. When a farm changes hands, the new owner is regarded as a new supplier to a dairy factory because supply is tied to the owner, not to the farm location. The new owner must meet the terms and conditions of the supply before being accepted, and if these are met Fonterra, if approached, must accept this milk. The same is not true of any of the IPs, which can refuse on the basis that it doesn't 'want/need' this new supply, without giving a reason and little redress.

4.11. If this obligation on Fonterra to accept this 'new' milk is removed, Federated Farmers' concern is for the value of the land/farm and for those Fonterra suppliers who take for granted that Fonterra will continue to pick up the milk on the sale of their dairy farm.

4.12. Farms that are suitable for dairying can fetch a premium in most regions, but this is recognised as being a very complicated relationship. The Reserve Bank's May 2016 Financial Stability Report[3] states "Valuing farm land is an inherently complicated exercise as several factors may influence prices. For example, average dairy farm values are affected by the expected future profitability of the dairy operation, the value placed on nearby amenities and the option to convert the land to other agricultural or non-agricultural uses".

4.13. Nevertheless, it is likely that, if Fonterra were no longer obligated to accept all milk offered, then dairy land values would drop. This would hold true for most regions as IPs pick and choose their suppliers.

4.14. This of course, would affect the sale price and for many who sell to retire, less to retire on.

4.15. Many retiring farmers sell to their chi dren or the sharemilker who has worked on the farm. They automatically expect that Fonterra would continue to pick up supply. Few would even consider this to be 'new' supply, but it technically is.

4.16. **Succession**: Some farmers change the use of their land to manage succession. They may have children who do not wish to become dairy farmers or to use the land, but they may see that their grandchildren are interested. While some might choose to engage a sharemilker or employees in the interim to milk the cows and run the farm as a dairy farm, others may choose to close down the milking shed and use the land for another, less labour-intensive purpose. The farm is therefore left intact for the grandchildren. However, this hits two barriers when the grandchildren are ready – they are 'new' suppliers and the land could be deemed a new conversion. This latter issue is discussed below (paragraph 4 26).

4.17. **Farms on the edge of pick-up or across a geographic hurdle**. Federated Farmers is concerned for areas that lie within Fonterra's current supply footprint and where there is currently no transport differential.

4.18. Golden Bay, while it does have a Fonterra factory, has the Takaka Hill or the sea between them and the rest of New Zealand. It is a significant barrier and could easily be seen by Fonterra as being uneconomical to continue picking up supply. Land-use in Golden Bay is also changing, with more dairy farmers choosing to do something else with their land, including dairy support. Anecdotally, 20 percent of dairy farms in Golden Bay have been lost over the last 20 years, with the majority shifting to beef and dairy support. A few have amalgamated to form

[3] https://www.rbnz.govt.nz/financial-stability/financial-stability-report/fsr-may-2016/dairy-farm-land-valuation-an-examination-based-on-price-multiples

larger dairy units. Farmers here are now aware of their reliance on open entry, thanks to Federated Farmers' activity in the area.

4.19. Land-use change on the edge of supply could see fewer dairy farms 'down the road' in remote areas, and the dairy farmers at the end of that road could find themselves with a stranded dairy operation.

4.20. Another remote area is Kaikoura, which sits on the edge of the Canterbury collection area. While Canterbury has competition, there is only one processor currently willing to cover the distance to Kaikoura and that is Fonterra. Coromandel is another example.

4.21. In these scenarios described, we are concerned that Fonterra could choose to either refuse to pick up supply or could add a transport differential which would impact on the farm's profitability, if open entry were removed from the DIRA.

4.22. **New conversions**: This is an issue Federated Farmers considered when the previous Government's DIRA Amendment Bill in March 2017 was notified (*Allowing Fonterra discretion to accept supply from new dairy onversions)*. We suggest that the intent within that Bill be carried over into the current consultation, and as such, we will address it here, as it affects Fonterra's current obligation to accept all supply.

4.23. While we consider that there is very little lan left to be converted to dairying in environmentally sensitive areas, given the current volatile milk price conditions (and therefore less certainty of return on capital), Fonterra should be given the ability to refuse to accept milk from new conversions.

4.24. Farmers are very supportive of protecting environmentally sensitive land. The Federated Farmers' survey provided a number of comments on new conversions:

Seeking processors should be part of the conversion's due diligence

This clause in DIRA has probably led to the development of dairy in certain sensitive environments. Just because someone wants to do something doesn't mean that he should be automatically allowed to

4.25. Federated Farmers considers that Fonterra should have discretion to accept suppl from land which has been converted to dairying, from a defined date, wh ch Federated Farmers suggests could be from the season after the DIRA has been amended.

4.26. We consider that a new conversion be defined as a milking platform where greater than 50 percent of the land is new to dairy. This manages farms which have been previously used to milk cows on, as discussed above in paragraph 4.16.

4.27. In order to be clear and to prevent gaming, Federated Farmers suggests that "new conversion" land continue to be considered new conversion land (if it fits the date restriction) even if it supplies an IP prior to the application to supply Fonterra.

4.28. Having this specified within the DIRA would give Government some comfort that so called ‘sensitive’ land could be shielded from dairying, while giving farmers clarity on the type of activity that can be carried out on land.

4.29. **A new way.**

4.30. Because of the concerns we have set out above, and because we represent dairy farmers no matter who they supply, Federated Farmers needs to be very sure that any changes made manage those risks and protect the businesses of all dairy farmers.

4.31. **What would this look like**. Federated Farmers considers that Fonterra should have some discretion to refuse supply.

4.32. However, Fonterra must continue to accept supply from farms supplying Fonterra on a share-backed basis (full or part), protecting Fonterra s footprint. It must also accept supply from farms that change ownership as long as the supply from that farm was continuous, share-backed and the new supplier meets the normal terms and conditions of supply.

4.33. **Do farmers want this?** After setting out our concerns, we asked in our survey if farmers would have enough certainty to decide on what the best use of their land was and what was best for their business, if open entry fell away and farmers had to rely on some surety that managed these risks. The vast majority (yes: 272, no: 34) agreed they would have enough certainty. Of those who supplied processors other than Fonterra (total 52), 31 said ‘yes’ and 12 indicated ‘no’.

4.34. Of those who replied ‘yes’, one (Southland, Fonterra suppler) stated:

We do not rely on the open entry p ovisions anyway, but actually were I to game the system by exiting cashing up my shares, using the shares as a deposit for another farm, supply my current milk and the new milk to the opposition for 3 years, and then try to re-enter the coop it should be on terms favourable to the coop not a matter as of right

A Synlait supplier gave their reason for ‘yes’ as:

There is the certainty to continue supply. And I believe Fonterra would only refuse supp y if it wasn't economically viable for the company to do so, therefore obviously not the "best use for that land". If Fonterra wasn't obliged to collect milk that wasn't profitable to the co-op it would be of benefit to shareholders and current suppliers.

4.35. Of those who replied ‘no’, one (Waikato, OCD supplier) added this comment:

If this provision is allowed, it could materially affect the property values of dairy land. If a farmer wishes to sell his/her property they may then have to acquire written confirmation from Fonterra that supply will be granted to get potential purchasers.

Another respondent (Waikato, Fonterra supplier) stated:

Farmers in remoter areas may face uncertainty if Fonterra decides it’s not economical to their business model for them to pick up milk. Also, what’s stopping Fonterra from refusing milk from people who are outspoken about how *things are run, don't have the right Fonterra attitude, or they don't supply a lot of milk, ie smaller farms.*

4.36. We know that some of the IPs do not agree with removing the open entry provisions – we have read their pre-consultation submissions. However, we consider that this could be due to them not having to consider the fate of their own suppliers should they decide to not accept milk from them. Currently they are able to refuse their supply in the certain knowledge that Fonterra must pick them up (with some exceptions), leaving these farmers with their business more or less intact.

4.37. Should the DIRA be amended to allow Fonterra discretion on accepting supply then these IPs will need to face this moral dilemma.

4.38. We also consider that this freedom would drive IPs to perform well as they would need to attract more certain supply from farmers, those who knew they would be supplying the IP on a more permanent basis than may currently be the case.

4.39. One farmer (Waikato, Fonterra supplier) considered this outcome, stating:

Fonterra should not need to provide capacity for all of NZ dairy farmers. If they choose to leave then they take risk of not being accepted back. The only concern is that this may tip the balance too much in Fonterra's favour as farmers may not want to risk supplying other companies

4.40. In our survey we also asked if a risk management strategy covering this should be formalised in some way: placed in legislation, placed in Fonterra's Constitution or left for Fonterra to manage. 48 percent of respondents who stated a preference (137 of 285, 123 being Fonterra suppliers) supported putting this into Fonterra's Constitution; 25 percent (72 respondents, 65 being Fonterra suppliers) supported it going into legislation; and 27 percent (76 respondents, which includes 63 Fon erra suppliers) suggested that a formal commitment from Fonterra would be sufficient.

A Canterbu y, Fonterra supplier who supported placement into the Fonterra Constitution stated:

Dairy farmer has major investment in their farm so needs some certainty to ensure they can continue operating and will need time to change farming if they cannot

4 41. Because removal of open entry could have a significant effect on the regions of Tasman/Golden Bay and Northland, where Fonterra has a true monopoly and where distance may be a barrier, we include a breakdown of these regions' responses:

Question	Tasman/Golden Bay (7 respondents)	Northland (15 respondents)
Do you think that, if the Open Entry clause was removed from the DIRA, and a commitment by Fonterra was relied on, farmers would have	Yes: 6 No: 0	Yes: 12 No: 0

enough certainty to decide on what was the best for their business and the best use of their land?		
Should this be placed in Legislation	1	2
Should this be placed in Fonterra's Constitution	5	7
A commitment from Fonterra is good enough	0	2

4.42. From these two regions come the following comments:

Because it basically allows continuity of supply from the land;

As long as there was sufficient notification of proposed changes that would affect individual suppliers;

As long as there is a process that is fairly administered then the decision should be correct.

4.43. Federated Farmers considers it a reasonable requirement for a commitment from Fonterra to manage these risks be placed into Fonterra's Constitution. However, in order for it to be placed into the Constitution, it needs to be agreed to by the majority of shareholders We are aware that if it failed to pass, then the status quo would remain.

4.44. We therefore recommend that it be placed into legislation.

4.45. **RECOMMENDATIONS**: Federated Farmers **recommends** that the DIRA be amended to allow Fonterra to have discretion over accepting suppliers, based on the fol owing provisions:

4 45.1. Fonterra's supply footprint is protected, which includes those farm properties which change hands and become 'new' supply.

4.45.2. New conversions: Fonterra be given discretion to accept supply from land that has been converted to dairying, as per our argument set out in paragraphs 4.22 – 4.28.

4.46. **Safeguards within the DIRA**. To further safe guard farmers, we express here our continued support for Sections 73 (2) and (3), 74, 75, 95, 97, 106, 107, 108 and 109 of the DIRA.

4.47. Sections 73(2) and (3) deals with shareholders who wish to increase their supply while Section 97 manages those who wish to withdraw or reduce their supply volume. This must stay because it reflects farmer's ability to match the milk price with their business plans. The DIRA already allows Fonterra to manage capacity (Sections 86-89), which we still support.

4.48. Section 74(1) requires Fonterra to accept milk tied to the application at the commencement of the season following the application, while the other sub-sections relate to terms of supply. Farmers make their decisions based on current information and delaying pick up of supply will frustrate farmers' plans.

4.49. Section 75 requires Fonterra to set an application period (15 December-28 February) in which farmers may apply to enter Fonterra or for shareholders to increase the volume of milk. Both farmers and Fonterra are used to working to this timetable and it seems sensible to keep to this requirement. All processors will have an application period within their own business operations.

4.50. Section 106 requires Fonterra to not discriminate against suppliers. The new entrant must be treated in the same way as a shareholder in similar circumstances, while those in different circumstances are treated only to reflect the different circumstances. This prevents Fonterra from adding, for instance, a transport differential to a new supplier in areas where previously there has been none.

4.51. The Federation supports Section 95 which manages transport costs, too. Some farms really are just too far away for the rest of the co-operative members to carry this cost of transport.

4.52. Section 107 is about locking in shareholders for more than one season. This is a very important Section and one which some dairy farmers who were not dairy farming before 2001 might be unaware of. Fonterra shareholders are used to 'renewing' their contract on an annual basis.

4.53. The DIRA (Section 107(3)) requires Fonterra to ensure that at all times, 33 percent or a greater percentage of milksolids produced within a 160km radius of any point in New Zealand:

4.53.1. is supplied under contracts with an independent processor, or

4.53.2. is supplied under contracts with Fonterra that expire, or may be terminated by the supplier at the end of the current season without penalty to the supplier and

4.53.3. on expiry or termination, end all the supplier's obligations to supply milk to Fonterra.

4.54. Without this safeguard Fonterra could, in areas where it suited the co-op, lock shareholders into contracts that were longer than one year. Fonterra shareholders will argue that this is what IPs are able to do but that does not make it acceptable for a processor that has a market share value of 80.5 percent. Shareholders must be able to exit Fonterra easily because they must be able to react to the milk price and other business indicators.

4.55. Section 108 allows shareholders to supply up to 20 percent of their weekly production throughout the season, to other IPs, both big and small. In the past, Federated Farmers has argued for this provision to be dropped because of the way it could be exploited. However, we now support this provision.

4.56. Because of our arguments in sections 5 and 7 of this submission, farmers must be able to supply those who come to the farmgate. This helps the smaller IP, and while it is unlikely to be of much use to the bigger IP, allowing for it is sensible. The 20 percent rule manages this supply.

4.57. Section 109 requires Fonterra to sell the milk vat at market value to the exiting shareholder or to the new IP, if that is desired. This is a sensible provision, poses no extra cost on Fonterra and saves wastage in the industry.

4.58. **MPI'S OPTIONS ON OPEN ENTRY**

4.59. **4.1.1 Status Quo.** Federated Farmers **rejects** this option. We consider that the arguments set out above and the recommendations will give farmers surety and choice, while encouraging processors to perform well and in the interests of the suppliers and New Zealand Inc.

4.60. **4.1.2 Repeal the DIRA Open Entry Requirements.** Federated Farmers **rejects** this option. Farmers run the risk of having stranded assets as per the arguments set out above.

4.61. **4.1.3. Amend the DIRA open entry requirements to allow Fonterra to decline to accept applications from new and existing farmers if Fonterra considers their supply is unlikely to comply with Fonterra's terms of supply.**

4.62. Customers across New Zealand and the world are requiring more traceability of their food. Safe food, nutrition, animal welfare, climate change and the environment are key to being able o sell products for customers to consume directly or for inclusion in such things as pharmaceuticals.

4.63. New Zealand has a comprehensive regulatory system that manages all of these aspects at central and local government levels. Legislation that affects dairy farming includes the RMA, the Animal Welfare Act, the Food Act, Animal Products Act, the Food Safety Law Reform Act, the Agricultural Compounds and Veterinary Medicines Act, Health & Safety at Work Act, Employment Relations Act, are just a few. Reg onal councils and district councils add to this by having their own rules.

4.64. Federated Farmers considers these existing regulatory regimes to be sufficient to manage the risks and costs associated with dairy farming. If there are problems with any of the areas these regimes oversee then addressing them through changes to those regimes is the first-best approach.

4 65. **Can dairy processors help with this?** Yes, and they all do, through their Conditions of Supply. Each processor reviews its Conditions of Supply annually or as required, and as such can add in what suits their customer base, reputational risk profile and that which can be achieved by their suppliers. These are over and above those set out in the Codes and Practices for the Design and Operation of Farm Dairies (NZCP 1), which is prescribed by MPI and developed by the industry, and other requirements.

4.66. **Can more be done by Fonterra?** Federated Farmers considers Fonterra already has the ability to refuse supply if the current supplier does not meet the terms and conditions of supply (Section 74 (2) of the DIRA). Fonterra has to date however, been cautious about using it, choosing instead to work with the current supplier on the issue at hand. It also has the ability to reward suppliers for certain behaviours, and it is consulting with its shareholders on this matter.

4.67. The implication of the discussion document is that greater clarity is required to ensure that all prospective suppliers are aware that they must meet Fonterra's terms of supply **before** they will be accepted as a supplier. There may be some confusion in the DIRA because it appears that Fonterra can only consider an application to supply once shares have been purchased and the application made. Consideration should be given to whether this situation needs to be changed to give greater clarity.

4.68. Federated Farmers is of the view that the DIRA is about competition policy and should not be used as secondary planning regulation

4.69. Federated Farmers asked in its survey if Fonterra should have the ability to refuse new and current supply based on environmental matters. The result was 64 percent (204 respondents out of 318 who stated a preference) in favour of Fonterra being able to refuse supply, while 36 percent (114 respondents) considered that current rules (via RMA, regional council requirements etc) should be relied on.

4.70. Taking notice of all the feedback we have obtained on this issue, we consider that clear guidelines within the DIRA of areas that could be included in any dairy processor's terms and conditions would be useful in m naging their reputational risk. This would allow Fonterra to be transparent with its suppliers.

4.71. **Dispute mechanism.** We agree that some sort of dispute resolution mechanism would be required to manage those farmers who disagree with Fonterra's refusal to pick up supply, both new and exist ng. We acknowledge there is the provision within the DIRA of using the Commerce Commission for disputes. This has to date only been used for those at the processor level.

4.72. Federated Farmers is concerned that farmers would be unlikely to use this route, perceiving this as being unlikely to work in their favour, costly and long-winded. However, offering another independent avenue is not efficient, and having Fonterra manage the dispute itself is unlikely to be seen as being impartial.

4.73. **RECOMMENDATIONS**: That MPI Option 4.1.3 be adopted.

4.74. **And**

4.75. Communication of the current dispute resolution route via the Commerce Commission be made known, the costs advertised and a time limit on resolution of farmer-Fonterra disputes be set at 10 working days.

5. OPTIONS FOR ACCESS TO REGULATED MILK FOR LARGE DAIRY PROCESSORS (EXCEPT GOODMAN FIELDER)

5.1. Chapter 4.2 of the discussion document puts options for access to regulated milk for large dairy processes (except Goodman Fielder).

5.2. Federated Farmers understands the intent of providing some milk at a regulated price to all IPs that are starting up in business. They need certainty of supply and farmers might not supply them until the new business has shown its ability.

5.3. The risk if access to regulated raw milk is denied during the start-up period for any IP is that few, if any, majority-owned New Zealand firms or co-ops would be able to start up, as they would be unlikely to have enough capital to set up a new business and buy milk on the open market.

5.4. This removal of access to regulated raw milk, on the other hand, would be unlikely to make any difference to foreign-backed firms who may have easier access to capital and a demand for food security in their home country. They could also consider this to be an advantage as fewer new IPs would be starting up, creating less competition for milk.

5.5. Despite some farmers' resistance to encouraging new competition, helping what could be a New Zealand-backed start-up is always a possibility (and foreign-backed firms cannot be discriminated against), Federated Farmers therefore continues to see the need for new IPs to have access to regulated milk.

5.6. In our previous submissions on the Raw Milk Regulations (the most recent being on the proposed changes to the Dairy Industry Restructuring Act 2001 and Dairy Industry Restructuring (Raw Milk) Regulations 2012; MPI Discussion Paper No. 2016/05) Federated Farmers supported this provision fo new IPs and we continue to do so.

5.7. Since the last review, we have seen the large established IPs with their own supply of greater than 30 million litres and who are past the start-up phase, shift to depend completely on their own supply or go to the market if more was needed. Federated Farmers considers this as being the Raw Milk Regulations acting as it should.

5.8. **RECOMMENDATION**

5.9. That MPI Option 4.2.2: Amend the eligibility provisions in the Raw Milk Regulations to exclude large dai y processors, be adopted, as per the proposal.

6. OPTIONS FOR THE BASE MILK PRICE CALCULATION

6.1. Chapter 4.3 of the discussion document puts options for the base milk price calculation.

6.2. Federated Farmers acknowledges that a base milk price is a key foundation for the D RA. The price paid by Fonterra to farmers for their milk drives the profitability of both Fonterra and independent processors and it will also influence prices paid by consumers for dairy products.

6 3. We agree that Fonterra's market dominance means its milk price has had a st ong influence on the milk prices dairy processors have to match or better to maintain supply from farmers. This would have especially been the case in the years immediately after its formation.

6.4. That said, Fonterra's market dominance has been eroding over time, and in recent years there has been more variation in farmgate milk prices. For the 2017/18 season Fonterra's milk price was $6.69 per kg MS. For the other processors the range was a low of $6.12 (Westland) to high of $8.62 (Tatua) although Synlait, Open Country, Miraka and Oceania Dairy were all close to Fonterra's price. While Fonterra's milk price will set a benchmark, international prices for the mix of dairy products produced and sold by the processors will also have a strong influence.

6.5. As a point of principle Federated Farmers supports light-handed regulation and the DIRA is no exception. We believe the approach of DIRA to the base milk price calculation remains appropriate, especially if Fonterra's market dominance continues to erode over time. If there was a time for a more heavy-handed approach (such as having the Commerce Commission setting the base milk price) then it might have been in the years immediately after Fonterra's formation.

6.6. As mentioned in the discussion paper, the DIRA provides a number of mandatory assumptions, inputs and processes and the Commerce Commission reviews and comments on the appropriateness of the 'practical feasibility' of Fonterra's assumptions inputs and processes. Each year it reviews Fonterra's milk price manual and its base milk price calculation.

6.7. While the Commission's reports usually identify a few areas for improvement (for example, the appropriateness of the asset beta used by Fonterra) overall it has found the manual and the milk price to be 'largely consistent' with the DIRA and that inconsistencies tend not to be material. The main exception is the 0.38 asset beta Fonterra uses for calculation of the milk price.

6.8. The Commerce Commission's Final Report of its Review of Fonterra's 2017/18 Base Milk Price Calculation (14 September 2018) found that the 0.38 asset beta is too low and therefore 'unlikely to be practically feasible for the purpose of milk price calculation'. Asset betas of comparator dairy and commodity companies (which Fonterra disputes as being appropriate for its calculation) were found to be in the range of 0.45-0.58.

6.9. Setting the asset beta too low could lead to an inflated the milk price, raising the bar for entry and expansion by competing processors. The Commission 'estimates that a 0.1 change in asset beta would have approximately a 3 to 4 cents effect on the milk price', indicating that the 0.38 asset beta would, all other things being equal, overstate the milk price by around 5 to 7 cents on the milk price. Put into context this is less than 1 percent of the current milk price, although it will be more material in terms of profitability.

6.10. Setting asset betas with accuracy is notoriously difficult and it is highly contentious. While we would be open to improvements to the regulatory framework, such as better guidance on the term 'practically feasible', we would be very concerned about major change such as a government agency setting the milk price or setting inputs, such as the asset beta. This would result in greater potential for rent-seeking behaviour (e.g., lobbying by Fonterra, by other processors, and by other stakeholders) and a price-setting process, if it is slow and exhaustive, could also make it harder to make timely adjustments to the milk price, say due to volatility in commodity prices and/or milk production. Getting the price signals wrong would be more likely under such a heavy-handed approach.

6.11. On balance, Federated Farmers does not believe that there is a need for substantial change from the current approach to regulation of the base milk price.

6.12. **MPI'S QUESTIONS**

6.13. **Q19. Do you consider that greater confidence in the base milk price calculation outcomes could be achieved if additional legislative guidance**

on the term 'practically feasible' were to be provided for in the DIRA? Please provide detailed comment in support of your views.

6.14. Federated Farmers believes that the current approach provides sufficient confidence in the milk price calculation. We would not be averse in principle to consideration of additional guidance on the term 'practically feasible' but, as mentioned in the discussion paper, this is unlikely to be straightforward and if not done carefully would have risks of unintended consequences.

6.15. **Q 20. Do you consider that the base milk price should be set by an independent body (e.g., the Commerce Commission)? If so, please provide supporting information.**

6.16. Federated Farmers does not think such a change is necessary or desirable. We agree with the discussion paper's comment that such an option would likely have significant risks and costs.

6.17. **RECOMMENDATION**

6.18. That the **status quo** be retained for the base milk price calculation.

7. ACCESS TO REGULATED MILK FOR GOODMAN FIELDER AND SMALLER PROCESSORS.

7.1. Chapter 4.4 of the discussion document puts options for access to regulated milk for Goodman Fielder and smaller processors. Federated Farmers will consider Goodman Fielder and smaller processors separately.

7.2. Farmers, and in particular those supplying Fonterra, in their responses to the Federated Farmers survey were clearly against providing what they term DIRA milk (milk sold through the Raw Milk Regulations) to Goodman Fielder, 'cheaply'. One farmer even suggested that the amount of milk that Fonterra shareholders supply free of charge to schools should be taken into account and deducted from the 250 million litres allocated to Goodman Fielder. Given this amounts to approximately one tanker a day, it appears to be insignificant, but could perhaps be acknowledged more widely.

7.3. Federated Farmers believes that where it's required the DIRA and Raw Milk Regulations must adequately balance the interests of New Zealand dairy farmers and New Zealand consumers.

7.4. **Smaller processors**. When we consider the IPs with their own supply of less than 30 million litres or no own supply at all, we are disappointed that MPI is considering that the status quo stand.

7.5. There has been no known movement of these IPs to enter either the factory gate or the farm gate market for milk supply. This is due to the new Dairy Industry (Raw Milk) Regulations 2012, which allowed this continued access.

7.6. We were disappointed in the new Regulations, which gave these IPs no time limit on their access and changed the price of raw milk bought from Fonterra from the Farm Gate Milk Price (FGMP) plus \$0.10 per kilogram of milk solids (plus transport costs and winter-milk premiums) to a fixed quarterly price being

Fonterra's most recent forecast FGMP (plus transport costs and winter-milk premiums).

7.7. Federated Farmers considers this continued access as completely unacceptable and does not even meet MPI's own stated reason in the discussion document (p 22) that 'the DIRA also enabled new dairy processors to access raw milk from Fonterra, on agreed or regulated terms, during their **initial establishment** phase'.

7.8. There are enough IPs across New Zealand who could contribute at the factory gate and be approached under normal business practices, as well as Fonterra. All IPs could also approach the farmgate, taking advantage of what is known as the 20% Rule in section 108 of the DIRA, whereby Fonterra shareholders are allowed to allocate up to 20% of their weekly production to IPs. As we discussed in our previous submission, continued access cannot be tolerated

7.9. Processing milk is a business, therefore it should practice under full business conditions.

7.10. **RECOMMENDATION**

7.11. That small IPs (under 30 million litres of own supply or no supply) have access to Regulated Milk for a maximum of 3 years.

7.12. **Goodman Fielder**. Given that the clear majority of milk and milk products sold in New Zealand retailers is either Fonterra's own brands or manufactured with milk from Fonterra there is clearly potential for a lack of competition in the domestic milk product market that has to be addressed.

7.13. In acknowledging this ongoing risk the preliminary analysis in the discussion document notes, correctly that the only other significant player in the domestic market is Goodman F elder with access to Fonterra milk and that other players who have access to their own milk supply have so far shown little willingness to participate in the local market.

7.14. In the same part of the discussion document we note that it was assumed on the introduction of the DIRA that Goodman Fielder would over time seek its own supply of mil and therefore reduce its reliance on Fonterra milk. Assuming that Goodman Fielder bought into this assumption it is disappointing they have made no move in that direction. Nevertheless, consumers must still be protected so in the short term the provisions of the DIRA that allow Goodman Fielder to access Fon erra milk on regulated terms must be continued in some form. See section 7 4-7.11 of this submission for discussion on small IPs and section 5 for large IPs. These will not be discussed further here.

7.15. Federated Farmers essentially agrees with the preliminary analysis contained within the discussion document although we note one aspect that is absent. It is conceivable that the presence of Goodman Fielder on regulated terms (or at least under the threat of access to regulated terms) is a barrier to the entry into the domestic market of primarily export companies like Synlait or Open Country Dairy. This could be the case if the terms of Goodman Fielder's contract with Fonterra are below the cost that these companies could supply the domestic market. This cannot be known without access to the commercial arrangement between Fonterra and Goodman Fielder referenced in the discussion document.

7.16. We understand that Synlait is shortly to begin supplying liquid milk to the New Zealand (South Island) market. While this is positive, the fact that it has not happened earlier in the lifespan of the DIRA indicates that barriers may still be unacceptably high.

7.17. Turning to possible solutions, and separating out the smaller processors (as Federated Farmers has discussed these separately) the discussion document proposes five separate approaches for consideration:

Option 4.4.1 Status quo: retain the existing provisions in the raw milk regulations as they apply to Goodman Fielder.

Option 4.4.2 Amend the Raw Milk Regulations to update the terms on which Goodman Fielder can access regulated milk from Fonterra

Option 4.4.3 Amend the Raw Milk Regulations to gradually reduce Goodman Fielder's eligibility to access regulated milk over time

Option 4.4.4 Amend the Raw Milk Regulations to remove limits on the amount of regulated milk available to dairy processors supplying New Zealand consumer markets

Option 4.4.5 Amend the Raw Milk Regulations so that the terms on which dairy processors supplying New Zealand consumer markets can access regulated milk mirror the terms on which Fonterra supplies its own New Zealand consumer business

7.18. Federated Farmers considers that at a high level these options represent the breadth of appropriate available regulatory measures. The best opportunity to protect the interests of consumers in the short term while still providing an incentive for Goodman Fielder to establish their own supply, either directly from farmers or from another processor on a commercial basis is to implement option 4.4.3 to gradually reduce Goodman Fielder's access to regulated milk.

7.19. While they have the back stop of the 2012 Raw Milk Regulations, Goodman Fielder has so far not relied on them. They have established a long term commercial agreement with Fonterra that will expire in 2021. If they are unable to conclude a further mutually acceptable commercial arrangement, then they will be able to rely on the regulations to access up to 250 million litres of regulated milk from Fonterra so therefore have a continuity of supply. However, the discussion document notes that the current regulations may not contain terms that will be viable for Goodman Fielder and that the regulations may require an update.

7.20. It is vitally important for continued competition in the domestic markets that Goodman Fielder continue to operate alongside Fonterra brands so it is appropriate to ensure the terms of the Raw Milk Regulations are updated as described in 4.4.2. In principle, Fonterra should not face costs for supplying regulated milk to Goodman Fielder. We believe this is the intention of the regulations as they are currently drafted and that should not be lost in any revision. They may, of course, incur an opportunity cost having to divert supply away from commercially saleable products.

7.21. In the medium to long term, provision must be made to ensure Goodman Fielder is incentivised to seek its own supply on commercial terms. Option 4.4.3

proposes gradually phasing out the ability for Goodman Fielder to access regulated milk over time. This is wholly appropriate given the intentions of the DIRA at introduction was for a completely independent domestic competitor to Fonterra to be set up.

7.22. Option 4.4.4 proposes removing the restriction on the amount of regulated milk to be supplied to any processor (including Goodman Fielder) supplying the domestic market. Federated Farmers has always considered that this would counter any incentive for Goodman Fielder (or any other processor) to establish its own supply. To remove or increase the limits would be to acknowledge that there will never be competition in the domestic market and would foster regulatory dependence as well as to preserve the basic duopoly that exists currently.

7.23. This option notes that the initial volume contained within the Raw Milk Regulations was set at 250 million litres per year because it was considered that it represented roughly half the total milk put into the New Zealand Market. However, this does not justify any suggestion that the allocation be increased to closer to 300 million litres which would today represent the same proportion. There are a number of albeit small independent companies working in the market and, again, increasing the limit does not incentivise Goodman Fielder to stand on its own two feet or encourage other larger processors.

7.24. Federated Farmers accepts the analysis presented by the discussion document where it discusses option 4.4.5 that raises an option of requiring Fonterra to supply Goodman Fielder on the same terms as they supply their own domestic retail business. While, in principle, there would appear to be some advantages in terms of transparency, this option does represent a significant regulatory intervention that cannot be justified and will likely lead to increased regulatory dependence. It is appropriate th t Fonterra continues to play its part in ensuring competition in the domestic consumer market but forcing it to account for its retail business separately is too large an intervention that would necessitate the identification of obvious competitive deficiencies in that market. We do not see those obvious deficiencies and there are none outlined in the discussion document.

7.25. **Recommendation**: That policy changes be made to ensure that New Zealand consumers are protected from the risk of lack of competition by adopting a composite of option 4.4.2 and with consideration to also exploring option 4.4.3.

8. OPTIONS FOR THE DIRA REVIEW AND EXPIRY PROVISIONS

8.1 Chapter 4.5 of the discussion document puts options for the DIRA review and expiry provisions.

8.2. As we stated in the introduction, a well-working DIRA would be better than relying on the Commerce Act. It therefore comes down to what a ‘well-working’ DIRA would look like.

8.3. We suggest that giving some discretion for Fonterra to refuse milk, as discussed in Section 4, would go some way to providing a more permanent DIRA. As one of the respondents stated:

DIRA in some form (ensuring local market competition for consumers) is needed because the Commerce Act can't handle one player handling 80% of the raw *milk. But DIRA provisions supporting new entrants and forcing Fonterra to accept all milk should be dropped immediately*

8.4. However, some sort of check will need to be made to make sure that any changes made now are working.

8.5. Federated Farmers does not support automatic expiry based on a number, whether it be a date or a market share threshold. In either instance a review will be needed because the industry is not just about numbers.

8.6. Predicating a review on a market share basis is, in the Federation's opinion, not necessary, unless this was to be the only trigger. Market share triggers have been previously set and changed, and farmers see this as the goal posts being shifted, which irritates them.

8.7. Setting an expiry date (and no review) which would suit everyone would be too difficult – farmers want, on the whole, the DIRA to expire yesterday, processors are unlikely to agree on a date and government would be lobbied intensely.

8.8. Setting a time period for a review of how the industry is working is sensible. The dairy industry is New Zealand's second biggest exporter and reviewing it would be required, regardless of the DIRA. Having the DIRA puts some rules around what is reviewed, sets a track record and is something to benchmark against.

8.9. The submissions made on the terms of reference for this review have shown the maturity of the industry, with good research and data to back their submissions. While reporting is time consuming and costly, Federated Farmers considers this beneficial to the industry.

8.10. Reviewing it at five yearly intervals is almost business as usual given there have been around three reviews since its inception.

8.11. Allowing for no review or possibility of expiry (as per Option 4.5.1) would not be acceptable to Federated Farmers.

8.12. **RECOMMENDATION:**

8.13. That Option 4.5.2, requiring periodic reviews of competition in the dairy industry to determine if the regulatory regime should be retained, repealed or amended, be adopted. The Federation recommends that the reviews be held at five yearly intervals. Competition is unlikely to have ramped up to the extent that it distorts the intent of the DIRA within this timeframe.

9. THE FEDERATED FARMERS SURVEY ON THE DIRA

9.1. As stated at the beginning of this submission, Federated Farmers surveyed farmers over a period of 3 weeks, which covered the Christmas/New Year break. We received 339 responses across most of the companies (see Table 1) with 10 selecting 'other' which included Danone, Green Valley, Origin Earth, Mercer, Dairy Goat and Organic – some of these also supplied another processor.

Table 1: Processing companies of each respondent

Processor	Synlait	Westland	OCD	Tatua	Miraka	Oceania	Fonterra
Number of respondents	9, 1also supplies Fonterra	9, 1 also supplies Fonterra,	20, 4 also supply Fonterra	2, 1 also supplies Fonterra	3	9, 3 also supply Fonterra	293, 14 also supply others

10. ABOUT FEDERATED FARMERS

10.1. Federated Farmers of New Zealand is a primary sector organisation that represents farming and other rural businesses. Federated Farmers has a long and proud history of representing the needs and interests of New Zealand farmers.

10.2. The Federation aims to add value to its members' farming business Our key strategic outcomes include the need for New Zealand to prov de an economic and social environment within which:

- Our members may operate their business in a fair and flexible commercial environment;
- Our members' families and their staff have access to services essential to the needs of the rural community; and
- Our members adopt responsible management and environmental practices.

FOMA

ME URU KAHIKATEA

SUBMISSION ON 2018/19 REVIEW OF THE DAIRY INDUSTRY RESTRUCTURING ACT 2001 [“DIRA”]

To:	DIRA Review Team Ministry for Primary Industries [“MPI’] Pastoral House 25 The Terrace Wellington 6140 E: dira@mpi.govt.nz
Contact for service:	Anaru Smiler Chief Operating Officer Federation of Maori Authorities [“FOMA”] Level 2, BERL House The Terrace Wellington 6149 Ph: s 9(2)(a) E: anaru@foma.org.nz

Purpose

1. This submission outlines FOMA’s position on the 2018/19 DIRA review.

About Us

2. FOMA exists to grow the wealth and prosperity of its members, communities and Aotearoa. With 150 member organisations with a collective asset base of around $13b, FOMA represents New Zealand’s largest voluntary membership group of Maori landowners and businesses, including some of the best thought and business leaders in the country with significant regional economic and commercial interests. The Dairy industry is a considerable investment focus for our members, including both on-farm production and supply activities, to independent business investments in processing and exporting of dairy products.

Background

3. FOMA formed a technical reference group from among its members to meet with MPI officials and to inform our position on the DIRA review. This reference group includes both Fonterra and non-Fonterra suppliers.

4. FOMA and MPI officials met twice to discuss the review of the DIRA, with a particular focus on Maori interests and the impact of the DIRA on Maori dairy farmers and landowners

5. The first meeting was held on 8 August 2018, as part of the pre-engagement process to inform the development of the DIRA review discussion document. The second meeting, held as part of the formal consultation process, took place on 11 December 2018.

6. This submission summarises FOMA's key position on the DIRA review and is grouped into the five policy issues and options set out in the review discussion document.

FOMA Position

DIRA Open Entry and Exit requirements

7. FOMA submits that while there have been concerns ra sed by a number of parties relating ot the existing open entry and exist rules in place, ***open entry and exit should be retained in its current form.***

8. FOMA notes the concerns raised by Fonterra [nd its shareholding farmers] with regard to open entry and exit. We also acknowledge that there are concerns about the environmental impacts of dairying and the reputational risks arising from Fonterra's obligation to accept all milk, including from marginal areas. We are not convinced that giving Fonterra discretion to refuse supply would offer reputational benefits that outweighed the possible negative impacts of removing the exisiting open entry and exit requirments.

9. A key focus for Maori landowners is on driving investment further up the value-add chain, and growing value through increasing profits, given that a majority of Maori landholders are unable to realise capital gains on their land. Open entry and exit helps create competition for raw milk, and in areas where that competition exists landowners are able to make decisions on who to supply to help realise that drive up the value chain.

10. Option 4. .3 from the discussion document (i.e amend the open entry requirements to allow Fonterra to decline to accept applications from new and existing farmers if Fonterra considers their supply is unlikely to comply with Fonterra's terms of supply) was considered by our reference group in detail. FOMA understands the intent of this option and holds a number of concerns, including:

    - a key principle of the DIRA is farmers choosing Fonterra, not Fonterra choosing farmers. This option could be seen as a dilution of this;
    - the DIRA is a piece of competition policy legislation. Environmental concerns should be addressed through the Resource Management Act and not through amendments to the DIRA;
    - by providing an ability to pick and choose suppliers, this option could provide Fonterra with an avenue to utilise their dominance;

- any associated "challenge system" would likely be costly, putting rural Maori farmers at a disadvantage if they did not have the funds to take forward a case; and
- if Fonterra already has terms of supply, those should be used to deal with environmental and other issues.

11. Further, environmental concerns should be addressed by the relevant regional council. Given processors have ongoing relationships with farmers, if they have evidence of poor environmental practice, they could work with regional councils if necessary without the need for competition regulations to manage this. Another option is for Industry and government to agree ***environmental standards*** to manage the issues, again without the need for competition legislation to manage such issues.

Access to regulated milk (excluding Goodman Fielder)

12. FOMA recognises some of the concerns raised by others about overseas owned companies taking regulated milk and competing with New Zealand companies in export markets, and on balance takes the view that the current approach to the provision of regulated milk should be retained.

13. Access to regulated milk for new entrants to the market helps foster innovation and greater choice for suppliers in the processors they may choose to supply. For Maori farmers, this is particularly important as we want a maximised milk price, and confidence in processors, to ensure that we are getting the best value for the milk that we produce.

14. FOMA accepts there are differing views with regard to overseas owned companies accessing regulated milk solely fo export purposes. FOMA too has concerns about the opportunity to add value to that milk being missed in New Zealand, and the associated benefits with this. We also recognise that foreign investment can be an important part of suporting Maori investment further along the dairy value-chain, for example Miraka and the opportunity that foreign investment has provided dairy farmers, particularly Maori dairy farmers, now involved in the Miraka value-chain.

15. Competition is key for landowners invested in the dairy industry to ensure that they get the greatest value for their milk. The access to regulated milk reduces the risk for new processor ent ants, as they have a guaranteed consistent supply for a set period while they establ sh themeseleves in the market. From a landowner point of view, this provides gr ater security if they choose to switch to this new entrant.

16 Fu ther, a great deal of innovation in the dairy industry comes from smaller, niche operators that access regulated milk. These operators often have the ability and flexibility to try methods and product-mixes that larger processors may not be able to do due to their size. FOMA is therefore of the view that any changes made to the DIRA should not curb innovation by impacting on smaller, niche operators ability to compete in the market.

Regulated milk for Goodman Fielder

17. FOMA understands the intention behind regulated milk being supplied to Goodman Fielder to service the domestic consumer market. We are concerned that Goodman Fielder has developed a regulatory dependence on this, and that Fonterra may not be receiving a fair value for the milk that is provided to Goodman Fielder.

Base milk price

18. FOMA submits **that the base milk price calculation is an important part of the DIRA, and it should be retained.** There are a number of issues regarding the oversight of the base milk price setting mechanism, that need to be addressed.

19. One issue is the pace and effectiveness of the Commerce Commission review and recommendations with regard to how Fonterra calculates the base milk price. We are concerned that given the market effect that the base milk price has, the existing mechanisms in place are too slow and cumbersome to have an effective impact. FOMA considers that if the regulatory body does not have powers to control behaviour, it is rendered somewhat "toothless" and therefore ineffective at it s intended role.

20. FOMA considers that option 4.3.3 as set out in the di cussion document (i.e. amend the DIRA to give the Commerce Commission statutory power to set the base milk price for the dairy industry) goes too far to address the issues.

21. An option to consider is that the DIRA should empower the Commerce Commission to alter components of the milk price if, after an investigation, it considered that a component of the milk price was inaccurate This approach would ensure that the base milk price is transparent and accurate.

22. It should be noted that the impact of a perceived distortion between what farmers are paid for milk and the dividend they receive has driven a greater transfer of wealth through capital gains. This has had a significant negative impact on Maori landowners invested in the dairy sector, given that the majority of our farming interests operate on land that cannot be sold, therefore any capital gains (and hence the value that can be derived by Maori from this type of industry growth) associated with a high milk price cannot be realised.

DIRA expiry provisions

23 FOMA submits that **there should be a mechanism to ensure that further reviews can take place,** and should be based on a case having to be being put forward for a review to occur.

24. The exisiting review approach based on Fonterra "falling below a percentage of market share" is too blunt, and creates unrealistic expectations. The time-bound approach, as described in option 4.5.2 of the discussion document, is a simple option, however, it could create a cycle of ineffectual and costly reviews.

Concluding comments

25. FOMA looks forward to closely engaging with the government on the changes as the review process continues.

Me Uru Kahikatea

Federation of Maori Authorities

Fish & Game NEW ZEALAND

Review of the Dairy Industry Restructuring Act 2001

Submission To: The Ministry for Primary Industries

Response to Discussion Document Paper No: 2018/13

FISH AND GAME NEW ZEALAND

INTRODUCTION

1. Fish and Game New Zealand welcomes the opportunity to submit on the review of the DIRA 2001. Fish and Game recognizes the role the dairy industry plays in the New Zealand economy, but believes much more needs to be done to mitigate its adverse effects on the environment. By making changes to the dairy industry's regulatory framework, better outcomes can be achieved both for farmers and the environment.

2. It is clear from environmental monitoring data that the rapid expansion of the dairy industry over the past two decades has had a detrimental effect on the environment. Water quality has deteriorated across the country[1] and the loss of scrub and forested land[2] is causing higher levels of nitrogen and phosphorous loss[3]. Testing by Fish and Game in 2018 revealed anti-biotic resistant E. coli in Canterbury river which could have only come from ruminants, such as cows[4]. A Colmar-Brunton poll, also commissioned by Fish and Game, showed water pollution is now New Zealanders' number one concern[5]. Clearly, the social license for intensive dairy farming is waning.

3. While the Dairy Industry Restructuring Act is primarily a market regulatory scheme to eliminate concerns about competition, it has undoubtedly had negative impacts on the environment by incentivizing ever increasing milk production. As identified by MPI in the Discussion Document, DIRA currently prevents Fonterra from effectively managing aspects of farmer's environmental performance[1]. In fact, Fonterra must accept milk from suppliers under open entry requirements, even if environmental bottom lines are not being met.

Statutory managers of freshwater sports fish, game birds and their habitats

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4. The current review of DIRA represents a chance for the dairy industry to begin to correct its environmental track record. Fish and Game urges the Ministry for Primary Industries to quantify the negative externality the dairy industry creates, and use this as one measure of industry performance for the purpose of this review. Fish and Game fully supports the proposal to remove the open entry requirements which have been driving rapid dairy intensification. These requirements are not only a reputational risk to New Zealand's economy, but impact ordinary New Zealanders' enjoyment of the environment. Fish and Game suggests compulsory environmental standards should be met before milk can be accepted from farmers.

FISH AND GAME NEW ZEALAND

5. Fish and Game is a statutory entity established by Parliament under the Conservation Act 1987 to manage, maintain and enhance sports fish and game birds and their habitats throughout the country. Fish and Game represents 140,000 license holders across twelve regions throughout New Zealand and is governed by elected councilors, who report directly to the Minister of Conservation.

6. Fish and Game's Parliamentary mandate to protect sports fish and game birds and their habitats has seen them recognized as one of the leading environmental advocacy groups in New Zealand. Fish and Game has been successful in securing 12 of 15 Water Conservation Orders, and their environmental work protects not only sports fish and gamebirds, but native species such as bittern, mudfish, eels and galaxiids. Fish and Game is committed to ensuring that the tradition of angling and hunting in New Zealand is available for many more generations.

ANSWERS TO CONSULTATION QUESTIONS

2. Are there any other dairy industry developments or industry performance indicators that are not captured in Chapter 2, Appendix 1, or the reports by Frontier Economics? Please provide details and supporting evidence.

7. Fish and Game would like to see the environmental cost of the dairy industry more fully considered as an indicator of performance. Measuring changes in value, size and structure of the industry is undoubtably important, but it needs to be considered in the broader economic context. Dairying creates a negative externality of production[1] that is not captured in a quantitative way by any of the chosen measures.

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Fish & Game NEW ZEALAND

8. To truly calculate the change in value of the dairy industry, the cost borne by the public of New Zealand in deteriorating water and environmental quality needs to be considered. A 2015 research paper found this cost could be up to 15 billion dollars[6]. Fish and Game ask the Ministry for Primary Industries to undertake this costing as part of the current review of the dairy industry structure and regulations.

14. Do you agree with our preliminary analysis of the DIRA's impact on the industry's environmental performance? If not, please provide your reasons and supporting evidence.

9. Fish and Game New Zealand believes the production focus of the DIRA has driven the dairy industry's poor environmental performance. Guaranteed purchase of unlimited quantities of milk by Fonterra has driven dairy expansion where it would not have otherwise occurred, even by the industry's own admission. The regulatory framework has encouraged a race to produce as much milk as fast as possible, with little regard for environmental outcomes. Dairy conversion in the internationally renowned Mackenzie Country serves as an example.

10. By granting Fonterra a monopoly like position in the market, the Act may also be removing incentives for environmental protection. Despite the open entry and exit model, areas such as Northland and Wairarapa have no alternative buyers competing for milk[1]. Fonterra therefor does not need to offer incentives to farmers who are excelling in their environmental performance, as they face no competition for supply. In some areas new competitors Synlait and Miraka reward farmers who meet environmental excellence targets with a premium milk price. We question whether Fonterra's market dominance has allowed them to lag behind in environmental protection for almost two decades.

15. Do you agree with our view that environmental issues are best dealt with through the Resource Management Act and not the DIRA regime?

11. No. The current state of our waterways indicates we need the DIRA regime to directly tackle the environmental damage it has encouraged. Although the DIRA was primarily about ensuring fair competition within the industry, it is now time to ensure the industry regulations are fair to all New Zealanders. The regulatory framework around any industry that degrades the environment should clearly have environmental considerations. DIRA should serve as an effective industry wide tool to fix the environmental issues the RMA and Regional Councils have failed to address.

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12. The structure of the RMA tasks Regional Councils with monitoring and compliance. This model has proved to be ineffective, with many Regional Council's failing to take their role seriously. For example, a 2018 report by Forest and Bird found that the Waikato and Southland Regional Councils could not even identify the number of dairy farms in their region, and across the country cases of non-compliance with consents were not being addressed[10]. The current regime has not worked effectively to mitigate the dairy industry's environmental impact.

13. Both Fonterra and Dairy Farms are business and, like any other business, they should cover the full costs of their operations. The nation-wide reduction in water quality from the rapid expansion of the dairy industry has created costs for tax payers and rate payers. This needs to be addressed. DIRA could contain provisions for a levy per liter of milk produced by farmers or received by processors to be paid into a fund for Regional Councils or an independent agency to monitor water quality.

14. If the dairy industry does not cover the full costs of their operations on the environment, then they are effectively being subsidized by the rest of New Zealand. The DIRA regime needs to recognize this reality and respond accordingly.

26. What is your preferred option for the DIRA open entry requirements? Please provide your reasons and information/evidence in support of your views.

15. We accept that the arguments for and against the open entry requirements are quite balanced. However, Fish and Game supports option 4.1.2 - Repeal the DIRA open entry requirements. As one of the key mechanisms that has facilitated the growth of this industry, we recommend that the open entry provision be completely removed. For completeness we recommend that open exit be retained, so Fonterra cannot impose any restrictions on farmers who wish to move to more profitable and less environmentally damaging land practices.

16. In the event that option 4.1.3 is chosen, Fish and Game strongly suggest there must be a compulsory element to rejecting applications. That is, if environmental bottom lines are not met, then Fonterra is compelled not to accept product from that farmer. This would not only ensure that environmental standards are met, but would also ensure that Fonterra does not use such a provision to artificially restrict the open entry requirement. If such a mechanism is not added, then Fonterra gains the ability to stop accepting product from under-performing farmers whenever is it convenient for their business plan, rather than truly for environmental reasons.

FURTHER CONSIDERATIONS

17. The Discussion Document states there "appears to also be some ambiguity" as to whether Fonterra can financially incentivise environmental performance[1]. The schemes set up by Synlait and Miraka to financially reward farmers who excel environmentally should be applauded, and set a high bar for Fonterra to meet. Whether Fonterra's inability to provide such as scheme is an issue that needs to be addressed through DIRA, or through Fonterra's internal terms of supply, the legal framework needs to be in place to ensure such schemes can be created. Financial incentives such as those run by Synlait and Miraka are essential to creating real progress in environmental protection and restoring the public's trust in the dairy industry.

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Fish & Game
NEW ZEALAND

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PUBLIC VERSION

Fonterra Co-operative Group Limited
109 Fanshawe Street, Auckland
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8 February 2019

Ministry for Primary Industries
Pastoral House
25 The Terrace
Wellington
New Zealand

By email: dira@mpi.govt.nz

Dear Sir / Madam

FONTERRA CO-OPERATIVE GROUP LIMITED – RESPONSE TO REVIEW OF THE DAIRY INDUSTRY RESTRUCTURING ACT 2001 AND ITS IMPACT ON THE DAIRY INDUSTRY: DISCUSSION DOCUMENT

We welcome the opportunity to submit on the Government's review of the Dairy Industry Restructuring Act.

DIRA has been critical to the performance of the New Zealand dairy sector since its passage in 2001. The formation of Fonterra has created wealth for New Zealand and New Zealanders. It has improved social and economic outcomes for New Zealand's dairy farmers and their communities. The evolution of the industry since 2001 has had a significant impact with dairy exports growing from $6.3b in 2001 to $17.1b in 2018.

The legislation has achieved what it set out to - create competition. Farmers now have choices in who they supply their milk to and New Zealand consumers have many choices when purchasing dairy products.

Since he passage of the legislation, our Co-operative has created a transparent milk price calculation that is the envy of farmers the world over. Through our Co-operative and a strong transparent milk price the entire New Zealand dairy industry has benefited. Where once, Kiwi dairy farmers were paid approximately half that of their European or US peers, New Zealand farmers are now consistently paid at parity, or more. Fonterra farmers are paid the maximum sustainable price for their milk by their Co-operative.

Fonterra remains a New Zealand owned co-operative. The money our farmers are paid for their milk and the profits their Co-operative makes, remain in New Zealand. The majority of it goes into our rural communities, where our farmers spent roughly 50 cents of every dollar they earn.

DIRA has the dual objective of establishing a strong exporter at scale taking New Zealand's products to the world, and protecting New Zealand dairy farmers and domestic consumers. It is critical for the evolution of the legislation that both are kept in focus and neither is prioritized over the other.

Our Co-operative continues to work to develop a modern and world-leading dairy sector where our products are desired in markets around the globe and where consumers are prepared to pay a premium for New Zealand products. We also want domestic consumers to have choices when feeding their families.

Fonterra's performance is not solely driven by DIRA, however a modernised DIRA will contribute to delivering our shared vision for the future of the industry.

Our Co-operative wants an industry that promotes investment in regional New Zealand and where profits are kept at home for the benefit of all New Zealanders. We want an industry where farmers are paid good money for their milk and the unique attributes of New Zealand's environment are protected and enhanced.

New Zealand farmers also want certainty about the future of their industry so they can make informed investment decisions and be able to determine their own destinies.

It's difficult for New Zealanders to achieve scale when marketing their products to the world. The Government helped to achieve this by allowing the formation of Fonterra. It recognised the value it could bring New Zealand. But it also recognised that certain safeguards were needed.

Some safeguards are still critical today, and they should be expanded to be a requirement of every dairy processor. Others are inadvertently tipping the playing field in favour of foreign exporters, at the expense of kiwi farmers

For the dairy industry to continue to succeed, some aspects of DIRA must be modernised, as set out below. Our position on the issues raised in the Discussion Document is briefly summarised below.

DIRA OPEN ENTRY REQUIREMENTS	
Issue: The DIRA open entry requirements play a key role in the wider open entry and exit regime and its effectiveness in managing Fonterra's dominance.	**Fonterra's position:** 1. We seek the removal of open entry and the non-discrimination rule. 2. As a second preference, we support the removal of open entry, and the non-discrimination rule in any region where our market share drops below 75% and nationwide removal for new conversions and applications we consider unlikely to comply with our terms of supply. 3. Our third preference is for an exception to open entry and the non-discrimination rule for new conversions and applications we consider unlikely to comply with our terms of supply.

ACCESS TO REGULATED MILK	
Issues: a) The DIRA original rational for providing large dairy processors with access to regulated milk from Fonterra, while they are establishing own supply, may no longer stand b) The DIRA ensures that there is viable competition in the New Zealand consumer dairy markets, but it	**Fonterra's position:** We support a strong, competitive domestic market. We do not support milk being given, effectively at cost, to new processors who are focused on exporting their products.

may also be facilitating a long term, and potentially undue, dependency on regulated milk from Fonterra	

BASE MILK PRICE CALCULATION	
Issue: The DIRA may be able to promote greater confidence in the base milk price calculation outcomes.	**Fonterra's position:** We support the current regime. Efficiency and informed decision-making by farmers would be improved if the transparency of price setting and payments was spread throughout the industry. We support all processors being required to publish the average price they pay to farmers, the key parameters of their milk price and examples showing the payout that would be received fo different parameters, in a way that is consistent across processors to allow proper comparison.

DIRA REVIEW AND EXPIRY PROVISIONS	
Issue: The need for the DIRA is contingent on Fonterra retaining its dominant position. While it appears that the DIRA is still needed at this stage, there is a risk that DIRA could be kept in place for longer than necessary.	**Fonterra's position:** We want a clear pathway to deregulation. We recognise th significant danger of having legislative con traints when they are no longer required The industry requires and deserves clarity as to inform future investment decisions. We support a further review of DIRA three years aft change is effective.

Please find attached Appendix A – which sets out our specific proposals for change on one page and provides a brief overview of those changes, and Appendix B – a substantive response to the questions posed in the Discussion Document. Also accompanying our submission are reports by NERA Economic Consulting and NZIER.

We look forward to working with the Government over the coming months as the review progresses and to supporting a fair outcome that is in the interests of all dairy farmers and New Zealand.

Yours sincerely

Miles Hurrell
Fonterra CEO

Note: We request that all of the information deleted from the "public version" of this submission (shown as ■ in the confidential version) be treated as confidential, on the grounds that it is commercially sensitive. Disclosure of that information would be likely to unreasonably prejudice our commercial position. If you receive any requests under the Official Information Act, please contact us.

APPENDIX A: PROPOSALS FOR CHANGE (to be effective 1 June 2020)

DIRA OPEN ENTRY REQUIREMENTS AND THE NON-DISCRIMINATION RULE (sections 73, 74 and 106)	
First preference • Repeal in full.	**Option 4.1.2**

Second preference
• Repeal of open entry, and the non-discrimination rule in any region where our Co-op's market share drops below 75%.
• Exceptions to open entry and the non-discrimination rule:
  ◦ for new conversions;
  ◦ in respect of applications from new and existing farmers if we consider their supply is unlikely to comply with our terms of supply.
• Requirement that our Co-op continue collecting milk from existing farms that continue to supply us while open entry remains in other regions.
	Option 4.1.3, and new

Third preference
• Exceptions to open entry and the non-discrimination rule:
  ◦ for new conversions;
  ◦ in respect of applications from new and existing farmers if we consider the supply is unlikely to comply with our terms of supply.
	Option 4.1.3, and new

DIRA OPEN EXIT REQUIREMENTS (sections 97 and 107(3))	
• Repeal in any region where our Co-op's market share drops below 5%	**New**
ACCESS TO REGULATED RAW MILK FOR LARGE DAIRY PROCESSORS (EXCEPT GOODMAN FIELDER)	

• Exclude large, export-focused processors, being pro essors that:
  ◦ source 30m litres/year of their own raw milk; or
  ◦ have capacity to process more than 30m litres/year and export 20% or more of their processed volume.
	Option 4.2.2 and new

BASE MILK PRICE CALCULATION	
• Status quo. • All processors publish the average mi k price they pay to farmers, the key parameters for their milk price and examples of th payout for different parameters.	**Option 4.3.1 and new**
ACCESS TO REGULATED RAW MILK FOR GOODMAN FIELDER AND SMALLER PROCESSORS	
• Status quo for Goodman Fielder and smaller processors, plus additional fee of around 12c per kgMS. • Regulation 4 - reg lated raw milk should have to be processed into finished consumer or foodservice products. • Regulation 10(3) – limit the variation in processors' one-week estimates for supply to 20% more or less than the earlier three-month estimate. • Regulations 21(1) and 21(2) – limit the variation of the contracted volume to between 90% and 1 0% of the one week estimates for supply. • Regulation 11(2)(a) – extend 18 month notice for requiring winter milk supply above 20,000 litres per day to 24 months. • Regulation 11(3) – limit the variation in processors' one-week estimates for winter milk supply to 10% more or less than the earlier 24-month estimate. • Regulation 21(5) – allow take or pay requirements in respect of supply of winter milk premium. • Regulation 6(1) –amend the October rule to include the winter months. • Regulation 6(3) – remove the potential for "gaming" the own-supply limits by skipping one year of supply and re-starting the three year period (only relevant if our preference regarding access to regulated raw milk for large processors is not adopted).	**Option 4.4.1, part of option 4.4.2 and new**
DIRA REVIEW AND EXPIRY PROVISIONS	
• Review of DIRA (to the extent provisions are not repealed earlier) every three years after any change is effective.	**Option 4.5.2**

BRIEF SUMMARY OF ISSUES

Raw Milk Regulations

1 We agree with MPI that support for larger export-focused processors who are capable of sustaining their own supply is now unnecessary, and it risks creating long-term regulatory dependence.

1.1 Kiwis will benefit the most if we're backing dairy companies that supply the domestic market and putting New Zealand first.

1.2 We have always supported a strong, competitive domestic market – which is present in New Zealand. That includes support for Goodman Fielder and or processors supplying the domestic market who need a leg-up.

1.3 If the raw milk entitlements are removed for processors with significant own-supply, and other large processors that are focused on exports, we have no objection in principle to the removal of individual supply limits for smaller independent processors and those who supply the domest c market, provided there are considered and appropriate safeguards around this including an overall cap of 650 million litres (which is approximately the total size of the domestic market, including our own domestic division sales).

1.4 We have always supported ensuring Goodman Fielder remains a viable, large-scale domestic competitor [redacted] However given the flat profile of Goodman Fielder and other processors supplying the domestic market, we support an additional fee of around $0 12 per kgMS to contribute to the additional costs of a flat supply curve and the additional costs of running a milk sourcing operation.

Milk price

2 The current regime is robust and works well, supporting an efficient and transparent milk pr ce

2.1 Given the level of competition in the market and that independent processors compete effectively and sustainably, there is no clear basis for a lack of confidence in the milk price regime.

2.2 In that context, the options to increase regulation by adding to the regime or by having the Commerce Commission set our milk price, would be counterproductive and contrary to the policy direction.

2.3 As shown in its latest review, the Commerce Commission is satisfied that our calculation of the milk price is largely consistent with both the efficiency and contestability purposes of DIRA, and that our assumptions, inputs and costs (other than the asset beta used in the calculation of the WACC component of our milk price) meet the "practically feasible" standard. We are actively working to resolve the Commission's issues with the asset beta used in our milk price calculation.

2.4 Efficiency and informed decision-making by farmers would be improved if the transparency of price setting and payments was spread throughout the industry. We support all processors being required to publish the average price they pay to farmers, the key parameters of their milk price and examples showing the payouts that would be received for different parameters, in a way that is consistent across processors to allow proper comparison.

Open entry and exit

3 Open entry has helped bring about the vibrant and competitive dairy sector we have today – in this respect, DIRA has done its job. It seems it is also no longer being relied upon to the same extent it might once have been.

3.1 Removal of open entry would help our Co-operative achieve our vision and control our strategic direction. Decisions on whether to build new manufacturing sites need to be based on the real world and not because a company is getting a leg up at the expense of farmers and their families.

3.2 The downsides of open entry should not be under-estimated particularly for the environment, and sustainability more generally, and the risk of industry-wide over-capacity:

(a) Strong healthy local environments and communities are the foundation for sustainable, profitable dairy farming and removal of open entry would better enable our Co-operative to be a *leader* on the environment.

(b) Industry-wide over-capacity 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 fo the individuals and communities affected.

3.3 In that context, removal of open entry would not entail the costs and risks it may have once done and the benefits are materially depleted; the costs of open entry now outweigh the benefits.

3.4 Given the importance of environmental/sustainability considerations and the regulatory burden, for the next phase of the development of the dairy industry and our Co-operative, we need to be in a position to exercise more meaningful control over our volumes. Contrary to MPI's view, we can't (for a number of good reasons) control our volumes by manipulating the milk price. The milk price regime and Trading Among Farmers (TAF) in fact prevent us from manipulating our farm gate milk price to control the volume of milk we receive. If we were to use our price to control the volume of milk we receive, we would need to breach both our own constitution and the requirements of DIRA (which are monitored by the Commerce Commission).

3.5 The most effective way to provide control is to remove open entry. This is low-risk given competition is well-established, and open entry's role in safeguarding pricing has been superseded and replaced by the milk price regime and TAF, which have more force given they prescribe what we need to do rather than relying on the incentives of open entry and exit.

3.6 However, if MPI considers it too soon to remove open entry altogether, we propose open entry falling away in any regional council region where our market share drops to 75% or less, with nationwide exceptions to open entry for new conversions and (as MPI suggests) for suppliers who will not be in a position to meet our terms of supply.

3.7 Our estimates based on DairyNZ data for 2017/18 suggest our market share is already below 75% in the Greater Auckland ([redacted]%) and Westland ([redacted]%) regions, and is near that level in the Canterbury ([redacted]%), Horizons (Manawatu-Whanganui) ([redacted]%) and Southland ([redacted]%) regions. A regional approach would provide assurance that the Co-operative is still bound by open entry in areas where competition is not yet as well developed. If there are outlier farmers in any such region that do not have a viable alternative processor, we would commit to pick up the milk for so long as the farm remains a supplier to our Co-operative, while open entry remains in other regions.

3.8 As a final back-stop if MPI does not agree with the above, we would support a discretion to not accept supply from new conversions (effective from the start of the 2020/21 season), and (as suggested by MPI) from suppliers who will not be in a position to meet our terms of supply.

3.9 We also propose open exit falling away in any regional council region where our market share drops to 75% or less. In this case, it is important to bear in mind that we would continue to be subject to the Commerce Act, which protects against the misuse of market power.

Review and expiry provisions

4 We agree with MPI that having no review and expiry provisions creates a risk of regulating for longer than is necessary; it results in the potential for unnecessary and costly long-term dependence on regulation.

4.1 There needs to be a path to deregulation to provide certainty and so the dairy industry can start working towards it.

4.2 We support a further review of DIRA three years after change is effective, given the process of review and implementation of any change can take two years.

4.3 Market share thresholds for expiry would not need to be added to the periodic review requirement if our preferred changes are implemented.

APPENDIX B: RESPONSE TO DISCUSSION DOCUMENT QUESTIONS

Chapter 2: Performance of the dairy industry

1	*Do you agree with our description of the DIRA regulatory regime and its original policy rationale? Do you consider the original policy rationale is still valid?*

1.1 The Discussion Document does not accurately describe the DIRA regime or capture its original policy intent. We also query the extent to which this question is even relevant, given the 2012 DIRA Amendments which incorporated significant changes in respect of the milk price regime and Trading Among Farmers (TAF).

1.2 The key statement that is incorrect is "the chief way DIRA intervenes in industry dynamics is by incentivising Fonterra to use price signals as the means of managing the volume of its milk supply" (at p13).

1.3 The rules and incentives of the milk price regime and TAF in fact purposely *prevent* us from using our farm gate milk price to control the volume of milk we receive. If we were to manipulate our price to control the volume of milk we receive, we would breach both the milk price requirements of DIRA (which are overseen and monitored by the Commerce Commission) and our own Constitution. We address this point here, and separately address factual e rors in the relevant section of the Discussion Document below in response to Q10.

We cannot use our milk price to influence supply volumes

The milk price regime and TAF do not allow us discretion to use the farm gate milk price to control the volume of milk we rece ve

1.4 The purpose of the milk price regime is to promote the setting of a base milk price that provides an incentive for our Co- p to operate efficiently while providing for contestability in the market for the purchase of milk from farmers (we discuss the statutory milk price regime in more detail in response to Q12 below).

1.5 There are several safeguards that ensure the farm gate milk price complies with the prescribed purpose.

1.6 First, the m lk price regime (which was introduced in the 2012 DIRA Amendment and enshrined ou existing milk price regime):

- requires our Co-op to maintain and publish a Milk Price Manual which describes the calculation of the base milk price;
- requires the base milk price to be calculated consistent with certain principles;
- establishes an independent Milk Price Panel, which oversees calculation of the base milk price; and
- provides for Commerce Commission oversight by requiring the Commission to review and report on the extent to which the Milk Price Manual and the milk price are consistent with specified principles in DIRA. We are also obliged to explain publicly any deviations from paying the base milk price calculated in accordance with the Milk Price Manual.

1.7 While the Commerce Commission does not have a formal enforcement role, departing from the base milk price solely to meet commercial strategic objectives in terms of volume would be viewed as contrary to the purposes of the DIRA because it would undermine contestability in New Zealand dairy markets (and would potentially be anti-competitive e.g. if we paid a higher milk price with the purpose of thwarting other processors' ability to compete in the market). Any deviation from the base milk price would need to have a justification that outweighs these factors. Non-compliance, particularly if it is repeated, also risks more intrusive price regulation, as well as significant reputational damage with a wide range of stakeholders. We discuss the constraints imposed by the Commerce Commission monitoring regime in detail in response to Q12 below.

1.8 In addition to regulatory oversight, our Constitution requires that we comply with the milk price principles, including the obligation to pay the maximum milk price that our Co-op, as a properly managed and efficiently run sustainable co-operative, could pay. We explain our Constitution, and the strength of our co-operative model, further in response to Q2.

1.9 Finally, the Milk Price Manual, which was introduced in 2008/09 and built on existing practice, ensures the calculation of an efficient milk price. The base milk price calculation is broadly based on notional revenue, assuming our entire New Zealand milk volume is processed and sold as commodity products that would be likely produced by an efficient near-term competitor to our Co-op for raw milk in New Zealand (currently, whole milk powder and skim milk powder and their by-products buttermilk powder, butter and anhydrous milkfat) minus the notional manufacturing costs of an efficient competitor.

1.10 The Milk Price Manual can only be amended or replaced with the approval of at least 75% of our Co-op's board, including at least a majority of independent directors (section 3.3.5 of the Fonterra Shareholders' Market Rules on the NZX website), and must remain consistent with the DIRA principles.

1.11 Alongside the milk price regime, TAF was introduced in 2012 and established:

- a Fonterra Shareholders' Market, a private market regulated and monitored by NZX and the Financial Markets Authority on which farmer shareholders can trade Fonterra shares; and
- the Fonterra Shareholders' Fund (*FSF*), a registered scheme under the Financial Markets Conduct Act 2013 listed on the NZX and ASX, in which external investors can buy units and enjoy certain economic rights in our Co-op shares.

1.12 Under TAF, external unit-holders as well as farmer shareholders have an interest in our share value and dividend payments. Our share value is directly impacted by the milk price (which is our largest input cost). For our Co-op farmers holding shares in excess of their production (referred to as "dry" shares) and for external investors holding units in the FSF, there is no offsetting benefit to them of a higher milk price. TAF accordingly embeds incentives on our Co-op to determine an efficient milk price, and to be transparent in our milk price-setting process.

1.13 In summary:

- the milk price regime, including Commerce Commission oversight, ensures we pay an efficient price for milk;
- scrutiny from external investors provides an additional material constraint on our ability to over-pay for milk; and
- scrutiny from farmer suppliers provides an additional material constraint on our ability to under-pay for milk.

1.14 So the logic of the milk price regime and TAF are to ensure we set an efficient milk price; we do *not* as MPI has described it, have the ability to set and maintain a different price to achieve a specific volume outcome. We cannot sustain a price deliberately set above or below that equilibrium because of the safeguards described in this section.

1.15 The Discussion Document seems to suggest that we should have set a lower milk price to manage volume growth (see for example p25). However, if we did so we would be answerable to the Commerce Commission, and we would not be acting in the best interests of our Co-op or our farmer shareholders (in breach of company law), since we would be disincentivising the supply of milk that, if supplied, would result in higher overall returns both on-farm and for our Co-op Equally, while the Discussion Document does not seem to suggest we should have set a higher milk price, if we did we would be answerable under the milk price regime, and we would be incentivising the supply of milk that could not be sold for the price paid for it, resulting in lower returns for our Co-op and farmers overall

Milk price would not be an effective tool to influence supply volumes

1.16 Even if we could alter our milk price to control volume for strategic purposes, it would be ineffective because:

- the final milk price is announced after the end of the season, and therefore always comes after milk volume has been produced;
- any steps to change volumes within a season based on forecast milk price would be at the margins and would need to factor in other costs, such as the price of supplementary feed (which can rise in response to a high milk price and increased demand); and
- there is unlikely to be any effect on incentives to leave or join our Co-op because other processors would likely benchmark against our milk price, as they do currently, and would therefore look to match the revised price.

1.17 In practice, for such a strategy to be effective in altering supply volumes we would need to signal an intention to pay a milk price materially in excess of, or below, the base milk price over multiple seasons. In addition to that not being financially prudent (particularly given the volatility of global dairy commodity prices), it would require our Co op to set aside materially adverse implications under the milk price regime (i.e there would be serious questions as to whether the Milk Price Manual and the calculation inputs were delivering a price that meets the section 150A purpose), our Constitution and would likely cause our directors to breach their legal duties to the Co-op and its shareholders.

1.18 MPI a knowledges (at p25) that “adjusting the milk price to manage the volumes of milk [we receive] presents a significant management challenge for a large co-operative company, with a significant existing investment in highly efficient commodity processing assets, a highly seasonal milk supply, and a highly diffused and relatively risk-averse supplier-shareholder base.” While correct, this materially understates the practical issues and challenges with what MPI is proposing.

Original policy rationale behind the DIRA

1.19 The purpose of DIRA (section 4) was to promote the efficient operation of dairy markets in New Zealand by regulating the activities of our Co-op to ensure New Zealand markets for dairy goods and services were contestable. In our view, this policy rationale remains valid in that we need to ensure New Zealand markets for dairy goods and services remain contestable, but the tools regulating the activities of our Co-op require a refresh to ensure they remain fit for purpose.

Original intention of open entry and exit to incentivise an efficient milk price

1.20 Originally, DIRA's primary intervention was open entry and exit – encouraging new processors to enter by giving farmers confidence to "take a chance" on a new processor.

1.21 Open entry and exit were conceived as an alternative to price regulation to mitigate the risk of our Co-op manipulating the milk price and/or our share value to create barriers to new milk suppliers joining our Co-op or switching to other processors, by incentivising us to set an efficient milk price. As Evans and Quigley explain in their 2001 paper, "Watershed for New Zealand Dairy Industry" (at p 9), the free movement of milk volumes as a result of open entry and exit required efficient pricing, as follows (see also the Compass Lexecon Report "The Effectiveness of DIRA in Fostering Competition and Economic Efficiency in New Zealand Dairy Markets, 20 July 2011, pp 10 – 11):

- if we set *a milk price that was too high, and a share value that was too low*, it would result in our Co-op making payments for milk in excess of economic earnings, and thus over time lead to a deterioration in our capital base. New entrants would be attracted by the high milk price and low equity required, increasing the number of suppliers who must be paid at these prices. This would produce a level of entry that would be unsustainable (and would result in a wealth transfer from existing to new suppliers);
- if we set *a milk price that was too high, and a share value that was too high*, it would result in payments for milk in excess of economic earnings and payments to exiting suppliers that are in excess of the true value of their capital. This would deplete our balance sheet and may lead to a run on our Co-op by suppliers attempting to exit in anticipation of our collapse;
- if we set *a milk price that was too low, and a share value that was too low*, it would result in an accumulation of profits in our Co-op, which would make the low equity price increasingly unrealistic. Suppliers would enter in anticipation of obtaining a share of retained profits, and increase pressure on our Co-op to pay a higher return on capital; and
- if we set *a milk price that was too low, and a share value that was too high*, it would incentivise suppliers to exit our Co-op in response to low returns for milk and a high equity pay out (leading to a wealth transfer from remaining to exiting suppliers).

1.22 At the outset of DIRA, open entry and exit therefore incentivised our Co-op to price efficiently – by setting a milk price that accurately reflected the true marginal ex-farm value of milk, and leaving farmers to choose how to act on those incentives by making decisions regarding their level of milk production and whether to apply land to dairying or to alternative uses.

1.23 As NERA explains in its 7 February 2019 report "DIRA review: response to issues raised in the MPI discussion document", these incentives also addressed the "catch-22" of independent processors being reticent to invest in processing capacity without certain raw milk supply, and farmers being reticent to provide supply without investment in processing capacity (see section 2.1). The free movement of volume into and out of our Co-op disciplined price and ensured we paid farmers an "efficient" price for their milk (i.e. a price which reflected the value of that milk on international markets).

1.24 Efficient pricing should help to ensure the dairy industry's resources flow to their highest value use (although we are not aware that this was, as the Discussion Document describes (at p13), DIRA's core regulatory objective). We note that this is not about incentivising dairying over alternative land uses; rather, it is about removing barriers to efficient competition within the dairy sector.

1.25 Open entry and exit also meant that we could not use price to influence supply volumes based on our commercial strategy. For example, if we sought to manage our open entry obligation by lowering our milk price to discourage further milk supply growth so that we would not have to invest in additional processing capacity, then we would create the following risks that could not be managed:

- destabilising transfers of wealth between suppliers as outlined above;
- even less certainty of volume of milk supply as we would not be able to predict when and how much volume would leave the Co-op in response to the lower prices, with potential to lead to underutilisation of existing capacity; and
- lower overall returns to our farmers.

1.26 So, the original logic of DIRA was the potential for the financial consequences of changes in milk volume to discipline price back to equilibrium; *not* as MPI has described it, that we would have the ability to set and maintain a different price to achieve a specific volume outcome. We could not, and cannot, sustain a price deliberately set above or below equilibrium because of the volume effects, and this is a deliberate outcome of the original DIRA regime.

1.27 The incentives created by open entry and exit were reflected in our original Constitution, which was part of the original DIRA legislation, and required calculation of a commodity milk price and a fair value for shares (applicable to both entry into and exit from the Co-op).

Milk Price Regime and TAF supersede and replace the open entry and exit incentives

1.28 When our Co-op was formed we initially paid a bundled pay-out that did not differentiate between the milk price and a return on processing capital and other downstream returns. However, farmers sought greater transparency, and in 2007 we also began looking to bring in external investors to stabilise our Co-op's capital base and reduce he impact on our balance sheet of the Co-op being required to redeem shares where milk volumes reduced (e.g. due to weather conditions or suppliers switching to independent processors). This also required greater transparency around the calculation of our milk price to account to investors. The upshot was the Milk Price Manual, and later the milk price regime and TAF.

1.29 When the milk price regime and TAF were introduced and enshrined through the 2012 DIRA Amendments, they superseded and replaced the same pricing incent ves that are generated by open entry and exit. In fact, the milk price regime and TAF have *more* force than open entry and exit because they rely on legal obligations, and additional oversight by a regulator and scrutiny from two types of investor, as opposed to incentives. They effectively require an efficient milk price, and do not allow for setting the farm gate milk price with the purpose of influencing supply volumes.

National Champion

1.30 As MPI notes (at p5), DIRA was also designed to facilitate our Co-op to be a national champion and a strong competitor in international markets. As a national champion, we support the New Zealand dairy sector and the economy as a whole, by opening up new markets and building the "NZ Inc." brand. All other New Zealand dairy exporters are able to benefit from this investment. Robust competition in international markets also imposes disciplines on our Co-op (the Compass Lexecon Report at p52).

1.31 Our scale has also allowed us to take the lead on industry and social good projects, such as:

1.32 Fonterra Milk for Schools, which helps more than 140,000 school children aged 5-11 access milk for free every day.

1.33 Living Water, a partnership with the Department of Conservation focusing on 5 catchments to identify game-changing and scalable solutions that demonstrate dairying and freshwater can thrive together.

1.34 Fonterra Grass Roots Fund, through which we provide financial support for local initiatives that help make communities safer (e.g. we have provided grants for volunteer fire brigades, surf lifesaving and land search and rescue; through bulk buying we also provided more than 10,000 high visibility vests and 25 defibrillators to community groups).

1.35 More detail can be found in our 2018 Sustainability Report available at https://view.publitas.com/fonterra/sustainability-report-2018/page/1.

1.36 For the reasons above, and as discussed further be ow DIRA has achieved its purpose. It has created real competition in New Zealand dairy markets – farmers have choices in who they supply milk to, Kiwis have choices in terms of the dairy products they can buy and the contribution to N w Zealand from dairy exports has grown from $6.3b in 2001 to $17.1b in 20 8.

2	*Are there any other dairy industry developments or industry performance indicators that are not captured in Chapter 2, Appendix 1, or the reports by Frontier Economics?*

2.1 In this section, we commen on four themes which the Discussion Document either does not address, or which require clarification:

- value add and New Zealand's dairy export product mix;
- our investment in R&D and innovation;
- our Co op's role as a national champion; and
- the str ngth of our co-operative model.

2.2 In addition, as the DIRA is no longer primarily about the restructure of the industry, it should be renamed the Dairy Industry Act.

Investment in value added production

2.3 MPI notes (at p16) that New Zealand's dairy exports remain strongly focussed on commodities and the focus on commodities is particularly evident in our export product mix. It is important to unpack this message, which in our view obscures some key factors and shifts in our business and the dairy sector.

2.4 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 New Zealand's dairy exports to more value add.

2.5 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.

2.6 Advanced ingredients are differentiated products that attract premium prices over base ingredients through superior product performance, differentiated of erings (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 – gi ing our customers new ways to differentiate their products with consumers. Examples include low lactose instant whole milk powder (which offers lactose into erant people the chance to enjoy dairy), pastry butter (designed for exceptional performance in pastry and bakery applications), extra-stretch cheese, our Surestart™ range of science backed ingredients for infant and maternal nutrition and our Sureprotein™ 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.

2.7 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 b llion today and is expected to grow to almost $24 billion by 2020.

2.8 On the consumer products side, we are expanding both our Darfield cream cheese plant and 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%.

2 9 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 (which is larger than the entire New Zealand wine industry). Globally, people are increasingly eating out and we are taking advantage of this 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

2.10 That said, our view is that we could have invested more in value added production in the absence of open entry. During the period of high 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.

2.11 Over the last decade there has been strong international demand for commodity products, so these investments have delivered growth and returns. Frontier also discusses (at p68 “Drivers of Industry Performance”) the large and sustained increase in international demand for commodity dairy products, which rightly drove strategy in the New Zealand dairy sector. Frontier also notes that New Zealand did not (and still does not) have free trade agreements facilitating access to markets likely to demand more value add product (like Europe and the US). Dairy companies such as Friesland Campina and Arla are based in Europe with a population approximately 100 times New Zealand’s population where there has been sizeable and strong local demand for value add products for some time. Europe also has much greater spending power than countries that import milk products, with, for example, a GDP per capita roughly four times that of China. But market conditions are changing, and preferences as to appropriate strategy will shift as well. With New Zealand milk volume growth flattening over the last four years, we have been able to continue to develop customer demand and innovations for higher-value products and services. As a result, our more recent significant capital investments have been in value-add manufacturing facilities, as discussed in our 29 June submission (at [27]).

2.12 As discussed further below, our firm view is that removing open entry would ensure that we are able to pursue a strategy that involves more value-add and less commodity processing. It would also support efforts to improve the dairy sector’s environmental performance in a number of ways, including facilitating strategies and product offerings that require less milk volume growth.

Significant investment in R&D and innovation

2.13 The Discussion Document suggests that our Co-op has underinvested in R&D. We disagree. Our Co-op has made a significant contribution to R&D and innovation. 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 Agrigate, 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.

2.14 Further, we think it is wrong 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. The Discussion Document seems to imply that we are not spending enough but there is no analysis of R&D outcomes per dollar spent.

2.15 We are also concerned with Frontier’s R&D intensity comparison analysis (at p56 “Analysis of Industry Performance”) which does not appear to have been normalised to account for different accounting policies and appears to involve companies in very different sectors and with different business models – which clearly limits the utility of the comparison.

2.16 Our R&D investments and their outcomes keep us competitive with other global food companies. [redacted]

2.17 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 larg st 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.

2.18 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 ac ively exploring new applications and benefits.

2.19 Frontier also refers to 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 fa ms 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.

2.20 We also note that Frontier (at p50 "Analysis of Industry Performance") states that Glanbia invests a similar proportion of its revenue in R&D as we do. However, Glanbia is identified as "moving up the value chain". As NERA notes (at [46]), analysis of the Glanbia annual report suggests that the R&D expenditure figure may refer to the R&D figure for Glanbia PLC (a separate company to the co-op which has external investors) rather than the co-op itself. We understand that Glanbia is also a closed co-operative, ie, it has control over who supplies it (NERA, [47]).

Scope for more investment in R&D

2.21 Like value add investments, we could have made a larger contribution to R&D and innovation in the absence of open entry and the attendant volume pressure. As discussed, open entry requires that we invest in sufficient processing capacity to meet all potential new supply, crowding out investment in higher value producing plant or R&D.

Our value as a national champion

2.22 The Discussion Document notes that foreign ownership of other processors has provided links to particular foreign companies and their marketing and customer network, and we agree, although it is questionable whether these links have to date provided additional value to the New Zealand sector. But it is important to acknowledge that our scale allows us to contribute to “NZ Inc” and our Co-op has facilitated 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, which we have invested in heavily and which all New Zealand-origin dairy and other products benefit from.

2.23 In the absence of our Co-op, New Zealand branding investments would be under-provided for, since they suffer from a free-riding problem (i.e all players benefit from one player’s investment, so no one player has an incentive to invest). Our size and scale address this, at least to some degree (NERA, [55]).

2.24 Our Co-op also provides input and support on New Zealand trade negotiations and broader trade policy issues. We also support DCANZ’s trade policy work on behalf on the New Zealand dairy sector.

2.25 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.

2.26 We play a key role in broader advocacy on trade, with offshore trade strategy roles based in Europe (Amsterdam), the US (Chicago) and South East Asia (Malaysia). Recent examples include our advocacy for the CPTPP Agreement in Washington and for high quality EU-NZ and UK-NZ FTAs. We have participated in UK Select Committee hearings on a potential future UK-NZ FTA, and have advocated strongly for such an FTA to be launched and deliver high-quality results for the New Zealand dairy sector. Another example is our recent participation in RCEP FTA negotiations, where we engaged in industry discussions on market access and non-tariff barriers (*NTBs*), including with Lead Negotiators.

2.27 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. We have also recently taken a lead role in successfully opposing the Chilean Government’s proposed imposition of safeguards on imports of key dairy products.

2.28 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). We do our best to provide accurate and timely information to the New Zealand Government on key trade-related issues.

2.29 Through our in-house trade team, we are also actively engaged on critical trade policy and strategic issues here in New Zealand. [redacted]

2.30 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 f dairy products out of New Zealand. We are also closely engaged in regiona and international trade associations such as the International Dairy Federat on 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.

2.31 These are all examples of the value our Co-op as a national champion with significant critical mass, brings to New Zealand.

The strength in our co-operative mode

2.32 The Discussion Document and Frontier rep rts do not comprehensively address or take into account the rationale for our co-operative model, and we think it is important to do so. There are significant and continuing economic and social advantages in our co-operative model, including distributive implications.

2.33 Firstly, the Discussion Document states that DIRA does not require us to take any particular corporate form (at p26). This is incorrect. While the DIRA does not specifically require us to be a co-operative company, DIRA is premised on our existence as a co-operative. For example, the requirement in section 73 to accept applications to become a shareholding farmer only make sense if we continue to exist as a o-operative. Similarly, section 81 relates specifically to the price of a "co-operative share". Section 106 enshrines the principle of non-discrimination between new entrants and shareholding farmers, consistent with our being a co-operati e subject to open entry obligations. Accordingly, any change to our corpo at form would in our view require significant legislative amendment. A change away from the co-operative model would also fundamentally change the structure of the New Zealand dairy sector and would have major (including potentially unforeseen) consequences.

2.34 Secondly, the Discussion Document also does not acknowledge or address the advantages of the co-operative form for our Co-op, our farmers and New Zealand. The co-operative model ensures co-op farmers are able to elect directors, hold management to account and have a say in business decisions – and it ensures that profits from the sale of dairy products are returned to farmer suppliers, rather than to external (potentially overseas) investors. This has flow on benefits for the wider New Zealand economy because for every dollar a farmer earns he or she will spend around 50 cents in his or her local community. The co-operative structure has a long history and continues to be important in enabling dairy farmers to succeed in New Zealand.

2.35 In 2001, Evans and Quigley explained these benefits as follows (at p5 “Watershed for New Zealand Dairy Industry”):

> Processor co-operatives were principally established by farmers to avoid being at the mercy of a monopoly purchaser they could not control. If suppliers do not control the monopoly processor they will be paid just the minimum to ensure supply, and they miss out on the surplus profit – rent – resulting from the monopoly’s restriction of output. Co-operative processors solve this problem by making the suppliers the shareholders. Thus, if there are any surplus profits they are returned to suppliers in proportion to the milk that they have contributed.

2.36 Others in the industry have recognised the value of a strong Fonterra and the strength of our co-operative model. For example, in its submission on the Terms of Reference, Tatua stated (at [1.7] and [5.3]):

> Tatua believes 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 farm ng 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 isk that long term farm returns would diminish, resulting in erosion of farm resilience, and at the extreme, failure of the farm-gate milk market in some regions…
>
> In the absence of a co-operative Fonterra, milk produce s supplying independently owned processors would likely bear the impact of global market and foreign exchange downturns, but not necessarily obtain the ful rewards of positive market performance. In dairying regions with no or l ttle farm gate milk competition this could lead to an erosion of long term returns and reduced on-farm resilience.

2.37 The Australian dairy industry provides a useful comparison. In its dairy inquiry, the Australian Competition and Consumer Commission (*ACCC*) found that farmers are disadvantaged by information asymmetries with processors. Farmers have little insight into how farm gate prices are set, relying heavily on estimates set by processors that can change without consulting farmers. Farmers can suffer significant loss through these changes to price, and their lack of information throughout the process can leave them unprepared. Further, processors are better informed about the minimum price that farmers are likely to accept, than farmers are abou the maximum price that processors are willing to pay.

2.38 Overall the ACCC concluded that these issues and farmers’ lack of bargaining power result in practices that transfer a disproportionate level of risk to farmers and soften competition between processors. The ACCC considered that processors should publish information identifying how their pricing offers apply to individual farm production characteristics to enable better farm income forecasts.

2.39 n contrast, our co-operative model ensures fairness in our supply chain. It constrains our milk pricing, and ensures we do not have an incentive to exercise market power against our farmer suppliers. The Commerce Commission, in its “2016 Review of the State of Competition in the New Zealand Dairy Industry” (at [X30.1]), concluded that the co-operative structure protects farmer suppliers from our market power in relation to milk purchases, because the suppliers ultimately control the decisions of the company. Australia is currently considering a mandatory industry code of conduct to address some of these concerns.

2.40 Our co-operative model also helps to drive the dairy sector’s contribution to New Zealand, and particularly regional New Zealand, by ensuring farmers are treated fairly and profits are directed widely into the community, particularly regional communities. The October 2018 NZIER report entitled “How does the dairy sector share its growth? An analysis of the flow-on benefits of dairy’s revenue generation" commissioned by DCANZ identifies some of the key benefits to New Zealand from the dairy sector, and these illustrate the way these benefits are both large but also broadly distributed:

- Dairy farming is the top income generator in Waikato, West Coast, and Southland. The dairy sector accounts for 14.8% of Southland's economy, 13.4% of the West Coast economy, 11.2% of the Waikato economy, 11.1% of Taranaki's economy and 6% of Northland's economy (at (i));
- The dairy sector accounts for $8.2 billion (3.1%) of New Zealand's total GDP (at p8);
- Dairy employment was 38,700 in February 2017, and dairy supports jobs in other sectors of the economy (at p10);
- The dairy sector's contribution to national employment has steadily increased over time. Since 2000, dairy sector employment has grown by an average of 3.1% per year, compared to 1.8% for total employment (at p11);
- Dairy sector wages almost tripled between 2001 and 2017, with $2 6 billion delivered in wages in 2017 (at p12);
- Dairy farming and dairy processing are the largest purchasers of output from seven and six industries respectively in the New Zealand economy. This means the wider dairy sector is vitally important as a purchaser of goods and services from around a third of all industries in he New Zealand economy (40 industries for dairy farming accounting for 41% of GDP, and 33 industries for dairy processing accounting for 29% of GDP) (at p17);
- The dairy industry is amongst the top 0 employers in more than half of New Zealand territorial authorities (at p26); and
- About 80% of all dairy wages ($2.1 billion) are earned in rural areas (at p31).

Chapter 3: The effects of the DIRA and other factors on industry performance

3	*Do you consider the DIRA has been effective at achieving its core regulatory objective of preventing Fonterra from using its dominance to create barriers to farmers' milk and land flowing to their highest value uses? If not, please provide reasons and supporting information/evidence.*

3.1 As discussed in response to Q1 above, DIRA's core regulatory objective is to promote efficiency and contestability in New Zealand dairy markets.

3.2 In our view, DIRA regulation has worked well. The incentives initially created by open entry and exit, and then subsequently the milk price regime and TAF have ensured efficient pricing (and mean that, as discussed in Q1 above, we cannot use pricing signals to influence volumes) – and, as a consequence, have enabled d iry resources to flow to their highest value uses. DIRA has fostered contestability and enabled both small and large processors to enter.

3.3 Competition in New Zealand's dairy markets is robust and sustainable. The risk of our Co-op using our position to dampen competition has materially decreased. Any residual risk is, in our view, now effectively managed by the milk price regime, TAF, and ongoing support to participants in the domestic consumer market. DIRA's objectives have been largely achieved and so the full costs of the regime are no longer justified.

3.4 In the absence of DIRA regulation going forward, we would not have the ability or incentive to frustrate entry by new proces ors. This is supported by the Commerce Commission's recent findings (n its "2016 Review of the State of Competition in the New Zealand Dairy Industry" at [5.165]–[5.167]), that, in the absence of DIRA, we would not have a strong incentive to frustrate entry by new processors because:

- while we may have an incentive to foreclose downstream competitors in a deregulated environment our ability to do so would be limited because many independent processors would likely have alternatives at the factory gate or be able to increase their own supply; and
- independent processors that did not have access to alternative supply collectively accounted for a small market share, and our Co-op may not obtain a benefit from their foreclosure.

3.5 As NERA notes at [7], [12] and [15], since that report, competition has developed further, with Fonterra's national market share continuing to fall from 85% in the 2014/15 season to 81-82% now.

3.6 In the absence of open entry and exit in particular, we would continue to operate largely as we do now:

- In an environment of low to flat milk growth and significant invested capital, we would have limited interest in turning away milk.
- The Commerce Act, as well as the material competitive constraints we now face, would limit our ability to tie up milk supply where our contracting substantially impacted competition in the farmgate milk market (see the discussion below on the Commerce Act constraint in response to Q5).

3.7 The primary difference under the removal of open entry is that we would refuse applications to enter our Co-op or increase supply where there was a reputational issue in collecting the milk (for example, because a farmer would not meet our environmental or animal welfare standards). In our view, this would be a positive step for the industry as a whole. Further, we would have the ability to respond to any new unforeseen developments in the dairy industry.

3.8 We would otherwise continue to collect from all our existing farmers. Furthermore, we would not expect this to have a material impact on existing shareholders' ability to increase their supply, in the ordinary course of business. That is, we calculate share requirements based on a rolling three-year average of supply, so farmers typically manage their increased supply without making an application to increase their supply (under section 73(2)). In fact, in 2017 and 2018 we received only 5 and 8 such applications, respectively. Therefore, removal of open entry would only potentially affect existing farmers where they applied to provide new supply (e.g as a result of buying a farm and converting it to dairy).

3.9 We may refuse to collect new or increased supply (to the extent it requires an application) where it is uneconomic to do so, for example from geographically remote farms. But as NERA notes, even in the absence of the open entry requirement it is unlikely our Co-op would refuse to accept farme s that wished to switch from an independent processor. Independent processors have invested in New Zealand's primary dairy areas, and so their farmers are likely to also be proximate to our existing plants (at [20]).

3.10 In the absence of open entry, we would also have greater ability to evolve in response to other changes in the domestic and global dairy industry (for example, new environmental threats).

3.11 We are conscious of the public perceptions around our historical behaviours such as when NZDL went into liquidation in 2012 (at the time TAF was being introduced). Although we negotiat d a deal to acquire the plant on terms which enabled the ex-NZDL suppliers to be paid the significant amounts owed to them by NZDL for milk, we also contracted the ex-NZDL suppliers on non-standard terms. We acted in good faith and genuinely believed these non-standard terms reflected their different circumstances The Courts ultimately found otherwise, and we have learned from that experience.

3.12 Other DIRA backstop protections could remain in place, including the open exit obligations (being the right to withdraw and the 160km rule) until a regional market threshold is reached, as discussed below, the milk price regime, TAF and certain entitlements under the Dairy Industry Restructuring (Raw Milk) Regulations (*Raw Milk Regulations*).

4	*Do y u think Fonterra is still dominant in the market for farmers' milk, at the national and regional levels?*

4.1 As discussed above in response to Q3, we do not consider that we have the ability or incentive to use our position to frustrate entry by new processors and we also have no ability or incentive to exercise market power against farmers.

4.2 At a national level, our market share dropped from 96% in 2001 to, according to the Discussion Document at p19, 80.5% in 2018 in a market that has grown significantly, which indicates the existence of sustainable competition. Our calculations indicate our national market share is currently around 81- 82%.

4.3 National market shares also understate the competitive impact of independent processors (NERA, [16]). Under our co-operative structure we adopt uniform pricing and average transport costs across all of our suppliers. This means that we must respond to regional competitive pressure on a national basis – so competition in just some areas benefits all of our suppliers (NERA, [85]). In any event, there is robust and sustainable competition in most regions in New Zealand, where our market share is around 85% and falling.

4.4 That said, we understand there might be some reluctance to rely on our co-operative structure to protect farmers in regions where competition has not yet developed materially. On a conservative basis therefore, we consider below whether our Co-op has market power based on regional council region market shares (calculated using New Zealand Dairy Statistics data and overlaying our collection data).

Regional Council Region	Fonterra Market Share % (2017-2018)
Northland	[redacted]
Auckland	
Waikato	
Bay of Plenty	
Taranaki	
Horizons (Manawatu-Whanganui)	
Hawke's Bay	
Greater Wellington	
Tasman	
Marlborough	
Westland	
Environment Canterbury	
Otago	
Environment Southland	

4.5 In the dairy sector and our experience, independent processors can exert significant competitive pressure with market shares of 5% or 10% in a region. For example, there is more than one independent processor, and our Co-op is subject to effective and sustainable competition, in the Waikato, Horizons, Canterbury and Southland regions Based on this, a conservative view is that sustainable competition exists in regions where independent processors have a share of 15% or more.

4.6 While robust competition has developed in some regions, we acknowledge that MPI may wish to recommend open entry remains in those regions where limited competi ion has developed to date. Our strong preference is for the removal of open entry (the obligation to accept supply, as well as non-discrimination) entirely, but we have also proposed as a second preference in response to Q23 below a new possible option for regional expiry of open entry and exit (the right to withdraw and the 160km rule) when a 75% market share threshold is met.

4.7 NERA notes that in 2010 they recommended a 75% market share threshold for review of DIRA, by Island. Since then, the number of independent processors has increased, and we can be much more confident about the sustainability of independent processors (at [86]). In their view, 75% continues to be an appropriate threshold for removal of open entry (NERA, [64]).

5	*Do you think the DIRA imposes unreasonable costs on Fonterra? If so, please provide supporting information/evidence.*

DIRA imposes unreasonable costs on our Co-op

5.1 In our view, DIRA imposes material costs on our Co-op and has served its purpose. Therefore, those costs now materially outweigh the benefits, and are in our view unreasonable. The key costs are the following:

- At its broadest, open entry has and will continue to materially influence the strategic decisions that our Co-op makes. It pervades our decision-making causing us to make decisions that an unencumbered corporate strategy would not contemplate. In this regard, the costs of DIRA are material, though difficult to estimate because the costs flow from constraints on our Co-op's s rategic orientation.
- Open entry encourages inefficient investment decisions. NERA identifies two (interrelated) categories of costs of open entry: excess capacity on the part of our Co-op, due to uncertainty, and crowding out of investment in higher value producing plant (at section 3.2). Open entry has required our Co-op to build and maintain a large footprint to ensure we can process all milk that could come our way. This means that capital has been directed away from other, potentially higher-value uses. It has also constrained capital investments in R&D and innovation, as discussed above. In addition, NERA identifies the broader risk of inefficient independent processor entry and potentially industry over-capacity (at [57]). We discuss th s issue in more detail in Q8 below.
- Open entry has imposed reputational costs, as well as time and resource costs, requiring our Co-op to deal with farmer suppliers that do not meet our standards and damage our brand in the market. For example, our staff and management invested significant time and made numerous visits, phone calls and emails in respect of the 98 farms issued with suspension notices due to stock exclusion in the 2017/18 season.
- Open entry also imposes significant environmental costs, which we discuss in detail at Q14 below.

5.2 Against this, open entry is no longer required to ensure contestability in the New Zealand dairy sector. Open entry was originally intended to:

- solve the "catch-22" described above (new independent processors' reluctance to invest without raw milk supply, and farmers' reluctance to supply without independent processor investment); and
- ensure efficient pricing (see NERA, section 2, and our response at Q1 above).

5.3 These two objectives are now secured in other ways. Competition is robust and sustainable, and there is no longer a "catch-22" constraining independent processor investment. Several independent processors are now well established and farmers can rely on their track record and reputation in their decision-making around who to supply. In addition, the milk price regime and TAF ensure efficient pricing. In this context, the benefits of open entry have, in our view, fallen away. We also support ongoing obligations to supply raw milk to processors supplying the domestic consumer market, providing additional protection for New Zealand consumers.

5.4 In 2016, the Commerce Commission found the costs and benefits of DIRA to be "finely balanced", in a context where the Commission had, in our view, under-estimated the costs, and over-stated the benefits (at p7 "Review of the State of Competition in the New Zealand Dairy Industry").

5.5 Competition has developed further since the Commerce Commission's report (the Commission's assessment of competition was undertaken between June and November 2015). As NERA describes , there is now robust and sustained competition in the dairy sector, with double the number of competitors in the farm gate market as there was prior to the formation of our Co-op. NERA's view is that "*IPs have developed to the point that there is unlikely to be a material catch-22 problem today*" (at [7]).

5.6 Given that the policy rationale for open entry has fallen away, the costs of DIRA outlined above now clearly outweigh the benefits, and are therefore unreasonable.

5.7 There is no evidence new processors consider they need open entry to become established in New Zealand. MPI notes in the Discussion Document that independent processor investment is unlikely to be based just on open entry and exit (indeed, it suggests that DIRA protections are likely to have a limi ed role in such investment decision-making) (at p30). NERA states tha independent processors investment suggests a high degree of confidence and it is interesting to consider what role DIRA plays in this (at [9]). They note that presumably continued investment by a processor does not depend on continued access to DIRA (regulated) raw milk, because we are not obliged to supply raw milk to an independent processor that has collected 30 million litres or more of its own supply for three consecutive seasons.

5.8 Farmers have not expressed a strong desire to retain open entry, and there is no evidence that the ability to return is a material factor in farmers' decision go to another processor.

5.9 NERA also notes that a key aspect of the "catch-22" problem was farmers' uncertainty around an independent processor's track record/reputation (at [11]). As NERA notes, there are now a number of well-established independent processors. There also appears to be an emerging trend of global food and dairy companies vertically integrating upstream into New Zealand by taking material ownership stakes in independent processors: "*Because this is upstream vertical integration, these investors will be less concerned about finding output markets for their processing investments. This is turn will provide some comfort to farmers about the sustainability of these processors*" (at [13]).

5.10 Other stakeholders also support removal of the open entry requirements, at least in part, ncluding other processors Synlait and Westland (which supports removal of open ntry in relation to new conversions).

Capacity constraint notices do not mitigate the cost of open entry

5.11 The Discussion Document refers to capacity constraint notices as a mechanism to minimise the costs of DIRA to our Co-op. Capacity constraint notices do not effectively mitigate the costs of open entry. Capacity constraint notices allow us to defer collection in an area for one year only. But capacity build decisions (and all of the pre-work needed to make those decisions) need to be made more than one year out. [redacted]

5.12 Our Co-op must plan for capacity investments at least three years out, which means we cannot rely on capacity constraint notices as a mechanism to mitigate the costs of the open entry obligation.

Commerce Act constraints

5.13 Finally, the Discussion Document asks whether, in the absence of DIRA, the Commerce Act could be relied upon to manage our Co-op's dominance. As noted above, we support retention of key aspects of DIRA, including the milk price regime and aspects of the Raw Milk Regulations.

5.14 That said, our view is that the Discussion Document under-estimates the effectiveness of the Commerce Act as a constraint. We are very mindful of the Commerce Act which we see as one of the key regulatory constraints on our activities. It is an important and well-established regulatory framework, backed up with an effective independent regulator, and accordingly should not be under-estimated.

5.15 Section 36 is designed to prevent unilateral anticompetitive behaviour by firms with a significant degree of market power. It captures players that use their market power for certain anticompetitive purposes, to:

- restrict a person from entering into a market; or
- prevent or deter a person from engaging in competitive conduct in that or any other market; or
- eliminate a person from that or any other market.

5.16 Section 36, in our view, provides a real constraint on market power, and the provision is backed by a significant body of regulatory and judicial guidance. For example, we apply a Commerce Act analysis in addition to the restrictions under section 107 of the DIRA when we are making decisions whether to contract supply for more than one season.

5.17 Section 36 is currently under review by MBIE. At this stage, MBIE proposes to amend section 36 to bring it into line with the recent reforms of the parallel provision in Australia. MBIE considers the changes will "level the playing field again by preventing powerful businesses from harming their competitors in ways that produce no benefit to consumers" (MBIE, "Review of Section 36 of the Commerce Act and other matters – summary", (January 2019)). In other words, the impetus behind the proposals has been to tighten the (in our view already effectiv) provision vis a vis companies with a substantial degree of market power.

6	*Are there ways for the costs imposed on Fonterra to be mitigated without impacting on the effectiveness of the DIRA regulatory regime? If so, please provide supporting information.*

6.1 Yes, we consider that there are amendments to the DIRA regime which could mitigate the costs imposed on our Co-op without impacting on the effectiveness of the regime in promoting efficiency and contestability.

6.2 The primary change is removal of open entry (the obligation to accept supply and the non-discrimination rule), which would reduce the costs on our Co-op without adversely impacting competition in the New Zealand dairy markets. In the absence of open entry, we would still be incentivised to accept milk consistent with our co-operative principles and to utilise already existing capacity. In addition, there are now several well-established and sustainable competitors, which give farmers choice in who they supply to. The viability of these competitors would not be affected by removal of open entry.

6.3 In addition, as NERA explains, the Raw Milk Regulations impose a cost on our Co-op, because on an expectations or systematic basis the regulated price will be lower than our opportunity cost (at [78]). To the degree that price is less than opportunity cost, then our Co-op investors are subsidising processor entry (at [80]). Further, independent processors can materially vary their forecasts at short notice which creates uncertainty for our Co-op regarding the amount of milk we are required to process, leading to, for example, potential plant overbuild or other inefficient operating decisions. This issue is particularly costly for our Co-op at peak. As NERA notes: "*this flexibility grants IPs a free option to vary milk taken from Fonterra at peak, which transfers the risks IPs would otherwise face around forecasting peak supply onto Fonterra*" (at [87]).

6.4 Changes to the Raw Milk Regulations (to remove entitlements for large export-focused processors) and the return of a clear pathway to deregulation w uld mitigate the costs on our Co-op without reducing the competitiveness of the dairy sector or allowing any misuse of market power. We discuss these proposals further below in our responses to Q18, Q29-31 and Q40-43.

6.5 As noted above in response to Q5, capacity constraint notices are not a practical mitigation for the costs of open entry, since we cannot decline to accept new supply, and the maximum deferral period of 12 months is too short a period to build new capacity.

6.6 MPI has also pointed out that we could charge actual transport costs to our farmer suppliers. While theoretically possible, we do not see this as a viable option for the following reasons:

- There are practical difficulties as ociated with calculating and applying actual transport costs which would be prohibitive – it is not a simple "distance" multiplied by "transport charge" calculation as the actual costs would depend on other factors including how many other farms the tanker visited, the nature of the terrain (i e. hilly or f at), whether there were any delays at the farm, and the condition of the roads.
- In our view, such an approach would run counter to our co-operative principles and DIRA.
- Such an approach would likely have unintended consequences, such as an impact on land values and significant lobbying from our shareholder base on whe e to build new plant or whether to close a site which would distract from making decisions for the benefit of the broader Co-op.

7	*Are there any other regulatory tools that, in your opinion, would be more effective than the current DIRA provisions at managing Fonterra's dominance? If so, please provide examples and supporting information/evidence.*

7.1 In our view, DIRA continues to be an important framework for the New Zealand dairy sector. As above, we support retention of open exit (the right to withdraw and the 160km rule) until a market threshold in a region is reached, and certain of the Raw Milk Regulation obligations, the milk price regime, TAF, the 20% rule and provisions concerning the sale of milk vats.

7.2 However, we also support a clear pathway to deregulation to provide certainty and sustainability in the sector. Over time, as DIRA regulation falls away, our view is that the Commerce Act framework (an important and well-established regulatory framework) and the extent of sustainable competition in the day industry will be sufficient to ensure efficiency and contestability in the dairy sector.

8	*Are there other factors you consider need to be taken into account when considering the effectiveness of the DIRA regime and whether it is still needed?*

8.1 It is important to consider:

- Where our Co-op and the industry could be in the absence of open entry. Removal of the open entry obligation would allow our Co-op to better manage volumes and invest more in value added production, R&D and innovation It would also ensure we can manage reputational concerns associated with new farmer suppliers who do not meet our standards.
- The original rationale for open entry: addressing the "catch 22" associated with new independent processor investment, and ensuring efficient pr cing. Both objectives are now met in other ways, through the level of sustainable competition in the dairy sector, and through the milk price regime and TAF. There is no compelling rationale for retention of open entry in this context.
- The constraints and incentives imposed by our co operative model. As noted in response to Q1, DIRA is built on the structure and incentives created by our cooperative model. Furthermore, for the reasons given in response to Q2, we consider our co-operative model to be a source of strength for us, for our farmers and for the New Zealand industry as a whole.

8.2 In addition, there are real risks associated with the continuation of open entry. In particular, entry-facilitating policies like open entry (and the Raw Milk Regulations) could result in inefficient independent processor entry, and potentially an industry with over-capacity, as the meat industry has faced many times (NERA, [57]).

8.3 As NZIER discuss in their February 2019 report "Indicative estimates of the economic impacts of over-capacity", industry over-capacity could result in under-utilised plants being kept in service (due to the large sunk investments they entail, and the consequent reluctance to exit), causing a period of stagnation and low returns. Even when this problem ultimately "corrects" by some plants closing, this in itself creates negative consequences for the employees and communities affected. Tatua a so perceives a risk of over-capacity, and negative consequences arising from it (see their submission on the Terms of Reference at [3.6]):

> W th static or declining milk volumes, and the very real likelihood of excess rocessing capacity, it is more likely that some companies will pay more than they can afford in the long term to secure milk in the short term. i.e. a procurement war similar to what has been seen in the meat industry at various times. This could escalate until one or more firms actually fails.

8.4 NZIER has modelled the potential impact of a decrease in capital investment and productivity as a result of over-capacity, indicating that a 1%, 5% and 10% capital productivity decrease would result in New Zealand's GDP falling by $149 million, $276 million and $441 million relative to business as usual. This excludes the social and human cost of such a process.

9	*Do you agree with our preliminary assessment of the extent to which the DIRA encourages industry growth? If not, please provide reasons and supporting information/evidence.*

9.1 In our view, the Discussion Document understates the importance of DIRA as a standalone factor encouraging industry growth. DIRA ensures that farmers have a guaranteed buyer for their product – incentivising dairying over alternative land uses. The concern here is not that independent processors will increase their relative share, which is an issue on which policymakers should be neutral. Rather, the concern is that DIRA directly contributes to inefficient new capacity and inefficient new conversions. This is expanded, including with reference to the work carried out by NZIER, below in response to Q13.

9.2 We had [redacted] new dairy conversions join our Co-op for the current season, across both the North and South Islands. NERA also describes the magnitude of new conversions as a result of DIRA (at [39]), noting that between the 2009/10 and 2017/18 seasons:

- [redacted] new farms joined Fonterra, [redacted] of which were new conversions, these new farms represent an increase in yearly production of about [redacted] m kgMS;
- Of those [redacted] new farms, only [redacted] remain with Fonterra today (i.e., [redacted] have joined Fonterra and then subsequently left), in 2017/18 these remaining farms represent an annual production of [redacted] m kgMS and
- Annual supply from the remaining [redacted] farms that were existing in the 2009-10 season has grown over the same period by about [redacted] m kgMS.

9.3 As discussed above in response to Q8, th risks in retaining DIRA entry assistance also include the potential to incentivise inefficient new capacity, which may lead to over-capacity and under-utilisation.

9.4 The growth incentives created by DIRA are also an environmental concern, as discussed in response to Q15 below.

10	*Do you agree with our preliminary assessment of the extent to which Fonterra can influence milk supply volumes through price, notwithstanding the DIRA open entry requirements?*

10.1 No, we do not ag ee with MPI's preliminary assessment of the extent to which our Co-op can influence milk supply volumes through price. We have addressed this issue in detail in response to Q1 above. There are, however, some factual errors in this section of the Discussion Document that we address below.

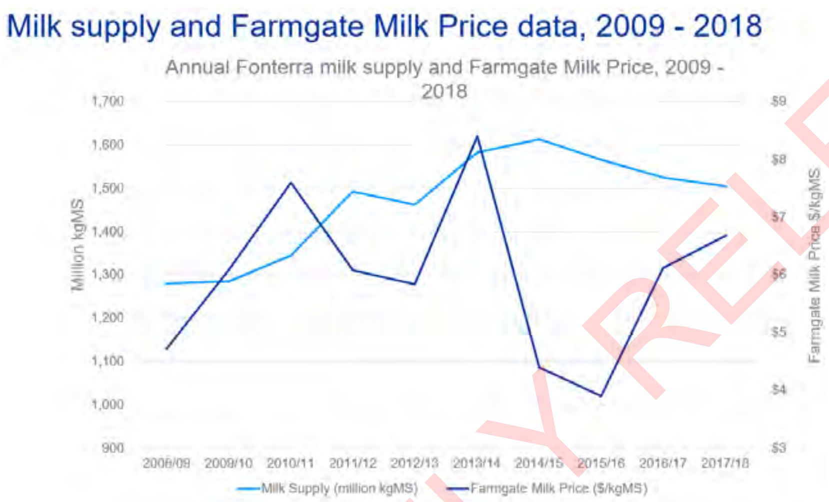
10.2 On p24 of the Discussion Document, MPI states that New Zealand dairy farmers' milk production decisions are sensitive to price and suggests that supply volumes fell in 2013/14 in response to lower global demand and commodity prices. This is not correct:

- In FY14, the farm gate milk price was $8.40. Very good conditions, contrasted with poor conditions the previous season, contributed to production increasing to 1,584 million kgMS – 8% more than the previous season.
- In FY15, the farm gate milk price was $4.40 (compared to an initial forecast of $7), but again milk supply increased, by 2% to 1,614 million kgMS.

- It was not until F16 that volumes started to fall. In F16, with a farm gate milk price of $3.90, farmers decreased production to 1,566 million kgMS, down 3% on the previous season, but only down 1% on the FY14 season.

10.3 This indicates that, within a given season, a low farm gate milk price leads farmers to control costs (e.g. reduce stocking rates and/or supplementary feed), but does not result in major shifts in volume – i.e. within a season, farmers are unlikely to enter or exit the dairy sector as a result of price changes. This supports our view set out in response to Q1 above, that even if we were free to deviate from the base milk price to pursue commercial strategies (which we are not), the milk price would not be an effective tool to influence supply volumes on a season by season basis.

10.4 The graph below further demonstrates the lack of clear correlation between price and volumes:



10.5 This lack of correlation (particularly on a timely basis, and given the myriad of other factors involved) is another reason why, even if we were able to change the milk price with the intention to change milk supply volumes, it is highly unlikely it would be effective This is in addition to considering the many other reasons that we do not and cannot manipulate volumes using the milk price.

10.6 On p25, the Discussion Document suggests that we could deviate from the base milk price where we are facing intense competition for supply (by raising our price) or where we wish to reduce supply to pursue a value add strategy (by lowering our price).

10.7 These suggestions are unrealistic. As explained in response Q1, manipulating the milk p ice to control volumes would breach both our own Constitution and the requirements of DIRA. Departing from the base milk price solely to meet commercial strategic objectives in terms of volume would be viewed as contrary to the purposes of the DIRA because it would undermine contestability in New Zealand dairy markets (and would potentially be anti-competitive e.g. if we paid a higher milk price with the purpose of thwarting other processors' ability to compete in the market). We do not believe that we could do this legally and have certainly never done so. Secondly, and for the reasons given above, we do not consider that the farm gate milk price has a significant effect on volumes within a season. Further, to the extent that the absolute level of the farm gate milk price does impact volumes for a season, it is not possible to accurately predict the impact before or early in the season, because the forecast farm gate milk price is by its nature subject to at times material variation across the season until it is finalised after the season ends.

10.8 The only situations in which we have deviated from the base milk price (in 2013/14 and 2017/18) have been when the Co-op's wider financial circumstances have meant we could not afford to pay the benchmark price.

10.9 There are also some specific flaws in the Frontier analysis relating to our ability to control the milk price, including an apparent belief that we can manipulate the Milk Price Manual and inputs, without affecting our credibility (p16ff and p53ff "Drivers of Industry Performance"). This is not correct.

10.10 Any change to our Milk Price Manual requires approval from at least 75% of our Co-op's board, including at least a majority of independent directors, and must remain consistent with the DIRA principles. These requirements are set out in the Fonterra Shareholders' Market Rules (regulated by NZX), and our Constitution (which is not simple to change). Any changes to Part A of our Constitution (which includes the provisions relating to the milk price) first require majority support of the Shareholders Council (Constitution, cl 18.1). Then, in accordance with the Companies Act, at least 75% of the shareholders voting must approve the change. Constitutional change can take time - for example, it took over two years to finally pass previous capital structure changes. Further, DIRA requires the Commerce Commission to review the Manual for consistency with the DIRA regime every season.

10.11 Accordingly, our compliance with the milk price regime is closely monitored both internally, in accordance with our Constitution, and externally by the Commerce Commission in accordance with DIRA. We are required to publicly explain any deviation from the Milk Price Manual. It is wrong to suggest that our Co-op has broad or unlimited discretion when it comes to setting the milk price; it is quite the opposite, as we explain below.

10.12 We discuss the statutory regime that governs the milk price in response to Q12 below.

We cannot use our terms of supply, shareholding requirements or dividends policy to control volume

10.13 The Discussion Document also suggests that we could use our terms of supply, shareholding requirements or dividends policy to control volume. This is incorrect.

Terms of supply

10.14 MPI has suggested that we could use our terms of supply to control volumes – for example, by setting a volume threshold on suppliers, after which a lower price kicks in – to encourage farmers to reduce supply.

10.15 In our view, for the reasons below it is not practical for us to attempt to control volumes and growth through our terms of supply in this way. It would also, in our view, be contrary to the purpose of DIRA and our co-operative structure (because it would have a differential effect on our farmer suppliers). NERA notes that this approach would have unintended consequences and a differential effect, penalising large farmers (in the case of an absolute volume threshold) or penalising small farms (in the case of a relative volume threshold) (at [35]).

10.16 It would also likely be contrary to the requirement in our Constitution that we pay the maximum sustainable price for milk under the milk price principles in our Constitution.

10.17 Our terms of supply are intended to govern the commercial relationship between our Co-op and our farmer suppliers and establish our minimum operating standards (on environment, animal welfare etc.). Given DIRA, our terms of supply are not intended to operate as a strategic lever that we can pull in order to achieve a particular volume outcome – in our view, this would amount to gaming the open entry protections. While we review our terms of supply each season, any changes are incremental and designed to facilitate our supply chain and ensure our standards evolve. Any changes to our terms of supply are also subject to robust review and challenge by our Shareholders Council on behalf of our farmer shareholders.

10.18 It would be inappropriate to attempt to use our terms of supply to achieve a volume outcome that is otherwise prohibited under DIRA, including by open entry and exit, the milk price regime and TAF.

10.19 The appropriate and most straightforward way for our Co-op to influence volumes is to remove open entry.

10.20 To be clear, despite the above, DIRA does not prevent us from altering our payment structures for all farmers, for example, to incentivise our farmers in relation to environmental performance (a point about which MPI expresses uncertainty – see p29 of the Discussion Document).

10.21 Note that at p26 MPI indicates that colostrum is paid a premium. This is incorrect – we do not collect colostrum, which is instead kept separate from farmers' supply and fed to calves.

Shareholding requirements and dividend policy

10.22 The Discussion Document states (at p26) that:

> The number of Fonterra shares that farmers must purchase and hold per kgMS is determined by Fonterra, at its complete discretion. Where the number of shares that must be held per kgMS is high, the ost to farmers of supplying milk to Fonterra is high. Fonterra can influenc farmers overall profitability of supplying milk to Fonterra by increasing or decreasing th numbers of shares it requires its suppliers to hold per kgMS. It appears that since 2013 Fonterra has undertaken a number of initiatives that have made it cheaper for farmers to supply more milk...

10.23 We do not agree. Importantly, shareholding requirements are not a "cost" to farmers: shares are an investment, and if our earnings are returning the appropriate amount for the risk of holding our Co-op shares, then holding shares is not a "cost".

10.24 The number of shares required to be held (1 share/kgMS) is enshrined in our Const tution. It has not changed since our formation and given it is in the Constitution it is not something that can be easily changed season to season. As outlined above at paragraph 10.10 constitutional change can be difficult to achieve and can take considerable time.

10.25 In the context of growing competition, farmer supply growth and increasing global demand for dairy products we sought to ease cash flow and capital investment pressure on farmers who needed to purchase shares to enter our Co-op or expand their volumes, through tools such as milk growth contracts and MyMilk. The bonus share issue (following the launch of TAF) was to ensure there were sufficient shares on issue above minimum shareholding requirements and contribute to ongoing liquidity in the Fonterra Shareholders' Market and the Fonterra Shareholders' Fund.

10.26 We also do not agree with the statement at p27 of the Discussion Document that we can use our dividend policy to influence milk supply volumes or that our dividend payout ratio has been trending upward over time (as demonstrated by the decision to pay no final dividend for FY18, which reflected financial discipline in our Co-op and had nothing to do with the milk price). Our dividends are not a payment for milk supplied – they are a cash dividend return on equity capital invested in our Co-op.

10.27 It is also important to note that under TAF, the return on the capital investment is applied equally to unit holders – i.e. our dividend policy applies to the unit distributions received by non-supplying unit holders, as well as to shares held by supplying farmers.

10.28 Our financial performance and balance sheet position (including our capacity to fund future growth) are the most important factors influencing dividend policy. Further, to the extent earnings are retained (i.e. not paid as dividends), our equity capital amount increases. If the equity holder does not receive returns as a cash dividend, they remain entitled to any dividend in the future, or they benefit through the share value, as demonstrated by listed securities where the share price adjusts ex-dividend.

11	*Are there other factors that you consider should be taken into account? Please provide detailed comment in support of your views.*

11.1 No.

12	*Do you consider that the DIRA provisions governing Fonterra's base milk price calculation and Commerce Commission monitoring may be preventing or disincentivising Fonterra from deviating from the base milk price calculation for strategic or commercial reasons?*

12.1 Yes, the milk price regime and Commerce Commission monitoring, together with TAF, prevent our Co-op effectively deviating from the base milk price calculation purely for strategic or commercial reasons. These constraints mirror (and replace the need for) open entry and exit as a constraint on our milk pricing. The constraints are evidence of the system working as it should, ensuring that we pay a contestable and efficient milk price.

DIRA milk price regulation

12.2 Our Co op is subject to price regulation under the DIRA milk price regime. The current regime is enshrined in DIRA, Part 2, Subpart 5A and provides an effective contro on our base milk price calculation.

12 3 DIRA states the purpose of the milk price regime is to promote the setting of a base milk price that provides an incentive for our Co-op to operate efficiently while providing for contestability in the market for the purchase of milk from farmers (section 150A(1)). It requires the base milk price to be set in accordance with the principles in section 150C.

12.4 DIRA requires that we establish and maintain a Milk Price Panel to supervise the calculation of the base milk price, advise us on the application of the Milk Price Manual, and recommend the base milk price (section 150D). We are required to publish the Panel's terms of reference (section 150D(5)). The chair and majority of Panel members must be independent (section 150E).

12.5 DIRA also requires that we maintain the Milk Price Manual, setting out how the base milk price is calculated (section 150F). The terms of the Manual need to reflect the principles in section 150C. We are required to publish the Milk Price Manual. We are required to publicly explain any deviation from recommendations of the Milk Price Panel (section 150G).

12.6 It is a criminal offence for our Co-op to fail to comply with key aspects of the milk price regime (see, e.g. sections 150E(3), 150F(3), 150N).

12.7 The Commerce Commission is required each season to review the Milk Price Manual (section 150H) and report on the extent to which the Manual is consistent with the purpose of the milk price regime (section 150I). DIRA sets out the procedure for the Commission's review of the Manual (sections 150K – 150M)

12.8 The Commerce Commission is also required review our calculation of the base milk price (section 150O) and report on the extent to which the assumptions adopted and the inputs and processes we use in calculating the base milk price are consistent with the purpose of the milk price regime (section 150P). DIRA sets out the procedure for the Commerce Commission's review of he base milk price calculation (sections 150S – 150U).

12.9 In relation to Commerce Commission reviews under the milk price regime, DIRA imports relevant provisions of the Commerce Act 1986 including information gathering powers (section 150V).

12.10 We are required to publicly explain any change to the base milk price made after the Commerce Commission publishes its report (section 150R).

12.11 The statutory milk price regime, together wi h Commerce Commission monitoring, provides an effective constraint on our price setting; clearly, this is reinforced with a constant underlying threat of more intrusive regulation if explanations for deviations are not accepted.

Additional constraints on milk price setting

12.12 Our Constitution TAF, and co-operative structure also effectively constrain our ability to deviate from the base milk price. This is discussed in response to Q1, but in summary

- The milk price regime is further reinforced by our Constitution (which implements the statutory regime), and the interests of our stakeholders, including farmer suppliers and our investors – both external investors and fa m rs holding dry shares. Our Constitution requires that we comply with the mi k price principles, including the obligation to pay the maximum milk price that our Co-op, as a properly managed and efficiently run sustainable co-operative, could pay. The Commerce Commission noted in 2016 that our co-operative structure and stakeholder base create balanced incentives with respect to setting our base milk price (at p14 "2016 Review of the State of Competition in the New Zealand Dairy Industry").
- Under the Fonterra Shareholders Market Rules, the Milk Price Manual can only be amended or replaced with the approval of at least 75% of our Co-op's board, including at least a majority of independent directors, and our Constitution requires that the Manual must remain consistent with the DIRA milk price principles.
- The milk price directly affects our share value. The milk price regime (including monitoring by the Commerce Commission) provides assurance to external

investors (and farmers holding 'dry' shares) that we are not strategically inflating the milk price.

Our compliance with the milk price regime

12.13 As noted above, we have only deviated from the base milk price calculation twice – in 2013/14 and in 2017/18, both during difficult financial periods where our Co-op could not afford to pay the price calculated under the Milk Price Manual. (see our 22 August 2018 response to MPI's request for information, at paragraphs 14 – 17 and Appendix 2). In both of those cases, explaining our reasoning to the Commerce Commission, and having the Commission accept that reasoning, was an essential part of the process. In performing its oversight role, the Commission receives regular and extensive disclosure from our Co-op with respect to the milk price.

12.14 We engage actively with the Commerce Commission in setting our milk price, and the Commission tests the assumptions and judgements underpinning our milk price calculation. For example, we are currently engaging with the Commission regarding the asset beta used in our milk price calculation. This is an example of the milk price monitoring regime working in a robust way, with the Commission openly challenging assumptions and judgements made as a part of our milk price calculation.

12.15 There are good reasons for these constraints, and we support the retention of the milk price regime.

13	*If the DIRA is not driving Fonterra's business and investment strategy, what is? Please provide detailed comment in support of your views.*

13.1 While not the only driver, DIRA has and continues to play a significant role in the orientation of our business and investment strategy. The primary influence is open entry, and the limited control we have over our milk supply volumes.

13.2 Note that Frontier (at p33 "Analysis of Industry Performance") attempts to summarise our business growth strategy, describing it as "Volume and Value", but does not accurately reflect the documents it references. Further, in the last 6 months we have announced a number of changes. At our 2018 annual meeting we dropped our volume-based ambition to achieve $35 billion in revenue from 30 billion LME (Liquid Milk Equivalents) by 2025 because it placed too much emphasis on volume. We also outlined a plan to lift our business performance by taking stock of the business and re-evaluating all investments, major assets and partner hips to ensure they meet our needs today, focusing on getting the basics right and ensuring more accurate forecasting.

13.3 Open entry has acted as a constraint on our investment strategy, as well as individual investment decisions. It drives us to invest in sufficient processing capacity to be able to accept all potential new supply, which exceeds the buffer capacity that we would build into our investment plans in the ordinary course of business (NERA at [45]). With New Zealand milk volumes increasing quickly, particularly between the 2008/09 and 2014/15 seasons, we were required to weight investment in whole milk powder and skim milk powder plants to ensure we had the capacity to process significant volumes of milk. Similar strategic constraints could arise again, with increases in supply due to weather conditions, on-farm productivity gains, or one or more competitors exiting the market.

13.4 This creates risks of stranded assets when supply conditions change. It creates inefficiency by distorting the priority we would place on investing in new processing capacity, compared with other investments. It also alters the product mix that our Co-op would otherwise maintain under our commercial strategy.

13.5 The risk of over-capacity goes beyond our Co-op to other industry participants, in part because of the inefficient entry incentives created by DIRA and the Raw Milk Regulations. This leads to industry, and community, problems to the extent that industry over-capacity results in under-utilised plants being kept in service (due to the large sunk investments they entail, and the consequent reluctance to exit), causing a period of stagnation and low returns. Even when this problem ultimately "corrects" by some plants closing, this in itself creates negative consequences for the employees and communities affected. NZIER in its 1 February 2019 report has modelled the potential impact of a decrease in capital investment and productivity as a result of over-capacity, indicating that a 1%, 5% and 10% capital productivity decrease would result in New Zealand's GDP falling by $149 million, $276 million and $441 million relative to business as usual. This excludes the social and human cost such a process would exact on communities

13.6 Our recent investments demonstrate that, when volume pressure eas s, we can and do invest in higher-value production. Our Co-op has commissioned no new dryer plants since 2014, and there has been increased investment in processing capacity for higher-value products like cream cheese and mozzarella.

13.7 As discussed above and in response to Q14 below, DIRA also has significant environmental implications, as open entry creates, among other things, an artificial incentive in favour of dairying over alternative land uses – encouraging new conversions and putting pressure on marginal land. It also raises potential environmental issues associated with surplus factories being built and a "race to the bottom" with respect to environmental standards when processors begin having to pay more for milk to fill their excess processing capacity, potentially paying less attention to environmental standards and farm practices with a view to obtaining or retaining milk supply.

14	*Do you agree with our preliminary analysis of the DIRA's impact on the industry's environmental performance? If not, please provide your reasons and supporting evidence.*

14.1 Although we agree that DIRA is not solely responsible for dairy conversions in environmentally sensitive areas, in our view the Discussion Document under-estimates the significance of the entry incentives created by DIRA.

14.2 As above, DIRA, and open entry in particular, creates an incentive in favour of dairying over alternative land uses, because it establishes a guaranteed buyer for farme s' milk. No other industry in New Zealand provides this type of incentive. It is important to note that this incentive carries with it no potential corresponding benefit for competition; DIRA is intended to safeguard entry and exit for existing farmers, not to encourage more participants to take up dairy farming.

14.3 As MPI notes, under open entry we are not able to decline an application from new or existing farmers on the basis that the applicant has a record of poor on-farm practice and will likely fail to meet our terms of supply. This means we cannot send the clearest possible signal to farmers about our, and the industry's, expectations around on-farm environmental performance. It also leads to reputational risk for our Co-op, as MPI has identified.

14.4 DIRA's impact on the industry's environmental performance should not just be considered at the farm land use level. Even if the environmental impacts from land use decisions were otherwise managed, there are other downstream environmental impacts, such as those associated with our obligation to retain sufficient processing capacity to meet all potential new supply. This is an ongoing issue for our Co-op. [redacted]

15	*Do you agree with our view that environmental issues are best dealt with through the Resource Management Act and not DIRA regime?*

15.1 We agree that the Resource Management Act (RMA) has an important role to p ay in dealing with environmental issues. It is New Zealand's primary mechanism for controlling the environmental impacts of land use.

15.2 But DIRA has a significant role to play as well. The removal of open entry would allow our Co-op to show leadership and to respond quickly as environmental issues arise. This is in contrast to the RMA and planning frameworks, which are generally reactive and slower to respond. Removing open entry would allow our Co-op to help lift standards, for our own suppliers and potentially across the industry.

15.3 We have strong incentives to improve the environmental performance of our Co-op and the dairy sector at large. Environmen al performance is one of the most important reputational issues affecting our Co-op. We expect that, in certain cases, we would seek to impose higher environmental standards than required under the RMA.

15.4 [redacted]

15.5 Our Co-op needs to be responsive to consumers' and farmers' environmental concerns. The views of those groups move more quickly than legislation can, and in some cases impose different and more stringent standards than the RMA (which is focused on environmental effects). Our Co-op wants to be able to respond to those issues.

15.6 Additionally, our Co-op operates nationally while the implementation of the RMA takes place by region and district. This has implications for consistency, and knowledge of issues that span more than one area.

15.7 We are already investing significantly in improving our environmental performance and the environmental performance of our farmers. As noted in our most recent Sustainability Report for the year ending 31 July 2018, our Tiaki programme has already helped our farmers to develop over 1000 Farm Environmental Plans, and we are on track to meet our goal of a further 1,000 by 31 July 2019. These are tailored plans to improve on-farm environmental outcomes, utilising digital mapping tools and a suite of good management practices. On the processing side, our recent water recycling innovation at our Pahiatua manufacturing site will save about half a million litres of water a day. Our factory in Darfield also has new technology in place that will reduce the amount of groundwater drawn by around 70 per cent.

16	*Are there other environmental issues that you consider should be addressed either through the DIRA review or some other means?*

16.1 No, removing open entry is the primary way that review of the DIRA could help to address environmental issues associated with dairying.

17	*Do you agree with our preliminary analysis of the impact the D RA has on new processor entry? If not, please provide your reasons and information/evidence in support of your views.*

17.1 DIRA has supported the development of competition in the New Zealand dairy sector. There are now a number of large well established independent processors (as well as smaller independent processors) in the market. Milk supply growth has tapered off and there is now more than enough processing capacity across New Zealand. To the extent that DIRA continues to incentivise new processor entry, it creates an ever-increasing risk of overcapacity and under-utilisation. As discussed in response to Q8 above, this could have an adverse impact on the dairy sector and the economy at large.

17.2 MPI suggests in the Discussion Document (at p30) that the DIRA entry incentives were never, or are no longer material to (large) processor investment decisions – given the complexity and sca e of investment required for a new processor to enter. Reliance on these entry incentives may well have diminished (and if that is correct, then the value of retaining DIRA entry assistance, including open entry, must be reassessed for that reason). But for the reasons given above, the incentives t creates have material potential downsides that must be taken seriously.

17.3 Regulation, including DIRA entry assistance, imposes costs on regulated entities. Against the costs of regulation, there does not appear to be any good justification for retaining open entry. As discussed above, the role of open entry in ensuring that we price our milk efficiently has been replaced by the milk price regime and TAF, which are more effective than open entry as they rely on statutory obligations and regulatory oversight rather than incentives. In addition, there is now robust competition in the dairy sector with several large and well-established processors exerting significant competitive pressure in almost all regions. The "catch-22" that could have impaired independent processor entry in 2001 is no longer a concern. While DIRA has worked well at facilitating contestability in the dairy sector, it is time to reset our regulatory framework to enable the industry to continue to prosper.

17.4 It is also worth noting that even with the removal of open entry, independent processors would continue to have regulatory support to secure milk supply, through raw milk entitlements (although in our view, this should be limited to smaller processors and those supplying the domestic market), open exit (subject to a market share threshold being met) and other safeguard provisions. We also support retention of the statutory milk price regime.

18	*Do you consider that large dairy processors should continue to be eligible to purchase regulated milk from Fonterra under the Raw Milk Regulations or not? Please provide detailed comment in support of your views.*

18.1 No – there is now a number of established large processors in the market, and the "leg-up" under the Raw Milk Regulations is no longer required for these processors.

18.2 Removing raw milk entitlements for large export-focused processors would ensure regulatory support is targeted to those smaller independent processors who need a leg up and to ensuring competition in domestic consumer markets. It would also enable development of the factory gate market, and longer term sustainability of the dairy sector.

18.3 We note MPI's preliminary analysis (at p31) that large New Zealand-based dairy processors are not necessarily our closest competitors in export markets, and are likely to provide a net gain for New Zealand, although the basis for this analysis is unclear. We query whether New Zealand sees the full benefits of or returns from exports by large foreign-owned independent processors. There are also real and significant risks to the New Zealand industry, such as overcapacity, while the profits are being made offshore by the parent companies.

18.4 We do agree that some large dairy processors have access to different foreign distribution channels that may not otherwise be available to New Zealand dairy products. However, the evidence of any resultant benefit to New Zealand, NZ Inc. or New Zealand farmers from this is lacking. In contrast, as discussed above in response to Q2, it is important to acknowledge the value of our Co-op as a national champion. We are now in over 100 markets around the world and help to facilitate access to new markets for other New Zealand companies and build the NZ Inc. brand.

18.5 Previous DIRA reviews have proposed removing entitlements for large export-focused processors. While large processors would no longer benefit from the DIRA entrance pathways, their established capital and demonstrated ability to attract suppliers will mitigate any risk to competition. Already, some large processors have entered the market without the need for supplies of regulated raw milk as they can source this directly from farmers (MPI Discussion Document: Proposed changes to the Dairy Industry Restructuring Act 2001 and Dairy Industry Restructuring (Raw Milk) Regulations 2012 (May 2016) at 13). Any additional costs to new entrants can be transferred to consumers in export markets and, to a lesser extent, in domestic markets (at 14).

18.6 The Raw Milk Regulations have prevented development of a functioning factory gate market, because DIRA requires us to sell raw milk at the farm gate milk price. However this does not account for costs incurred by our Co-op in terms of farmer support (including environmental and sustainability support) or milk quality programmes. As a result, buying raw milk at the farm gate milk price is effectively lower cost than what it would be for a competitor to operate their own milk supply.

18.7 NERA addresses MPI's assertion regarding the high opportunity cost for independent processors supplying the factory gate market (p79). NERA notes, correctly, that there is no relevant distinction between the business models of independent processors and our Co-op. The difference is that current regulations require us to sell raw milk below our opportunity cost, which means that independent processors who may wish to compete in the factory gate market would be crowded out by regulated milk (NERA, at [77]–[89], the Compass Lexecon Report, p27). Removing the requirement on our Co-op to supply raw milk to large independent processors would remove a key barrier to developing a competitive factory gate market.

18.8 In our view, entitlements to raw milk should be removed for large export-focused processors. We would define a large processor as (i) a processor that sources 30m litres of its own raw milk, or (ii) a processor with the capacity to process more than 30m litres/year, which exports 20% or more of its production volume. The second limb is important as [redacted] does not currently process raw milk or have its own supply. It may choose to never source its own farmers, and could then, under the current regime, take and export raw milk from our Co-op in perpetuity (which it would be processing for export and not the domest c market). In our view, it is not appropriate that this scenario be treated differently from the large export-focused processors that do secure their own m lk supply.

18.9 We also support tightening the forecasting requirements in Raw Milk Regulations. As we noted in our 29 June 2018 submission (at [2.79]), the Raw Milk Regulations allow independent processors to vary the estimates of the quantity of raw milk they intend to purchase by a wide range and up until very close to the time they receive the supply, creating significant cost for our Co-op and unnecessary inefficiencies. This is primarily in the form of opportunity cost to our Co-op in terms of alternative, higher value use of the milk, and inefficiency in the form of not being able to optimise production relative to supply. Independent processors effectively have a free option to vary the milk they take from us at peak such that we bear the risk of forecasting peak supply. These freedoms are not connected to any countervailing need on the part of independent processors These and other minor improvements to the Raw Milk Regulations are set out in our response to Q36 below.

19	*Do you consider that grea er con idence in the base milk price calculation outcomes could be achieved if additional legislative guidance on the term "practically feasible" were to be provided for in the DIRA? Please provide detailed comment in support of your views.*

19.1 In our view, additional legislative guidance on the term "practically feasible" is not required.

19.2 The Commerce Commission recently released a guidance note *Practical feasibility discussion: Our approach to reviewing Fonterra's Milk Price Manual and base milk price alculation* (August 2017). The note summarises the Commerce Commission's approach to interpreting the term "practically feasible" in section 150A of DIRA. The Commission states:

> Our interpretation is that practical feasibility under s 150A goes further than theoretical feasibility and technical feasibility. Subject to the safe harbours in s 150B and the mandatory requirements in s 150C, practical feasibility includes commercial feasibility in the sense that it must be possible for an efficient processor operating in New Zealand to replicate or achieve the component being assessed.
>
> In our view, there is clear evidence that a notional cost, revenue or other assumption is commercially feasible if it can be demonstrated that an existing plant, or processor, can achieve the revenue, cost or other assumption (e.g. the unit costs achieved at one existing plant, or the gross values achieved in a part of Fonterra's current business).

19.3 This guidance note, together with the Commerce Commission's body of previous decisions under the milk price regime, provide sufficient clarity and certainty around how this term will be interpreted. It is unlikely that amending s 150A would provide greater certainty, and it may in fact create uncertainty if it implies a change in how the Commission has interpreted this provision to date.

19.4 We support transparency and efficiency in the milk price regime. As discussed above, in our view the regime is working well. The milk price regime ensures that our farmers, investors and the market as a whole can have confidence in an efficient base milk price calculation.

19.5 We note that there is no evidence that the base milk price calculation is inefficient or that our milk price is not contestable. Independent processors are able to pay the base milk price. To our knowledge, no independent processor has provided the Commerce Commission evidence of its own costs or sales to refute the practical feasibility of the base milk price.

19.6 We actively engage with the Commerce Commission regarding our m lk price calculation. As noted above, we are currently engaging with the Commission regarding the asset beta used in our milk price calculation. This is an example of the milk price monitoring regime working in a robust way, with the Commission openly challenging assumptions and judgements made as a pa t of our milk price calculation.

19.7 As discussed below in response to Q32, a mo e useful way to improve transparency regarding milk price in the sector more generally would be to require other processors to provide information regarding their milk price. This would promote greater confidence in the base m lk price and support informed decision-making by farmers.

20	*Do you consider that the base milk price should be set by an independent body (e.g. the Commerce Commiss on?) If so, please provide supporting information.*

20.1 No, there is no compelling reason why the base milk price should be set by an independent body As discussed above, the current milk price regime is working well and promoting transparency and efficiency in the base milk price calculation (and already involves robust oversight by the Commerce Commission).

20.2 It is not clear wha problem this idea is intended to solve. For example, there is no evidence that entry has been deterred by the milk price. Indeed, entry has occurred with full knowledge of the regime.

20.3 Additional price regulation would impose high costs that are not justified. The Commerce Commission has stated that the milk price monitoring regime promotes greater transparency in our milk price setting processes, and greater confidence in the consistency of our base milk price with contestable market outcomes. (See, e.g. the Commission's "2016 Review of the State of Competition in the New Zealand Dairy Industry", at [2.10], and the Commission's most recent milk price manual and base milk price calculation monitoring reports). It also (correctly) did not consider that we would, without the milk price regime, make significant changes to how the milk price is set (at [5.117]).

20.4 Having the price set by an independent body would be an intrusive regulatory intervention, and we agree with MPI that any additional confidence in the base milk price calculation would be unlikely to outweigh the additional costs and risks. Complying with such a regime is likely to be costly for our Co-op as well as materially more costly and resource intensive for the Commerce Commission (by way of comparison, the levy we currently pay for the Commerce Commission's existing monitoring regime is around $500,000 - $600,000 annually). There is also a risk that it would lead to investment being obstructed, to the long run detriment of farmers and consumers, especially if such investment is necessary to facilitate entry or more competitive conduct in downstream markets. These risks should be given particular consideration given the significance of the base milk price for the New Zealand dairy sector and the economy overall.

20.5 In terms of the perceived benefits, it is not clear to us that a price set by the Commerce Commission would be viewed with more confidence in the market, or become an industry benchmark, as compared with a price set by our Co-op under the milk price regime and scrutinised by the Commission. While the Commission is an expert body, there is still a risk it would not be sufficiently close to the industry to set an appropriate price, or for some other reason its price would be regarded as too high or too low.

21	*Do you agree with our preliminary analysis of the DIRA impact on the domestic consumer dairy markets? Please provide your reasons and information/evidence in support of your views.*

21.1 We agree with MPI that New Zealand consumers are well erved by the domestic consumer dairy markets. Domestic consumer dairy markets re highly competitive and support a variety of competing, sustainable business models and strategies. Consumers have access to a variety of dairy products, from basic to premium products, at different price points. This is consistent with Commerce Commission findings, including in its 2011 consideration of whether to initiate a Part 4 inquiry into milk prices (at pp188, 210), and in the 2016 review (at [4.161]-[4.167]).

21.2 We agree that DIRA has supported the development of competition in domestic consumer markets, by enabling the creation and safeguarding the presence of Goodman Fielder and supporting small dairy processors through access to raw milk.

21.3 We support retention of raw milk entitlements for Goodman Fielder, or an equivalent large scale supplier for the domestic market, to ensure a domestic competitor at scale [redacted] We also support ongoing entitlements for small independent processors, who exert real competitive pressure in the domestic consumer markets.

21.4 However, we do not agree that open entry has been material in enabling competition in domestic consumer markets. Open entry is not the sole, or primary, protection for Goodman Fielder (which relies on raw milk entitlements from our Co-op) or for small, domestically-focused processors (which also tend to access milk under the Raw Milk Regulations, and/or use the 20% rule). Removal of open entry would have no material impact on domestic competition.

22	*Are there any other factors that should be taken into account regarding the domestic consumer dairy markets? Please provide your reasons and information/evidence in support of your views.*

22.1 In 2016, the Commerce Commission found that the competitive dynamics in domestic consumer markets were stable. Despite our Co-op remaining the most significant player, other independent processors were able to and did apply price and quality pressure (at p111). As noted in our previous submission, competition has increased in the downstream domestic market, with the increase of niche players, imports and a new large entrant (Synlait) into the domestic market.

22.2 The Commerce Commission's recent approval of Goodman Fielder's acquisition o Lion's yoghurt business evidences robust and sustainable competition in the domestic consumer market for yoghurt. The Commission approved the acquisition on the basis that:

- Over the past decade the domestic yoghurt industry has been characterised by innovation, particularly in the higher-end (and higher-price) categories as well as Greek yoghurt (at [21]).
- The proposed acquisition would not have, or would not be likely to have, the effect of substantially lessening competition in the market given (at [155]):
  - strong competition from remaining competitors
  - the threat of entry from new suppliers (in re ation to Greek yoghurt), and
  - the role of the supermarkets in ex rcising countervailing power.

22.3 In our view, similar factors exist in relation o other product categories. For example, there is strong competition for butter (with 7 companies actively competing) and flavoured milk (with 9 competitors). New suppliers, including niche suppliers, are also provide competition in other categories, for example cheese. The number of competitors in esh milk has even increased recently, with the entry of Synlait. Importantly supermarkets can and do exercise countervailing power in respect of all consumer product categories.

Chapter 4: Options for change

4.1 Options for the DIRA open entry requirements

23	*Are there any other options for the DIRA open entry requirements that you think should be considered? Please provide sufficient detail when describing any alternative options as well as reasons for considering these.*

23.1 For a summary of our proposals, please refer to the table in Appendix A on p4.

23.2 As discussed below, our preferred option is the full removal of the DIRA open entry requirements (option 4.1.2). This would mean repeal of DIRA sections 73 and 74 as well as section 106 (non-discrimination).

23.3 Repeal of section 73 would include both the obligation to accept supply from new farmers, and the obligation to accept increases in supply from existing farmers. We do not expect this to have a material impact on existing shareholders' ability to increase their supply, in the ordinary course of business. In 2017 and 2018 we received only 5 and 8 such applications, respectively. This is a reflection of the fact that we calculate share requirements based on a rolling three-year average supply.

23.4 As discussed below, in the context of regional expiry, we would also propose a statutory provision requiring our Co-op to continue to accept supply from our existing farmer suppliers in remote locations while open entry remained in place in any region.

23.5 In relation to section 106, the non-discrimination rule is closely linked to open entry and where open entry is no longer considered justified then the non-discrimination rule also does not make sense. Specifically, if open entry were removed, Fonterra could choose to accept or turn down new supply. But in some circumstances, it might be efficient for Fonterra to accept supply, but only if it could do so on altered terms that reflected the value of the additional supply to Fonterra (or required environmental performance and good farming practice requirements). Those altered terms might well be beneficial to farmers, giving them the opportunity to supply Fonterra rather than being turned down. But altering terms based on the value of the supply to Fonterra, where the relevant farmers' circumstances are otherwise the same as farmers who are on standard terms, would contravene the non-discrimination rule.

23.6 If MPI is not prepared to recommend removal of open entry (and non-discrimination), we propose an alternative second preference option that removes open entry (and non-discrimination) in any region where our market share drops below 75%, and nationwide exceptions to open entry:

- for new conversions;
- in respect of applications from new and existing farmers if we consider their supply is unlikely to comply with our terms of supply (option 4.1.3 – discussed further below in response to Q24).

23.7 Although removal of open entry (and non-discrimination) is our priority, we also consider it would be appropriate to remove open exit (the right to withdraw and the 160km rule, sections 97 and 107(1)) in any region where our Co-op's market share falls below 75%.

Regional expiry

Our proposal

23.8 As noted above, our co-operative structure means that competition in one region benefits farmers nationally (because we respond on a national basis to regional competition) (NERA, [61]).

23.9 Nevertheless, while robust competition has developed in some regions, we acknowledge that MPI may wish to recommend open entry remains in those regions where limited competition has developed to date. As such, if MPI is not prepared to recommend the repeal of open entry at this stage, we propose expiry of the obligation to accept supply and the non-discrimination requirement in regions where our market share drops below 75%.

23.10 Although expiry of open entry is our priority, in our view regional expiry would justifiably include open exit (the right to withdraw and the 160km rule) as explained below.

23.11 It is important to note that significant DIRA protections would remain meaning there would be safeguards for competition even in regions where open entry and exit expired. These include the milk price regime, TAF, the Raw Milk Regulations (on the revised basis proposed below), the 20% rule and sale of vats.

Our proposed market share threshold is appropria e

23.12 In our view, market share thresholds are a workable proxy for levels of competition. They were previously used in the legislation as a workable proxy for the competitive landscape. In its Regulatory Impact Statement "Dairy Industry Restructuring (Raw Milk) Regulations – options for amendments to ensure objectives are met" (August 2012), MPI attributed Fonterra's dominance to its high market share. "Workable competition was said to occur when this dominance, i.e. market share, has reduced (p3)

23.13 Our proposal for a market share threshold reflects existing dynamics in regional markets. In our view, we are subject to sustainable and robust competition in all regions where our share is around or lower than 85%. In these regions, independent processors exert substantial competitive pressure and farmers have real choice in terms of who they supply to, meaning we are subject to genuine constraint. Our proposed 75% is lower than this and lower than the 80% which previously applied on an island by island basis. Given this and the smaller regional council regions, MPI would have significant assurance that the protections of open entry are no longer required. See further the discussion in response to Q4 above

23 14 In terms of open exit, MPI emphasises in the Discussion Document the importance of farmers' ability to switch away from our Co-op – we agree, and we have not proposed the immediate, wholesale removal of open exit. Open exit constrains our ability to present a range of offers to existing and potential suppliers and make more efficient planning decisions. While we have some flexibility in our supply contracts to operate and compete within the existing constraints, as competition develops, the costs outweigh the benefits and the open exit protections should expire. It would be appropriate to repeal open entry once sustainable competition develops to a point that MPI could be comfortable we would be constrained by competition not to "lock in" our suppliers anti-competitively. Also, and importantly, section 36 of the Commerce Act has a large and well-established body of precedent to prevent misuses of market power, and can be relied upon as a powerful backstop. As noted in response to Q5, while section 36 is currently

slated for reform, a purpose of that reform is to tighten rather than loosen the rules for entities with substantial market power.

23.15 The proposed regional market share thresholds provide the comfort that competition has developed to a meaningful and sustainable level in a particular region, and the open exit protections should expire in that region.

Regional council boundaries appropriately define a "region"

23.16 We propose using regional council boundaries as the basis for regional expiry of open entry and exit. Regional council boundaries are well known, and align with environmental regulatory boundaries. Under the previous 80% threshold, DIRA required our Co-op and independent processors to provide market share data in order for the Minister to determine whether the threshold had been met in either the North or South Islands (see DIRA, section 147 (now repealed)). A similar information disclosure requirement could be put in place to support regional expiry of open entry and exit. DairyNZ also collects nationwide market share d ta and publishes geographical breakdowns, which could assist.

23.17 Regional council boundaries are also a relatively accurate proxy for competition as shown in the maps attached at the end of this Appendix.

23.18 An alternative would be to use a radius from independent processor sites. While this would potentially more accurately reflect areas where armers have real choice in who they supply, it would be much more dif icult to implement and we do not recommend this.

23.19 Our estimates from DairyNZ data suggest we are below the proposed market share threshold in Greater Auckland ([redacted]%) and Westland ([redacted]%) regions, and are close to the threshold in Canterbury ([redacted]%), Horizons (Manawatu-Whanganui) ([redacted]%) and Southland ([redacted]%). A regional approach would provide assurance that the Co-op is still bound by open entry and exit in areas where competition is not yet as well developed.

Further details

23.20 To protect outlier farmers, we propose a statutory provision which would require our Co-op to continue to collect milk from our outlier farmer suppliers (including in succession situations where the farm changes hands) while open entry remains in other regions. The new rules would apply only if the farmer ceased supplying our Co-op For farms that cross regional council boundaries, the location of the farm dairy shed should determine the applicable regional council.

23.21 As this approach would be more complex than straight removal of open entry, we have thought carefully about the potential for unintended consequences. Removal of open entry (potentially, along with open exit) could impact land values in the region, although in our view this is unlikely to be material – particularly with a protection for outlier farms. It also avoids North Island / South Island issues because the determination would be based on competition within a regional council area. For example, Tasman/Marlborough and Northland would likely remain subject to open entry until the provisions were removed entirely. Regional expiry is unlikely to impact viability of independent processors in regions where it occurs (because those are the regions with robust and sustainable competitors). In fact, independent processors may behave differently – for example, they might enter other regions where the open entry protections remain in place, which would be a positive consequence for competition in the industry.

Open entry for new conversions

23.22 In our view open entry in relation to new conversions should be thought of separately from open entry for existing dairy farms:

- Open entry creates an inefficient incentive to enter dairying (due to the guaranteed customer for milk), which is distortionary and potentially environmentally damaging.
- It has no upside for competition; open entry is about free entry to and exit from our Co-op, not about encouraging more dairying for its own sake. NERA "Assessment of Competition in Raw Milk Markets and Costs and Benefits of the DIRA provisions" 17 August 2015 pp 40 – 43.
- The Commerce Commission noted that open entry for new conversions may impose costs on our Co-op without providing significant competition benefits ("2016 Review of the State of Competition in the New Zealand Dairy Industry, p21).
- The Commerce Commission also considered that open entry for new conversions could contribute to the risk of asset stranding (p160) The government accepted these critiques of open entry for new conversions, and proposed section 29 of the Dairy Industry Restructuring Amendment Bill 2017 (which was withdrawn and superseded by the current review), to give Fonterra discretion whether to accept supply from new con ersions.

23.23 Accordingly, even if MPI does not consider repeal of open entry (entirely or by region), open entry should be repealed in respect of new conversions at a minimum.

24	*What costs and benefits would each of the options for the DIRA open entry requirements create for your business? Please provide quantitative information if possible.*

4.1.1 Status quo: retain the existing open entry and exit requirements

24.1 We do not support this option. We agree with MPI that it would not minimise the unintended consequences of DIRA in preventing our Co-op from effectively managing eputational risk. It is no longer required and creates unnecessary costs for our Co-op and the industry at large that far outweigh any benefits now that sustainable competition exists in the farm gate market.

24.2 The cos s of open entry to our Co-op are material, and outweigh any residual benefi

- We discuss the costs to our Co-op, in terms of our commercial and investment strategy, in response to Q5.
- The potential costs associated with over-capacity in the market and lower returns for farmers are discussed in response to Q8.
- We discuss environmental costs associated with open entry in response to Q14.

24.3 In addition, in our view, open entry unnecessarily perpetuates long-term dependence on regulation, which imposes cost on our industry and the New Zealand economy. Removal of open entry is necessary if we want a sustainable dairy industry for the future. Removing open entry would remove cost by deterring inefficient investment decisions and promoting sustainable competition.

24.4 Our view is that the benefits of open entry have significantly decreased:

- As NERA outlines, the key problems that open entry was designed to solve (ensuring independent processors could attract supply and ensuring efficient pricing) are no longer an issue or are otherwise managed (see in particular sections 2 and 4). There are now 10 dairy companies operating and competing in the New Zealand dairy market. Independent processors are able to attract their own supply, or access supply on the factory gate market on commercial terms. Furthermore, under our proposals smaller domestic processors will retain the "leg up" of the Raw Milk Regulations.
- As described in Q1 above, the milk price regime and TAF ensure an efficient base milk price.

24.5 Without open entry, we would be in a position to make a greater contribution to New Zealand. The ability to manage our volume in response to demand and our commercial strategy will allow us to invest in value added production and achieve higher returns for our stakeholders.

24.6 It is important to note that as competition develops the costs of the protections of open exit will also supersede the benefits. Open exit constrains our Co-op's ability to present a range of offers to existing and potential suppliers and make more efficient planning decisions. And where we face vigorous and sustainable competition that constraint, as well as the Commerce Act, can be relied on to ensure we offer competitive terms to our suppliers (including in relation to rights to exit); the costs of open exit at that point would outweigh the benefits and consideration should be given to its repeal.

4.1.2 Repeal the open entry requirements

24.7 We support repeal of the open entry requirements for the reasons given above. This is our preferred option. As noted above, several other stakeholders also support removal of the open ent y requirements, at least in part, including other dairy processors (Synlait p4 "Initial Comments on the Terms of Reference for the DIRA review" July 2018) and Westland (p26 "Initial Submission on DIRA Review", June 2018) and Environment Canterbury ("Environment Canterbury Interest in the DIRA Review" Ju y 2018) We summarise the costs and benefits of open entry immediately above.

Regional expiry and expiry for new conversions

24.8 Regional expiry of open entry and non-discrimination would not result in the benefits of open entry in other regions outweighing the costs, but it would at least address he costs in certain geographic areas. The same applies for open exit.

24.9 In respect of new conversions, the proposed exception would remove the costs of open entry and non-discrimination for a type of potential supplier in respect of which there is no competition benefit (see the response to Q23 above).

4.1.3 Amend the DIRA open entry requirements to allow Fonterra to decline to accept applications from new and existing farmers if Fonterra considers their supply is unlikely to comply with Fonterra's terms of supply.

24.10 We agree that open entry creates reputational risk for our Co-op. As noted above, our preferred option is to repeal open entry. Our second preference is to remove open entry for new conversions and in regions where our Co-op's market share is below 75%, along with this option 4.1.3.

24.11 Option 4.1.3 alone would not materially reduce the costs of open entry, and for the reasons set out above in our view the benefits are no longer material. While it would be an improvement on the status quo, and would give rise to net benefits, it will increase administrative burden (cost).

24.12 In terms of costs, exceptions that involve material discretion (unlike the simplicity of an exception regarding conversions, or a regional market share threshold) can be difficult and costly to manage and monitor. Exceptions can also be confusing and difficult to implement and lead to disputes – in this case by farmers who may be declined entry under the exception. This in turn would lead to costly review processes and slow, administratively burdensome decision making. These costs would need to be added to those identified above.

24.13 At present, we are able to decline to *collect* milk if a farmer is in breach of our supply terms. As a co-operative, we prefer to work closely with our farmer suppliers to ensure compliance, and non-collection notices are only issued as a last resort. This is because the implications of a non-collect notice are s gnificant for farmers and can have animal welfare implications and environmen al issues (including the potential dumping of milk), and can lead to disputes over whether we have properly exercised our discretion to decline collection. Wh le we back ourselves to make good decisions and exercise our discretion reasonably, there is little downside for a farmer in challenging that decision, and we know from experience that disputes will arise and resolution can be costly and time consuming.

24.14 Removing open entry entirely is the best way to achieve the objectives of this option – without the cost or confusion. If MPI is not prepared to recommend this, then as outlined earlier, we would propose a combination of this option, along with an exception where we consider a farmer w uld be unable to comply with our terms of supply, and where our market share in a region drops below 75% – see further the table in Appendix A on p4

25	*How well do you think each of the options for the DIRA open entry requirements would perform against the principles of good regulatory practice of promoting certainty and predictability of regulatory outcomes, transparency, cost-effectiveness and timeliness of regulatory processes?*

4.1.1 Status quo: retain the existing open entry and exit requirements

25.1 The status quo (option 4.1.1) is no longer required.

25.2 While open entry and exit has provided for certain and predictable outcomes, it is no longer cost effective. It creates unnecessary costs for our Co-op and the industry at large that far outweigh any benefits now that sustainable competition exists in the farm gate market.

4.1.2 Repeal the DIRA open entry requirements

25.3 Repeal of open entry (option 4.1.2) would remove unnecessary regulation, and allow our Co-op to better manage our volumes. It would provide certainty and predictability in regulatory outcomes. It would also improve cost-effectiveness for our Co-op and the industry as a whole.

25.4 If MPI is not prepared to recommend the repeal of open entry, then removal of open entry by region would have a similar impact, albeit incrementally. We consider removal of open entry by region would be capable of being implemented in a way that preserves certainty and predictability of regulatory outcomes, transparency, cost-effectiveness and timeliness of regulatory processes, in particular by using regional council boundaries. Regional council boundaries are well known and established, providing certainty, and avoiding the cost and uncertainty that would arise out of having to establish new boundaries.

25.5 For the reasons given in response to Q24 above we also consider regional council boundaries are a sufficiently accurate proxy for the boundaries of regional competition, data collection on a regional council basis is administratively easy, and regional council boundaries align with environmental regulation. All of these elements contribute to the compliance of this proposal with principles of good regulatory practice.

4.1.3 Amend the DIRA open entry requirements to allow Fonterra to decline to accept applications from new and existing farmers if Fonterra considers their supply is unlikely to comply with Fonterra's terms of supply

25.6 Option 4.1.3 would go a small way to removing unnecessary regulatory constraints on our Co-op. However, it would create an additional administrative cost burden. It would also provide less certainty and predictability than full epeal of open entry, as it would inherently involve the exercise of discretion. Would-be suppliers would not automatically or immediately know whether they would qualify for entry, which means this option would be less attractive in terms of the principles of good regulatory practice than the full removal of open entry, or removal on a regional council basis.

26	*What is your preferred option for the DIRA open entry requirements? Please provide your reasons and information/ev dence in support of your views?*

26.1 See our proposals in the table in Appendix A on p4.

26.2 Our preference is for open entry and non-discrimination to be repealed immediately (option 4.1.2).

26.3 However, if MPI is not willing to recommend this proposal, our second preference is repeal of open entry, and the non-discrimination rule in any region where our Co-op's market share drops below 75%, along with exceptions to open entry and the non-discrimination rule elsewhere:

- for new conve sions; and
- in respect of applications from new and existing farmers if we consider their supply is unlikely to comply with our terms of supply (option 4.1.3).

26 4 If this were not considered acceptable, then we would advocate exceptions to open entry and non-discrimination:

- for new conversions; and
- in respect of applications from new and existing farmers if we consider their supply is unlikely to comply with our terms of supply (option 4.1.3).

26.5 As noted above, our view is that open exit (the right to withdraw and 160km rule)) should not be repealed wholesale, but should expire in any regional council region where our-Co-op's market share falls below (75%).

4.2 Options for access to regulated milk for large dairy processors (except Goodman Fielder)

27	*Are there any other options for access to regulated milk for large dairy processors that you think should be considered? Please provide sufficient detail when describing any alternative options as well as reasons for considering these.*

27.1 No – we agree with MPI's preliminary analysis.

28	*Do you consider that the proposed 30 million litres threshold is too high or too low? If so, what would you consider the right threshold to be, and why?*

28.1 The 30m litre threshold is a workable proxy for large processors; it is a level tha has worked well under the current own-supply limits. The 30m litre threshold sits between what known small processors, and what known large processors, take or have taken under the Raw Milk Regulations as reported annually to MPI.

28.2 However, the threshold (including for Goodman Fielder) should be 30m litres of own supply *or*, where the processor exports 20% or more of its production volume, 30m litres of processing capacity. This is because:

- As noted above, the definition should capture la ge processors who have the capacity to process large volumes for export, and who do export in significant quantities. This is necessary to ensure that the Raw Milk Regulations do not incentivise a deliberate business strategy involving long term regulatory dependence (i.e. avoiding sourcing own supply in order to take advantage of the regulatory protection). It could also help to facilitate development of the factory gate market, by reducing dependence on regulatory support (see NERA, section 5, discussed further below).
- In a situation where a processo holds a large amount of processing capacity, but that capacity is used for domestic supply, then we propose that processor continue to be eligible to receive regulated raw milk. This would allow a domestic processor to enter, at scale, without first establishing its own supply, and is consistent with the Raw Milk Regulations' objective of safeguarding competition in domestic markets.

29	*What costs and benefits would each of the options for access to regulated milk for large dairy processors create for your business? Please provide quantitative information if possible.*

4.2.1 Status quo: retain the existing eligibility provisions for regulated milk in the Raw Milk Regulations

29.1 We agree with MPI that this option would not be effective in meeting the objective of ensuring that access to regulated milk from our Co-op is targeted to dairy processors who need it to be able to enter and compete in New Zealand consumer dairy markets. Current regulations mean that large export-focused processors can obtain DIRA milk for at least three years (and longer if they do not establish 30m litres of own supply). In addition, we discuss the role of export-focused processors in the dairy sector, in response to Q18.

29.2 This is a cost to our Co-op (and to New Zealand farmers) as our Co-op does not make any return on raw milk supplied under the Raw Milk Regulations. Large independent processors are able to access raw milk below its true cost (as they generally benefit from a flatter supply curve and do not incur the additional costs of running a milk sourcing operation) and with flexibility and security around volume. Our Co-op bears the risks of, for example, weather implications and biosecurity threats on production (both increases and decreases) which can be material in terms of our ability to use raw milk for our own purposes or meet other contractual obligations.

29.3 As noted above, eligibility for raw milk under the Raw Milk Regulations also carries a cost in terms of encouraging long-term regulatory dependence. Furthermore, it impacts on capacity requirements, crowding out value added investment, as well as development of the factory gate market. As NERA notes, independent processors could compete with our Co-op in the factory gate market if they were incentivised to do so and were not crowded out by regulated milk (at [82]). NERA goes on to explain (at [86]) that, to the degree the price of regulated milk is less than our opportunity cost, then:

a. our Co-op investors are subsidising independent processor entry which, as well as being allocatively inefficient, could also reduce our ability to invest in profitable opportunities;

b. this could lead to inefficient independent processor entry; and

c. there could be crowding out of development of the factory gate market.

29.4 In our view, there are no material countervailing benefits of large export-focused processors' eligibility under the Raw Milk Regulations. As set out above, competition is well-established and sustainable. Removal of eligibility under the Raw Milk Regulations would not comprom se that. Any new processors looking to enter New Zealand should not be relying on access to regulated milk in order to do so. Those processors ought to be incentivised to be sustainable regardless of access to regulated milk.

4.2.2 Amend the eligibili y provisions in the raw milk regulations to exclude large dairy processors

29.5 We support this option. There are now sufficient numbers of established large processors who are able to access and sustain their own supply that this element of the Raw Milk Regulations does not bring any material benefit. It is open to large processors to contract with our Co-op (or others) on commercial terms for raw milk. The costs and benefits of this option are as outlined in our response to option 4.2 1 above.

30	*How well do you think each of the options for access to regulated milk for large dairy processors would perform against the principles of good regulatory practice of promoting certainty and predictability of regulatory outcomes, transparency, cost-effectiveness and timeliness of regulatory processes?*

30.1 Excluding large processors from eligibility under the Raw Milk Regulations would reduce regulatory dependency and remove a material regulatory cost for our Co-op and for New Zealand. It would also promote certainty and predictability in the regulatory regime, because it would signal a clearly-defined and unambiguous pathway out of the regime for growing processors.

31	*Do you have a preferred option for access to regulated milk for large dairy processors? Please provide your reasons and information/evidence in support of your views.*

31.1 See our proposals in the table in Appendix A on p4. Our preferred option is 4.2.2: amend the eligibility provisions in the Raw Milk Regulations to exclude large dairy processors. As above, our proposed definition of large dairy processor is a processor with 30m litres per year of its own supply, *or*, where the processor exports 20% or more of its production volume, 30m litres per year of processing capacity.

4.3 Options for the base milk price calculation

32	*Are there any other options for the base milk price calculation that you think should be considered? Please provide sufficient detail when descr bing any alternative options as well as reasons for considering these.*

32.1 We support an efficient and transparent milk price, for our Co-op our farmers and the wider industry. But at this stage, we consider that the milk price regime is working well and should be maintained.

32.2 In addition, we propose a requirement on other processors to provide information regarding their milk price, to improve transparency throughout the industry (rather than only by our Co-op). Specifically, we suppor all processors being required to publish the average price they pay to farmers, the key parameters of their milk price and examples showing the payout for different parameters. This would ensure that all farmers are able to make more informed choices about what they are likely to receive for their milk and who to supply. In our experience, some farmers have not received the amount they thought they would receive from some independent processors.

32.3 We have noted above the comparison with the Australian market and the difficulties associated with information asymmetry (in our response to Q2 and in particular paragraph 2.37 and following); in our view, greater transparency would enhance competition in the market.

32.4 The Raw Milk Regulations already require independent processors to provide information regarding milk solids collected (Raw Milk Regulations, regulation 23A ; DIRA, section 115(1)(f)). Previously, independent processors were required to provide market share data under s 147 (now repealed). Section 116 of DIRA also conta ns a general power to make regulations requiring our Co-op to disclose information. To facilitate greater transparency in the sector, DIRA could be amended to include a power to make regulations requiring other milk processors to provide information regarding their milk price. This would be consistent with the purpose of DIRA to promote contestability in New Zealand dairy markets, by reducing the asymmetry of information between farmers and independent processors. Similar regulation making powers are contained in the Gas Act 1992 (section 43G). The Electricity Authority has similar information disclosure powers under the Electricity Industry Act 2010 (section 46).

33	*What costs and benefits would each of the options for the base milk price calculation create for your business? Please provide quantitative information if possible.*

4.3.1 Status quo: retain the existing DIRA provisions for our base milk price calculation and Commerce Commission monitoring

33.1 This is our preferred option. The milk price regime is working well and should be retained in its current form. Given the level of competition in the market and independent processors' demonstrated ability to compete effectively and sustainably, there does not appear to be any basis for a lack of confidence in the current milk price regime.

33.2 The milk price regime is enshrined in DIRA and is a form of statutory price regulation. We describe the statutory regime in detail in response to Q12 above. The milk price regime means that we cannot manipulate the base m lk price for strategic or commercial reasons.

33.3 We also consider that, in the absence of DIRA regulation, we would not make material changes to the way we set our base milk price (and this is consistent with Commerce Commission findings in its "2016 Review of the State of Competition in the New Zealand Dairy Industry" at [X35]). This suggests that the costs of the regulation outweigh any benefits.

33.4 However, the milk price regime supports transparency and efficiency in the farm gate milk market. It ensures that farmers and other processors have access to our pricing information and can make informed decisions. Through the statutory monitoring regime, the Commerce Commi sion has full access to our Co-op's underlying data and pricing information. That data is assessed by experts engaged by both us and the Commission.

33.5 Given other aspects of the regime are consistent with the practice our Co-op would adopt regardless of the regime, the key costs of the regime arise out of the administrative burden of complying with the Commerce Commission's oversight processes. The levy we pay for the Commerce Commission's statutory monitoring is around $500,000 – $600,000 annually. In our view, these costs are outweighed by the benefits in terms of providing additional transparency, and comfort regarding the efficiency of the milk price (as well as an effective regulatory backstop should we attempt to game the regime).

4.3.2 Amend the DIRA to provide additional statutory guidance on the meaning of the term "practically feasible"

33.6 We do not support this option. Implementing this option would result in the increased cost of regulation but no corresponding benefit.

33.7 In our view, there is sufficient certainty in how the Commerce Commission interprets the term "practically feasible". The Commission's August 2017 guidance note, discussed in response to Q19 above, explains in detail the Commission's approach to interpreting this term. It is unlikely that legislation would provide further clarity. It may also have the perverse effect of creating additional uncertainty (cost), to the extent it implies a change in how the Commerce Commission has interpreted the term to date.

33.8 Since this option would not be likely to enhance the clarity of the "practically feasible" it would not result in any material benefit. Further, as noted above, if the option is implemented then the Commerce Commission and our Co-op may be required to make additional effort (i.e. incur cost) to re-settle the interpretation of the term.

4.3.3 Amend the DIRA to give the Commerce Commission statutory power to set the base milk price for the dairy industry

33.9 We do not support this option.

33.10 There is no evidence to suggest that the existing milk price regime is broken. For the reasons given above, the current regime supports transparency and efficiency. Commerce Commission oversight provides an effective check on our compliance with the milk price regime.

33.11 Implementing this option would result in the increased cost of regulation but no corresponding benefit. Accordingly, on a cost-benefit basis it is not justif ed

33.12 The market is becoming more competitive, not less competitive. In this context, a more highly regulated model of price control would be costly, time consuming and inefficient. We note that a more highly regulated model was also rejec ed at the time DIRA was implemented. It would be counter-productive to move to more regulation now, when the aim of DIRA has always been to facilitate a move to a less regulated environment.

34	*How well do you think each of these options for the bas milk price calculation would perform against the principles of good regulatory practice of promoting certainty and predictability of regulatory outcomes, transparency, cost-effectiveness and timeliness of regulatory processes?*

4.3.1 Status quo: retain the existing DIRA provisions for our base milk price calculation and Commerce Commission monitoring

34.1 Given the level of competit on in the market and independent processors' demonstrated ability to compete effectively and sustainably, there does not appear to be any basis for a lack of confidence in the current milk price regime. The milk price regime is working well, and meeting the objective of ensuring the base milk price provides an incentive to our Co-op to operate efficiently and provide for contestability in the farm gate market. The milk price is well understood by the Commerce Commission, Fonterra and stakeholders and its outcomes are predictable.

34.2 As noted above, the regime also promotes transparency. The statutory framework for se ting the base milk price, and in particular the Commerce Commission's monitoring role, ensure transparency in the way we set the base milk price. The Commerce Commission has noted, in its 2016 "Review of the State of Competition in the New Zealand Dairy Industry", the increased transparency their monitoring has delivered (at [4.74]):

> We consider that the increased transparency of information and the additional independent assurance provided by our reviews under the milk price regime may help reduce barriers to entry by IPs, by providing some disincentive for Fonterra to set the farm gate price of milk too high, and providing IPs and other stakeholders with a better understanding of and confidence in how Fonterra sets its milk price.

34.3 The Commerce Commission runs an open and transparent process, although it is not required by the legislation to do so - DIRA only requires the Commission to consult with us. An open and transparent process results in a trade-off for the cost-effectiveness and timeliness of the regulatory processes, but on balance we would expect most stakeholders to agree this is worthwhile due to the importance of allowing submissions and debate in the process. The Commerce Commission is experienced at managing such input.

34.4 As noted above, we propose that independent processors also be required to publish the average price they pay to farmers, the key parameters of their milk price and examples showing the payout that would be received for different parameters, to improve transparency throughout the industry. We believe this would enhance competition in the market via increased transparency and be good for farmers who would be able to make more informed choices about who to supply. This proposal is detailed in response to Q32 above.

34.5 For completeness, we note that two independent processors have raised concerns regarding the process for setting the base milk price. OCD submits that the process for the setting the farm gate milk price is flawed, and the monitoring regime overseeing that process is ineffective. It submits that, as a result, the farm gate milk price does not represent the most accurate approximation of a market-derived price. Synlait submits that the farm gate milk price is too high due in part to the fact that there are shortcomings in the method for calculation, which largely come from lack of transparency and oversight in how we set the milk price. OCD also supports establishing a new Dairy Authority to either approve the Milk Price Manual and other inputs used by our Co-op, or determine the p ice-setting methodology itself.

34.6 We believe these concerns are unfounded. While we agree that an efficient and transparent milk price is important for our Co-op, our farmers and the wider industry, we consider that the current regime is working well and is sufficiently transparent. We note that for the majority of independent processors (that are not co-operatives), any reduction in milk price is a direct benefit to their non-farmer shareholders.

34.7 It is worth nothing that independent processors have made similar arguments during the Commerce Commission's milk price monitoring processes for some time, which, for good and sound reasons, the Commission does not accept. In its Review of Fonterra's 2017/18 Base Milk Price Calculation, the Commission noted (at [B180]):

> We acknowledge the continued investment and growing share of milk production which is now processed by independent processors. We agree that this suggests that th overall milk price is set at a level which provides for contestability.

34.8 As adv sed to MPI, OCD has recently commenced a claim for judicial review of certain decisions made by the Commerce Commission in its review of our milk price calculation for the 2017/2018 season under the DIRA milk price regime. The claims are generally focused on issues on which OCD has submitted in the course of the 2017/2018 milk price review and earlier milk price reviews by the Commission. The Commission is actively defending these claims. We consider that OCD claims have little merit and are joining the proceedings to defend the decisions of the Commission that are being challenged. OCD's ability to do this is another element of the checks and transparency in the regime.

4.3.2 Amend the DIRA to provide additional statutory guidance on the meaning of the term "practically feasible"

34.9 In our view there is already a satisfactory degree of regulatory certainty on this point, and in fact adopting new statutory language would likely lead to increased uncertainty. Furthermore, the current statutory language and its interpretation results in predictable and sound outcomes – as noted above, there is no evidence the milk price regime has led to detrimental processes or outcomes.

34.10 Additional statutory language would also not improve the transparency, cost-effectiveness or timeliness of the regulatory processes that are a part of the milk price regime; and these do not appear to be goals of this option.

4.3.3 Amend the DIRA to give the Commerce Commission statutory power to set the base milk price for the dairy industry

34.11 This option would materially reduce the timeliness and cost-effectiveness of the regulatory process, given the existing process is satisfactory and this option would be much more costly and time consuming.

34.12 The Commerce Commission is an independent body with pricing expertise - but there does not appear to be any suggestion the current regime fails to achieve certainty and predictability in terms of the milk price it produces. It is als not clear that having the Commission set the milk price would improve certainty and predictability.

35	*Do you have a preferred option for the base milk price calculation? Please provide your reasons and information/evidence in support of your views.*

35.1 See our proposals in the table in Appendix A on p4

35.2 Our preferred option is 4.3.1: status quo: etain the existing DIRA provisions for our base milk price calculation and Commerce Commission monitoring. In addition, we support all processors being required to publish the average price they pay to farmers, the key parameters of their milk price and examples showing the payout that would be received for dif erent parameters.

4.4 Options for access to regulated milk for Goodman Fielder and smaller processors

36	*Are there any options for access to regulated milk for Goodman Fielder and smaller processors that you think should be considered? Please provide sufficient detail when describing any alternative options as well as reasons for considering these.*

36.1 See our proposals in the table in Appendix A on p4.

37.1 We a e happy to support ongoing access to regulated milk for Goodman Fielder and smaller processors (as it is important that we protect and retain robust competition in domestic consumer markets). We consider the current limits to be working effectively.

36.2 There are, in our view, some minor improvements that could be made, first, to prevent independent processors from "milk component harvesting" i.e. taking their entitlement to raw milk to obtain certain components and then on-selling the rest (e.g. taking the cream for ice-cream to be exported, and on-selling skim milk, or taking the skim for infant formula and selling the cream). This should also apply to Goodman Fielder. The intent of the Raw Milk Regulations is to support domestic consumer markets, not to enable processors to broker milk components – if they do that, they are profiting from a cost to Fonterra, and this is not what was intended. It should be the case that raw milk supplied under the Raw Milk Regulations must be processed into finished consumer or foodservice products.

36.3 Secondly, we propose improvements to the Raw Milk Regulations in relation to forecasting (currently independent processors forecast on a Thursday for delivery the following Sunday-Saturday) and certain other matters.

36.4 In particular:

- The tolerances in Regulations 10(3), 21(1) and 21(2) in relation to independent processors' estimates of the quantity of raw milk they anticipate purchasing should be reduced, as they have a significant combined effect. We are generally able to cope with these during "shoulder" months but face significant costs and challenges dealing with the potential variability of demand during "peak" months. We agreed with MPI's proposals to address this in the previous DIRA review by limiting the variation of: (a) processors' one week supply estimates to 20% more or less than the earlier three-month estimate; and (b) contracted volume to between 90% and 110% of the one week supply estimates.
- Currently in Regulation 11(2)(a), independent processors must give 18 months' notice of requiring winter milk supply above 20,000 litres per day. A period of 18 months can be insufficient for our Co-op to source new winter milk supply and for successful applicant farmers to alter calving patterns in order to supply milk in June and July (changing calving patterns itself takes at least 18 months), although the amount of any winter milk premium can impact this. We recommend the notice period is extended to 24 months
- Regulation 11(3) provides a large (40%) tolerance for winter milk supply quantity estimates. We need to separately contract winter milk from our suppliers and pay them a winter milk premium. If independent processors do not purchase the winter milk they have forecast to purchase we still have to pay the premium to our suppliers. Although we are able to process the milk we do not recover the winter milk premium. Accordingly, the tolerance for winter milk supply quantity estimates should be reduced to 10%.
- Regulation 21(5) – for the same reasons, we should be able to impose a take or pay obligation in respect of the winter milk premium component of the regulated price While we can process the winter milk not purchased into other products, we would not be able to recover the winter milk premium when an independent process does not take what they forecast to take on short notice.

36.5 We also note that winter months are currently excluded from the months that are subject to maximum monthly volume limits (the "*October rule*") and there does not appear to be any basis for this. While we can obtain a winter milk premium, which reflects the cost to Fonterra of sourcing that milk, the premium does not justify independent processors purchasing unlimited volumes of winter milk under Regulation 6.

36 6 Separately, there is an ambiguity in the drafting of the Raw Milk Regulations. Specifically, it could be argued they allow independent processors to forego their supply of milk under the Raw Milk Regulations for a season, which would allow them to re-start the three-year supply period and circumvent the Raw Milk Regulations. Regulation 6(3) provides for the limit on supply to independent processors whose own supply in the prior three seasons was greater than 30 million litres, "as specified in the returns provided" to Fonterra under regulation 18(2). However, under regulation 18(2) an independent processor is only required to provide us with a return if it requires supply in the current season. If the independent processor wishes to purchase milk in a subsequent season, it will not have submitted a return and yet might have had more than 30m litres of its own supply in the three preceding seasons. However this would no longer be a

concern if the changes to the eligibility criteria set out in response to Q28 and Q31 are implemented.

37	*What costs and benefits would each of the options for access to regulated milk for Goodman Fielder and smaller processors create for your business? Please provide quantitative information if possible.*

4.4.1 Status quo: retain the existing provisions in the raw milk regulations as they apply to Goodman Fielder and smaller processors.

37.2 It is important that we protect and retain robust competition in domestic consumer markets. New Zealanders place value on access to high quality and affordable dairy products. We support a conservative approach to policy change and risk in relation to those markets.

37.3 We acknowledge the importance of Goodman Fielder as a viable large-scale competitor. We have consistently supported retaining Goodman Fielder's regulated supply.

37.4 [redacted]

37.5 MPI notes some uncertainty around the arrangements between our Co-op and Goodman Fielder post-2021, when the current contract expires. Negotiations [redacted]

37.6 [redacted]

37.7 [redacted]

37.8 There is a cost to this regulation [redacted] regulatory protection of Goodman Fielder's supply does provide an important benefit in terms of safeguarding confidence in the competitiveness of domestic dairy supply and on that basis is justified.

4.4.2 Amend the raw milk regulations to update the terms on which Goodman Fielder can access regulated milk from Fonterra.

37.9 Overall, we do not support this option because, in our view, the current regulations are working well in relation to Goodman Fielder's regulated supply. Unnecessary additional regulation would add to the cost burden and in our view would not provide corresponding benefits.

37.10 In particular, we do not consider that the regulations should be updated to:

- allow Goodman Fielder to purchase raw milk at fixed quarterly prices. The intent of the fixed quarterly price is to avoid complexity for small players. Goodman Fielder is large and sophisticated enough to manage the final price; or
- increase the total amount Goodman Fielder could buy. We do not consider Goodman Fielder requires more than its current entitlement to service its domestic market. If it did, there is sufficient competition in the marke for it to obtain that product without regulatory support. If Goodman Fielder requires additional supply, it can seek it on commercial terms from our Co op another processor at the factory gate or by sourcing its own supply. As above, we support Goodman Fielder's presence as a large-scale domestic competitor, but we do not consider regulatory dependence should be encouraged beyond what is required to guarantee that position.

37.11 However, we do support MPI's proposed option to amend the regulated price to include a margin to contribute to the additional costs of flat supply and running a milk sourcing operation. We recommend a margin f $0.12 per kgMS. We also recommend that it applies to all independent processors entitled to raw milk supply (not just Goodman Fielder) as they all take a flat supply and benefit from our additional costs of running a milk sourc ng operation. From our perspective $0.12 per kgMS is conservative: we estimate the cost of flat supply is more than $0.10 per kgMS, with the remainder being a small contribution towards the costs of running a milk sourcing operation.

37.12 It is worth bearing in mind the goal of these provisions, which is to safeguard domestic competition They are not designed to support Goodman Fielder's international exports and there would be no benefit in doing so that would outweigh the cost of the regulatory burden.

4.4.3 Amend the raw milk regulations to gradually reduce Goodman Fielder's eligibility o access regulated milk over time.

37.13 As noted above, Goodman Fielder can obtain competitive terms and/or choose to educe i s reliance on our Co-op and on that basis the cost inherent in the regula ions could be said to be unnecessary. However, we acknowledge that the existence of the regulations underpins public confidence in the security of Goodman Fielder's position as a viable and large-scale domestic competitor. In our view, there would not be a net benefit in reducing Goodman Fielder's entitlement to regulated raw milk at this stage.

4.4.4 Amend the raw milk regulations to remove limits on the amount of regulated milk available to dairy processors supplying New Zealand consumer markets.

37.14 As noted above (at [6.3]), and as NERA discusses in section 5 of its report, there are costs to our Co-op in complying with the existing requirements. Nevertheless, we have always supported, and continue to support, measures to safeguard domestic competition. This includes the supply of raw milk to smaller processors supplying the domestic market that might not otherwise be able to do so.

37.15 While this option would increase the cost burden on our Co-op, we have no objection in principle to removing the individual limits, but further careful consideration would be needed, including safeguards to ensure:

- an overall cap of 650m litres – we estimate the total New Zealand domestic market to be around 650m litres (including Goodman Fielder's and our own domestic division sales), so this total cap combined with the 20% rule and supply from other independent processors should be sufficient to meet domestic demand;
- a margin of $0.12 per kgMS to reflect the costs of the flat supply curve and the additional costs of running a milk sourcing operation that benefits all independent processors.
- regulated raw milk is used primarily for supplying the domestic market, rather than for exports.

37.16 These measures would mitigate the increased costs. The knowledge that regulated raw milk is available in volumes sufficient to satisfy domestic demand would also allow Goodman Fielder and other processors to bid for contracts without concerns about adequacy of supply.

37.17 Lifting the individual limit (but retaining the overall cap) would make it easier for a new large processor supplying the domestic market to ente and remove the protection Goodman Fielder currently has over other independent processors seeking to enter the domestic market. (To date Synlait is the only independent processor that has managed to enter the New Zealand liquid milk market without DIRA supply.)

37.18 However, given the costs of this option, it is not in our view a priority. In any event, there are no limits on independent processors negotiating additional supply on commercial terms. We do p ovide additional volumes at a negotiated price to processors and there is no evidence the price of those volumes is hindering competition.

37.19 Finally, while we support safeguards on domestic competition, it is important to balance this against the risk of increasing the potential for long-term regulatory dependence, which can in itself result in material costs in terms of both the regulatory burden and inefficiencies in the market.

4.4.5 Amend the raw milk regulations so that the terms on which dairy processors supplying New Zealand consumer markets can access regulated milk mirror the terms on which Fonterra supplies its own New Zealand consumer business.

37 20 There does not appear to be any compelling reason that would warrant further regulatory intervention of this nature. The Raw Milk Regulations, and domestic consumer markets, are operating well. The Commerce Act also provides additional and effective protection (as noted above). Goodman Fielder and our own domestic division, the two largest processors supplying the domestic market, actively compete in the domestic consumer markets. Small independent players also compete effectively and apply real competitive pressure to larger processors. Domestic consumer markets are functioning well, and we do not believe that our domestic division has a competitive advantage that would justify a higher level of regulatory intervention. Given the lack of clear benefit, and that a higher level of regulatory intervention is likely to result in high costs, this option would be difficult to justify.

37.21 Regulatory intervention of this nature would impose in our view a disproportionate and costly administrative burden on our Co-op.

38	*How well do you think each of these options for access to raw milk for Goodman Fielder and smaller processors would perform against the principles of good regulatory practice of promoting certainty and predictability of regulatory outcomes, transparency, cost-effectiveness and timeliness of regulatory processes?*

38.1 Access to raw milk for processors supplying the domestic consumer market is important to maintaining confidence in the competitiveness of domestic consumer markets. In relation to Goodman Fielder specifically, the ongoing entitlement promotes certainty and predictability in the viability of a competitor at scale.

38.2 It is important to note that the status quo with the amendments we summarise in the table in Appendix A on p4 provides these benefits in a manner that does not conflict with the principles of good regulatory practice. In our view, inc easing the level of regulatory intervention would not enhance the regime s performance against those principles.

39	*Do you have a preferred option, or a combination of options, for access to regulated milk for Goodman Fielder and smaller processo s? Please provide your reasons and information/evidence in support of your views.*

39.1 See our proposals in the table in Appendix A on p4.

39.2 We consider the domestic market is generally working well, and no material problems have been identified with the current regime. As such, we favour option 4.4.1 – status quo – for Goodman Fi lder and smaller processors, except for the addition of a fee of around $0 12 per kgMS to contribute to the costs of flat supply and the costs of running a milk sourcing operation. Even with monthly volume limits, independent processors are still taking a flat profile – which they can do because the quantities they take are generally well below the volume limits.

39.3 We also consider raw milk supplied under the Raw Milk Regulations should have to be processed into finished consumer or foodservice products (to limit the Raw Milk Regulations o safeguarding domestic competition as intended).

39.4 We also p opose some amendments to the detail of the Raw Milk Regulations, as set out n our response to Q36.

39.5 Finally, it is not our preference, but we would not object in principle to the removal of limits on regulated raw milk supply to small independent processors. This would need careful consideration and safeguards as discussed above in response to Q37.

4.5 Options for the DIRA review and expiry provisions

40	*How best do you consider "market dominance" could be measured? For example, are there certain criteria (other than a market share threshold) that could be provided for in legislation as a trigger for review and/or expiry of the DIRA?*

40.1 In our view, and as noted above in our response to Q23, market share thresholds are a workable proxy for levels of competition. We consider a market share threshold would be suitable for triggering automatic expiry of open entry (and potentially exit) by region, as discussed above.

40.2 Another option would be some form of qualitative competition assessment, which could be used as a trigger for review provisions. A qualitative competition assessment could take account of complex factors but would be harder to administer than a market share threshold.

40.3 Other than for regional expiry of open entry and potentially exit, as outlined above in response to Q23, our view is that the legislative trigger should result in a review rather than the automatic expiry of DIRA; given that, we consider a simple time period to be appropriate. That is, the trigger itself does not need to do any "work" in terms of equating to a measure of market power; it needs only to provide an appropriate amount of time for market conditions to potentially alter.

41	*Are there any other options for the DIRA review and expiry provisions that you think should be considered? Please provide sufficient detail when describing any alternative options as well as reasons for considering these.*

41.1 See our proposals in the table in Appendix A on p4. If open entry and non-discrimination are not removed entirely, then we would support egional expiry of those provisions (and potentially open exit, being the right to withdraw and the 160km rule) subject to a market share trigger. Our reasons are given in response to Q23 above.

41.2 Regional expiry can in our view be justified given the significant presence of competitors in some regions, where our market share is relatively low. Although as set out above we would argue competitive regions "protect" regions where we have a higher market share, if MPI remains concerned about the regions where we have a high market share, then we would support expiry by region.

42	*What costs and benefits would each of the options for the DIRA review and expiry provisions create for your business?*

4.5.1 Status quo: no statutory provision for review and/or expiry of the DIRA regulatory regime in legislation

42.1 We do not suppo t this option. It is a priority to ensure a pathway to deregulation, particularly given the challenges facing the dairy industry including flattening milk supply, the increasing impact of climate change and other pressures.

42.2 Retain ng the status quo would result in unnecessary costs. As noted above in our view the costs of certain aspects of DIRA already materially outweigh the benefits, and this will only become more pronounced as competition develops in a low or flat milk growth environment.

42.3 Furthermore, this option goes against DIRA's original incentive structure and long-term policy signals, including providing long-term regulatory certainty around the pathway to deregulation, to support industry strategy and investment decisions. DIRA was always intended to set the dairy industry up to be deregulated. Failing to provide a pathway to deregulation increases the costs of the regime by encouraging inefficient investment decisions that are based on a reliance on the regime rather than a truly viable business case. There is no benefit to providing for continued regulatory protection regardless of the need for it.

4.5.2 Amend the DIRA to require periodic reviews of competition in the dairy industry to determine whether the DIRA regulatory regime should be retained, repealed or amended.

42.4 A periodic review mechanism has the benefit of simplicity. The disadvantage, however, is that – depending on the review trigger – it may not be possible to respond in a timely way to changes in market conditions, for example, material changes in our Co-op's market share. As such, it may result in costs arising out of regulation remaining in place longer than is justified. Automatic expiry of provisions would be less costly (avoiding a review) but the trigger point must be carefully judged.

42.5 We have proposed a hierarchy of preferences regarding the removal of open entry (and potentially open exit) as set out in the table in Appendix A on p4. We propose that the remaining DIRA regulation, including the milk price regime, TAF, the Raw Milk Regulations, the 20% rule and the sale of vats, remains in place subject to a periodic review commencing three years after any change is effective. In our view, a 5 yearly review period would be too long (if we assume hat implementation of each review could take between 12 and 24 months). Specifically, it would fail to keep pace with the industry's development, and consequently risk regulation remaining in place longer than is justified.

42.6 In our view, our proposals would provide an appropriate balance of costs and benefits: at a high level, simple triggers, but no wholesale expiry of DIRA without a review. The proposed automatic expiry by region hould not be considered risky and potentially costly given the level of competition that would be indicated by the market share threshold being reached (our reasoning is set out above in our response to Q23).

4.5.3 Amend the DIRA to requi e a review of competition in the dairy industry to determine whether the DIRA regulatory regime should be retained, repealed or amended, to be undertaken when a set market share threshold has been reached?

42.7 As noted above, market shares are a simple and useful initial proxy for market power – this approach would allow real market conditions to be taken into account in triggering a review of DIRA. However, we consider our proposed combination of regular reviews and regional expiry of certain provisions based on market share expiry triggers to strike a more appropriate balance of costs and benefits.

4.5.4 Amend the DIRA to provide for its automatic expiry from a nominated date or when a set market share threshold has been reached

42.8 We accept it would be difficult to identify an appropriate date trigger for expiry, unless it is in the near term (e.g. three years). In our view, wholesale automatic expiry without any review would be concerning to a number of stakeholders. Additionally, it could risk incurring costs associated with removing the DIRA regulation, or certain of its elements, too soon.

43	*How well do you think each of the options for the DIRA review and expiry provisions would perform against the principles of good regulatory practice of promoting certainty and predictability of regulatory outcomes, transparency, cost-effectiveness and timeliness of regulatory processes?*

43.1 In our view, the status quo – which is the latest shifting of the goalposts for deregulation – is generating uncertainty and is likely to result in unnecessary cost.

Over the past 17 years, the DIRA sunset provisions have been subject to a number of alterations, generating uncertainty for farmers and processors. A clear pathway to deregulation is in the long-term interests of the New Zealand dairy sector – for certainty and to avoid unnecessary (and potentially costly) dependence on regulation. The status quo is also likely to undermine cost-effectiveness because regulation would remain in place after costs outweigh benefits.

44	*Do you have a preferred option, or a combination of options, for the DIRA review and expiry provisions? Please provide your reasons and information/evidence in support of your views.*

44.1 Our preferred option is a periodic review (to the extent provisions are not repealed earlier in accordance with our proposals – see the table in Appendix A on p4) every three years after legislative change is effective.

Map 1: Regional Council boundaries with our estimate of competitor collection zones

[redacted]

Map 2: Regional Council boundaries and competitor collection zones overlaid with our Co-op supplier farms

[redacted]

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Public

DIRA review: response to issues raised in the MPI discussion document

Fonterra

8 February 2019

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Contents

1. Introduction and summary

1. On 2 November 2018 the Ministry for Primary Industries ("MPI") released a discussion document ("the MPI Discussion Document") as part of its review of the Dairy Industry Restructuring Act 2001 ("the DIRA"). We have been asked by Fonterra to review the analytical bases for various issues/options raised by MPI. Specifically, we have been asked to assess:

   a. The discussion of the costs and benefits of the "open entry" obligation;

   b. Arguments for tightening up the milk price manual ("MPM") regime; and

   c. The costs and benefits of the obligation to provide regulated milk to independent processors ("IPs").

2. Our conclusions on these three issues are:

   a. The costs of open entry now likely exceed the benefits. In other words, there would likely be a net benefit in repealing the open entry requirement;

   b. There is no need to tighten up the MPM regime; and

   c. There would be net benefits in removing the requirement to provide raw milk to exporting IPs.

3. The remainder of our report is structured as follows:

   a. Section 2 describes how the two key problems open entry was designed to solve (the "catch-22" for IPs attracting farmers and efficient prices) are no longer an issue or are otherwise managed. Accordingly, the benefits of open entry are low;

   b. Section 3 briefly sets out the costs imposed on Fonterra resulting from an inability to control the volume of milk or the identity of farmers who supply it. This includes a discussion of why the milk price does not allow Fonterra to manage milk volumes;

   c. Section 4 discusses Fonterra's proposal for a regional partial deregulation trigger;

   d. Section 5 assesses Fonterra's incentives to set an efficient milk price; and

   e. Section 6 considers the factory gate market and regulated milk sales.

2. Open entry has served its purpose

4. In this section of the report we explain that the benefits of the DIRA open entry provisions are low because:

   a. The entry assistance provided by open entry is no longer required (the catch-22 of new IPs attracting farmers is no longer a problem);

   b. Even in areas where only limited entry has occurred, farmers are protected by the co-operative nature of Fonterra; and

   c. The efficiency of the farm gate milk price is now dealt with by other mechanisms.

2.1. There is no longer a catch-22

5. Part 2, subpart 5 of the DIRA was put in place to provide the regulatory framework for the "efficient operation of dairy markets in New Zealand" (section 70). The key provisions are open entry and exit, the 20% rule, non-discrimination, the 160 km rule, the milk vat sale rule and the requirement to sell milk to IPs and Goodman Fielder.

6. When these provisions are viewed collectively, it is clear that a purpose of DIRA is to enable efficient entry and expansion by IPs.[1] This purpose was justified because dairy processing assets are to a considerable degree sunk – therefore investors will be reticent to invest without a certain raw milk supply. However, farmers also have sunk assets and a non-storable output, and they will be reticent to contract with an IP before that IP's plant is built and a track record established. In our 2010 report for the Ministry and Agriculture and Forestry ("MAF"), we referred to this as the "catch-22 situation".[2]

7. However, IPs have developed to the point that there is unlikely to be a material catch-22 problem today. Furthermore, there are now eight processors buying milk directly from farmers, compared to the four processors that existed prior to the formation of Fonterra. The four processors were the New Zealand Dairy Group and Kiwi Co-operative which merged to create Fonterra, as well as Tatua and Westland, which remained independent.[3]

8. Over recent years IPs have continued to invest in capacity, and new IPs have entered the market, as shown in Figure 1

[1] See our 17 August 2015 report for Fonterra, filed with the Commerce Commission.

[2] NERA, *An Assessment of the DIRA Triggers*, report for the Ministry of Agriculture and Forestry, March 2010, page 3

[3] See https://teara.govt.nz/en/dairying-and-dairy-products/page-3. In 2018, TDB Advisory reports that there are seven processers including Fonterra, plus Mataura Valley Milk which started processing in late 2018, making eight processors total. See TDB Advisory, *New Zealand Dairy Companies Review* (Apr 2018), p.6.

Figure 1
Historic and forecast capacity of IPs

[redacted]

Source: Fonterra

9. This investment suggests a high degree of confidence, and it is interesting to consider what role DIRA plays in this. Presumably continued investment by an IP does not depend on continued access to DIRA (regulated) raw milk, because Fonterra is not obliged to supply raw milk to an IP that has collected 30 million litres or more of its own supply for three consecutive seasons.[4] Given that the maximum volume Fonterra is obliged to supply to an IP (other than Goodman Fielder) is 50 million litres,[5] the collection data in Table 1 below implies that all identified IPs must currently collect more than 30 million litres per annum from their own supply.

10. We note also the MPI Discussion Document's finding that IP investment is unlikely to be based on just open entry and exit (page 30).

11. A key aspect of the "catch-22" problem we outlined in our 2010 report was that if farmers were unsure of the track record/reputation of IPs, they would be hesitant to commit their milk supply given it is a perishable good. Relevant to this issue is longevity and ownership of the IPs. Table 2 below sets out the entry date and ownership of each of the main IPs.

---

[4] Clause 6(3) of the Dairy Industry Restructuring (Raw Milk) Regulations 2012 states: "Despite subclauses (1) and (2), new co-op is not required to supply raw milk to an independent processor (other than Goodman Fielder New Zealand Limited) in a season beginning on and after 1 June 2016 if the independent processor's own supply of raw milk in each of the 3 consecutive previous seasons was 30 million litres or more as specified in returns provided to new co-op under regulation 18(2)".

[5] Clause 6(1)(c) of the Dairy Industry Restructuring (Raw Milk) Regulations 2012.

Table 1
IP milk collection 2017/18 season

[redacted]

Table 2
IP Establishment and Current Ownership

IP	Ownership	Entry date
Westland	Farmer owned co-operative	1937
Tatua	Farmer owned co-operative	1914
Synlait	Bright Dairy (39%); A2 Milk (17%)[6]	2008
Open Country Dairy	Talley's Group (77%); Olam (15%); Dairy Investment Fund (7%)[7]	2004
NZDL	Ceased trading in 2012	2007-2012
Yashili	Yashili Internation l Group (51%), Danone (49%)[8]	2015
Miraka	Wairarapa Moana Inc (34%); Tuaropaki Kaitkati (34%); Vinamilk (23%)[9]	2011
Oceania	Yili 100%)[10]	2014
Danone	Danone (100%)[11]	2012
Mataura Valley Milk	China Animal Husbandry Group (78.55%), McNab ventures (5.08%), Bodco (3.6%)[12]	2018

Source: Fonterra and public sources (see also footnotes below). Only entities with > 3% shareholdings are shown.

The remaining 56% are shareholders with < 3% shareholding. See https://app.companiesoffice.govt nz/companies/app/ui/pages/companies/1600872/shareholdings accessed 08/01/19

[7] See https://app.companiesoffice.govt nz/companies/app/ui/pages/companies/1911063/shareholdings

[8] Danone has recently purchased 49% of Yashili NZ previously held by Yashili International Group. See https://finance.yahoo.com/news/danone-acquires-49-shares-yashili-082600342 html

[9] Vinamilk (Vietna: https://www.vinamilk.com.vn/) owns roughly 23% of Miraka. See https://app.companiesoffice.govt nz/companies/app/ui/pages/companies/6145247/shareholdings, accessed 08/01/19.

[10] Oceania is owned by two companies that are both owned by Inner Mongolia Yili Industrial Group (Yili). See https://app.companiesoffice.govt nz/companies/app/ui/pages/companies/2199178/shareholdings, accessed 08/01/19

[11] http://www nzherald.co nz/business/news/article.cfm?c_id=3&objectid=11247038

[12] https://app.companiesoffice.govt nz/companies/app/ui/pages/companies/2094638

12. Synlait and OCD are (very) well established now, along with Tatua and Westland. Furthermore, there appears to be an emerging trend of global food and dairy companies vertically integrating upstream into New Zealand by taking material ownership stakes in the IPs. For example, Oceania, Yashili and Danone are all 100% owned by foreign food/dairy companies. Some of these companies (or related companies) were previously customers (or potential customers) of Fonterra/the IPs. Foreign food/dairy companies have also taken significant, but minority shares, in IPs such as Synlait, Miraka and OCD. Similarly, Mataura Valley Milk, the newest dairy company in New Zealand, has majority foreign company ownership, and minority farmer ownership.

13. Because this is upstream vertical integration, these investors will be less concerned about finding output markets for their processing investments. This in turn will provide some comfort to farmers about the sustainability of these processors. Farmers will also be aware that these global food companies may have strategic reasons to vertically integrate into New Zealand, such as diversity/security of supply and branding.

14. In any event, IPs do not appear to have had problems attracting farmers from Fonterra. Figure 2 below shows the number of competitive ceases from Fonterra over time.

Figure 2
Number of Fonterra competitive ceases per season by Island

[redacted]

Source: Fonterra
Note: A competitive cease is when a farm leaves Fonterra to go to an IP

2.2. All dairy farmers benefit from competitive tension

15. The Frontier reports prepared for MPI and the MPI Discussion Document refer to farm gate market shares at the national level.[13] Figure 23 of Frontier's first report states that Fonterra had an 82% market share at the national level in 2017, and the MPI Discussion Document reports that this decreased to 80.5% in 2018.[14] Fonterra estimates its current national market share is at 81-82%. Fonterra's national market share has continued to fall since the Commerce Commission's report, which noted Fonterra had a national market share of 85% for 2014/15 season.[15]

16. However, national market shares understate the competitive impact of IPs. This is because the cooperative form of Fonterra means that even farmers in areas without an IP benefit from competitive tension in areas with IPs. It is difficult for Fonterra to discriminate (e.g , on milk price or transport costs) between supplying shareholders. Discrimination could affect wealth (land values) of different suppliers, and generally raise tensions (for example, if differential transport costs were applied, there could be lobbying by shareholder suppliers as to the location of new processing plants). Fonterra could face significant backlash from hareholders if it attempted to implement any discriminatory policy (even if the policy did not contravene the non-discrimination provision of DIRA[16]).

17. Figure 3 shows the overlap of Fonterra farms and IP collection zones and Figure 4 shows the market shares within these IP collection zones - often in the IP ollection zones the IP is competing with both Fonterra and at least one other IP These figures show that most farmers have at least one alternative option for milk processing, and that in most of the IP catchment areas, the Fonterra market share is approximately at or below the national average. Approximately [redacted] of Fonterra's milk collection is outside of IP collection zones.[17]

[13] Fr ntier Report One: Frontier, *2018 DIRA Review: Analysis of industry performance: A Report Prepared For The Ministry For Primary Industries*, August 2018
Frontier Report Two: Frontier, *2018 DIRA Review: Drivers of industry performance A Report Prepared For The Ministry For Primary Industries,* August 2018

[14] Original source for Figure 23 in Frontier's first report is: TDB Advisory, *New Zealand Dairy Companies Review* (Apr 2018), p.6, https://www.tdb.co nz/wp-content/uploads/2018/05/TDB-Dairy-Companies-Review-2018-1.pdf

[15] Commerce Commission, *Review of the state of competition in the New Zealand Dairy Industry: Final Report,* 1 March 2016, par. X23.

[16] Section 106.

[17] Due to overlapping competitor catchments, this may overstate total milk supply

Figure 3
Geographic overlap of IP collection zones with Fonterra farms

[redacted]

Source: Fonterra.
Note: Collection areas are Fonterra estimates of an IP collection zone. Westland West Coast collection area is west of the Southern Alps only.

Figure 4
Fonterra market share IP collection zones

[redacted]

Source: Fonterr estimates

18. Under principle 5 of Fonterra's Co-operative Principles, the financial benefits and obligations that arise from "cornerstone activities" are alloca ed to supplying shareholders in proportion to milk supply.[18] Fonterra's equitable, uniform price treatment of shareholder suppliers is consistent with accepted definitions of a "cooperative" in agricultural settings.[19,20]

19. Furthermore, Fonterra's cooperative structure also prevents monopsony pricing, something that likely protects farmer suppliers to IPs as well, because Fonterra's milk price is treated by the broader market as a benchmark.[21] This protection exists regardless of open entry. We discuss the independence of an efficient milk price from the open entry requirement in section 4 of this report, but also note here the protection provided to farmers by the cooperative Fonterra model. Analogously, completely consumer-owned electricity distribution businesses ("EDBs") are exempt from the default price-quality path other EDBs are subject to due to their consumer

[8] Fonterr Co-operative Philosophy, Co-operative Principle 5.

[19] For example, the US Department of Agriculture (USDA) have defined cooperative in general terms to be a business owned and democratically controlled by the people who use its services and whose benefits are derived and distributed equitably on the basis of use. See http://www rd.usda.gov/files/cir55.pdf.

[20] We note in passing that it is virtually inconceivable that Fonterra would change from its cooperative status. According to Fonterra's constitution, any change in shareholder rights requires a special resolution, i.e., a 75% majority vote. (See: https://www.fonterra.com/content/dam/fonterra-public-website/phase-2/new-zealand/pdfs-docs-infographics/pdfs-and-documents/fonterra-our-constitution-2016.pdf par 24.1)
Additionally, Fonterra farmers have consistently voted to keep Fonterra completely under farmer control. (See https://www nzherald.co.nz/business/news/article.cfm?c id=3&objectid=10595315)

[21] As the MPI Discussion Document notes (page 24), "Given Fonterra's dominance, Fonterra's milk price tends to be the default price in the market for farmers' milk in New Zealand."

ownership, as stated in the Explanatory Note to the Bill introducing the new price control regime for EDBs:[22]

> *100% consumer-owned ELBs will be subject only to information disclosure and to monitoring by the Commission. The reason for this relatively light-handed regime is because consumers, as owners, are able to ensure that the business acts in their interests".*

20. As a final comment, even in the absence of the open entry requirement it seems unlikely that Fonterra would not accept farmers that wished to switch from an IP. IPs have invested in the primary dairy areas of New Zealand, and so their farmers are likely to also be proximate to Fonterra plants.

2.3. Efficient milk and share prices

21. The other original rationale for open entry (and exit) was to provide incentives on Fonterra to set efficient milk and share prices.[23] However, as we explain in more detail in section 5 below, there are now other mechanisms ensuring efficiency of these prices – the milk price manual ("MPM") and the "Trading Among Farmers" ("TAF") scheme.

22. Therefore, this original role of open entry is no longer necessary or relevant.

2.4. Conclusion

23. In summary:

    a. There has been a material level of IP entry, and these IPs generally appear to be well-established, reputable and investing;

    b. All farmers benefit from the resulting competitive tension, regardless of who they supply and where they are based geographically; and

    c. The MPM and TAF ensure efficiency of F nterra's milk and share prices, as we describe in more detail in section 5 of our report.

24. Accordingly, any entry assistance (social) benefit from keeping open entry is likely to be small, and there is no pricing ben fit. As we discuss in the next section of our report, the open entry provisions impose social costs

[22] Explanatory note to the Commerce Amendment Bill (201-1), Government Bill, as introduced to the House of Representatives, Wellington, 13 February 2008, p. 8.

[23] See Evans, Lewis and Neil Quigley (2001) "Watershed for New Zealand Dairy Industry", *ISCR Monographic Series*, No. 1.

3. The costs of open entry

25. This section sets out the costs of open entry on Fonterra resulting from an inability to control the volume of milk or the identity of supplying farmers. It will:

   a. Set out that Fonterra will find it difficult to control volume via the milk price;

   b. Set out the consequences (costs) for Fonterra of an inability to control volumes;

   c. Briefly discuss the environmental/reputational impacts of open entry; and

   d. Point out that open entry could provide an inefficient (over-)investment effect at the margin

3.1. Fonterra's ability to control milk volumes is limited

26. Fonterra believes that an effect of open entry is an inability to control the amount of milk Fonterra receives from farmers, which in turn forces Fonterra to invest in capacity it might not need.

27. We agree. The purpose of this subsection of our report is to set out why we do not agree with the MPI Discussion Document finding that "Fonterra can and does influence its milk supply volumes through the various price signals it sends to farmers" (page 27), and (also page 27):

   > *… our preliminary analysis indicates that DIRA does not appear to create unintended consequences in terms of driving Fonterra's overall business and investment strategy and, therefore, does not prevent Fonterra from being able to manage its milk supply volumes in a way that aligns with its chosen strategic direction.*

3.1.1. The milk price manual constrains Fonterra's ability to control volume via the milk price

28. The key part of MPI's reasoning is its view that Fonterra is free to set the price it pays for milk (page 28):

   > *It would therefore appear that the DIRA does not prevent Fonterra from adjusting its milk price to manage the volumes of milk it receives from farmers …*

29. In our view, MPI materially overestimates Fonterra's ability to use price to manage its volumes. To see why, note that there are two sources of supply for Fonterra to manage – supply from existing farmer suppliers, and supply from (potentially) entering farmer suppliers (whether switching from IPs or converting).

30. If Fonterra only needed to manage supply from existing suppliers, then it might be able to use the milk price to influence volumes. For example, Fonterra could explain to its farmers that paying a price lower than that calculated under the MPM is in their long-term interests because it would allow the cooperative to invest in value-added capacity, which would ultimately lead to higher dividends. This may not be an easy sell to farmers, but that is not really a DIRA issue.[24]

31. The DIRA issue comes in because Fonterra would have to use that same price tool to also manage supply from (potentially) entering farmers, given the open entry requirement. Because Fonterra cannot (in general) price discriminate,[25] if Fonterra wanted to lower its price to discourage entry by new farmers then it would need to lower its price to all farmers (whether existing suppliers or potential entrants), even if it was comfortable with the level of supply from existing farmers.

[24] Indeed, there is also some risk that the combination of low milk price and correspondingly high share price would encourage Fonterra suppliers to leave Fonterra.

[25] Section 106 of the DIRA.

32. Such a deviation from the MPM-determined price is likely to be harder to justify to Fonterra's constituents, particularly (existing) farmers. As a consequence, the tool is not as available to Fonterra as MPI suggests.

33. Furthermore, material and/or frequent deviations from the MPM-derived price may impact on the credibility of the MPM regime, raising uncertainty for stakeholders (including investors). As the Commission noted in its 2016 "Review of the state of competition in the New Zealand Dairy Industry" ("the Competition Review", X30):

> *X30.2 Even without the milk price regime under DIRA, we consider it likely to be in Fonterra's interests to provide a degree of transparency and independent oversight of base milk price setting This would provide assurance to farmer shareholders, external shareholders, and contract suppliers that the farm gate price of milk is set at an efficient level, which is important for the success of F nterra s Trading Amongst Farmers (TAF) scheme.*

3.1.2. Using the terms and conditions of supply to manage volumes would be problematic

34. Fonterra has asked for our views on whether some sort of declining price schedule could be used to discourage supply. We question the workability of such an approach, given that the average production of suppliers will vary, and the inconsistency of price discrimination with cooperative principles. Furthermore, to have any effect the average pri e would have to be lower than the MPM-derived price, which would once again be inconsistent with cooperative principles.

35. There would also likely be unintended consequences if Fonterra used its terms and conditions to implement volume-based pricing. For example, consider the two following potential methods:

    a. Setting an **absolute volume threshold** that applies to all farms, after which a discounted price kicks in: This would penalize large farms and (potentially inefficiently) influence the structure of farms; and

    b. Setting a **relative volume threshold** (e g., discounting volumes above historic production levels): This could penalize small fa ms seeking to grow and take advantage of economies of scale.

36. Even if Fonterra did use its terms and conditions to implement volume-based pricing, this may not result in volume certainty The mechanisms above would only influence the average production of farms, not the total number of farms. This would only address one part of increases in collection volumes and would not deal with open entry.

3.2. Lack of control over volumes imposes costs on Fonterra

37. In our 4 D cember 2015 report for Fonterra,[26] we noted that the efficiency costs of open entry come under the following broad headings, although we also noted they are interrelated:

    a **Excess capacity due to uncertainty:** Building capacity for farms that may or may not supply Fonterra, but Fonterra is effectively forced to assume they will due to free entry. This includes both existing dairy farms, and dairy conversions. This leads Fonterra to build earlier than it otherwise would and also to build excess capacity.

    b. **Investment in higher value producing plant is crowded out:** The obligation to accept supply in almost all circumstances means that Fonterra has limited scope to phase supply growth, including from conversions, to match its planned investment programme. As a consequence, it is prudent for Fonterra to advance investment in low-cost/low-value capacity earlier (and to a greater extent) than it might prefer. Investment demands arising from

[26] Also filed with the Commerce Commission.

unanticipated milk growth can also disrupt planned investments in higher-returning projects, as Fonterra is forced to deal with the immediate requirement. Overall, scarce capital is drawn away from higher-returning opportunities.

38. In addition, open exit means that capacity becomes stranded when Fonterra is obliged to build capacity for new farms that subsequently leave Fonterra.

39. To understand the magnitude of the issue, note that between the 2009/10 and 2017/18 seasons:[27]

    a. [redacted] new farms joined Fonterra, [redacted] of which were new conversions. These new farms represented an increase in yearly production of about 200 m kgMS;[28]

    b. Of those [redacted] new farms, only [redacted] remain with Fonterra today (i.e., [redacted] have joined Fonterra and then subsequently left). In 2017/18 these remaining farms represented an annual production of [redacted] m kgMS; and

    c. Annual supply from the remaining [redacted] farms that were existing in the 2009/10 season has grown over the same period by about [redacted] m kgMS.

40. We can characterise the open entry provision as requiring Fonterra to grant a "free option" to farmers – it is free to the holder, but is funded by the existing shareholder suppliers to Fonterra.

41. It is also important to note that, due to the seasonal nature of milk production in New Zealand, the extra capacity Fonterra needs to account for free entry is peak capacity, e.g., whole milk powder dryers that can process large volumes of milk at peak. An opportunity cost of this is the allocation of scarce capital to plants such as whole milk powder driers, rather than to plants that can produce higher value products (e.g., lactoferrin).

42. Citing the Commerce Commission review, the MPI Discussion Document finds that open entry under DIRA does not impose unreasonable costs on Fonterra, reasoning that:[29]

    > *"Fonterra's business model and strategy already require significant investment in substantial excess capacity to provide for Fonterra's existing milk supply growth, optionality in its production mix, and the natural weather dependent variations in milk supply".*

43. Frontier Report Two also cites the Commission's rejection of the excess capacity and opportunity cost arguments with respect to the costs of open entry. Frontier also argues that any investment crowding out is "more closely related to Fonterra's access to capital…than the requirement to accept more milk".[30] Additionally, Frontier argues that rather than crowding out investment, any share-backed entry or increase in supply would fund increased capacity and other investments. We understand that under TAF this point is factually inaccurate – so long as the number of dry shares and FSF units on issue exceeds the growth in milk volumes, increases in milk volume would be met by buying shares or units from existing farmers/unit holders. Fonterra made one bonus issue at the outset of TAF to ensure there were sufficient shares on issue above minimum shareholding requirements and to contribute to ongoing liquidity, but otherwise there has been no capital increase as milk volumes have changed.

44. We acknowledge the Commission's finding in 2016, which was largely due to the Commission's belief that Fonterra's growth strategy means it invests enough to deal with (DIRA created) uncertainty.

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[27] Source: Fonterra.

[28] This is summing the yearly production of these re-entries and conversions in the year that they joined

[29] *MPI discussion document,* page 7

[30] *Frontier Report Two*. page 78.

45. However, we disagree with the Commission's finding. The Commission is conflating investing for expected growth with building an additional buffer over that growth to deal with regulatory-induced uncertainty. On value-add, the Commission states (at 6.21.1) that capital constraints/the cooperative structure may have a bigger impact on investment than open entry.[31] But the Commission (and Frontier) misses that it is the interplay of open entry and capital constraints that creates an issue.

46. At page 54 of Report One, Frontier compares Fonterra unfavourably with Kerry Group and Glanbia, stating the latter two spend more on R&D than Fonterra.[32] However, analysis of the Kerry and Glanbia annual reports suggests that the R&D expenditure figures stated in Figure 43 of Frontier's Report One may refer to the R&D figures for Kerry Group and Glanbia PLC rather than the cooperatives themselves.[33] Both of these are separate companies to the cooperatives, with external investors:

    a. Kerry Group is only 14% owned by the Kerry cooperative[34]; and

    b. Glanbia PLC is only 36.5% owned by Glanbia cooperative.[35]

47. Furthermore, our understanding is that both cooperatives have control over who supplies them, unlike Fonterra.[36]

48. Perhaps of more interest is Tatua. Tatua is a closed cooperative and has significantly outperformed Fonterra in terms of its payout to farmers. Figure 5 shows the cash raw milk payouts for Fonterra and other independent processors from the 1998 season to the 2017 season. The graph shows the milk price for Tatua diverging from the milk prices of the other processors.

49. However, Tatua's milk price is effectively a bundled milk and dividend payment, so a proper comparison of performance is to Fonterra's total pay-out (milk price + dividend). Figure 6 shows this. Making this comparison, Tatua's pay-out has still materially exceed Fonterra's since 2012.

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[31] Commerce Commission, *Review of the state of competition in the New Zealand dairy industry*, 2016

[32] Frontier Report One, page 54

[33] Comparing the 2017 EU Industrial R&D Investment Scoreboard and annual reports suggests that the revenues and R&D expenditure reported is in fact from the larger dairy company groups rather than the cooperatives.

Company	EU Industrial R&D Investment		Annual report R&D spending	
	R&D expenditure	Revenue	R&D expenditure	Revenue
Kerry Group	$ 261	$ 6,131	$ 261	$ 6,131
Glanbia plc	$ 27	$ 2,848	n/a	$ 2,848

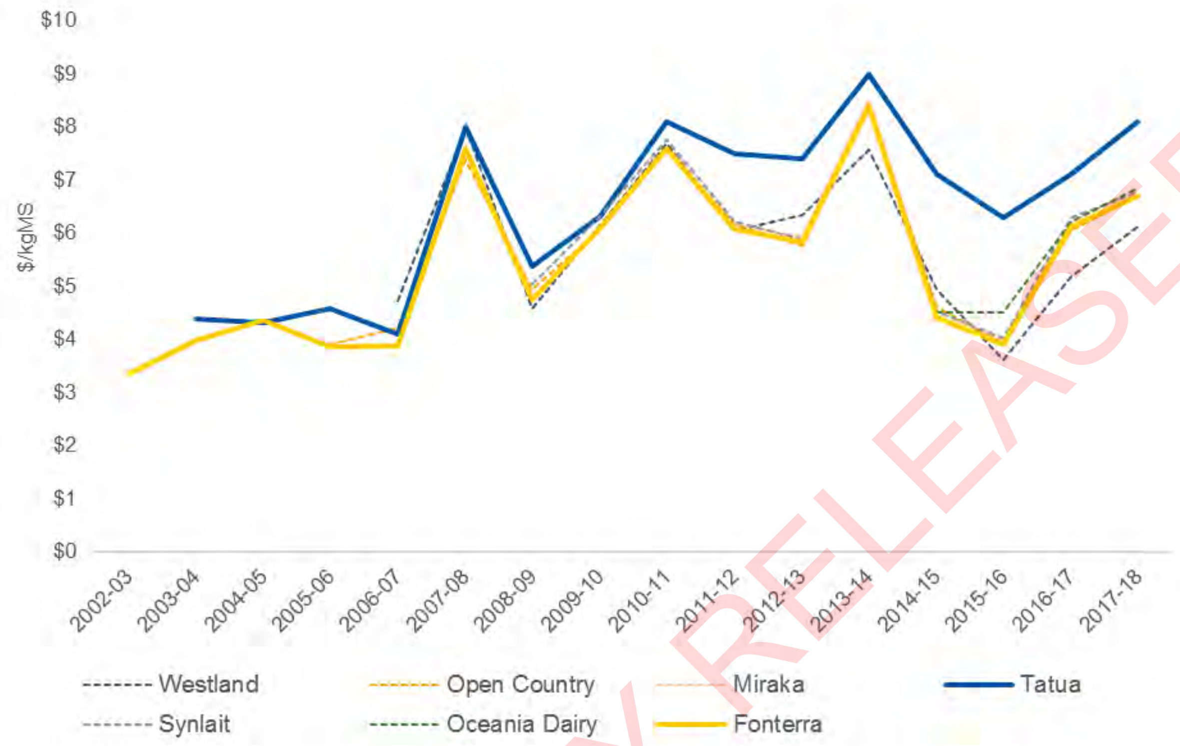
EU Industrial R&D investment from http://iri.jrc.ec.europa.eu/scoreboard17.html
Kerry Group 2016 annual report https://www.kerrygroup.com/investors/results-presentations/2016_KG_AR_lores_web.pdf*, R&D expenditure p.11, Revenue p.25*
Glanbia plc annual report https://www.glanbia.com/~/media/Files/G/Glanbia-Plc/documents/Glanbia%20FY%2016%20Results%20Release%20Final%2022%20Feb%202017.pdf*, p.2*

[34] https://www.kerrygroup.com/investors/investor-centre/shareholder-analysis/

[35] Glanbia plc ownership: https://www.irishtimes.com/business/agribusiness-and-food/glanbia-co-op-transfers-92m-of-glanbia-plc-shares-to-members-1.3206374

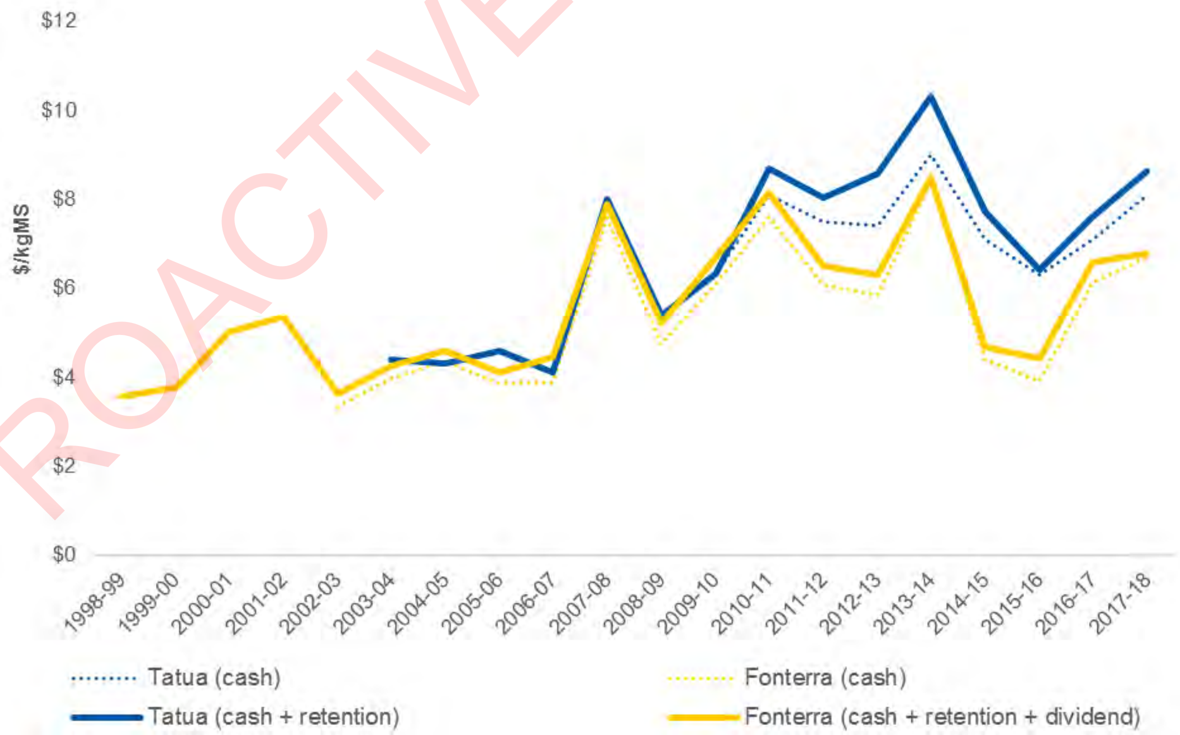
[36] In particular, we are not aware of any statutory restriction on the ability/inability of these firms to limit entry. We have also reviewed constitutions and related documents, and have not found anything implying there is an analogue to the DIRA open entry requirement.

Figure 5
Milk prices for milk processors in New Zealand – cash only



Source: https://www.interest.co.nz/rural-data/dairy-industry-payout-history

Figure 6
Cash milk price and bundled milk and equity payments



Source: https://www.interest.co.nz/rural-data/dairy-industry-payout-history
Note: The cash payment for each co-op includes the cash milk price paid only, the bundled price also includes dividend paid out for Fonterra and the retained earning not paid out for both co-ops

50. We are not necessarily claiming that the lack of an open entry obligation on Tatua is the only reason for Tatua's success, but we do think it is a key characteristic of Tatua that deserves analysis.

51. For example, we note the following excerpt from a 2014 *Waikato Times* interview with Tatua's (then) chief executive, Paul McGilvary:[37]

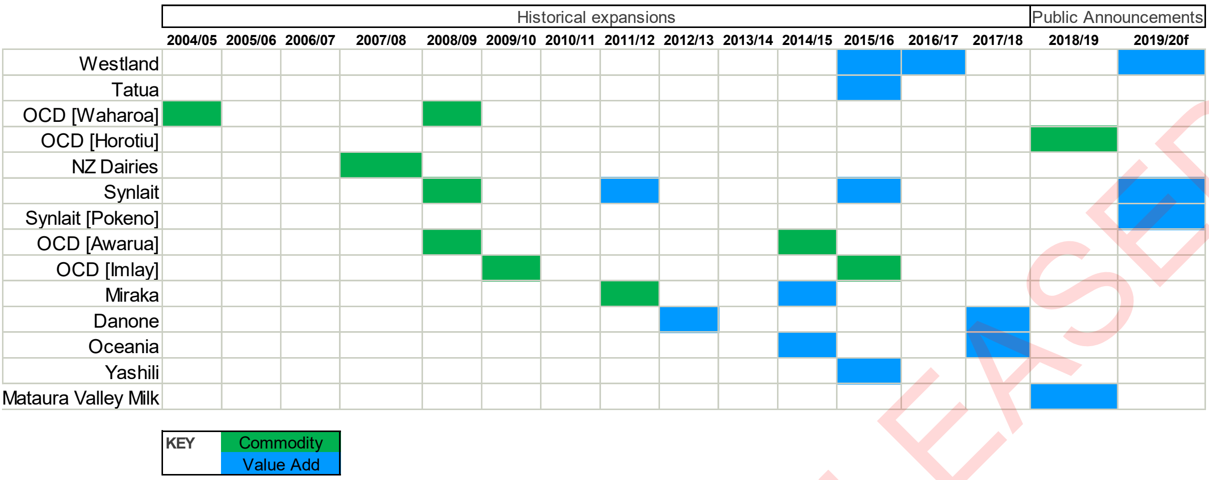
> *The company had developed constitutional arrangements that supported its drive into more specialised added value products.*
>
> *In addition to holding a nominal $2.50 share a kilogram of milksolids supplied, each Tatua suppli r must also hold, in addition, a milk supply entitlement for each kilogram of milksolids supplied.*
>
> *To supply Tatua, a supplier needs to hold the necessary number of shares and MSEs, he said.*
>
> *"MSEs are like a fishing quota. They are issued free of charge to suppliers based on shareholding, but once issued can be sold and leased among the supplier base."*
>
> *MSEs were issued up to the processing capacity of Tatua's factory just out of Morrinsville. That ensured it only received the amount of milk that could be processed at the existing plant and meant it was not forced to build new plants to produce the same products from an ever growing milk supply.*
>
> *The focus could then be on its investments on new plants and pro esses which increased the value derived from the existing milk.*
>
> *"The fact that we don't have a continuously increasing milk supply means management is forced to focus on adding value to our existing milk," he said. "Further reinforcing this are targets and performance incentives related to achieving this."*

52. More generally, the Frontier reports do not analyse at all the effects of open entry on Fonterra's investment and export mix (see in particular section 5.3 of the second Frontier report, which analyses the drivers of Fonterra's export product mix, without considering open entry), nor the lack of such an obligation on IPs [38] As can be seen from Figure 7 below, Fonterra characterises most of the recent and planned capacity investment by IPs as being of the value-added type.

[37] http://www.stuff.co nz/business/farming/dairy/10242979/Tatuas-secrets-of-success, access 18 December 2018.

[38] Frontier Report Two, page 67-75

Figure 7
Historical and future IP capacity investments



Source: Fonterra

3.3. Environmental/reputational impacts

53. Other than “residual reputational risk”, the MPI Discussion Document plays down the role of open entry on environmental issues (page 28). Key reasons for this view appear to be:

    a. That growth has been driven by global demand. However, this ignores that new conversions may not have occurred without a guaranteed buyer, and that Fonterra may have wished to control that growth to manage its environmental reputation, but could not due to open entry; and

    b. The asserted ability of Fonterra to influence supply through “its price signals”. We have already discussed why this ability is constrained.

54. Regarding Fonterra’s environmental reputation, it is important not to under-estimate the importance of this. Global consumers are becoming more interested in the environmental (and other) credentials of their suppliers, and so the potential costs to Fonterra of entry by environmentally unfriendly farmers are material. For example, a Lincoln University study found that consumers in China, India and the UK are willing to pay a higher price for lamb that achieves different sustainability certifications.[39] For instance, Chinese customers are willing to pay 9% more for animal welfare, 7% for water minimisation, and 8% for greenhouse gas minimisation. Also, Dhar and Foltz (2005) found that US consumers are willing to pay a premium of between 60 to over 100% for organic and r-BST free milk.[40]

55. Furthermore, there may be negative externalities on IPs in the global markets if the New Zealand dairy brand (which is led by Fonterra) is tarnished. And conversely, IPs are likely to benefit from marketing by Fonterra of New Zealand dairy products. Indeed, a potential efficiency rationale for creating a firm like Fonterra is to address what might otherwise be a free riding problem in marketing New Zealand dairy products. Because the benefits of marketing New Zealand as an origin of dairy products would not be fully appropriated by the spending processor, there is an

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[39] Tait, Peter, et.al, 2016, "Emerging versus developed economy consumer willingness to pay for environmentally sustainable food production: A choice experiment approach comparing Indian, Chinese and United Kingdom lamb consumers." *Journal of Cleaner Production*, 124 (2016): 65-72.

[40] Dhar, T. and J. D. Foltz, 2005, “Milk by any other name … Consumer benefits from labelled milk”, *American Journal of Agricultural Economics*, 87 (1), pp214-28

incentive on processors to free ride on the expenditure of other processors, potentially leading to under-provision of New Zealand marketing. Due to its size, Fonterra is likely to appropriate most of the benefits of marketing New Zealand dairy products, and so is less likely to be affected by the free rider problem.

3.4. Risk of inefficient entry

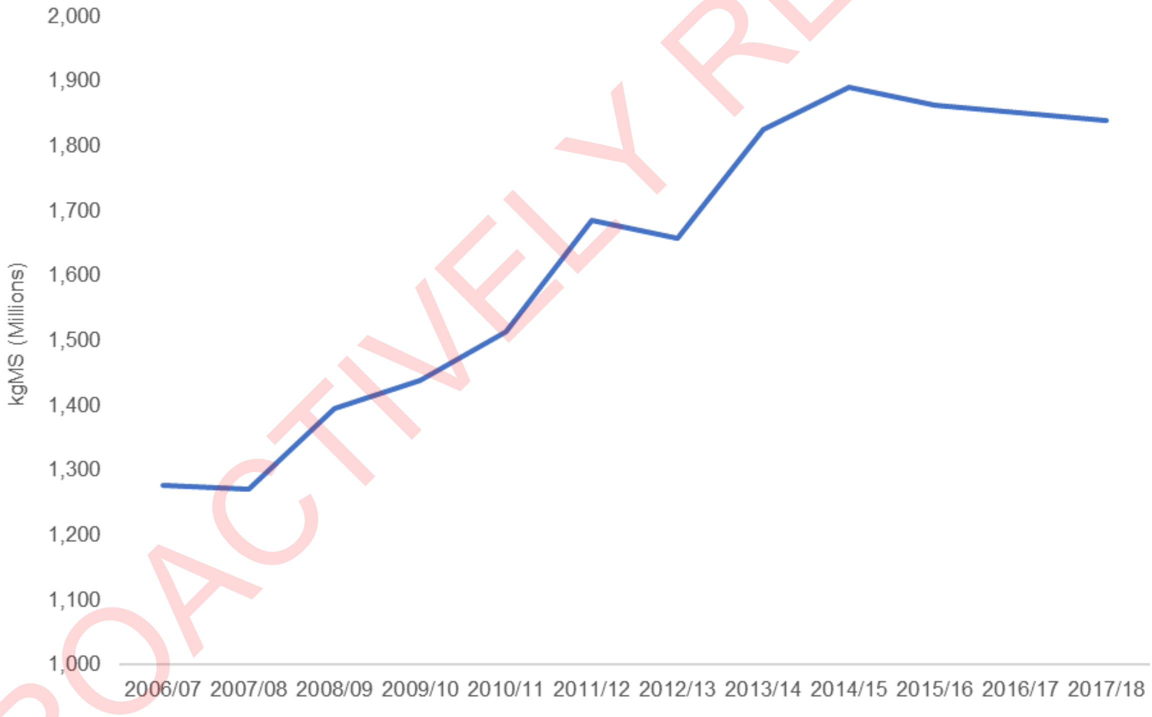
56. While there was likely an efficiency rationale for the open entry requirement while there was a catch-22 situation:

    a. As discussed earlier in this report, there is unlikely to be a material catch-22 situation anymore;

    b. There are now more processors buying milk directly from farmers (eight) than there were prior to the formation of Fonterra; and

    c. The national milk supply has flattened off since the 2014/15 season (see Figure 8). The milk supply peaked at 1.89 bn kgMS in the 2014/15 season and has flattened off at just over 1.8 bn kgMS since then.[41]

Figure 8
New Zealand Milk Production



Source: DCANZ

57. Given these factors, there is actually some risk that entry facilitating policies like open entry (and the raw milk regulations, as we discuss below) could result in inefficient IP entry, and potentially an industry with over-capacity, as the meat industry has faced many times.[42] It seems likely that economies of scale and scope are important in dairy processing, and perhaps at other functional levels. Furthermore, the ability to manage risk is also likely to be important, given the volatility

[41] We note that Fonterra has announced that milk production is up on last year. See, e.g. https://www.stuff.co nz/business/farming/markets/110303853/fonterra-milk-production-up-in-nz-down-in-australia

[42] See, e.g. Meat Industry Excellence, *Red Meat Industry: Pathways to Long-Term Sustainability*, March 2015.

in export prices and the exchange rate. Accordingly, there is likely to be a low limit to the number of efficient dairy processors in New Zealand, and an efficiency trade-off between the number of competitors and scale.

58. We understand Fonterra is providing a separate report by NZIER that discusses the implications for GDP of overcapacity scenarios in detail.

59. In conclusion, particularly because the benefits of open entry (and the raw milk regulations) are now minimal, the risk of inefficient entry is a valid policy consideration.

4. Partial deregulation trigger

60. Fonterra has asked for our view on its proposal for there to be partial deregulation by regional council boundary if Fonterra's collection share within that boundary drops to 75%.

61. As we have already noted in this report, because of the cooperative nature of Fonterra, farmers in areas with weaker IP presence are protected by those in more competitive areas. Accordingly, partial deregulation in competitive areas would not affect the position of farmers in less competitive areas (where the full DIRA would continue to apply anyway).

62. In our 2010 report for MAF, we suggested a 75% trigger for review of the DIRA, by Island Since then, the number of IPs has increased, and we can be much more confident about the sustainability of IPs, even without the DIRA. Concerns about the catch-22 barrier have largely fallen away, and the costs of deregulating are low, as we have discussed in this report.

63. Furthermore, the Fonterra proposal is partial deregulation by regional council boundary, not complete deregulation by Island.[43]

64. Accordingly, in the absence of complete removal of open entry, we think the use of a more mechanistic threshold for partial deregulation by region would be appropriate, and we continue to think 75% is an appropriate threshold.

[43] It would be relatively costly to hold a formal competition review for partial deregulation for each relevant regional council area.

5. The efficiency of Fonterra's milk price

65. There are aspects of the MPI and Frontier analysis implying that the efficiency of Fonterra's (farm gate) milk price still depends on the open entry requirements under DIRA.[44] However, this is not correct – the efficiency of the milk price is determined by Fonterra's status as a cooperative, the MPM and TAF.

66. In particular:

    a. Fonterra is a cooperative owned by its shareholder suppliers, so it does not have an incentive to exercise market power (by lowering the farm gate milk price) against the interests of these suppliers;[45]

    b. Fonterra introduced the MPM in 2008 (pre-TAF), to provide greater transparency and to support the integrity and consistency of the milk price; and[46]

    c. Aspects of Fonterra's governance and investor base (e.g., TAF, including the Fonterra Shareholders' Fund) limit its incentive and ability to raise the farm gate milk price above the competitive level. Raising the milk price above the MPM-determined level would lower the profits of Fonterra, and therefore reduce the value of its shares and units in the Fund. Fonterra has only departed from the MPM milk price twice in the past, deviating below the MPM price for justified reasons, including one-off expenses and lower profitability in the non-milk powder side of business.[47]

67. The Commission recognised these points in its 2016 "Review of the state of competition in the New Zealand Dairy Industry" ("the Competition Review"). For example, regarding Fonterra's incentive to exercise market power against farmers by *lowering* the farm gate milk price, the Commission noted (X30):

> *X30 However, we think that Fonterra would have little or no incentive to exercise its market power in this way despite its ability to do so. This is because:*
>
> > *X30.1 Fonterra is a co-operative owned by its farmer suppliers. This ownership structure protects farmer suppliers from Fonterra's market power in relation to milk purchases, because the suppliers ultimately control the decisions of the company.*
> >
> > *X30.2 Even without the milk price regime under DIRA, we consider it likely to be in Fonterra's interests to provide a degree of transparency and independent oversight of base milk price setting. This would provide assurance to farmer shareholders, external shareholders, and contract suppliers that the farm gate price of milk is set at an efficient level, which is important for the success of Fonterra's Trading Amongst Farmers (TAF) scheme.*

68. Regarding *raising* the farm gate milk price, the Commission noted (X33, footnotes omitted):

> *X33 Fonterra's ability to render rivals less competitive by increasing the farm gate milk price is largely the same with and without regulation. Even with the regulation Fonterra could pay a higher price than that which results under the Milk Price Manual. However, Fonterra's ability, both with and without the regulation, is constrained due to:*
>
> > *X33.1 the importance to Fonterra of its TAF scheme;*

[44] For example, see pages 50-51 of *Frontier report two*.

[45] As we discuss in footnote 20, it is virtually inconceivable that Fonterra would switch away from being a cooperative.

[46] Fonterra, *Farmgate Milk Price Manual – Part A: Overview*, August 2014, section 2.5

[47] See:
https://www.nzx.com/announcements/321996
https://www.nzx.com/companies/FSF/announcements/244980

> *X33.2 a need to protect the divergent interests of its supplier shareholders, outside investors and contract suppliers; and*
>
> *X33.3 a need to also fund its capital programme and maintain a sustainable business.*

69. As is clear from this discussion, Fonterra's cooperative nature and stakeholder base are key drivers of the balanced incentives it faces with respect to setting the farm gate milk price. These balanced incentives are also demonstrated by the fact that Fonterra's current approach to setting the milk price predates the DIRA milk price regime by about four years. Indeed, when the milk price regime was introduced in 2012, it effectively just enshrined Fonterra's existing practice.[48] This differs from traditional regulation, which is generally expected to change behaviour. The explanatory statement for the bill introducing the monitoring regime noted:[49]

> *A review of Fonterra's existing milk price setting methodology found that the approach Fonterra takes to setting its milk price is a reasonable proxy for how the milk price would be set in a workably competitive market.*

70. Accordingly, there is no longer a role for open entry in price setting.

71. The MPI Discussion Document appears to be concerned about a "lack of confidence" in the milk price calculation, and suggests an option to increase the statutory guidance over the assumptions, inputs and processes to be used by Fonterra (section 4.3).

72. The only specific issue identified by MPI to justify this option is the disagreement between Fonterra and the Commission over the appropriate asset beta to apply. The MPI Discussion Document does not acknowledge that Fonterra has relatively balanced incentives when it comes to estimating asset beta for regulatory purposes, and indeed the milk price more generally. The MPI Discussion Document also does not analyse whether the disagreement over asset beta has any material effects.

73. For example, the evidence about IP growth and sustainability described in section 2.1 of our report makes it difficult to argue that IPs have been deterred by a manipulated high milk price – Fonterra's market share has continued to fall and IPs have continued to invest since the Commission's review. Accordingly, we do not think the MPI Discussion Document makes out a case for any change to the existing milk price regime.

74. As noted above, one of the rationales for the MPM and regime is to increase transparency over the calculation of the milk price. In its dairy inquiry, the Australian Competition and Consumer Commission (ACCC) found that farmers are disadvantaged by information asymmetries with processors. The ACCC found that:[50]

    a. Farmers have little insight into how farm gate prices are set, relying heavily on estimates set by processors that often change without consulting farmers; and

    b. Transparency issues and farmers' lack of bargaining power result in practices that transfer a disproportionate level of risk to farmers and soften competition between processors.

75. The ACCC considered that processors should publish information identifying how their pricing offers apply to individual farm production characteristics to enable better farm income forecasts.

76. We have not analysed whether similar concerns apply in New Zealand, but we do note the fundamental economics principle that increased information generally increases the efficiency of

---

[48] For example, the explanatory statement to the *Dairy Industry Restructuring Amendment Bill* 2012 (page 2) notes that:

> *The milk price regime will include enshrining Fonterra's existing milk price governance and transparency processes in DIRA and the introduction of a new farm gate milk price monitoring regime undertaken by the Commerce Commission.*

[49] *Dairy Industry Restructuring Amendment Bill 2012*, page 2.

[50] ACCC, *Dairy Inquiry – Final Report*, April 2018.

markets. The better informed farmers are about processor (Fonterra and IP) pricing and pricing mechanisms, the more efficient their supply decisions will be, and the more efficient the dairy processing sector will become.

6. The factory gate market and regulated milk sales

77. On page 79 of its second report, Frontier argues that IPs "typically have neither the business model to supply the factory gate market (as their opportunity cost is likely high) nor the scale to compete with Fonterra."[51] We disagree.

78. The assertion about high opportunity costs appears to be on the basis that these IPs serve "specific export markets and specific products" (page 79 of the second Frontier report). However, the same could be said about Fonterra. We explained why this is the case in section 4 of our 4 December 2015 report (page 13):

> *But even if a shorter timeframe and smaller increment is adopted, Fonterra would generally be able to sell the processed milk at a higher price than that assumed by the milk price manual. This is because world commodity prices are volatile, creating option value that Fonterra could take advantage of by either producing a different ratio of WMP/SMP than assumed in the milk price or by producing more commodities outside the reference bundle. Put another way, the marginal value of a unit of milk is not the bundle assumed in the milk price calculation, but instead the highest value product stream at the time the IP takes the milk.*

79. We have updated this analysis in Appendix A.

80. Our point being there is nothing distinctive about the business models of IPs versus Fonterra that results in IPs having a higher opportunity cost in selling to the factory gate market than Fonterra does.[52]

81. Regarding Frontier's argument that IPs do not have the scale to compete with Fonterra for factory gate sales, this is also wrong. As an indication of the relative size of the factory gate market, the total volume of regulated milk supplied in the 2017/18 season was 271 million litres, which represents around 1.3% of total milk processed in New Zealand.[53] Fonterra estimates that the total domestic milk consumption in New Zealand is roughly 650 million litres. By comparison, total collection of raw milk by IPs in 2017/18 was approximately [redacted] million litres.[54]

82. Accordingly, in our view the IPs can compete with Fonterra in the factory gate market if they were incentivised to do so (e.g. if Fonterra attempted to exercise market power) and were not crowded out by regulated milk.

83. Returning to the opportunity cost point, we also note that at page 51 of their second report, Frontier states "Independent processors can purchase milk in the factory gate market for an efficient price".[55] It is clear from the following text on page 51 that Frontier is referring to the regulated price, i.e., Frontier is asserting that the regulated milk price is efficient.

84. We refer back to our 4 December 2015 report, where we explained that on an expectations or systematic basis, the regulated price will be lower than Fonterra's opportunity cost. In its final report, the Commission acknowledged there may be times when the regulated price (the "DIRA price") does not recover all of Fonterra's opportunity costs, although overall the Commission was equivocal on this issue:[56]

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[51] Frontier Report Two page 79

[52] Or at least Frontier has not made the case that the business models are distinctive in this way.

[53] Using 2017/18 New Zealand volume of 20.7 billion litres (source: Fonterra).

[54] Source: Fonterra

[55] Frontier Report Two, page 51

[56] Commerce Commission, *Review of the State of Competition in the New Zealand Dairy Industry*, March 2016, page 132

> *However while we consider that the DIRA price is likely to cover Fonterra's average opportunity costs most of the time, we have not undertaken a review of how often the DIRA price may or may not cover opportunity costs under the current DIRA Regulation. However, we have no reason to believe that any inefficiencies created are material.*

85. The Commission did not provide any further justification for this finding, and did not rebut the analysis we set out in our 4 December 2015 report.

86. To the degree that price is less than opportunity cost, then:

    a. Fonterra investors (who are often suppliers) would be subsidising IP entry. As well as being allocatively inefficient, this could reduce Fonterra's ability to invest in profitable opportunities;

    b. This could lead to inefficient entry. As already noted, there is an efficiency trade-off between the number of competitors and scale; and

    c. There could be crowding out of development of the factory gate market.

87. Furthermore, particularly because IPs can significantly vary forecasts (by up to 40% of the original estimate 1 week prior to taking delivery of the milk),[57] there is uncertainty to Fonterra regarding the quantity of milk it might need to process, leading to, for example, potential plant overbuild or other inefficient operating decisions. We understand that this issue is particularly costly for Fonterra at peak when it may not be able to process milk or may incur large transport costs to process milk that IPs decide they do not need t lat notice. In effect, this flexibility grants IPs a free option to vary milk taken from Fonterra at peak, which transfers the risks IPs would otherwise face around forecasting peak supply onto Fonterra.

88. Similar to the discussion of free entry, this impacts on capacity requirements and hence crowding out value added investment.

89. For export focused IPs, as already noted, the catch-22 issue has essentially gone, and providing regulated raw milk to these firms just risks inefficient entry and inefficient investment decisions by Fonterra.

[57] Clause 10 (2) (b) of the Dairy Industry Restructuring (Raw Milk) Regulations 2012.

Appendix A. Opportunity cost of regulated milk sales

In Section 6 above we discuss our previous finding (in section 4 of our 4 December 2015) that on an expectations basis, the DIRA price for regulated milk sales is likely to be below Fonterra's opportunity cost at a given point in time. In this appendix we update the analysis contained in section 4 of our 4 December 2015 report comparing Fonterra's opportunity cost to the DIRA milk price

The precise opportunity cost of milk sold at the factory gate depends on the increment and tim frame adopted. For example, the longer the timeframe and larger the increment adopted, the more likely it would be that Fonterra could sell at least some proportion of the DIRA milk as a value added product, earning higher returns than are assumed by the regulated price. Similarly, timing might be important - the opportunity cost of supplying milk at peak is likely to be different from that during the shoulder periods when milk is scarcer.

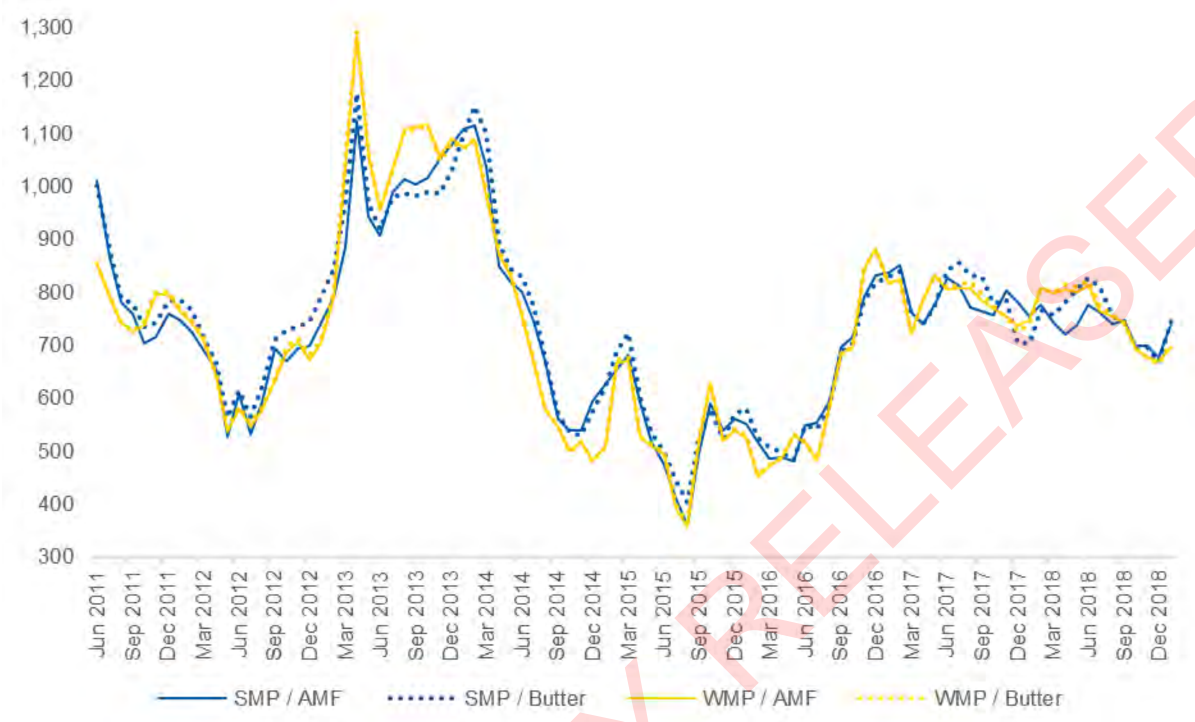
But even if a shorter timeframe and smaller increment is adopted, Fonterra would generally be able to sell the processed milk at a higher price than that assumed by the milk price manual. This is because world commodity prices are volatile, creating option value that Fonterra could take advantage of by either producing a different ratio of WMP/SMP than assumed in the milk price or by producing more commodities outside the reference bundle. Put another way the marginal value of a unit of milk is not the bundle assumed in the milk price calculation, but instead the highest value product stream at the time the IP takes the milk.

To see this, note for a start that the regulated price i s t by the milk price manual, and is therefore based off a portfolio of commodity product prices at certain points in time. The commodity products are the "Reference Commodity Products", being WMP and SMP, and their by-products BMP, butter and AMF. The milk price is calculated as a weighted average of the average (mainly GDT) returns over a year to milk allocated to four 'str ams' of these products, comprising WMP/Butter/BMP, WMP/AMF/BMP, SMP/Butter/BMP and SMP/AMF/BMP. We understand from Fonterra that these "stream returns" are updated every week based on Fonterra's view of the current market price for the base specification of each product.

Returns to these four streams can be expected to be around the same over time,[58] but at any point in time there will invariably be differences in relative returns. This is illustrated by Figure 9 below, which plots Fonterr 's calculated "stream returns" for the four RCP streams.

[58] This is because the four streams are effectively different ways of "cutting" raw milk, so producers can move between the different product streams and therefore arbitrage away any profit differentials.

Figure 9
Stream returns for RCP streams (monthly average cents per kgMS)



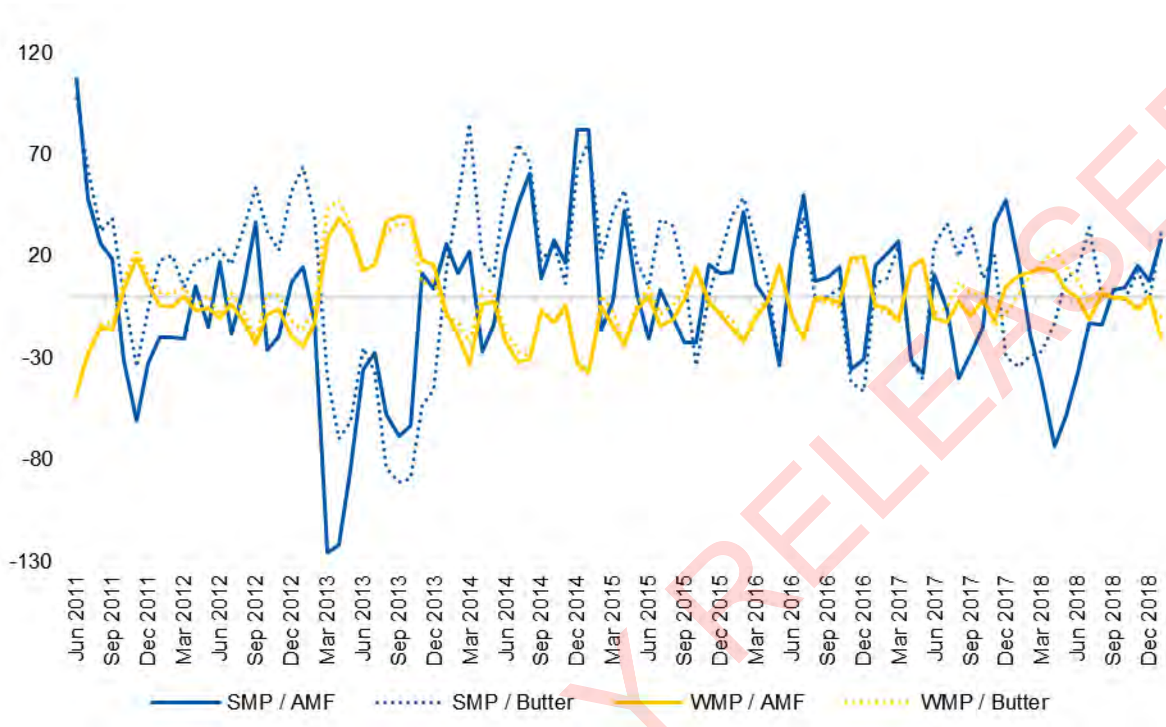
Source: Fonterra. Note: Stream returns ass me all product is sold on GDT, or at GDT-equivalent price and factor in variable but not fixed costs.

Figure 9 demonstrates that the most pr fitable stream at any one point varies over time. Because the milk price manual uses assumed weightings for each stream,[59] when Fonterra is supplied an incremental kilogram of milk solids, it will generally be able to generate superior returns to the prior milk price basket return by allocating the milk to whichever stream yields the highest returns at the time of allocation. If the incremental milk is allocated to an RCP stream, the resulting returns will be averaged into the milk price, resulting in a slightly higher milk price than would otherwise have been the case. But if the milk is not available to Fonterra, the milk price will of course remain unchanged. It therefore follows that the difference between weighted average milk price stream returns and the returns available to the highest returning RCP can be regarded as an opportunity cost of the milk not being available to Fonterra.

This opportunity cost is demonstrated in Figure 10 below, which tracks the difference in returns to each of four RCP streams relative to the weighted average returns going to the milk price calculation (over 2011 – 2018).

59 Being a weighted average over the entire year.

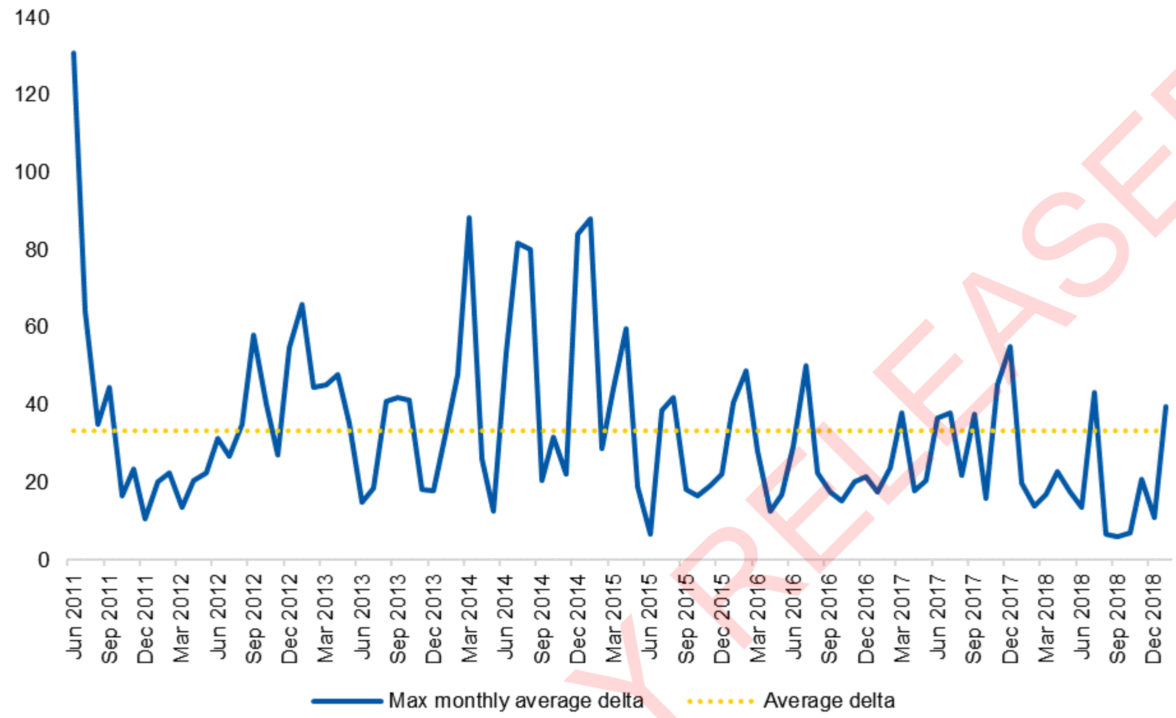
Figure 10
Difference in returns between each RCP stream and the weighted average milk price (monthly average cents per kgMS)



Source: Fonterra. Note: Stream returns assume all product is sold on GDT, or at GDT-equivalent prices, and factor in variable but not fixed costs. The weights used are the final weighted average for the year in question, as this is what determines the milk price.

This graph demonstrates that the return of ea h RCP stream relative to the milk price varies substantially over time. Rather than look at each individual stream, we can look at the maximum delta over the milk price that would be achieved (i.e., create a series where at each point in time the RCP stream with the highest delta is chosen). This is shown in Figure 11 below.

Figure 11
Maximum delta assuming optimal RCP stream chosen at each point in time relative to weighted average milk price (monthly average cents per kgMS)



Source: NERA analysis of Fonterra data. Note: Stream returns assume all product is sold on GDT, or at GDT-equivalent prices, and factor in variable but not fixed costs.

This analysis demonstrates that over he period 2011-2018, an incremental kilogram of milk solids allocated to the highest returning RCP stream would on average have generated a return that was 30 cents per kgMS higher than the Farmgate Milk Price. This is equivalent to 4.9% of the average milk price of $6.19 over the 2011 - 2018 period.[60]

60 https://www.interest.co.nz/rural-data/dairy-industry-payout-history

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PUBLIC VERSION

Indicative estimates of the economic impacts of over-capacity

Potential impacts on living standards from lower innovation in dairy processing

NZIER final report to Fonterra

01 February 2019

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Key points

- The New Zealand dairy sector contributes $8.2 billion directly to New Zealand's GDP, with dairy farming accounting for $6.3 billion and processing a further $1.9 billion.
- DIRA's open entry provisions have had the desired effects of introducing additional competition in the dairy processing industry.
- This has led to substantial capital investment by both Fonterra and Independent Processors (IPs) over the past decade, particularly when milk supply growth was strong; and a decrease in Fonterra's share of the milk supply from above 95% in the mid-2000s to around 82% in 2018.
- With low growth in the milk supply now expected due to environmental constraints and a lack of additional available land that is suitable for dairying, this raises the possibility that the dairy processing industry may enter a period of over-capacity and under utilisation
- Since dairy processing investments are large and long-term in nature, the rationalisation of plant that we might ordinarily expect to see under such an over-capacity scenario is unlikely to occur.
- Instead, there is the potential for a red meat processing-type outcome, whereby dairy processors seek to outlast their competitors and stay in the industry by just covering their variable costs and competing hard for milk supply volumes.
- If this occurs, we would expect dairy processors to dial back their capital expansion plans as margins get squeezed in a 'war of attrition'. There will be less scope for investment in innovative, dynamic efficiency-inducing plant and equipment as processors focus on survival rather than boosting capacity and productivity.
- We use a Computable General Equilibrium model of the New Zealand economy to provide indicative estimates of the effects of two potential consequences of such a scenario occurring:
  - A 50% decrease in dairy processing capital investment, which sees annual investment fall from $672 million to $336 million; and
  - Respectively, a 1%, 5% and 10% decrease in capital productivity to proxy the impacts of processors investing less in innovative plant and equipment.
- These consequences are not forecasts of what *will* happen but are used to highlight the potential risks of over-capacity related to maintaining open entry provisions in a low milk supply growth situation.
- Our modelling suggests that a decrease in capital investment and capital productivity of this magnitude would see New Zealand's GDP fall by $149 million, $276 million and $441 million relative to business as usual, under the 1%, 5% and 10% capital productivity decrease, respectively.
- Rural areas that are heavily reliant on dairy processing, such as the West Coast, Southland, Northland and Taranaki, experience relatively larger falls in their GDP and household spending, which will decrease living standards.

- A wide range of industries closely related to dairy processing will also experience negative impacts on output, including dairy farming, transport, electricity and gas supply, primary sector support services.

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1. Objective and approach

This report provides indicative estimates of the national and regional economic risks associated with open entry-driven decreases in dairy processing investment and innovation.

1.1. Capturing the linkages between dairy processing and the wider economy

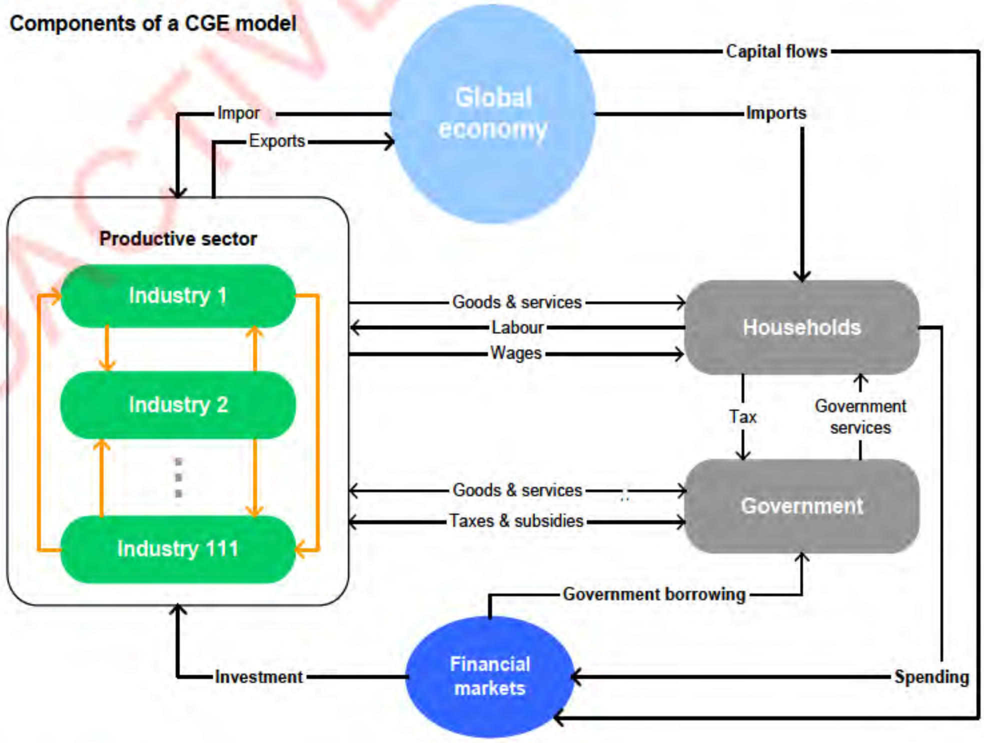
We use one of NZIER's suite of Computable General Equilibrium (CGE) models to explore these economic impacts.

A CGE model is a representation of an economy and the various inter-l nkages between industries, as well as their links to households (via the labo r market), the government sector, capital markets and the global economy (via imports and exports).

A visual representation is shown in Figure 1, highlighting the complex and multidirectional relationships between the v rious parts of an economy.

Any time that one part of the economy responds to a change in policy settings or industry conditions, there will be accompanying flow-on effects for supplying and downstream industries as resources move between industries towards their most productive use.

Figure 1 Components of a CGE model



Source: NZIER

1.2. Overview of modelling scenario and logic

In this report, we explore the potential impacts of a reduction in the quantity and dynamic efficiency of the dairy processing industry's investment in plant and equipment. This is based on a conceptual framework that explains how ongoing open entry provisions under DIRA could lead to over-capacity in the industry.

Under this scenario, we would see under-utilisation of plant on average across the industry and lower margins as Fonterra and Independent Processors (IPs) compete hard for a constrained milk supply. As margins fall and processors seek to retain a foothold in the industry by trying to outlast their competitors (given processing plant is an inherently long-term investment whereby capital is sticky due to high fixed costs), it is reasonable to expect investment to be put on hold.

As investment in efficiency-enhancing innovation drops across the dairy processing industry, capital productivity will also fall.

This will have flow-on effects for industries that supply the processing industry (such as dairy farming, packaging, energy, etc.) and which rely on its outputs and the income generated by its workers (road transport, supe markets other retail, etc.).

The dairy sector as a whole, including dairy farming, accounts for $8.2 billion of New Zealand's GDP, split into dairy farming ($6.3 billion) and dairy processing ($1.9 billion) (NZIER, 2018b). As dairy processing is one of the most connected industries in the economy (NZIER, 2018b), lower productivity in processing will have a wide range of macroeconomic and industry-specific economic impacts. Kiwi farmers will also be affected since they collectively own much of the processing industry's asset base.

It will also have implica ion for wellbeing in a Living Standards Framework context due to potential impacts on regional jobs and incomes.

To get a sense of these direct and indirect/flow-on impacts, we consider a modelling scenario that sees additional annual investment in the dairy processing industry fall by 50%, or $336 mi lion. In addition, we assume that the new investment is 1%, 5% or 10% less innovative or dynamic efficiency-enhancing than what would otherwise occur.

1.3. Caveats

It is challenging, *ex ante*, to determine the potential magnitudes of such investment and dynamic efficiency decreases, so these assumptions are designed solely to provide an answer to the following 'what if?' question:

> *If investment falls by 50% in response to over-capacity caused by a low milk supply environment and inefficient incentives to enter and exit the industry, and this new investment is 1%, 5% or 10% less efficient, what would be the impacts on the national and regional economies?*

Our estimates should not be seen as forecasts of what *will* happen if open entry provisions are retained in DIRA. Rather, they provide an order of magnitude indication of what *could* happen if the scenario we have described plays out in reality.

2. Conceptual framework

Open entry provisions have been successful in inducing independent processors (IPs) into the dairy processing industry

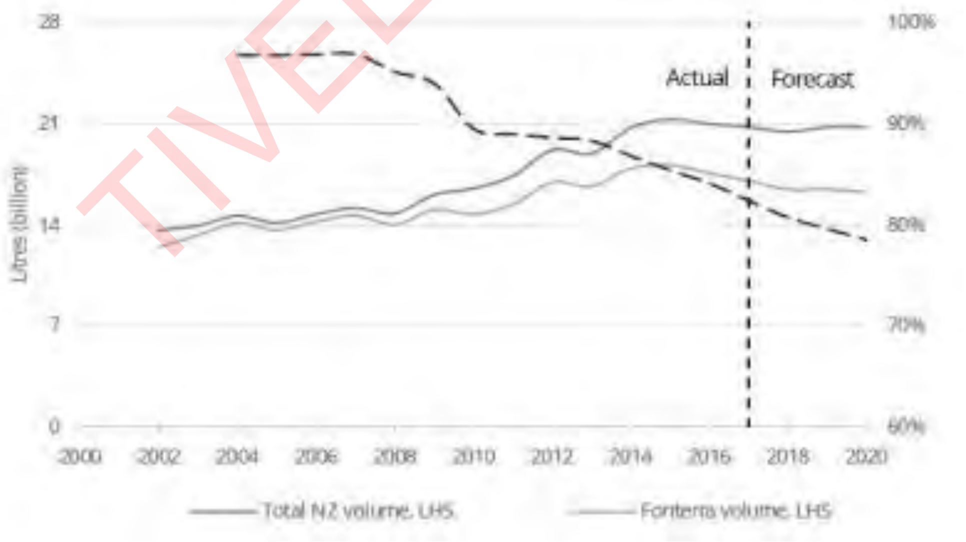
The open entry provisions of DIRA effectively require Fonterra to accept all growth in milk supply and thus hold capacity for the marginal litre, and provide opportunit es for IPs to enter the processing industry.

These competitive pressures have seen IPs increasing their processing capacity and market share. TDB (2018) estimates that around $18 billion has been nvested in dairy processing since 2001, with Fonterra accounting for $15.3 billion and IP a further $2.7 billion.

This investment by IPs has seen their milk supply processing capacity expand significantly from 57 million litres in 2001/02 to 343 million in 2017/18; by an average of 11.9% per year over this period (see Figure 3).

As a result, Fonterra's share of the New Zealand milk supply has trended downward over the past 15 years, from above 95% in th mid 2000s to around 82% in 2018. With flat milk supply growth expected, Fonterra's market share is projected to decline further (see Figure 2).

Figure 2 **Fonterra's share of milk production**



Source: TDB, 2018

Figure 3 Expansion of **independent processors'** capacity

[redacted]

[redacted]

We are headed towards a low milk supply growth future

Annual growth in New Zealand's milk supply averaged 4.5% between 2006 and 2012. This has fallen to an average of 1.7% between 2013 and 2017.[1]

A range of factors are affecting dairying in New Zealand. These include prices being achieved, strict environmental regulation and competition for the land.

Few of these seem likely to go away in the immediate future, and indeed we can expect more stringent environmental regulation around water quality and greenhouse gas emissions to place further pressure on dairy farming.

As an example, recent independent modelling of the economic impacts of 2050 greenhouse gas emissions targets (NZIER, 2018a) indicates that under an ambitious net zero all gas target, dairy farming's output would fall by over 50% compared with 2017 levels (see Figure 4).

Despite better output per cow, cow numbers have fallen in the past five years, by an average of -0.29% per year,[2] thereby reducing milk supply growth.

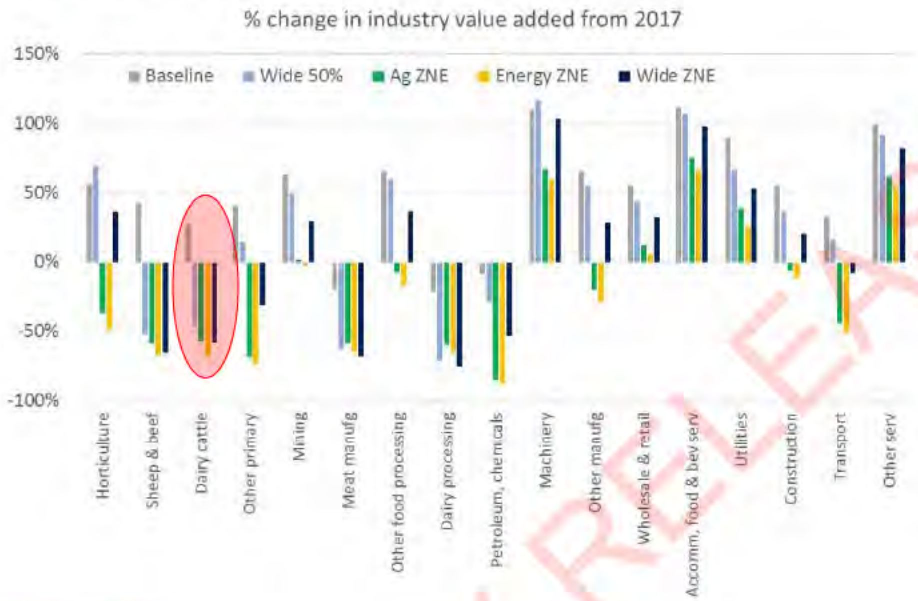
A low growth outlook suggests consolidation in products, markets and production. The local dairy processing industry is likely to become more tightly focused and managed.

1 Data taken from DairyNZ. 'New Zealand Dairy Statistics 2016/17', Table 2.2.

2 Data taken from DairyNZ. 'New Zealand Dairy Statistics 2017/18', Table 2.2.

Figure 4 Change in industry GDP if 2050 emissions targets are introduced

% change in industry value added from 2017



Source: NZIER

Ordinarily this might be expected to lead to a rationalisation of processing plants

Under the conditions pr vail ng in other industries this might produce a 'shakeout' of plants. This reflects an industry maturing to be more driven by cost efficiency, rather than other factors like innovation and marketing.

We might o dinarily expect most dairy processing operators would seek to trim costs and match capacity to expected throughput.

But capital is not highly mobile in the industry because of the long-term nature of dairy processing investments

Dairy processing plants are relatively capital intensive. Once in place, they are designed to operate for decades and cannot easily be retired without significant costs to the processor.

There is little scope to scale back operations if input volumes (i.e. milk supply) fall. The more likely outcome is a processor seeing a fall in capacity utilisation, whereby fixed costs are spread across lower volumes of milk.

As Fonterra's previous submissions have highlighted, the open entry and exit provisions of DIRA mean that it has to maintain a level of capacity to cope with any marginal litre of milk supply that farmers might generate. This leads to a "stranding risk", whereby Fonterra is forced to provide processing capacity for new conversions, even though those new farms may not decide to supply Fonterra in the medium- or long-term (NERA, 2015a).

NERA (2015b, p.3) supports this view, noting:

> *A cost of free entry is that existing shareholder suppliers to, and investors in, Fonterra, are required to fund inefficiently high transport and plant costs, in case other farmers exercise their "free option" to enter. The larger the farm in question, the more significant is the cost of this option. Indeed, it is difficult to think of firms in other markets in the economy that have such little control over the quantity of their inputs.*

Under these conditions, "it has been very difficult to do anything with the additional volume other than to channel it into commodity exports" (TDB, 2018)

Mexican stand-off: the incentives are to stick it out, compete for volumes to cover variable costs and hope the competition blinks first

In an environment where processing capacity has expanded significantly but forecast milk supply growth is flat or declining, we might reasonably expect to see the following outcomes:

- Over-capacity means all operators function at below break-even point – their average revenue does not meet their average costs.
- But they are not operating below variable costs – the revenue generated from lower-than-optimal utilisation is still high enough to cover the variable cost of inputs.
- This means they can keep operating as going concerns as long as they have strong balance sheets or willing owners to cover the deficits.
- There is always a chance that things will come right – milk supply might grow faster than expected. So, they keep a foothold in the industry rather than exiting completely and losing this 'option value'.

The obvious way things come right is if a competitor exits the industry – say by going bust so their plants withdraw. This reduces capacity in the medium term and makes all the other players more profitable, but will have negative consequences for the existing processor (in terms of stranded assets) and its workforce, who may be temporarily or more permanently out of a job.

However, any such exits may not occur quickly, for the reasons listed above. In economics a phenomenon known as the war of attrition (see for instance Bulow & Klemperer, 1999) applies to such circumstances. The typical results from a war of attrition involve excess capacity clinging on in the industry for a period and then the exit not necessarily being in order of productivity.

Under these conditions margins will be squeezed…

If a war of attrition occurs in the dairy processing industry, we would expect to see "the potential for stranded assets and therefore those with spare capacity fighting harder to keep milk volumes resulting in greater variations in milk prices from competing dairy companies" (TDB, 2018).

Processors will compete for milk supply volume through paying higher prices. This in turn will reduce dairy processing margins, further exacerbating the bottom-line impacts of lower volumes.

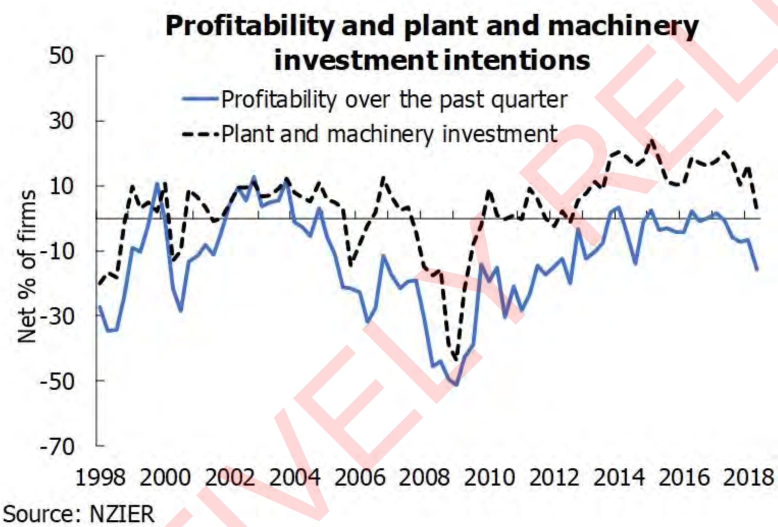
While this may seem to be beneficial for farmers in the short term, processors cannot continue to absorb higher input costs (i.e. farm-gate milk prices) in the medium- to long-term, and will seek to trim spending elsewhere, which will have potentially negative consequences on the processing industry and all related upstream (supplying) and downstream (users of the processing industry's output) industries.

…which will impact on intentions to invest in efficiency-boosting or capacity-expanding investment

When firms' profitability falls, they tend to be less willing to invest in plant and machinery (see Figure 5).

Figure 5 Weak profitability affects investment intentions

Net % of firms



Source: NZIER *Quarterly Survey of Business Opinion*

We would expect this to play out in the dairy processing industry if we end up in a situation where over-capacity and under-utilisation becomes the norm in a war of attrition.

This would have two potential impacts:

1. The expansion of the dairy processing capital stock will be slower than we have seen in the past decade. While some degree of ongoing capital investment is likely to occur, we would expect processors to be more cautious with their expansion plans than they have been over the past decade.

2. Processors will be focusing on surviving rather than investing in innovative equipment and processes that are designed to boost dynamic efficiency over time.

Weaker profitability will also constrain the industry’s investments in social goods

Lower margins due to a war of attrition associated with over-capacity will also have potential implications for firms in the processing industry beyond crimping their capital investment plans. In more uncertain financial conditions, there will be fewer resources available to distribute to the community in terms of financial and in-kind support for environment programmes, nutritional programmes and the like.

Summary

- If open entry provisions remain in a low milk growth environment, the most likely outcome is a dairy processing industry with excess capacity and under-utilisation.
- Processors will compete for milk volumes to at least try to cover their variable costs, in order to remain in operation while hoping their competitors cannot go the distance in a war of attrition.
- The competition for static milk supply will see input costs rise and profit margins fall across the processing industry.
- Under such a scenario, we would expect a decrease in capital investment and less focus on innovative, efficiency inducing, value-added processes.

3. Over-capacity case studies

3.1. Australian dairy processing

Summary

The volume of raw milk available in Australia has decreased over the past few deca es, partly following deregulation and partly as a result of drought. This reduc ion has led to over-capacity in processing plants, leading to closure of plants in some instances, and processors staying in the market due to the sunk costs of open ng he plant in others.

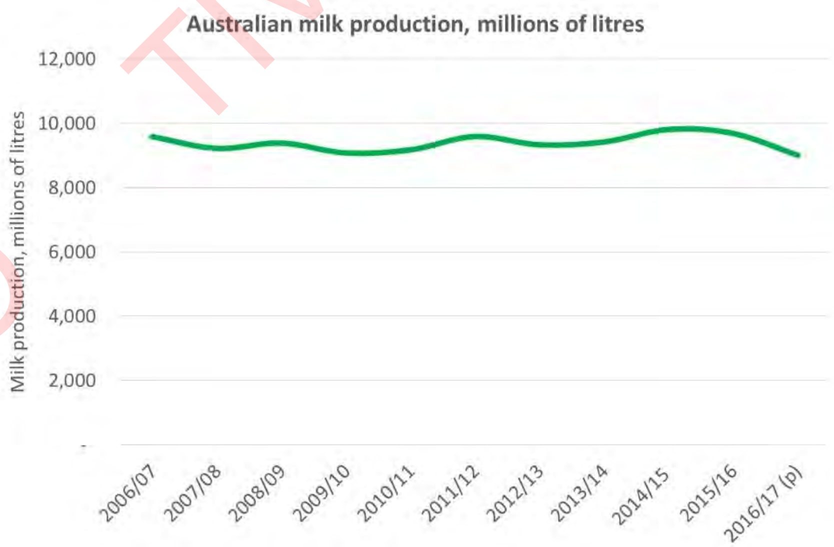
However, when processors stay in the market, they sometim s clo e plants for a significant portion of the year and underspend on innovation. This process can continue for some time as processors seek to remain viable y covering fixed costs and hoping its competitors fold first.

Milk supply growth has been non-existent

There has been a lack of growth in milk production in Australia over the past decade. reducing the need for Australian dairy companies to invest in processing capacity (Dairy Australia, 2017 p.18). Drivers of t is lack of growth include periods of weak global prices, adverse weather conditions and low farmer confidence (Dairy Australia, 2018).

Figure 6 Australian milk supply is going sideways

Milk production, millions of litres



Source: Dairy Australia website

...leading to over-capacity in the processing industry...

As early as the mid-2000s, researchers started identifying over-capacity as a concern in the Australian dairy processing industry. The Australian Government (2004, p.34) noted that “Even though some rationalisation in the number of milk processing factories has generally lowered fixed processing costs, it appears that significant overcapacity is an issue in the sector.”

This view was corroborated by industry bodies, Australian Dairy Industry Council and Dairy Australia (2014, p.3), who added that “Outside of peak season, a significant part of the dairy manufacturing sector is forced to run at lower capacity: facilities with milk powder dryers run at lower capacity between January and August, and some are forced to shut down given the high fixed cost associated with such capital intensive plant.”

The Australian dairy sector entered a highly challenging period from 2016, as Murray Goulburn, Australia’s largest processor, announced significant farmgate price cuts in the face of significant shifts in the global market related to Russia’s banning of imported dairy products, slower-than-expected Chinese demand and a stronger-than-forecast Australian dollar. Other suppliers followed suit.

This prompted the Federal government to announce A$555 million of concessional loans to support dairy farmers. The Victorian State government provided a further A$11.4 million in support to its farmers.

Murray Goulburn announced in mid-2017 that it would close three processing plants, citing a lack of milk supply as a key reason. It also scrapped its plans for any further capital investment.

The Victorian government injected A$180,000 into Northern Victorian communities affected by the closure of two of these plants in Tangambalanga (Kiewa) and Rochester. It also offered employment incentives to any business that agreed to take on workers displaced from these plants, in a support package valued at up to A$5 million.

As of April 2018, Murray Goulburn had lost some 45% of its milk supply. Its Board essentially stated that it had no option but to sell if it wanted to continue to operate[3], and it was sold to a Canadian dairy company Saputo.

The Australian experience, as reported by ACCC (2018, p.95) suggests that processors do not easily exit the industry because their capital – and especially at older plants – is expensive, specialised and thus not easily transferable to other parts of the economy.

The “big battle for milk”: processors are bidding hard for milk volumes and seeing margins compressed

As explained in section 2 above, capital investments in the dairy processing industry are large and long-term in nature. The viability of such investments relies heavily on the volume of milk available.[4]

The ACCC (2018, p.96) explains the potential consequences of over-capacity in a low milk growth environment that experiences seasonal fluctuations in milk availability:

[3] Murray Goulburn stated “if [the sale to Sapurt] does not proceed, and in the absence of an alternative transaction, MG may not be able to pay a competitive farmgate milk price. Further losses of milk flow may trigger an impairment to MG’s assets that could breach banking covenants and result in potential withdrawal of creditors’ support and an increased risk to MG’s ability to refinance its expiring debt facilities”, from https://www smh.com.au/business/companies/murray-goulburn-milk-intake-down-almost-30-per-cent-20180207-p4yzkd.html

[4] See, for example, page 14 of Senate Economics References Committee. 2017. ‘Australia’s Dairy Industry: Rebuilding Trust and a Fair Market for Farmers’, August 2017; and Australian Government (2004, pp.33-34).

"Aggregate national production is consistently below total capacity. Some plants are fully shut down between January and August. As a result, processors can only spread the fixed costs of their asset over a relatively short period of time, effectively increasing the processing cost compared to a scenario where they can run the facility at full capacity year-round.

Given the incentives for heavily invested dairy processors to maximise milk throughput, the outcome has been that competing processors bid up milk prices, even though this places pressures on their margins.

Rabobank (2018), describes this as "the big battle for milk", adding that "without a growing milk pool, the industry risks carrying too much surplus processing capacity, fuelling manufacturing inefficiencies… with the margin pressure just 'pin balling' from one processor to the next".

It adds that if the sector "faces another sustained period of aggressive milk pricing, it could potentially transform into an unsustainable squeeze on processors' margins and profitability".

3.2. New Zealand meat industry

Summary

Prior to the 1980s, New Zealand meat industry regulation meant processing plants could not open unless it could be shown they were economically justified and would not adversely affect the viability of existing plants.

Following deregulation in the early 1980s, more processing plants opened to compete. This led to overcapacity and stagnation, a situation from which the industry has not yet escaped.

Deregulation in the 1980s led to significant changes in the meat processing industry

From 1981 onwards, the deregulation of the meat industry allowed previously region-specific processors to try their luck in other regions. This resulted in greater competition for inputs (i.e. lambs) (McDermott et al., 2008). This competition was exacerbated by declining livestock numbers (MIE, 2015).

As with dairy processing, meat processing plant investments were large, long-term projects, and the result was over-capacity.

A classic war of attrition ensued

McDermott et al. (2008, p.42) summarises the over-capacity and competition for inputs story very clearly:

> *An extreme example of the impact of competition for stock to maximise throughput occurred in the early 1990s with the introduction of new players to the industry that was facing a decline in raw material.*
>
> *In this type of environment, the larger companies began to battle to protect their share of the national kill while leaving the new companies to fight for access to what was a decreasing resource*

These challenges persist to this day. MIE (2015, p.24) highlight several key challenges facing the New Zealand red meat industry, two of which:

- Excess processing capacity resulting in inefficiency and unnecessary cost.
- Inefficient procurement of stock created largely by this over-capacity.

Due to the high cost and long-term nature of their capital investments, competing processors did not simply exit the market, even when struggling with low margins and high levels of debt. These "barriers to exit" included the high costs of redundancy pay for staff, plus any site remediation work that was required to deal with contaminants, chemicals and by-products of meat processing activity.

McDermott et al. (2008, p.59) notes that it cost AFFCO $71 million to close four processing sites in the late 1990s; and that "high debt levels mean that incumbent companies are not readily able to close plants because their balance sheets cannot bear the large redundancy and write-down costs" (2008, p.vi).

MIE (2015, p.22) suggest an average cost of $10.5 million to close a plant. It goes on to outline the potential scale of industry-wide capital losses (p.57, emphasis added):

> *Large amounts of capital have been expended and lost through asset write-downs, plant closures and company collapses. Various sources have suggested this was about $900 million between 1989 and 1994. Similarly, large amounts of capital have been successfully invested in plant upgrades and the building of new single-chain processing plants since the early 1990s. There have been numerous company takeovers and several rounds of rationalisation within the industry* ***. The meat industry appears to be intrinsically unstable, with intense competitive rivalry and even cutthroat competition at times****, both in procurement and in the marketplace.*

The closure of meat processing plants usually occurred in rural areas where alternative job opportunities were scarce, such as Kaitaia, Feilding, Tomoana near Hastings, Tirau, Oringi, Thames, Waipukurau and Mataura (MIE, 2015, p.8).

Quite aside from the immediate community impacts of the job losses as plants closed, researchers also found evidence of increased mental distress leading to a higher risk of self-harm. In a study on the long-term health outcomes of two plant closures in Tomaoana and Whakatu in the Hawke's Bay, the Department of Public Health at the

University of Otago concluded that "exposure to involuntary job loss more than doubled the risk of serious self-harm over the following 8 years" (Keefe et al., 2002).

Two key outcomes ensued from an environment of over-capacity and intense competition, where exiting was not easy (McDermott et al., 2008, p.42):

1. Processors competed to determine "the last man standing" through paying higher prices to farmers, sometimes dipping into their balance sheets to do so.

2. With lower margins and funds being used for buying inputs at high prices, lower priority was placed on product and market development, innovation and investment.

4. Economic modelling

Dairy processing accounts for $1.9 billion (0.7%) of New Zealand's total GDP (March 2017). We estimate the economic impact analysis of a decrease in capital investment and productivity in the dairy processing sector, at the national and regional levels.

To evaluate these impacts, we use our CGE model of the New Zealand economy

As our CGE model is static, it can only look at 'before' (i.e. current situation) and 'after' We therefore do not explicitly model the *timing* of the decrease in dairy processing capital. Instead, we analyse a static, long-term scenario that estimates the overall economic effects of a decrease in dairy processing capital.

It is important to note that this means the model does not purport to illustrate the full effects of the "Mexican stand-off" described above. The period when capital has not been re-deployed could be considerable and could entail significant non-financial costs for workers and communities experiencing the stagnancy and subsequent disruption (due to plant closures).

For our scenario design, we implement shocks to represent what the regional and national economies would look like if a decline in investment and a productivity decrease in the dairy sector were to occur. We choose a long-run closure which allows capital stock economy-wide to adjust over time. In the long-run, we assume that the capital that was initially used in dairy processing can eventually be used elsewhere (if not the physical capital, then the proceeds from selling it). This is the standard CGE modelling approach when we are thinking about changes to an industry/economy that might take longer than 6-12 months to occur.

We then determine the flow-on effects of our shocks throughout the national and regional economies on GDP, employment, household income and industry output.

A decline in capital investment and a productivity decrease in the dairy processing sector

We have modelled two scenarios in the dairy processing sector:

- A 50% decrease in capital investment in dairy processing (capital investment scenario). In our CGE database, which is based on Statistics New Zealand's 2013 input-output tables, updated to 2017, capital investment in the dairy processing industry was $672 million in 2017.

  We assume that, due to concerns about over-capacity and squeezed margins in a low milk supply environment, the amount of investment falls by 50% – to $336 million from $672 million.
- A 1%, 5% and 10% decrease in capital productivity. In a war of attrition due to over-capacity, it is reasonable to assume that the focus of investment will be maintaining the existing capital stock rather than investing in innovative plant, machinery or equipment (which could be riskier in nature).

  To proxy this impact, we reduced the capital productivity of the $336 million of investment by 1%, 5% and 10%. That is, it can produce 1%, 5% or 10% less output per unit of capital employed than would otherwise have been the case. There is no direct comparison in the existing literature of dynamic efficiency losses in New Zealand which base the calculation on sales, rather than capital investment.[5] Accordingly we have used a range of % reductions to show the sensitivity.

Economic impacts at the national level

Table 1 shows the macroeconomic impacts of a decline in capital investment and a capital productivity decrease in the dairy processing industry.

Economywide GDP falls by $149 to $ 441 million, while household spend ng decreases by $86 to $254 million, depending on the level of capital productivity decrease.

Table 1 Economic impacts at the national level

Change from baseline (2017)

Indicator		GDP	Household spending	Wages	Exports	Imports
Capital productivity decrease (1%)	% change	-0.06%	-0.06%	-0 01%	-0.07%	-0.04%
	Level ($ millions)	-149	-86	NA	-48	-28
Capital productivity decrease (5%)	% change	-0.10%	-0.11%	-0.01%	-0.12%	-0.08%
	Level ($ millions)	-276	-159	NA	-87	-52
Capital productivity decrease (10%)	% change	-0.17%	-0.18%	-0.02%	-0.20%	-0.12%
	Level ($ millions)	-441	-254	NA	-137	-83

Source: NZIER

Regional New Zealand suffers the most

Table 2 and Table 3 overleaf illustrate how this scenario negatively impacts regional New Zealand, both in terms of GDP and household spending (our proxy for 'welfare' or living standards).

The percentage declines in GDP and household spending are largest in West Coast, Southland, Northland, and Taranaki as dairy processing accounts for a larger share of the economy in these regions.

The dollar impacts are largest in Auckland, Canterbury and Wellington (which includes the Wairarapa), where key dairy processing plants are located.

5 For example, in *Cavalier Wool Holdings Limited; New Zealand Wool Services International Limited*, dynamic efficiency losses from a potential merger were estimated at 0.5% to 1.5% of sales; in *Air NZ/Qantas 2003* these were 0.5% to 1 5%; in *Air NZ/Ansett Holdings Ltd and Bodas Pty Ltd 1996* innovation efficiency was assessed at 1% to 2.5% of costs; and in *Ravensdown Corporation Ltd/SouthFert Ltd 1996* dynamic efficiency was estimated at 0.5% to 1.5% of sales.

Note that we apply this dynamic efficiency cost only to capital investment, not total sales. If we applied it to total sales, the economic costs would be much larger.

Table 2 Regional GDP impacts of decrease in capital investment and capital productivity

Change from baseline (2017)

Region	Capital productivity decrease (1%)		Capital productivity decrease (5%)		Capital productivity decrease (10%)	
	Change in GDP (%)	Change in GDP ($m)	Change in GDP (%)	Change in GDP ($m)	Change in GDP (%)	Change in GDP ($m)
Northland	-0.12%	-6.9	-0.21%	-12.7	-0.34%	-20 3
Auckland	-0.04%	-33.7	-0.07%	-62.5	-0.10%	-100 0
Waikato	-0.05%	-11.0	-0.10%	-20.5	-0.16%	-33.0
Bay of Plenty	-0.07%	-8.8	-0.13%	-16.4	-0.20%	-26.2
Gisborne	-0.01%	-0.2	-0.03%	-0.4	-0 04%	-0.7
Hawke's Bay	-0.06%	-3.9	-0.11%	-7.3	-0.18%	-11.7
Taranaki	-0.12%	-11.9	-0.23%	-22.0	-0.36%	-34.9
Manawatu-Wanganui	-0.08%	-7.7	-0.15%	14.2	-0.24%	-22.6
Wellington	-0.06%	-20.7	-0.[illegible]%	-38.4	-0.17%	-61.2
Tasman-Nelson	-0.05%	-2.2	-0.09%	-4.0	-0.15%	-6.5
Marlborough	0.00%	0.0	0.00%	0.0	0.00%	0.0
West Coast	-0.18%	-3.3	-0.34%	-6.1	-0.54%	-9.7
Canterbury	-0.06%	-22.5	-0.12%	-41.7	-0.19%	-66.5
Otago	-0 08%	-8.4	-0.15%	-15.5	-0.23%	-24.7
Southland	0 16%	-7.8	-0.29%	-14.4	-0.46%	-22.9
Total	**-0.06%**	**-149.1**	**-0.11%**	**-276.2**	**-0.17%**	**-440.9**

Source: NZIER

Table 3 Household spending impacts of decrease in capital investment and capital productivity

Change from baseline (2017)

Region	Capital productivity (1%)		Capital productivity (5%)		Capital productivity (10%)	
	Change in household consumption (%)	Change in household consumption ($m)	Change in household consumption (%)	Change in household consumption ($m)	Change in household consumption (%)	Change in household consumption ($m)
Northland	-0.08%	-2.3	-0.15%	-4.2	-0.24%	-6.7
Auckland	-0.06%	-29.7	-0.11%	-55.0	-0.17%	87.8
Waikato	-0.04%	-7.1	-0.07%	-13.2	-0.11%	-21.1
Bay of Plenty	-0.07%	-4.8	-0.13%	-8.9	-0.20%	-14.3
Gisborne	-0.05%	-0.8	-0.10%	-1.5	-0.16%	-2.4
Hawke's Bay	-0.07%	-3.0	-0.13%	-5.6	-0.21%	-9.0
Taranaki	-0.07%	-2.2	-0.14%	-4.0	-0.22%	-6.4
Manawatu-Wanganui	-0.07%	-4.2	-0.12%	-7.8	-0.20%	-12.5
Wellington	-0.07%	-11.	-0.13%	-20.3	-0.21%	-32.5
Tasman-Nelson	-0.05%	-1.8	-0.10%	-3.4	-0.16%	-5.4
Marlborough	-0.03%	-0.9	-0.06%	-1.6	-0.10%	-2.6
West Coast	-0.09%	-0.7	-0.17%	-1.3	-0.27%	-2.1
Canterbury	-0.06%	-11.3	-0.11%	-20.9	-0.17%	-33.3
Otago	-0.07%	-4.0	-0.13%	-7.5	-0.20%	-12.0
Southland	-0.08%	-2.0	-0.14%	-3.7	-0.23%	-6.0
Total	**-0.06%**	**-85.9**	**-0.11%**	**-159.1**	**-0.18%**	**-254.0**

Source: NZIER

A wide range of industries are negatively affected

Table 4[6] below shows the flow-on impacts of slower growth in the dairy processing industry.

Lower capital investment and productivity – and hence lower production – in dairy processing will negatively affect a wide range of upstream (supplying) and downstream (using) industries, including:

- Dairy farming

6 The table shows just the industries that experience the largest negative impacts. The full list of results for all 106 industries in the model are in Appendix B.

- Electricity generation and distribution; and gas supply
- Primary sector support services
- Fertiliser and pesticide manufacturing
- Transport (road and rail)
- Warehousing and storage services.

Also, lower household incomes suppress domestic demand in industries such as department stores.

Table 4 Flow-on impacts on industry output: selected industries

Percentage change from 2017

Industry	Output change (%)		
	Capital productivity decrease ([illegible]%)	Capital productivity decrease (5%)	Capital productivity decrease (10%)
Dairy cattle farming	0.63%	-1.17%	-1.87%
Department stores	-0.36%	-0.66%	-1.04%
Electricity generation and on-selling	0.30%	-0.56%	-0.91%
Agriculture, forestry, and fishing support services	-0.25%	-0.45%	-0.72%
Fertiliser and pesticide manufacturing	-0.24%	-0.43%	-0.69%
Water supply	-0.19%	-0.36%	-0.57%
Warehousing and storage services	-0.16%	-0.29%	-0.47%
Rail transport	-0.15%	-0.28%	-0.45%
Religious services, civil, professional, and other interest groups	-0.11%	-0.21%	-0.33%
Gas supply	-0.11%	-0.20%	-0.33%
Road transport	-0.07%	-0.14%	-0.22%
Grocery, liquor, and tobacco product wholesaling	-0.05%	-0.10%	-0.16%
Petroleum and coal product manufacturing	-0.04%	-0.08%	-0.13%
Broadcasting and internet publishing	-0.04%	-0.07%	-0.12%
Banking and financing; financial asset investing	-0.03%	-0.06%	-0.10%
Veterinary and other professional services	-0.03%	-0.06%	-0.10%
Food and beverage services	-0.03%	-0.06%	-0.09%
Defence	-0.03%	-0.05%	-0.08%
Rental and hiring services (except real estate); non-financial asset leasing	-0.03%	-0.05%	-0.08%
Waste collection, treatment, and disposal services	-0.03%	-0.05%	-0.08%

Source: NZIER

Conclusions

This indicative modelling exercise demonstrates the potential negative impacts on economic activity and living standards across New Zealand of a fall in dairy processing capital investment and innovation that could be expected if DIRA’s open entry provisions lead to over-capacity in the industry.

These estimates are not forecasts because we do not know precisely how over-capacity might play out in the New Zealand dairy processing industry. However, they do quantify the potential risks of such an over-capacity scenario eventuating.

Appendix A CGE modelling

A.1 General equilibrium modelling captures the full impact of Fonterra

To capture the full impact of a decrease in capital investment and innovation in the dairy processing sector on the regional economies and New Zealand has a whole, we use one of our suite of CGE models.

CGE models are data-driven and used to capture the effects of a new policy or technology or other external shocks affecting economic activity. They capture the economy-wide effects of changes ('shocks' in modelling jargon) directly on the affected industry, as well as indirectly on supplying industries, competing industries, and factor markets (labour and capital).

CGE models also estimate the effect of a shock on macroeconomic variables such as GDP, employment, wages and trade.

CGE models are a powerful tool, allowing economists to explore empirically many issues on which econometrics or multiplier analysis would be unusable. For these reasons, CGE models have become widely used internationally (e.g. by OECD, IMF, World Bank) for economic impact analysis.

A.2 Why do we prefer CGE over multipliers?

Multiplier studies[7] are popular for economic impact analysis as they are relatively cheap and produce appealing big figures. However, they are based on several assumptions which requires them to be interpreted and considered with considerably care.

Key caveats include that multiplier studies:

- Do not consider any adjustment path between the status quo and the future state of the economy
- Do not consider the impacts of policy changes on the price of goods, services, intermediate inputs, labour (wages) and capital
- Assume that land, labour and capital are available in unlimited quantities, and at no additional cost to firms
- Cannot consider the opportunity cost of using additional resources in one industry on the rest of the economy – there are almost never any losers (i.e. contracting industries) in multiplier studies.

Because of these assumptions, multipliers overestimate the impacts of a change in a particular industry on the rest of the economy. Both the Ministry of Business, Innovation and Employment (MBIE) and Treasury have highlighted the inherent flaws in using multiplier studies for serious economic analysis.[8] NZIER no longer offers

7 Also known as 'input-output studies'.

8 For an overview of these weaknesses, see the New Zealand Treasury and MBIE. Both documents, and Gretton (2013), clearly state that multipliers over-state economic impacts and thus lack credibility for economic analysis. Or in Treasury's words:

multiplier-based analysis to our clients as they no longer align with our independence and reputation for delivering high quality, data-driven analysis.

For all these reasons, we prefer to use CGE models.

A CGE model provides an estimation of opportunity costs (between action and inaction), winners and losers. Resources are limited. It also considers price impacts of shocks and can capture regional linkages between industries as well as spill-over effects.

NZIER's CGE models are highly regarded amongst government agencies with whom we have worked for to conduct policy analysis or sectoral impact studies. This includes MBIE, Treasury, the Ministry of Foreign Affairs and Trade, the Ministry for Primary Industries and the Ministry for the Environment.

We also regularly work with private sector firms to provide them with economic evaluations of their activities. Some recent examples of our CGE work include:

- An economic impact analysis of expanding the Wellington International Airport for Air New Zealand.
- Analysis of growth in NZ wine sector for New Zealand Winegrowers.
- Analysis of Sky City Auckland's National Convention Centre and the Queenstown Convention Centre.
- Value of irrigation in New Zealand: an economy-wide assessment.
- Assessing the impact of the Canterbury rebuild at the regional and national level
- Estimating the impact of the Marlborough aquaculture industry on the regional and national economy.

A.3 How do CGE models work?

A CGE model consists of equations which describe model variables. It also uses detailed data on the structure of the economy that is consistent with these model equations.

This data provides a snapshot of the economy in a particular year, which is used as a starting point for a baseline (or business as usual (BAU)) against which to compare policy simulations or economic changes.

The model data is linked together through a set of equations which capture how the economy evolves over time in response to a shock. These equations, which are based on the economic theory of general equilibrium, ensure supply and demand for goods, services and factors of production in the economy are balanced, and determine how firms and households react in response to changes in incentives.

Most CGE models are written and solved in a specific software system, usually GAMS[9] or GEMPACK.[10]

In any CGE model, we must choose as to what is to be determined within the model (the endogenous variables) and what is to be considered external to the model (the

"Unless there is significant unemployment of people with the requisite skills, **it is therefore likely that multiplier effects do not exist**".

9 General Algebraic Modelling System: https://www.gams.com/

10 General Equilibrium Modelling PACKage: https://www.copsmodels.com/gempack.htm

exogenous variables). A CGE model is just a way of explaining the endogenous variables in terms of the exogenous variables.

Where we draw the line between endogenous and exogenous variables, and which ones can vary or have to remain fixed, depends on a number of factors, including the purpose for which the model simulations are to be used. The choice that we make is called the model closure.

Determining the closure is a key part of any modelling exercise and it is very important that the modeller be transparent about what is a result of the modelling and what has been imposed by assumption via the closure.

The difference between the initial and the new equilibrium can then be analysed to determine the effect of the shock on a range of economic indicators such as GDP, employment, wages and living standards.

A.4 Our regional CGE model ORANI-NZ

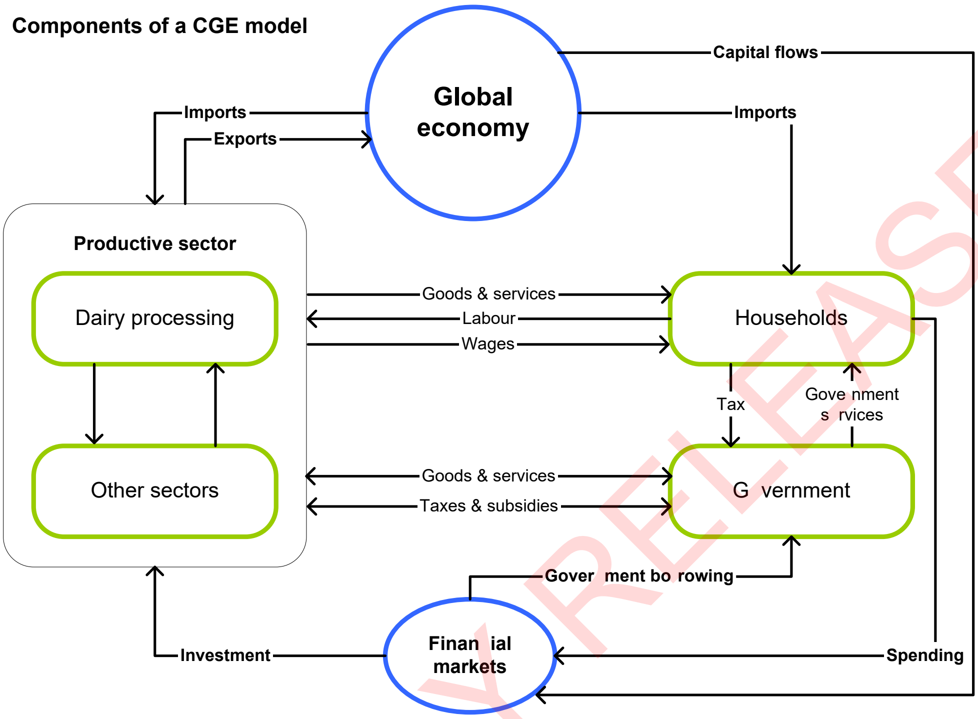
NZIER's ORANI-NZ[11] model is the only top-down CGE model of the New Zealand economy.

ORANI-NZ is based on a Statistics New Zealand's Input-Output table that identifies the structure of the industries involved. It contains information on 106 industries, 201 commodities and fifteen regions. It therefore offers a unique capability to highlight the role of the dairy processing sector in the national and regional economies.

Figure 7 shows how the model captures the complex and multidirectional flows between the various actors of each regional economy and how they interact with the rest of New Zealand and the rest of the world. More technical details on the model are available upon request.

[11] ORANI-NZ was developed at NZIER based on the original Australian ORANI model created by Professor Mark Horridge of the Centre of Policy Studies, Victoria University-Melbourne, Australia. http://www.copsmodels.com/term.htm. NZIER maintains close connections with the Centre, ensuring that our modelling techniques reflect international best-practice.

Figure 7 Our CGE model represents the circular flows between all the agents and activities in the economy



Source: NZIER

A.5 Our modelling approach

A.5.1 Business as usual 2017

We wanted to assess the economic impacts of a decrease in capital investment and capital productivity in the dairy processing sector.

Our first step was to develop a baseline or BAU (business as usual) picture of the economy. To do so, we calibrate our model of the regional and national economies to the latest available data from Statistics New Zealand. This allows us to ensure we correctly benchmark the size of the various industries and gives us a BAU snapshot of the local, regional and national economies.

A.5.2 Modelling the economic impacts of an investment decrease in dairy processing

We impose two negative shocks on the amount (50%) and productivity (1%, 5% or 10%) of additional capital investment in dairy processing. In effect, we are asking the model to determine how the national and regional economies will adjust to a decrease in production for dairy products, in a way that uses the economies' resources most efficiently to return all markets to equilibrium.

A.6 Closure

As noted previously, in any CGE model, it is important to understand which factors have been allowed to vary and which remain fixed by assumption (also known as exogenous variables). The particular combination of fixed factors is known as the closure.

In Table 5 below, we list the main variables included in the closure in the modelling underlying this report.

- National employment is fixed but labour is completely mobile between industries and regions, and real wages adjust to labour market changes This is consistent with the idea that both the labour force and th rate of employment are, in the long run, determined by mechanisms outside the model.
- Household and government expenditures move togethe to accommodate a fixed balance of trade as a share of GDP.
- Rates of return are exogenous and capital is mobile between industries and regions. This mobility can occur either in the form of machinery etc. being physically moved, or capital in one ndus ry/region being allowed to depreciate without replacement while investment builds up the stock of another industry/region.
- Foreign currency prices of impo ts are naturally exogenous.
- Real government consumption is also exogenous.
- Other exogenous variables include rates of production tax, technological coefficients, national population, and national labour supply.

Table 5 Fixed elements of the CGE model

Variables
Taxes on production
Technological change
Government demand
Gross growth rate of capital
Gross rate of return on capital
Number of households
National population
National labour supply
Import prices, foreign currency
Foreign demand for New Zealand exports
Land use

Source: NZIER

Appendix B Full industry results

Table 6 Flow-on impacts on industry outputs

Percentage change from 2017

Industry	Output change (in %)		
	Capital productivity decrease (1%)	Capital productivity decrease (5%)	Capital productivity decrease (10%)
Dairy product manufacturing	-0.67%	-1.23%	-1.97%
Dairy cattle farming	-0.63%	-1.17%	-1.87%
Department stores	-0.36%	-0.66%	-1.04%
Electricity generation and on-selling	-0.30%	-0.56%	-0.91%
Agriculture, forestry, and fishing support services	-0.25%	-0.45%	-0.72%
Fertiliser and pesticide manufacturing	-0.24%	-0.43%	-0.69%
Water supply	-0.19%	-0.36%	-0.57%
Warehousing and storage services	-0.16%	-0.29%	-0.47%
Rail transport	-0.15%	-0.28%	-0.45%
Religious services; civil, professional, and other interest groups	-0.11%	-0.21%	-0.33%
Gas supply	-0.11%	-0.20%	-0.33%
Road transport	-0.07%	-0.14%	-0.22%
Grocery, liquor, and tobacco product wholesaling	-0.05%	-0.10%	-0.16%
Petroleum and coal product manufacturing	-0.04%	-0.08%	-0.13%
Broadcasting and internet publishing	-0.04%	-0.07%	-0.12%
Banking and financing; financial asset investing	-0.03%	-0.06%	-0.10%
Veterinary and other professional services	-0.03%	-0.06%	-0.10%
Food and beverage services	-0.03%	-0.06%	-0.09%
Defence	-0.03%	-0.05%	-0.08%
Rental and hiring services (except real estate); non-financial asset leasing	-0.03%	-0.05%	-0.08%
Waste collection, treatment, and disposal services	-0.03%	-0.05%	-0.08%
Telecommunications services	-0.03%	-0.05%	-0.07%
Life insurance	-0.02%	-0.05%	-0.07%
Residential care services and social assistance	-0.02%	-0.04%	-0.06%
Hospitals	-0.02%	-0.04%	-0.07%

Industry	Output change (in %)		
	Capital productivity decrease (1%)	Capital productivity decrease (5%)	Capital productivity decrease (10%)
Public order, safety, and regulatory services	-0.02%	-0.04%	-0.06%
Preschool education	-0.02%	-0.04%	-0.06%
Employment and other administrative services	-0.02%	-0.04%	-0.06%
Superannuation and individual pension services	-0.02%	-0.04%	-0.06%
Auxiliary finance and insurance services	-0.02%	-0.04%	-0.06%
Polymer product and rubber product manufacturing	-0.02%	-0.04%	-0.05%
School education	-0.02%	-0.04%	-0.06%
Building cleaning, pest control, and other support services	-0.02%	-0.03%	-0.05%
Transport support services	-0.02%	-0.03%	-0.05%
Sport and recreation services	-0.02%	-0.03%	-0.05%
Medical and other health care services	-0.02%	-0.03%	-0.05%
Central government administration services	-0.02%	-0.03%	-0.05%
Furniture, electrical, and hardware retailing	-0.01%	-0.03%	-0.06%
Legal and accounting services	-0.01%	-0.03%	-0.04%
Health and general insurance	-0.01%	-0.02%	-0.03%
Library and other information services	-0.01%	-0.02%	-0.03%
Other goods and commission based wholesaling	-0.01%	-0.02%	-0.03%
Fuel retailing	-0.01%	-0.02%	-0.03%
Construction services	-0.01%	-0.02%	-0.03%
Forestry and logging	-0.01%	-0.01%	0.00%
Transport equipment manufacturing	-0.01%	-0.01%	-0.01%
Local government administration services	-0.01%	-0.01%	-0.02%
Non-residential building construction	0.00%	-0.01%	-0.01%
Personal services; domestic household staff	0.00%	-0.01%	-0.01%
Other transport equipment and parts	0.00%	-0.01%	-0.01%
Gambling activities	0.00%	-0.01%	-0.01%
Postal and courier services	0.00%	0.00%	0.00%
Printing	0.00%	0.00%	0.00%
Non-residential property operation	0.00%	0.00%	0.00%
Scientific, architectural, and engineering services	0.00%	0.00%	0.00%
Heavy and civil engineering construction	0.00%	0.00%	0.00%
Repair and maintenance	0.00%	0.00%	0.00%

Industry	Output change (in %)		
	Capital productivity decrease (1%)	Capital productivity decrease (5%)	Capital productivity decrease (10%)
Residential property operation	0.00%	0.00%	0.00%
Poultry, deer, and other livestock farming	0.00%	0.00%	0.01%
Owner-occupied property operation	0.00%	0.00%	0.00%
Fishing and aquaculture	0.00%	0.00%	0.00%
Residential building construction	0.00%	0.00%	0.00%
Motor vehicle and motor vehicle parts wholesaling	0.00%	0.00%	0.01%
Motor vehicle and motor vehicle parts retailing	0.00%	0.00%	0.01%
Real estate services	0.00%	0.00%	0.01%
Supermarket and grocery stores	0.00%	0.00	0.01%
Basic material wholesaling	0.01%	0.01%	0.02%
Advertising, market research, and management services	0.01%	0.01%	0.02%
Machinery and equipment wholesaling	0.01%	0.02%	0.03%
Coal mining	0.01%	0.01%	0.02%
Sheep, beef cattle, and grain farming	0.01%	0.02%	0.03%
Exploration and other mining support services	0.01%	0.02%	0.03%
Recreational, clothing, footwear, nd personal accessory retailing	0.01%	0.02%	0.03%
Heritage and artistic activiti s	0.01%	0.02%	0.03%
Computer system desig and related services	0.01%	0.02%	0.03%
Oil and gas extraction	0.01%	0.02%	0.03%
Fabricated metal product manufacturing	0.01%	0.03%	0.04%
Meat and meat product manufacturing	0.02%	0.03%	0.05%
Metal ore and non-metallic mineral mining and quarrying	0.02%	0.03%	0.05%
Tertiary education	0.02%	0.04%	0.06%
Publishing (except internet and music publishing)	0.02%	0.04%	0.07%
Non-metallic mineral product manufacturing	0.02%	0.04%	0.07%
Pharmaceutical, cleaning, and other chemical manufacturing	0.02%	0.05%	0.08%
Furniture manufacturing	0.03%	0.05%	0.09%
Air and space transport	0.03%	0.06%	0.09%
Adult, community, and other education	0.03%	0.06%	0.10%
Travel agency and tour arrangement services	0.04%	0.07%	0.12%
Pulp, paper, and converted paper product manufacturing	0.04%	0.08%	0.13%

Industry	Output change (in %)		
	Capital productivity decrease (1%)	Capital productivity decrease (5%)	Capital productivity decrease (10%)
Wood product manufacturing	0.05%	0.09%	0.14%
Beverage and tobacco product manufacturing	0.05%	0.10%	0.16%
Horticulture and fruit growing	0.06%	0.11%	0.18%
Fruit, oil, cereal, and other food product manufacturing	0.06%	0.12%	0.19%
Textile and leather manufacturing	0.06%	0.12%	0.19%
Sewerage and drainage services	0.08%	0.14%	0.23%
Machinery manufacturing	0.08%	0.15%	0.25%
Primary metal and metal product manufacturing	0.10%	0.18%	0.29%
Motion picture and sound recording activities	0.11%	0.21%	0.33%
Other manufacturing	0.12%	0.22%	0.35%
Electronic and electrical equipment manufacturing	0.12%	0.23%	0.37%
Accommodation	0.16%	0.29%	0.47%
Seafood processing	0.19%	0.36%	0.58%
Clothing, knitted products, and footwear manufacturing	0.20%	0.37%	0.60%
Electricity transmission and distribution	0.40%	0.75%	1.23%
Basic chemical and basic polymer manufacturing	0.41%	0.77%	1.23%
Specialised food retailing	0.52%	0.96%	1.55%
Total industry outputs	**-0.01%**	**-0.01%**	**-0.02%**

Source: NZIER

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FONTERRA SHAREHOLDERS' COUNCIL

Fonterra
Dairy for life

8 February 2019

Review of the Dairy Industry Restructuring Act 2001 and its impact on the dairy industry

TO: **DIRA Review team**
Agriculture, Marine and Plant Policy
Policy and Trade Branch
Ministry for Primary Industries
Wellington

By email: dira@mpi.govt.nz

FROM: **Fonterra Shareholders' Counci**

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Submission on the
Review of the Dairy Industry Restructuring Act 2001 (DIRA)
and its impact on the dairy industry

1. Introduction

1.1. This submission is made by the Fonterra Shareholders' Council (the ***Council***) on behalf of Fonterra Farmers in response to the Ministry for Primary Industries' (***MPI***) 2018 Discussion Document. This submission is separate to and independent of the submission of Fonterra Co-operative Group Ltd (***Fonterra***).

1.2. The Council is a national body of Fonterra Farmers elected by their fellow Fonterra Farmers to represent their interests.

1.3. Council welcomes the opportunity to express the collective views of Fonter a Farm rs on the impact of the DIRA on the dairy industry and the extent to which, and how, the DIRA should be amended to achieve the best outcomes for the New Zealand dairy industry and New Zealand as a whole.

1.4. The collective view of Fonterra Farmers has been gathered through the formal meetings arranged by MPI, and many small group and individual farmer engagements arranged by Councillors throughout the country to canvas views.

2. Executive Summary

2.1 DIRA now needs modernising to respond to changes in the global and domestic dairy markets.

2.2 This means:

(a) open entry needs to go;

(b) access to regulated milk fo export processors needs to end;

(c) Goodman Fielder shoul no be entitled to regulated price milk for its export products;

(d) there needs to be standardisation in the calculation of publicised milk prices by all processors; and

(e) there needs to e a clear pathway to de-regulation.

2.3 The focus needs to shift to the future and the highest value creation for New Zealand from our primary sector.

3. Overview

The DIRA's regulatory purpose has been achieved

3.1 DIRA in ts current form has achieved its regulatory purpose.

3.2 It enabled New Zealand's dairy industry to evolve by facilitating the merger of Kiwi Co-operative Dairies and New Zealand Dairy Group. That, together with the end of statutory control of export marketing by the Dairy Board, has contributed to a competitive domestic market and has enabled the merged entity (Fonterra) to compete strongly in international markets and as a result make a significant contribution to the economy.

3.3 In 2019 a majority of New Zealand's dairy farmers have choices as to who they supply their milk to and the public has wide choice in terms of the dairy products they buy.

It is imperative to now refresh DIRA's purpose, recognising the current environment but with the future top of mind

3.4 Whilst it's relevant to note the original policy rationale to provide context to the regulatory regime in DIRA, it is now imperative to focus on the future.

3.5 The global environment is changing at a rapid pace and is impacted by a wide range of factors. The domestic environment also is vastly different from 2001. What hasn't changed is that sustainable dairy farming has a critical role to play in New Zealand's future prosperity and economic and social wellbeing.

3.6 As noted in the October 2018 NZIER report to the Dairy Companies Association of New Zealand (***NZIER report***):

(a) the dairy industry remains New Zealand's only industry of global scale, operating in more than 140 countries;

(b) dairy is New Zealand's biggest goods export by far - the dairy sector a cou ting for 20% of total exports;

(c) dairy provides economic opportunities in many regions where there are few alternative sources of jobs and income; and

(d) dairy is uniquely important to New Zealand amongst developed nations.

3.7 DIRA needs to evolve in response to changes in the domestic market:

(a) milk volumes have plateaued;

(b) there is limited land remaining that is su ted for conversion to environmentally sustainable dairying;

(c) there has been significant competitor processor emergence since 2001;

(d) there is strong competition for farmer milk in the Waikato, Canterbury and Southland – Fonterra is not dominant;

(e) there has been a marked reduction in Fonterra's national market share;

(f) there significant risk of industry over-capacity; and

(g) regions have become increasingly reliant on the dairy industry in terms of economic and social contribution - if over-capacity leads to plant closures there may be significant impacts on some regional communities.

3.8 The Discussion Document notes flattening milk supply growth and anticipates more intense competition for farmers' milk. The dairy industry is now in a new phase. There is an existing footprint of stainless steel processing capacity with limited potential to grow the raw milk pool o flow through it. Further inefficient capacity (through additional new entrants) will lead to heightened risk of stranded assets, to the detriment of the entire industry and entire economy and with significant potential adverse consequences for rural communities with lower milk volumes and / or older, smaller processing facilities.

3.9 Council believes that the DIRA incentivises inefficient entry by large processors. Whilst establishing a plant requires capital and long-term investment, and businesses seek to generate sufficient returns to recoup that investment, the reality is that the majority of processors are backed by foreign capital and large global businesses.

Move forward with a new Dairy Industry Act – the status quo will not suffice

3.10 The New Zealand dairy industry no longer needs a 'Restructuring' Act - or an Act that focuses on Fonterra alone, if the Government is looking to shape the entire industry for the future.

3.11 It's time to shift the narrative and focus away from today and the past, from Fonterra (alone) and its dominance, to the wider industry, the future and value creation for New Zealand – for our people, communities, land and economy. The status quo will not suffice - DIRA needs to become a Dairy Industry Act.

3.12 When considering the options for change Council encourages MPI and the Government to:

(a) be 'NZ Inc.' focused – ensure New Zealand reaps the rewards of its dairy industry; and

(b) be future focused – don't be constrained by what exists today, anticipate future trends and advancements.

3.13 With that comes the challenge to ensure the heritage, agility and innovation of our dairy industry over the last 150 years is recognised and protected.

3.14 Council notes the following key findings from the NZIER report referred to in paragraph 3.6 above:

(a) the dairy sector is a major contributor to New Zealand's living standards;

(b) dairy plays a crucial role in supporting regional economic development;

(c) dairy plays a significant role in the Māori economy;

(d) dairy helps the New Zealand economy benefit from global economic development;

(e) dairy's impacts flow well beyond the farm gate and processing plant; and

(f) dairy shares its growth inclusively throughout the supply chain.

3.15 The Government has a significant responsibility with this review. It is imperative to ensure the regulatory framework moving forward does not adversely impact the sources of competitive advantage that the New Zealand dairy industry enjoys. The economic performance of the dairy industry is critical to New Zealand – as a nation and regionally. And Fonterra and its 10,000 farmer owners are significant stakeholders in that industry. This review, and the legacy of the current administration, cannot be the first step of a downwards slide of Fonterra or New Zealand's wider dairy industry.

4. What does success look like?

4.1 The New Zealand dairy industry must continue to be able to function sustainably and successfully.

4.2 In an engagement with the MPI DIRA Review team Councillors were asked "What does success look like?":

Success for farmers

- Farmers' long-term interests are protected to ensure farming businesses are sustainable, inter-generationally
- Benefits, risks and responsibilities (including for the environment) are shared equitably with others
- Farmers have the confidence to invest for the future in their farming businesses

Success for Fonterra

- Fonterra is a sustainable co-operatively owned business
- Fonterra is widely recognised as a 'national champion'

Success for New Zealand's dairy industry

- The industry is sustainable for the next 150 years

- Dairy remains a significant contributor to New Zealand's economic and broader wellbeing
- The competitive advantage of New Zealand dairy products is further enhanced
- The industry remains adaptive, agile, innovative and high performing
- New Zealand's reputation for world leading dairy innovation and quality is further enhanced
- The New Zealand public is proud of its dairy industry
- Dairy farming is, and is recognised as being, environmentally responsible
- Future generations of farmers are ensured

Success for consumers

- There is a wide choice of affordable, high quality and responsibly produced goods

For New Zealand

- Export earnings from dairying grow
- The benefits arising from sustainable dairy businesses are shared widely across regional communities
- There is effective and sustainable management of dairying's impact on the environment

5. The DIRA open entry and exit requirements

Farmers' preference is to repeal the open entry requirements

5.1 Council is aware Fonterra Farmers in many regions are advocating for open entry to end.

5.2 Council recognises that not all farmers have a choice of processor, and that some Fonterra Farmers (especially of smaller and / or outlier farms) are concerned they may be 'cut free' by their co-operative.

5.3 Council believes there are existing and adequate protections inherent within Fonterra's co-operative structure to address these concerns. These protections include:

(a) Fonterra's Co-operative Principles;

(b) Fonterra's constitutional provisions - including the requirement for both Council and shareholder support for any changes to the provisions in *Part A - Co-operative Principles of the Company*; and

(c) Fonterra's governance and representation structure - including the composition of the Board (a majority of farmer-elected governors), the processes for appointment of the Board and Council, the separation of governance and representation, and the constitutional functions of Council.

5.4 Council also questions whether it's the Government's role to protect farmer investments – or Fonterra's role to give certainty to its farmers it will continue to take their milk.

5.5 It is also relevant to note that before Fonterra's formation farmers did not have the protections offered by today's open entry. Before Fonterra's formation in 2001 New Zealand dairy co-operatives had well defined and separate collection areas with very little overlap, reflecting the historical geographical development of co-operative processors in New Zealand.

5.6 Open entry should end because:

(a) the key issues that open entry was designed to address are no longer an issue or are now managed in other ways – independent processors can attract supply and the efficient pricing of milk is dealt with through the Milk Price Manual regime and the Trading Among Farmers regime;

(b) open entry creates reputational risk for our co-operative (as noted in the Discussion Document);

(c) there is significant concern that with open entry and the continual building of stainless steel the NZ dairy industry will become fragmented and end up like the meat industry;

(d) there are low barriers for new processors to enter the market;

(e) open entry is encouraging a 'race to the bottom' in intensive dairying regions – new processing capacity chasing plateauing milk volumes will ultimately lead to surplus capacity and industry consolidation;

(f) removal of open entry will protect outlier regions – industry consolidation flowing from over-capacity in processing assets will be more keenly felt in outlier regions with processing facilities at risk of closure;

(g) open entry risks leaving Fonterra as the inefficient processor to pick up milk in those areas / regions which other cherry-picking processors leave behind;

(h) open entry may be artificially holding up the value of some land, thereby influencing best land use and impacting affordability (therefore creating a barrier to entry) for the next generation of dairy farmers looking to enter the industry;

(i) the Commerce Act should manage the risk of anti-competitive behaviour – if that Act is not well equipped to regulate, or is not clear or easy to enforce then its shortcomings should be addressed; and

(j) significant DIRA protections remain – open exit, the 160km rule, the Milk Price regime, Trading Among Farmers, the 20% rule, and sale of vats.

5.7 In 2017 Fonterra advised its shareholding farmers that it would give various undertakings if DIRA open entry was removed as part of the legislative amendments being considered at the time – in terms of continuing to collect milk from farmers supplying Fonterra and the purchasers of their farms for so long as other pro-competition provisions applied (***the 2017 agreement***).

5.8 Whilst Council believes the co-operative features discussed in paragraph 5.3 above address the risk of Fonterra Farmers being 'cut free' by their co-op, the principles of the 2017 agreement could be regulated to provide greater certainty to Fonterra Farmers.

The second preference is:

- ***open entry only applies in regions where there is insufficient competition***
- ***no obligation to accept new supply from conversion land***
- ***no obligation to accept supply from non-compliant farms***
- ***regulate the 2017 agreement to give Fonterra Farmers certainty***

5.9 If the Government remains concerned about competition at a regional level, then DIRA's open entry requirements should be amended to:

(a) Remove open entry in areas where there is competition for farmers' milk. Defining a 'competitive area' could be by reference to Regional Council boundaries, or by competitor supply footprint (adopting a DIRA section 107 160km rule-type approach). The required level of 'competition' could be measured by market share dropping below a specified threshold.

(b) Give Fonterra the discretion as to whether to accept milk from land that is not currently used in dairying.

(c) Enable Fonterra to decline to accept or retain supply from farmers who do not meet its supply terms - Fonterra must be able to protect its brand and reputation.

(d) Regulate the entitlement to continue to supply, and supply growth milk to, Fonterra (subject to compliance with its terms and conditions of supply) from its supplying footprint for as long as open entry applies in any other region as per the 2017 agreement.

5.10 Council sees no issues with different regulatory requirements for different parts of the country. That occurs now at a regional level. In addition, regional application of DIRA was previously envisaged (DIRA expiry provisions previously applied on a North Island and South Island basis).

5.11 Fonterra should not be required to accept supply from land that is not currently used in dairying in any region. Securing a supply entitlement for conversion land should be part of the conversion planning process.

Fonterra Farmers should not have to underwrite risks for farmers supplying other processors

5.12 The cost of maintaining processing capacity for milk from new or returning shareholders is only one cost to consider. As owners Fonterra Farmers are concerned about the free option tied to open entry. Risks associated with moving to a new / smaller processor that should be compensated by a higher milk price from the competing processor are instead carried by remaining Fonterra shareholders, given the exiting farmer's right to supply / return to Fonterra without penalty. Fonterra shareholders are effectively providing a free underwrite of the risk of failure of the alternative processor, and farmers' supply contacts with other processors.

5.13 The ability for all dairy farmers to supply Fonterra on standard terms, if and when they choose to, has essentially eliminated the price of risk that should be associated with supplying an alternative processor. Alternative processors are smaller, younger and / or not co-operatives, with fewer manufacturing sites and narrower product ranges. Maintaining a regulatory environment that does not allow that risk to be valued by the market (by essentially removing it) has limited the premium that corporate processors have had to pay to attract their suppliers and therefore limited the value that has been delivered to New Zealand farmers by these processors.

5.14 At the same time as profitability has been affected, so too has the allocation of capital. Land values have been driven higher than they otherwise would have, as there has been no need to add a risk premium (or discount) relating to the supply rights of that land. Therefore, the regulatory framework is distorting market values for farmland.

5.15 The right to return, once a decision has been made to exit, needs to be split from other aspects of open entry – being a Fonterra Farmer's right to continue to supply milk (existing and growth milk) to Fonterra.

5.16 And Fonterra should have the same discretion to accept new milk from a new entrant like other processors do – by assessing if the milk is of value to Fonterra and whether it has capacity to process it.

The capacity constraint notice regime is ineffectual

5.17 The capacity constraint notice regime theoretically gives Fonterra time to build new plant – 15 months. In reality, that window is inadequate and impractical. And at the end of the 15 months the milk must be collected. The cost of additional capacity is not avoided – just deferred for a short time.

Price does not influence milk supply volumes

5.18 Fonterra pays its Farmers a market price for their milk, not an artificially inflated or deflated price to encourage / discourage production.

5.19 The Constitution, milk price regime and Fonterra's co-operative structure require it to pay the maximum sustainable price for its Farmers' milk.

5.20 Since 2009 that price has been calculated using an independently approved methodology that enables total returns to be allocated between payments for milk and returns on capital invested by Fonterra Farmers and unit holders in the Fonterra Shareholders' Fund.

5.21 Deviations from the Milk Price Manual determined base milk price require exceptional circumstances and are closely monitored by Council, as well as the Commerce Commission.

5.22 There have only been two occasions when the final milk price set by the Board for a season has deviated from that determined under the Milk Price Manual. As required by the Milk Price Manual regime, the Board had to publicly explain why it had deviated from the base milk price calculated under the Manual. Basically, on both occasions (2013/14 and 2017/18) due to wider financial circumstances Fonterra could not afford to pay the Manual determined base milk price.

5.23 MPI's preliminary analysis is that New Zealand dairy farmers' milk production decisions are sensitive to price, albeit the price-volume relationship is not linear, can be subject to time lags and is impacted by multiple other factors. The Discussion Document states '...when the price paid to farmers for milk is high, production volumes tend to increase. Similarly, when prices fall, production tends to decrease."

5.24 The key factor influencing a farmer's production and production decisions is climate. Farmers are very wary about basing farming decisions on Fonterra pricing signals.

5.25 The 4 - 5% increase in milk volumes this season, when the milk price has been declining, is evidence of the major impact that climate has – rather than price. Further, the implications of a good climate this season will continue to be felt next season with more feed available, better in calf rates and cow condition etc. Farmers do not know what next season's price will be but are likely to see good production next season even in an average climate year due to these positive factors. Equally, a bad season can depress the next season's volume regardless of price for the same reasons.

5.26 It is also relevant to note that milk price movements are announced after milk has been supplied, and well after any decisions affecting production levels have been made.

5.27 In seasons when milk price is low or reduces, farmers will control costs – feed, stocking rates, defer maintenance etc.

6. Access to regulated milk for large dairy processors (except Goodman Fielder)

Access to regulated milk for export processors needs to end

6.1 Council strongly supports the proposal to remove access to regulated milk for large, export-focused processors because:

(a) access for export-focused processors has failed to add value to the domestic milk market in New Zealand;

(b) the original rationale - to reduce risk for dairy processors seeking entry into the market - is no longer valid;

(c) investment in additional processing capacity should not be encouraged in an environment of plateauing milk supply; and

(d) access provides a very poor business case for NZ Inc where there is foreign ownership of the processor – keep profits in New Zealand.

6.2 Council submits that access to regulated milk should be removed for <u>all</u> export focused processors, irrespective of the level of own supply or the size of the processor. The focus should be on whether the processor is primarily servicing the domestic or export market. Processors primarily servicing export markets could still purchase raw milk on commercial terms. What other industry is regulated in order to subsidise competitors focusing on offshore markets?

6.3 This would also encourage the development of a factory gate market, one of the outcomes sought by the last Commerce Commission review.

7. Access to regulated milk for Goodman Fielder and smaller processors

Amend the existing provisions in the Raw Milk Regulations as they apply to Goodman Fielder to remove access to regulated price milk for export volumes

7.1 Council supports the regulated supply of milk for the domestic market. Farmers support competition in New Zealand markets for dairy products.

7.2 Council notes the view of some Fonterra Farmers that Goodman Fielder's entitlement should end. However, Council is wary that those farmers may not understand the full context of all the commercial supply arrangements between Fonterra and Goodman Fielder. The volume supplied as a percentage of total milk collected is also relevant.

7.3 Council submits that Goodman Fielder should not, however, be entitled to regulated milk for product it exports.

7.4 This should also apply to any other processor entering New Zealand to primarily supply the domestic market which does not establish its own supply and also exports.

Develop a transition pathway to de-regulation

7.5 In its last review the Commerce Commission sought to develop the factory gate market. Is that still considered to be imperative for a competitive dairy industry? It won't develop while Fonterra is required to supply all needs of domestic raw milk users.

7.6 Some farmers have suggested other processors with their own supply should be regulated to sell raw milk. However, a better option may be to reduce the volume limits to reflect the reduction in Fonterra's market share – possibly on a regional basis. This could also help encourage the development of the factory gate market.

7.7 At some point the regulatory requirement to supply milk should end - there should be a clear transition pathway for the end of regulatory dependency.

Ensure there is a fair price at the factory gate and for consumers

7.8 Council submits that the price that Goodman Fielder and smaller processors pay should reflect the full cost to Fonterra of purchasing that milk from its suppliers, including in the 'shoulder' months.

7.9 Council notes and agrees with comments made by farmers during the MPI consultation process about the need for a review of the impact of the supermarket duopoly on retail pricing of dairy goods.

8. The base Milk Price calculation

8.1 Fonterra Farmers highly value the transparent milk price delivered by the current milk price regime. It ensures fairness, certainty and clarity.

8.2 Non-Fonterra farmers also value that regime as it effectively ensures they receive a market price for their milk. It is notable that Fonterra's competitors generally do not offer a milk price regime independent of the Fonterra milk price.

Retain the existing provisions for Fonterra's base milk price calculation and Commerce Commission monitoring

8.3 The existing regime for Fonterra's base milk price calculation and Commerce Commission monitoring should be retained without change. It provides a transparent calculation of the market value of New Zealand milk in global dairy markets.

8.4 The historical gap between the milk price achieved in New Zealand compared to the milk price received by farmers in the European and US markets has now closed. This can be attributed to:

(a) the Milk Price Manual providing a greater level of transparency of the cost of goods for Fonterra's business; and

(b) the introduction of Global Dairy Trade which has provided a true market signal, both internally and externally, of the market value for milk off farm

8.5 A strong co-op milk price means all processors pay a strong milk price, which means greater investment by all farmers in the environment and their communities. It also ensures more of the total value of milk produced in New Zealand is retained in New Zealand and not exported as profit, potentially through transfer pricing to other countries.

8.6 Alternative non-cooperative processors will assert the Fonterra milk price is too high, but their farmers won't, as they know it sets the base for the price they will be paid.

Fonterra should set its base Milk Price

8.7 An independent body should not set the Fonterra milk price. The Manual's clear methodology and the Commerce Commission's oversight address the regulatory concerns. There should be a focus on finding pathways to less regulation – not more regulation.

Greater transparency should be required from other processors

8.8 It is currently very difficult for non-Fonterra Farmers to understand the actual milk price they will be paid by the processor they supply, adversely impacting farmers' ability to make informed decisions on who to supply.

8.9 There is strong farmer support for better transparency from other processors.

8.10 During the consultation meetings the MPI Review Team commented that greater price transparency by competitor processors is considered to be an information disclosure issue and not relevant to DIRA or Fonterra. Council does not agree with this view for the following reasons:

(a) It is imperative, in the interests of fair competition, and an informed and efficient industry, for some standardisation in the calculation of publicised milk prices so that comparisons can be fairly made and therefore better-informed decisions by farmers about the highest alternative use of their milk.

(b) There's an imbalance of information available to farmers compared to the processor. It is currently very difficult for non-Fonterra Farmers to understand the actual milk price they will be paid by the processor they supply. Fonterra publicises the average milk price paid to its suppliers whereas other processors publicise the maximum price achievable if a supplier meets all the incentives offered by the processor. Transport costs, milk composition, demerit payments and other deductions, and incentive pricing mean that the milk price each competitor processor publicises is not usually the milk price paid to the majority of their suppliers.

(c) Corporate processors (that are not co-operatives) will not pay any more than they have to in order to secure milk. It is common knowledge that other non-cooperative processors set their milk price based on what Fonterra pays, not on a maximum sustainable price.

8.11 In its recent inquiry into the Australian dairy industry the Australian Competition and Consumer Commission (***ACCC***) determined:

(a) most Australian dairy farmers have little bargaining power when negotiating with a processor;

(b) given the number of farmers compared to processors, effective contract negotiations are unlikely to occur;

(c) there's an imbalance of information available to farmers compared to the proces or; and

(d) a processor (recognising there are no co-operatives in Australia) will not pay any more than it has to in order to secure milk.

8.12 The ACCC recommended:

Contracts between farmers and processors must set out either:

- *a clear price or schedule of prices that will apply to that farmer (based on elements such as volume, quality and composition) and/or a clear pricing mechanism (such as a formula); and/or*
- *a price notification process (the process by which the processor notifies the farmer of the price.*

Such that at any given point in time, a farmer can be certain of the base milk price that will be paid for the milk produced

8.13 All processors should be required to publish:

(a) total milksolids collected;

(b) the farm gate milk price fo the season – being the average amount paid for milk from farmer suppliers excluding any premium for winter or organic milk; and

(c) average premiums paid for winter and organic milk

Figures should exclude milk purchased / sold at the factory gate (that is, milk transferred between processors).

9. DIRA review and expiry provisions

There must be clear review and expiry provisions

9 1 The Government needs to send a clear sunset signal and transition pathway to farmers and the wider industry, and then stick with it. The industry is operating under ambiguity. Certainty will encourage the development of a sustainable industry with sustainable competition.

9.2 There is deep frustration within the Fonterra Farmer base around the continual shifting of the goal posts around the sunset provisions.

There should be regional thresholds and periodic review

9.3 There should be a combination of regional thresholds (with automatic expiry of pro-competition provisions when a set market share threshold is reached) and periodic review of competition in the dairy industry to determine whether what remains at the time of the DIRA regulatory regime should be retained, repealed or amended. That periodic review should commence no more than three years since the last review was completed, with a set expiry date to ensure the review is completed and changes are enacted on a timely basis.

9.4 Thresholds should not be set on a national basis, but rather should recognise the reality of regional competitor activity, and ensure competing processors don't eat away at New Zealand's dairy heartland to the detriment of the environment and other regions.

10. Fonterra's performance

10.1 Council notes the observations on Fonterra's performance in Appendix 1 of the Discussion Document.

10.2 In 2017 Council engaged independent advisors to assess Fonterra's financial performance since its inception. A copy of the resulting report accompanies this submission. This report provides an independent and reliable view of actual performance over the last 17 years based on sound methodology and, importantly, having access to relevant financial information. Council asks MPI and Government to draw conclusions and observations about Fonterra's performance from this report, and not from sources that are not independent and do not have access to all relevant information.

10.3 In particular, Council draws attention to the commentary (page 9 of the report) comparing Fonterra to other processors operating in New Zealand. This includes:

(a) Fonterra is very different to the other entities operating in the New Zealand dairy sector due to a range of factors, and a direct comparison of each company's performance is potentially misleading. Key differences include:

- Fonterra's historical obligation to supply competitors which has meant it has effectively internalised some production and volume risks on behalf of its competitors
- The limited catchments that some competitors purchase milk from, and the ability for some competitors to change their catchment over time to suit their needs – compared to the obligation in DIRA on Fonterra to collect milk from an extensive catchment.
- Scale – Fonterra collects approximately 12 times as much milk as OCD, 25 times as much as Synlait and 102 times as much as Tatua. Given its scale Fonterra is more exposed to international commodity prices and market fluctuations.
- There is a mix of higher and lower proportion of commodity products produced by each entity.

(b) Of the local processors, OCD is arguably the most comparable to Fonterra. Over the last 10 years OCD has derived an average pre-tax return on capital employed of 7% p.a. Over the same period Fonterra's was 8.3% p.a.

11 Fonterra's co-operative structure

11.1 The new legislation should continue to recognise, but better reflect, Fonterra's co-operative structure, the value to New Zealand of that structure and the fact that co-operatives act differently to corporates.

11.2 A strong co-operative is imperative to ensure the economic and social benefits of New Zealand's dairy industry are shared widely throughout New Zealand. Being a co-operative is a source of strength for the co-operative's farmer owners and for the New Zealand dairy industry as a whole.

11.3 A co-operative acts differently to a corporate and a co-operative's shareholders have greater influence and control than shareholders of, and suppliers to, a corporate. In Fonterra's case, this difference is evident through the Co-operative Principles, its Constitution framework, and Council's representation function.

11.4 Farmers get a say within a co-operative. Major Constitution changes need to be voted in by shareholders, and in Fonterra's case also by Council. Council acts as a gateway to changes to Fonterra's terms and conditions of supply – all changes are reviewed and reasons for those changes are validated to Council before the changes are put for approval by the Board.

11.5 Competition in one region benefits farmers nationally as co-operative principles (milk pricing, capital contribution, averaging of transport costs etc) are applied on a nationwide basis.

11.6 Members of a co-operative police its performance and behaviours. The 2018 Director Election, and shareholder disquiet about the 90-day creditor payment terms, are great examples of Fonterra shareholders exercising their ownership voice.

11.7 A co-op is equipped as a collective to protect its suppliers – farmers will unite to protect their common best interests.

12. Environmental considerations

12.1 Environmental issues are relevant to all processors and all their suppliers' farms – not just Fonterra and its suppliers' farms.

12.2 Environmental management should be determined by local and regional authorities through regional and district plans, and by Government through a well-functioning RMA.

12.3 DIRA's open entry has created an incentive over alternative land uses as it has given a guaranteed buyer of milk from land converted to dairy.

13. Overseas ownership of processing assets

13.1 Given the dairy sector remains New Zealand's largest goods exporter by some margin and accounts for nearly 20% of New Zealand's goods and services trade. In the same way that there are now restrictions on foreign investment in sensitive land, and recent measures implemented to address overseas ownership of housing, Council invites the Government to consider restrictions on overseas ownership of dairy processing capacity.

14. Putting value-add in context

14.1 There is a lot of commentary about Fonterra's investment in value-add production. Commodity milk products have been good for New Zealand and have their place.

14.2 Commodity products also reflect the reality of New Zealand's seasonal supply curve. There would be significant environmental consequences from square curving milk production.

14.3 Value add products only use a proportion of the components in raw milk – the remaining components also need to be processed. And all components need to be optimally processed.

15. Reasons farmers leave Fonterra

15.1 The Discussion Document discusses farmers switching milk production to the highest value user.

15.2 Recognising other processors generally base their milk pricing off Fonterra's milk price, key reasons farmers will supply an alternative processor are:

(a) as a general 'protest' to Fonterra's performance (not its milk price);

(b) to avoid compliance with Fonterra's supply terms;

(c) because they are capital constrained they can sell shares and supply another processor from the same farm;

(d) to fund additional investment; or

(e) they have a higher value alternative land or capital use.

16. In conclusion – in Farmers' own words

'Leaving DIRA the same encourages nothing new or better'

'Should this be the Fonterra regulatory Act or the Dairy Industry regulatory Act?'

'If we're not careful, we will end up like the meat industry or the Australian dairy industr

'The co-op will continue to pick up my milk if open entry goes. We own it'

'We know what we are getting paid is fair - the other companies want Fonterra to pay as little for their milk as possible'

'The way we produce our milk is New Zealand's competitive advantage. It should be New Zealanders who benefit from this'

'We are supposed to be a subsidy free industry yet Fonterra Farmers are subsidising other processors'

'Goalposts keep shifting and I have no confidence that the Government will implement deregulation'

'You cannot talk about Fonterra and its farmers separately – those farmers own Fonterra. Fonterra is its Fonterra dairy farmers'

'Good regulation is minimal regulation'

Council would be happy to discuss any aspect of this submission and requests the opportunity to provide further input as the process progresses.

Sincerely,

Duncan Coull
Chairman, Fonterra Shareholders' Council

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8 February 2019

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REVIEW OF THE DAIRY INDUSTRY RESTRUCTURING ACT 2001

This submission is made by Foodstuffs (NZ) Ltd on behalf of the Foodstuffs group of companies [Foodstuffs] including Foodstuffs North Island Limited, Foodstuffs South Island Limited, and Foodstuffs (Own Brands) Ltd.

Foodstuffs North Island Limited and Foodstuffs South Island Limited are retailer owned co-operatives. Members of each co-operative operate supermarkets and grocery stores trading under the following Foodstuffs owned brands: PAK'nSAVE, New World, Four Square, Raeward Fresh, and On the Spot.

Foodstuffs has an interest in the current review as a retailer of fresh milk and other dairy products. We also have an interest as the brand-owner of private label ranges which include dairy products, the supply of which is contract manufactured on our behalf and sold under the Pams and Value brands.

We respond to the key points of discussion in the order of importance to our business.

<u>Access to Regulated Milk for Goodman Fielder and Smaller Processors</u>

Foodstuffs key concern is that there continues to be effective competition for the supply of consumer-ready products into the retail market for fresh milk. This is necessary to protect consumer interests, ensure consumer milk is competitively priced, and provide incentives for product innovation.

In practice, effective competition requires there to be at least two potential suppliers to the retail market, each having enough scale to be able to supply fresh milk products to supermarket customers on a competitive basis. Until now, only Fonterra Brands and Goodman Fielder have had the scale to supply supermarket customers. From April 2019 a third supplier, Synlait, will be operating in the South Island, having contracted with Foodstuffs South Island Ltd to supply its private label milk range.

Supermarket private label milk is the price leader in the supermarket category and holds the largest share of the retail market for fresh milk. We need a supplier of scale to fulfil private label needs as we need to be very price competitive, apply consistent pricing across regions, and satisfy our customers' year-round demand with reliability of supply at the required volumes. Foodstuffs' private label supply contracts are periodically tendered by each regional Company and this ensures competitive tension occurs in the supply of private label milk. Private label milk competes with proprietary brands in the retail market and is therefore extremely important to promoting price competition at this end of the market.

Up until now, the DIRA regime has been pivotal in ensuring Fonterra Brands has had an effective competitor in supplying the retail market. Fonterra's obligation to supply Goodman Fielder has ensured Goodman Fielder has had enough milk product to be able to compete with Fonterra for supermarket supply. While Synlait's entry into milk processing in the South Island will enhance competition in the South Island market, Synlait does not operate in the North Island where Goodman Fielder remains the only effective competition to Fonterra.

In terms of the future options outlined in the consultation document. Foodstuffs does not have enough knowledge of upstream markets, or the economic expertise, to advise the government on the best path forward, however continued supply of regulated milk to Goodman Fielder is, in the short term at least, necessary to ensure ongoing effective competition in the North Island market for retail milk.

Foodstuffs private label ranges also include further processed dairy products including: butter, cheddar-style cheeses, and ice-cream. Supply arrangements are tendered nationally by Foodstuffs Own Brands Limited. The market for the supply of these products is competitive with a larger number of suppliers tendering for this business, however we know suppliers tendering for this business rely, at least in part, on Fonterra for the supply of their raw material. As with fresh milk, private label products provide additional competitive pressure for the proprietary brands and therefore fulfil an important role in fostering market competition.

<u>Base Milk Price Calculation</u>

The DIRA currently provides Fonterra with discretion to determine how it calculates the base milk price so that the calculation is “reasonably practical”. While some flexibility is desirable, we are aware other market participants have expressed concern about the lack of transparency in Fonterra’s calculations.

We understand that the base milk price sets an industry floor for the price paid to famers for milk – other processors collecting milk directly from farmers will have to match or better Fonterra’s price to secure supply. Ideally, the base milk price should mirror what would be paid to farmers in a competitive market.

In response to the expressed concerns, Foodstuffs believes additional guidance to Fonterra about the government’s expectations could be helpful. On this basis we support Option 2 – amend the DIRA to provide additional statutory guidance on the meaning of the term “practically feasible”.

<u>Open Entry Requirements</u>

As we understand it, the open entry requirement was initially established to ensure dairy farmers had a buyer for their milk, while open exit facilitates low cost switching to other processors. Going forward, Foodstuffs believes it would be sensible to enable Fonterra to better manage reputational risk by allowing the Company to attach conditions to supply e.g compliance with minimum environmental standards, animal husbandry practices, and quality criteria.

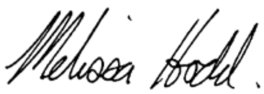
<u>DIRA Review and Expiry Provisions</u>

Markets are dynamic and can change in unexpected ways in unexpected timeframes. Flexibility is desirable. Foodstuffs favours Option 2 – periodic reviews of the regime on an “as-required” basis.

<u>Access to Regulated Milk for Large Dairy Processors (except Goodman Fielder)</u>

Foodstuffs understands the larger dairy processors are generally export focussed. Foodstuffs does not have enough knowledge of this part of the market to provide any meaningful comment.

Yours sincerely



Melissa Hodd
General Manager
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Forest & Bird
TE REO O TE TAIAO | Giving Nature a Voice

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13 February 2019

SUBMISSION ON THE DAIRY INDUSTRY RESTRUCTURING ACT REVIEW

1) The Royal Forest & Bird Protection Society of New Zealand has been New Zealand's independent voice for nature since 1923. Over generations the organisation has helped make New Zealand a better place to live by standing with community to protect forests, lakes and rivers from destruction, campaigning to create marine reserves and eco-sanctuaries and working to save threatened species.

2) Forest &Bird's constitutional purpose is:

> To take all reasonable steps within the power of the Society for the preservation and protection of the indigenous flora and fauna and the natural features of New Zealand.

3) Agricultural intensification over the last 20 years or so, including dairying, has sadly contributed to the loss of New Zealand's indigenous flora, fauna and natural features,[1] therefore any legislation that regulates the dairy industry falls squarely within the scope of this constitutional purpose and is an important issue for Forest & Bird.

4) Forest & Bird outlines our position below on the 'Review of the Dairy Industry Restructuring Act 2001 (DIRA) Discussion Document', referred to as the 'DIRA discussion document'.[2]

[1] This impact is discussed in the appendix 'Environment in crisis'
[2] MPI discussion document Paper No: 2018/13

FOREST & BIRD RECOMMENDATIONS[3]

5) Forest & Bird recommends that:

   a) open entry requirements are repealed,

   b) open exit provisions are maintained,

   c) and raw milk regulations are amended such that the requirement to have excess milk on hand for large dairy processors, smaller processors and Goodman Fielder are removed

NEW ZEALAND DAIRY & DIRA

6) Nationally, freshwater ecosystems and the climate are being negatively impacted by reductions in available habitat and increases in pollution. In most cases this is a direct result of the conversion of land use to dairying, which has destroyed natural habitat, led to the increase in cow numbers, increase in irrigation, an increase in effluent and fertiliser polluting waterways, and increase in greenhouse gases polluting the atmosphere.

   a) Increase in cow numbers

      1. New Zealand has 6.4 million dairy cows. New Zealand dairy cows numbers have increased nationally by 69% between 1994 and 2015, with some regions such as Canterbury, Otago and Southland increasing dairy numbers 490%, 368%, 539% respectively.

      2. While the number of dairy farms has decreased, the cow numbers and herd sizes have increased, indicating that nationally there has been a shift toward intensification of dairying. (See graphic in appendix.) This is contrary to what is stated in paragraph one under the heading 'land use' on page 62 of the DIRA discussion document.

   b) Increase in fertilizer, effluent, and pollution

      1. An MfE report from 2007 stated that "the amount of nitrogen fertiliser used in New Zealand has increased by about 10 times since 1985 and doubled since the mid-1990s" and referred to a 2004 report on agriculture by the Parliamentary Commissioner for the Environment, which "found that the use of synthetic fertilisers based on fossil fuels on dairy farms had increased in recent decades.[4]

      2. The 2007 report goes on to say that an increase in nitrogen "is consistent with the recent trend towards more intensive forms of farming in New Zealand; particularly dairy farming. The high density of grazing stock on dairy farms delivers more nutrients to the land than other forms of farming."

[3] The recommendations here are not available in the options provided, hence why Forest & Bird has not adhered to the 'Options' format of the DIRA discussion document.

[4] Ministry for the Environment report "Environment New Zealand 2007". http://www.mfe.govt.nz/sites/default/files/environment-nz07-dec07.pdf

3. The DIRA discussion document states that “data indicates an increase in nitrogen leaching of approximately 3 percent per annum, in line with the growth in milk productions since 2001.”[5]

4. Citing Environment Southland, the report states that “dairy cows excrete almost seven times the amount of nitrogen and phosphorus in their faeces and urine as do breeding ewes, and around three-and-a-half times that of breeding hinds” therefore the increase in dairy cows has accelerated the increase in pollution to waterways.

c) Increase in irrigation

1. Approximately 80% of the water allocated nationwide is for irrigation. Irrigation occurs over 80,000 hectares of land and 47% of this irrigation is used for dairying

2. The Ministry for the Environment stated that “intensification of land use has had a significant impact on water availability in some regions”. And that this “intensification of agricultural land use has occurred as farmers have responded to economic signals by converting suitable dry-stock pasture, exotic forestry, and existing dairy farms into more intensive dairy farms.”

3. In 1987, dairy farming exceeded sheep farming as New Zealand’s highest value primary export for the first time. Though agricultural intensification has been underway since the late 1970s, which has been accompanied by increased stocking rates; increased fertiliser, and food stock inputs; and conversion to more intensive forms of agriculture, i.e. dairying. [8]

7) Over a prolonged period, the Government has failed to take the steps necessary to avert the environmental crisis[9], instead it has actively promoted dairy farming through economic incentives such as DIRA and irrigation subsidies which has led to land use conversions and dairy intensification.

8) Historically, DIRA has been as influential as irrigation subsidies and insufficient environmental regulations, to the environmental crisis,[10] specifically through the provisions around “open entry” and “access to regulated milk” which is discussed in chapter 4 of the DIRA discussion document (specifically 4.1, 4.2, and 4.4).

a) Open entry provisions in DIRA have meant that Fonterra has had to accept all new dairy suppliers if the condition of distance to other suppliers was satisfied. This provided certainty to farmers and to banks that a buyer (i.e. Fonterra) is guaranteed. Hence, DIRA has enabled the dairy industry to grow rapidly.

b) Access to Fonterra’s regulated milk is available for large producers, small producers and Goodman Fielder. This DIRA requirement has caused Fonterra to build additional capacity

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[5] DIRA discussion document. Page 63.
[6] StatsNZ & DairyNZ (2012). See Appendix for the graphic.
[7] Ministry for the Environment report “Environment New Zealand 2007”. http://www.mfe.govt.nz/sites/default/files/environment-nz07-dec07.pdf
[8] Our Fresh Water Report, 2017, New Zealand Ministry for the Environment, http://www.mfe.govt.nz/sites/default/files/media/Environmental%20reporting/our-fresh-water-2017_1.pdf
[9] See section “Environment in crisis”
[10] See section, “Environment in crisis”

and collect large stores of milk beyond its own intended business model. In effect, these provisions in DIRA have also enabled massive growth of the dairy industry.

9) Forest & Bird acknowledges that the Act was intended to provide a regulatory tool to promote competition nationally among independent dairy processors and provide a safeguard against Fonterra becoming a monopsony.[11]

10) The DIRA discussion document states that "DIRA simply provides a framework to manage risks around Fonterra's dominance and incentivises performance, primarily through price signals."[12] Unfortunately, as MPI acknowledges on page 62 of the DIRA discussion document, the performance incentivised through price signals has reduced business risk such that "the expansion of dairying has […] come at the cost of the environment."[13]

11) Further, policies and rules in regional and district plans have not been able to deter the bulk of the effects that dairying has had on the environment. The DIRA discussion document states that "environmental regulations, and enforcement of those regulations in certain parts of New Zealand has not significantly constrained the growth in dairying that has increased pressures on the environment." Which has caused "unpriced externalities".

12) This has resulted in deteriorating water quality throughout New Zealand, increased GHG emissions and the loss of indigenous species' populations as a result of the conversion of native grasslands being converted into exotic pastures in areas such as the Mackenzie Basin and Otago.

13) Forest & Bird is concerned that one of the main functions of DIRA, which has been to promote competition and reduce the dominance of Fonterra in the market, has not worked.

    a) When DIRA was established, in 2001, Fonterra accounted for 96% of the market for farmers' milk which has fallen to 80.5 percent. Though while total milk volume produced has increased by 10 percent per annum nearly 60 percent of this increase has been undertaken by Fonterra (by milk solids).[14]

    b) The DIRA discussion document says that "the state of competition in the supply of fresh milk and other consumer dairy basics has remained largely unchanged since 2001. With the exception [one independent producer], the majority of basic fresh milk is supplied throughout the country by the two larger processors, Goodman Fielder and Fonterra."

    c) It goes on to say that "Goodman Fielder remains dependent on Fonterra for its supply of raw milk." And that "[t]here is no substantial market entry of scale into the consumer basic market since 2001."

    d) While smaller independent processors have been able to start up since 2001, it appears that Fonterra's major competition is via a company that sources its milk from Fonterra via a legal requirement set out in DIRA.

14) To summarise, DIRA has facilitated the dairy industry to expand unchecked due to Fonterra's requirements of 'open entry' and 'regulated access to raw milk' for other producers. And this

[11] Defined as: a market situation where there is only one buyer.
[12] DIRA discussion document. Page 59.
[13] DIRA discussion document. Page 62.
[14] DIRA discussion document. Page 61.

has “prevented Fonterra from effectively managing some aspect of its farmers’ environmental performance, thus producing unintended [environmental] consequences.”[15]

15) DIRA’s ability to increase competition has been questionable given the ‘regulated access to raw milk’ and made largely irrelevant when compared with the extreme degradation of the natural environment.[16]

FOREST & BIRD RECOMMENDATIONS[17]

16) Forest & Bird recommends that:

    a) open entry requirements are repealed,

    b) open exit provisions are maintained,

    c) and raw milk regulations are amended such that the requirement to have excess milk on hand for large dairy processors, smaller processors and Goodman Fielder are removed.

OPEN ENTRY REQUIREMENTS

17) Forest & Bird would like to see the open entry requirements repealed.

18) This provision has reduced the financial risk of farming milk to nearly zero in that it has guaranteed the farmer milk collection by Fonterra regardless of circumstances particular to a business model or business ethics. In other words, this provision in the Act has guaranteed a buyer to the farmer regardless of the conditions which affect profitability or quality of product.

19) This reduced risk, and guaranteed market has translated to reduced risk with respect to financial lending and thus inflating the property market as well as allowing loans which have been used to support irrigation structures and intensification.

20) It has also meant that Fonterra would have to accept all raw milk produced. This has allowed for the industry to intensify beyond natural business limits and at the risk of reputation because of the environmental damage.

21) Fonterra has publically stated that it “would prefer not to see dairy expansion in the Mackenzie Basin but if the farms are there, the co-op is legally required to collect their milk.”[18] This is a direct reference to the open entry requirements forcing Fonterra to accept a farm which has reduced Fonterra’s social licence due to the environmental implications of destroying a rich ecosystem such as the Mackenzie Basin (the Basin) for green monoculture dairy support pastures.

22) The Basin has extremes of drought and cold, shallow, porous and nutrient poor soils and has the highest density of naturally rare ecosystems of any region in New Zealand.

23) Agricultural intensification in the Basin has contributed to an alarming loss of rare and threatened species over the last two decades at a rate that is unprecedented in New Zealand.

[15] DIRA discussion document. Page 6.
[16] See section ‘Environment in crisis’
[17] The recommendations here are not available in the options provided, hence why Forest & Bird has not adhered to the ‘Options’ format of the DIRA discussion document.
[18] https://www.stuff.co.nz/business/farming/dairy/105219901/coops-stance-on-mackenzie-dairy-expansion-shows-depth-of-negative-feeling

24) It has over 60 species of rare and threatened plant species, a high number of which are endemic to the area, along with numerous threatened bird, fish and invertebrate species.

25) If open entry is removed, Fonterra will be required to stand behind and defend new and existing dairy suppliers (farmers), their locations, and their performances. Fonterra would no longer be able to excuse its poor business decisions or farmers' poor performance on DIRA regulations.

26) Forest & Bird would like to see the Fonterra have the ability to regulate its customer base by way of factors such as desired volume of milk production, market signals, business strategy, shareholder opinion, and above all environmental and social responsibility. Rather than arbitrarily accepting all dairy farmers, Forest & Bird would like Fonterra to have the right to refuse new dairy milk from farms that put rare ecosystems such as the Basin in peril.

OPEN EXIT REQUIREMENTS

27) Forest & Bird would like to see DIRA maintain its provisions on open exit. This provision "allow[s] farmers to withdraw from the co-operative without unreasonable restrictions or penalties."[19]

28) Maintaining the unencumbered right for farmers to leave Fonterra means that DIRA can continue to promote competition among other independent processors.

29) It is recommended that this provision is maintained in tandem with the removal of open entry requirements as this will ensure easier movement of farmers away from Fonterra than movement of new farmers into Fonterra, thus in theory, reducing Fonterra's stronghold on the customer base and supporting the intentions of the DIRA.

RAW MILK REGULATION REQUIREMENTS

30) Fonterra is required "to sell up to 50 million litres of raw milk per season, on agreed or regulated terms, to dairy processors who have not tyet established their own supply from farmers." Which is intended to provide new dairy processors with an "entrance pathway".[20]

31) As indicated in the sections above, the increase in dairying to support the need for greater milk volumes has been the catalyst for environmental decline in New Zealand.

32) Forest & Bird would like to see Fonterra regulate its volume of milk production by way of market signals, business strategy, shareholder opinion, and above all environmental and social responsibility rather than be regulated to accept every ounce of milk in order to support existing and emerging competition.

a) Forest & Bird recommends a timed transition of not more than 3 milking seasons for the discontinuation of raw milk regulations, except for Goodman Fielder,

b) With respect to Goodman Fielder, we recommend that the current supply arrangements which are scheduled to expire in 2021 should be honoured and naturally expire.

ENVIRONMENT IN CRISIS

[19] Discussion document. Page 14.
[20] Discussion document. Page 15.

33) The OECD's country report on the state of New Zealand's environment, released in March 2017, states that "New Zealand species extinction rate is among the highest in the world" and, more specifically, that New Zealand "has some of the highest levels of threatened freshwater species in the world" and that "deteriorating water quality remains one of [its] biggest threats to indigenous freshwater species."[21] With 90% of wetlands lost, and surface and ground water volumes being rapidly depleted, the habitat of these freshwater ecosystems is seriously under threat.[22]

a. Freshwater ecosystems in decline:

1. Majority of freshwater indigenous fish are at risk or threatened with extinction:

    i. The majority of indigenous freshwater fish populations have already been significantly affected and are in a critical state. Currently, 74% of indigenous freshwater fish are at risk or threatened with extinction.[23] This national decline across dozens of species of indigenous fish is comprised of reduced populations and localised extinctions regionally.

2. Landuse changes from natural cover to pastoral land correlate with the decline in native fish populations:

    i. A temporal study which looked at landuse changes and tested the correlation with fish populations found that the majority of 20 native species analysed showed a decrease in fish populations overtime (75%) where the majority of these displayed a significant decline (65%), and more native species demonstrated this decline in pastoral landcover than natural land cover.[24]

3. More waterways are doing worse, than are doing better:

    i. A 2017 report by Sir Dr. Peter Gluckman, then chief science advisor to the prime minister stated in a report that an evaluation of the water quality of 1000 rivers and 100 lakes in New Zealand during 2009-2013 showed that, '[t]here were more sites showing degrading trends in MCI scores (indicating declining ecological health) than the number showing improvement, and many sites showed degrading trends in nitrate nitrogen (NO3-N).[25]

4. Groundwater is polluted in most monitored sites:

    i. A 2015 study by GNS found that the state of groundwater had not improved in the previous two decades, and that most monitored

[21] http://www.keepeek.com/Digital-Asset-Management/oecd/environment/oecd-environmental-performance-reviews-new-zealand-2017_9789264268203-en#page38
[22] http://www.pmcsa.org.nz/wp-content/uploads/PMCSA-Freshwater-Report.pdf
[23] Conservation Status of New Zealand Freshwater Fish, 2013, New Zealand Department of Conservation, May 2014. www.doc.govt.nz/documents/science-and-technical/nztcs7entire.pdf.
[24] Joy Michael K., Foote Kyleisha J., McNie Pierce, Piria Marina (2018) Decline in New Zealand's freshwater fish fauna: effect of land use. Marine and Freshwater Research **70**, 114-124.
[25] https://www.pmcsa.org.nz/wp-content/uploads/PMCSA-Freshwater-Report.pdf

sites (62%) don't meet the Australian and New Zealand Guidelines for Fresh and Marine Water Quality (ANZECC) values for ecosystem health, and 9% exceeded toxicity levels.[26]

b. Destruction of natural habitat

1. Wetlands have historically been drained;

   i. Statistics New Zealand sites that the majority of wetlands have historically been drained, leaving only 10.1 per cent of the original wetlands as of pre-human times.[27]

2. Wetlands are still being drained today;

   i. A Maanaki-Whenua Landcare Report indicated that between 2001-2016, at least 214 wetlands were completely destroyed and an additional 746 wetlands had been damaged or partially destroyed, in that they had reduced in size.[28] See Appendix for percentage of wetland partial destruction by region

3. Wetlands drained for dairying;

   i. A study prepared for Environment Southland showed that the region drained 10 per cent of its wetlands from 2007-2017, further stating that 40 per cent of these wetlands were drained for dairying. This is especially detrimental given that Southland is the second largest region for wetlands by area in New Zealand.[29]

c. Dairying increases national risk to climate change

1. The DIRA discussion document states that "the dairy sector accounts for the majority of New Zealand's agricultural emissions" and that despite reductions in methane emissions across the entire agricultural sector (estimated at 0.1 percent per annum) "methane emissions from dairy cattle in New Zealand have grown […] since 2001, at approximately 1 percent per annum."

2. New Zealand has made commitments, under the Kyoto Protocol and the Paris Agreement, to reduce anthropogenic greenhouse gas emissions

[26] https://www.stats.govt.nz/~/media/Statistics/Sub-sites/EnvironmentalIndicators/PDFs/Update%20of%20National%20GW%20Quality%20State%20and%20Trends.pdf

[27] "Wetland Extent." *Home*, New Zealand Government, 2017, archive.stats.govt.nz/browse_for_stats/environment/environmental-reporting-series/environmental-indicators/Home/Fresh%20water/wetland-extent.aspx.

[28] Belliss, S, Shepherd, J, Newsome, P, & Dymond, J (2017). *An analysis of wetland loss between 2001/02 and 2015/16*. Landcare Research Contract Report LC2798 for the Ministry for the Environment.

[29] Ewans, Richard. "Environment Southland Wetland Inventory Project: Monitoring Wetland Extent on Non-Public Conservation Land in the Southland Region - Interim Report for 2016." Wetland Inventory Project 2015-16 PART 1.Pdf, EcoSouth, 15 July 2016, www.es.govt.nz/Document%20Library/Research%20and%20reports/Various%20reports/Science%20reports/Ecosystem%20health/Wetland%20Inventory%20Project%202015-16%20PART%201.pdf.

relative to 1990.[30] The Government is reviewing the 2030 and 2050 targets, with a view to making New Zealand carbon-neutral by 2050.

3. Scientific evidence from many sources, including the International Panel on Climate Change's Special Report on Global Warming of 1.5deg, highlights the importance of limiting warming to no more than 1.5deg above pre-industrial levels. Achieving that will require a much faster reduction in emissions than currently planned by New Zealand.

4. On current projections, using domestic emissions reductions alone, New Zealand is unlikely to meet even its current targets.[31]

5. Agricultural emissions – especially from the dairy sector – hav an important part to play in New Zealand's contribution to limiting global heating. The New Zealand Greenhouse Gas Inventory 2018 shows that between 1990 and 2016, emissions from New Zealand's agricultural sector increased by 12 per cent. This is primarily due to the national dairy herd nearly doubling in size since 1990 and an increase of more than 600 per cen in the application of nitrogen-containing fertiliser during the same period[32].

[intentionally left blank – see next page for conclusion]

[30] Ministry for the Environment website, About New Zealand's Emissions Reduction Targets http://www.mfe.govt.nz/climate-change/what-government-doing/emissions-reduction-targets/about-our-emissions-reduction

[31] National Communication and Biennial Report 2017 Snapshot http://www.mfe.govt.nz/sites/default/files/media/Climate%20Change/Final%20Snapshot_WEB.pdfhttp://www.mfe.govt.nz/sites/default/files/media/Climate%20Change/Final%20Snapshot_WEB.pdf

[32] New Zealand Greenhouse Gas Inventory, 1990-2016. http://www.mfe.govt.nz/sites/default/files/media/Climate%20Change/National%20GHG%20Inventory%20Report%201990-2016-final.pdf

CONCLUSION

34) The DIRA discussion document acknowledges that the Act has resulted in "unintended consequences" to the environment, though does not adequately explain these unintended consequences as a direct result of the particular Dairy Industry Restructuring Act's provisions being discussed.

35) Further to this point the DIRA discussion document doesn't adequately provide information on how the potential options might alter these unintended consequences to the environment.

36) We feel that the implications of Dairy Industry Restructuring Act on the environment have largely been ignored in the DIRA discussion document and this could lead to a continuation of "unintended consequences" or potentially cause new consequences to the detriment of the environment. Forest & Bird is concerned that if the Ministry for Primary Industries does not consider the inextricable link between the regulation which governs the dairy industry and the well-being of the environment, we may be doomed to repeat our mistakes.

37) Forest & Bird has informally consulted with a number of experts in dairy, economics, environment, and law to obtain the necessary information to arrive at our recommendations.

Nāku noa, nā,

Annabeth Cohen
Freshwater Conservation Advocate

Forest & Bird
TE REO O TE TAIAO | *Giving Nature a Voice*

APPENDIX 1

Wetlands by region which have been reduced in size due to partial destruction and drainage.

	total wetland hectares	%wetlands damaged hectares
Northland	14056	7%
Auckland	2533	20%
Waikato	28212	15%
Bay of Plenty	3287	8%
Hawkes' Bay	2456	3%
Gisborne	939	18%
Taranaki	3024	8%
Manawatu-Wanganui	6983	17%
Wellington	2765	37%
Tasman	5212	4%
Nelson	3	0%
Marlborough	1543	20%
Canterbury	19850	29%
West Coast	88417	12%
Otago	27049	9%
Southland	47272	8%
National	249609	13%

Figure 1 Wetland damage (partial d struct n, e. reduced in size) by region 2001-2016. (Source StatsNZ and Maanaki Whenua Landcare 2017).

APPENDIX 2

FARMING ENTERPRISES USING IRRIGATION

The range of crops and activities for which irrigation is used is shown in Figure 4.

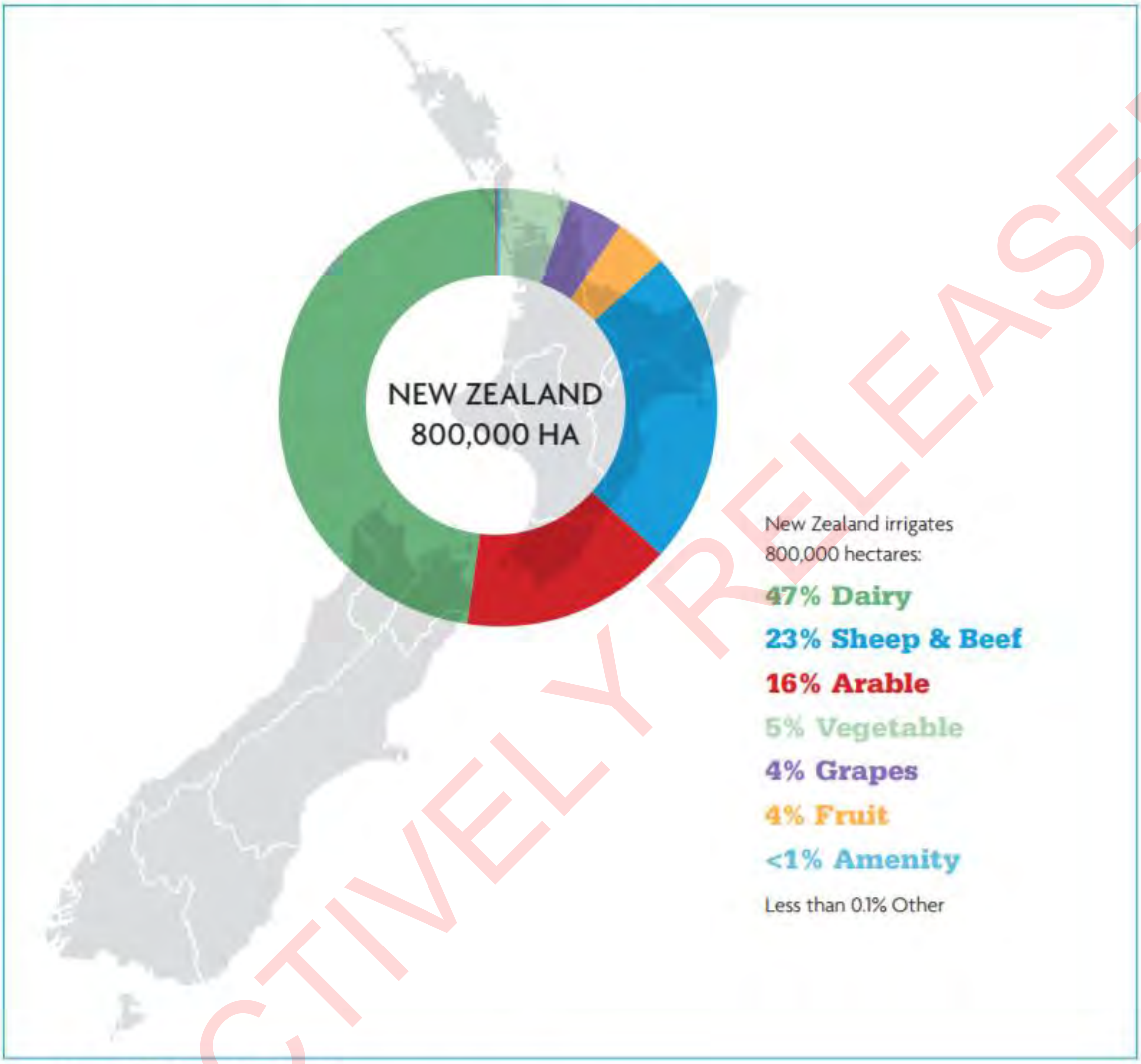

Figure 4. Irrigated land use in New Zealand

Source: Statistics New Zealand (2012). Updated with IrrigationNZ knowledge.

APPENDIX 3

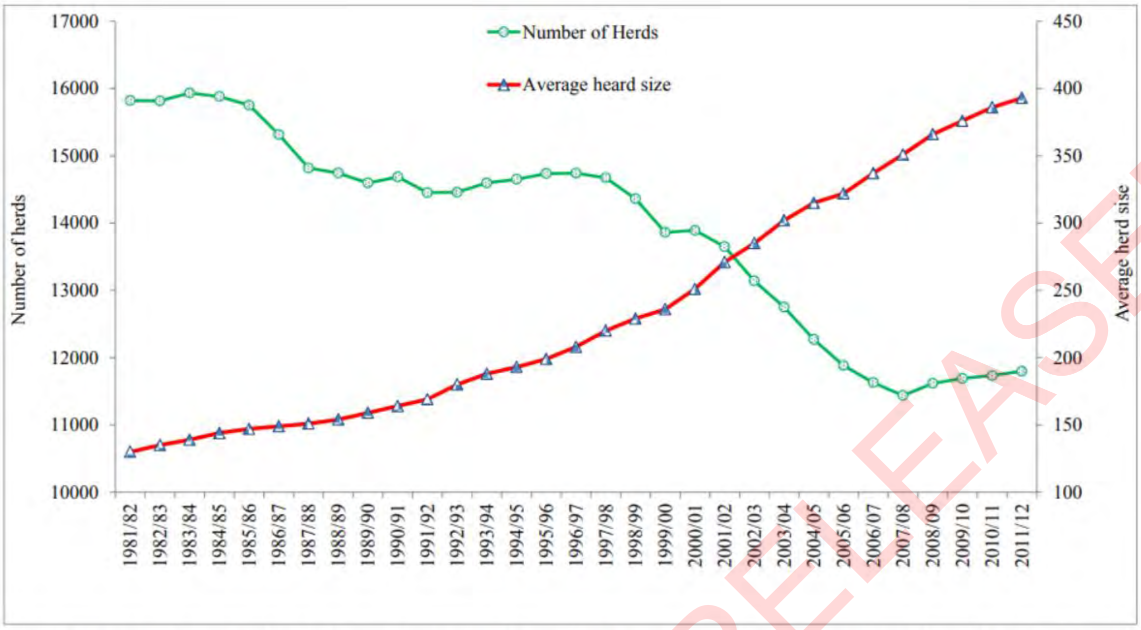

Figure 1.3 Trend in the herd numbers and average herd size in New Zealand dairying for the last 31 seasons (1981/82 – 2011/12), data sourced from (Dairy NZ, 2012).

Fresha Valley Processors (Waipu) Ltd

Submission to the Dairy Industry Restructuring Act

Fresha Valley Processors was established in 1988 by Paul Jensen and George Stodart, who are still the current owners, to process and market Goats milk through the Auckland City and Northland areas in the knowledge that the industry was to deregulate allowing any licensed processor to process and market cow milk in 1993. Following an approach from Woolworths in 1990 to process flavoured cow milk, which was legally allowable under the then regulations, and pack it under their private label brand we moved into cow milk using raw milk from two leased farms. This was the first private supermarket branded cow milk available in New Zealand offering the consumer a cheaper option in normal daily dairy products.

Woolworths private label is still a major customer, and the business has grown hugely now employing around 40 people in a small rural area and serving most of New Zealand in various ways in supermarket, route trade and food service areas.

Fifteen years ago we commenced production of A2 milk which we have supplied nationwide for many years.

We have always maintained our own farm supply base, currently 9 local contracted dairy farms. These farmers make every effort to maintain a flat supply curve throughout the year but this is impossible due to changeable climate conditions and associated natural factors which come into play. In the event of a raw milk shortfall we purchase from Fonterra at current market rates. We are very well looked after by Fonterra in terms of service, but it is hard to remain competitive at market price. We are unable to buy at regulated price because we do not meet the October rule, when in fact we have surplus from our own supply which we struggle to dispose of at even half cost price.

While there needs to be some mechanism where operations such as ours which are totally in the New Zealand domestic market are able to purchase milk outside their own supply base we do not believe that it was ever fair for Fonterra to legally have to supply their competition in export with guaranteed volume at discounted rates. Fonterra are the only operators in our region meaning no opportunity to purchase from other large companies due to logistics costs.

We believe the intent of the regulations was to foster, protect and guarantee supply to start up operations particularly in the domestic market, but that these were always expected to eventually source their own raw milk supply and create competition at the farm gate. It is therefore hard to accept that Goodman Fielder have done nothing in this direction as the other major domestic supplier. We believe they should have no regulatory right to controlled price raw milk from Fonterra but should now have to formalize raw milk supply under a contract with Fonterra or another major processor at rates returning a fair commercial profit to the supplier.

We do not believe there is anything in the open entry and exit provisions in DIRA which is detrimental to Fonterra and cannot be controlled in their terms of supply contract with farmers.

The base milk price calculation we think has turned into the base price for the dairy industry, as other processors only need to exceed it to attract supply interest. It of course also sets the price independent processors must pay for raw milk from Fonterra, giving them no incentive to compete at the farm gate. We believe most independents have now regarded DIRA milk as their permanent total supply or at least top up.

We have operated for 30 years with our own supply and also relied on Fonterra or its forerunners for supply in seasonal low periods. We have worked hard with quite a large and diverse range of farmers over this time to flatten their supply curve and production pattern to suit our requirements but without success, meaning we will always require some form of access to raw milk. To achieve this we need some form of regulation which is fair to all parties especially Fonterra to remain in place with perhaps three or five yearly reviews and a clear incentive to obtain more farm gate competition rather than reliance on Fonterra.

Thank you for your consideration

Paul Jensen

Director

Fresha Valley Processors (Waipu) Ltd.

7th February 2019

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Greenpeace NZ submission on the Review of the Dairy Industry Restructuring Act 2001

Tēnā koutou

Greenpeace NZ welcomes the opportunity to submit on the review of the Dairy Industry Restructuring Act (**DIRA**).

One of the purposes of this review is to consider whether the DIRA is operating in a way that protects the long term interests of New Zealand dairy farmers, consumers and the nation's overall economic, environmental and social wellbeing.

It is widely acknowledged that the dairy industry is having a severe impact on the health of our environment and the stability of our climate.

The Government itself acknowledges the environmental impacts. In the foreword to this DIRA discussion document the Minister for Primary Industry states that:

> *"... the growth of the dairy industry has had negative effects on our environment, through increased greenhouse gas emissions, nitrate leaching, and the expansion of dairy into increasingly marginal land areas."* - Minister for Primary Industries, Damien O'Connor.

The Government must turn this knowledge into regulatory action on intensive dairying.

Technological fixes to deal with impacts from the dairy industry are largely still under development and where they are available, are wholly insufficient to deal with the scale of the issues.

All efforts must be made, across Government departments and policies, to shrink the dairy industry, swiftly and significantly. New Zealand must undergo a rapid shift in land-use away from intensive dairy and livestock farming. Land use must be heavily diversified and put into high-value, plant-based farming.

Marginal and ecologically sensitive areas must be retired from production altogether and restored to their natural states. Land use practices across every type of farming must move away from the high-input, high damage methods that dominate today, into low/no input regenerative practices.

Without effective regulatory action driving these changes we will be unable to combat catastrophic climate change, clean up rivers or safeguard drinking water sources.

The DIRA discussion document takes the view that environmental issues are best dealt with through the Resource Management Act and not the DIRA regime. Greenpeace NZ disagrees with this view.

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The DIRA has played and continues to play a role in the ongoing expansion and intensification of dairying. It guides the operation of the dairy industry, which is operating in a way that is causing widespread and severe environmental degradation.

The discussion document itself accepts that “DIRA has enabled the industry‟s growth”. The DIRA must be amended, along with the RMA, to guide the operation of the dairy industry back within environmental limits.

Greenpeace recommends that the DIRA is amended so that it enables a rapid contraction of the dairy industry and a large-scale reduction in cow numbers and milk volume.

Specifically:

- That the open-entry provision be removed.
- That the text is clarified to ensure that Fonterra has the ability to differentially price its milk supply based on its Terms of Supply.

For completeness, we note that the wider regulatory environment, including DIRA must be amended to ensure that it not only becomes conducive to the contraction of the dairy industry but that it forces it.

<u>Greenpeace Recommendations</u>

The open-entry provision

Greenpeace supports option 4.1.2- Repeal the DIRA open entry requirements.

As one of the key mechanisms that has facilitated the growth of this industry Greenpeace strongly recommends that the open entry provision be completely removed. The impacts of this expansion are covered below.

For completeness we recommend that open exit be retained so that Fonterra cannot impose any restrictions on farmers who wish to leave Fonterra.

Fonterra Terms of Supply

The discussion document notes that there “appears to also be some ambiguity as to whether Fonterra could, through its terms of supply, provide positive financial incentives (i.e., pay price premiums) to reward dairy farmers who are performing at or above Fonterra‟s environmental standards, or provide financial disincentives (i.e., apply price discounts) to dairy farmers whose greenhouse gas emissions performance is at or above Fonterra s emissions standards.”

Greenpeace recommends that DIRA be clarified to ensure that Fonterra can provide financial incentives and disincentives to farmers who are performing above or below any element of Fonterra‟s Terms of Supply or standards.

Being able to use financial incentives and disincentives should include, but not be limited to, issues associated with environment, emissions and animal welfare standards.

<u>Impacts of the Dairy Industry and DIRA’s role</u>

Dairy expansion and intensification

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New Zealand has undergone one of the world's highest rates of agricultural land intensification over recent decades.[1]

Since 1990:

- Dairy cow numbers have more than doubled[2]
- The use of synthetic nitrogen fertiliser increased seven-fold.[3]
    - Dairying is the biggest user by far, using 70% of all the urea in NZ.[4]
- NZ has had the highest percentage increase in synthetic nitrogen fertiliser use out of all of the OECD countries.[5]
- The use of PKE went from virtually nothing to 2.2 million tonnes.[6]
- The average herd size has more than doubled.[7]
- Stocking rates have been increasing, from an average of 2.35 to 2.81.[8]
- Land in dairying has increased by 46% (from 1993 to 2012).[9]

Through the open-entry provision Fonterra has been legally obliged, in the majority of cases, to pick up milk from all new dairy conversions. This has facilitated dairy expansion and continues to do so.

The review notes that conversions have "fallen away sharply to around ten in 2017/18 year".

It must be noted that in terms of climate change even one new conversion to dairying, let alone ten, will cause increased emissions at a time when we must be urgently be reducing them.

It must also be noted that a single dairy conversion can have severe and irreversible environmental consequences. For example, a mega-dairy conversion is currently underway in the iconic and ecologically fragile Mackenzie Basin.

This one conversion has gained consents for 15,000 cows, seven dairy sheds, applications of over 650 tonnes of chemical fertiliser annually and an irrigation pipeline that will suck over 57 million cubic metres of glacial water every year.[10]

The land on which the conversion is happening is home to the world's rarest wading bird, the Kakī / black stilt, along with several other endangered animals, plants and

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[1] Ministry for the Environment & Stats NZ (2017). "New Zealand's Environmental Reporting Series: Our fresh water 2017."

[2] Ministry for the Environment 2017: Environmental Reporting Series; Livestock numbers http://archive.stats.govt.nz/browse_for_stats/environment/environmental-reporting-series/environmental-indicators/Home/Land/livestock-numbers.aspx

[3] Ministry for the Environment 2017: New Zealand's Greenhouse Gas Inventory 1990-2016, Snapshot.

[4] Statistics NZ 2017 Agricultural Census Tables https://www.stats.govt.nz/information-releases/agricultural-production-statistics-june-2017-final Note: The NZ Government does not specifically measure all the use of all synthetic N fertilisers, only Urea.

[5] OECD 2008 Environment Performance of Agriculture in OECD countries

[6] https://www.indexmundi.com/agriculture/?country=nz&commodity=palm-kernel-meal&graph=imports

[7] Dairy NZ 2017 https://www.dairynz.co.nz/media/5788533/nz-dairy-statistics-2016-17-web.pdf

[8] Ibid.

[9] Kyleisha J. Foote, Michael K. Joy, Russell G. Death (2015) "New Zealand Dairy Farming: Milking Our Environment for All Its Worth".

[10] CRC062867 CRC082311 (2012) Upper Waitaki Group hearing Simons Pass Station decision final CRC062867 (2016) Pukaki Water Take Consent and FEMP. CRC136283 (2013) Simon's Pass Pukaki Flats Consent to discharge dairy effluent to land. CRC176720 CRC082311 (2017) Application Change Simons Pass Station State Highway 8 Lake Pukaki Variation Changes Tracked

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invertebrates.[11] The soils are characterised as either 'well drained' or 'excessively well drained'. Conservative estimates predict that the conversion will leach an additional 76,615 kg/N/yr and lose an additional 1,938 kg/P/yr into the Waitaki catchment.[12]

Fonterra has publicly stated that in terms of his particular conversion it stated "*we'd prefer not to see more dairy expansion in the Mackenzie Basin.*"[13] However, under DIRA's open entry provision they have no choice but to pick up milk from this dairy conversion.

Climate change and the dairy industry

Climate change is an existential threat, posing grave danger to our health, homes, communities, food security, culture and livelihoods, as well as the wildlife and wild places with which we share this Earth.

Extreme weather events, intense wildfires, drought, flooding, sea level rise, displacement and resource conflicts are just some of the consequences of climate change. These consequences are already taking lives and causing major instability in our global society.

The most recent research by the Intergovernmental Panel on Climate Change (IPCC) confirms that we must limit the world's temperature increase to 1.5 degrees if we are to avoid worsening the impacts of catastrophic climate change. Furthermore, it outlines that achieving this requires us to reduce global emissions by half by 2030.[14]

Every single sector of society must turn their full attention to reducing emissions and preventing climate breakdown.

In NZ, agriculture is the country's worst climate offender, causing 49% of all our emissions and those emissions are rising.[15] Dairying accounts for the majority of agricultural emissions and is the cause of the ongoing increases in emissions.

> *"Between 1990 and 2016, emissions from the agriculture sector increased by 12 per cent. This is **primarily due to the national dairy herd nearly doubling in size since 1990 and an increase of over 600 per cent in the application of nitrogen-containing fertiliser** during the same period" - Ministry for the Environment* [16]

New Zealand's Parliamentary Commissioner for the Environment (PCE) reviewed available science on reducing agricultural emissions and found that there were no quick technological fixes available to reduce emissions from livestock farming. It noted in this report that:[17]

> "*It is axiomatic that the fewer sheep and cattle there are on a farm, the lower the biological emissions will generally be.*" - PCE[18]

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[11] Land Information New Zealand - LINZ (2008) Crown pastoral tenure review, Simons Pass

[12] CRC062867 (2016) Pukaki Water Take Consent and FEMP. CRC136283 (2013) Simon's Pass Pukaki Flats Consent to discharge dairy effluent to land.

[13] https://twitter.com/fonterra/status/1013704354249838592?s=21

[14] IPCC (2018) Intergovernmental Panel on Climate Change, Special Report https://www.ipcc.ch/sr15

[15] Ministry for the Environment 2017: New Zealand's Greenhouse Gas Inventory 1990-2016, Snapshot.

[16] Ibid.

[17] Parliamentary Commissioner for the Environment 2016: Climate change and agriculture: Understanding the biological greenhouse gases

[18] Ibid.

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Furthermore, Fonterra has become the second largest burner of coal in New Zealand which it burns in its dryer plants. The amount of coal burnt is directly influenced by the volume of milk produced. I.E. the more milk produced the more coal Fonterra burnt to dehydrate the milk. Fonterra has refused to rule out building new coal boilers until at least 2030.[19]

Climate change is threatening the lives of present and future generations and disproportionately impacting on those least responsible for causing it. Emissions must be significantly reduced from agriculture immediately. The only viable option to achieve this is to reduce cow numbers and eliminate the use of synthetic nitrogen fertiliser.

With the knowledge of the catastrophic impacts of climate change and the role the dairy industry is playing in causing them, it would be immoral to allow DIRA to continue to enable the dairy industry to retain its level of intensity or to facilitate its growth.

Water quality and the dairy industry

After decades of growth in the dairy industry, enabled by DIRA, New Zealand is now facing an unprecedented freshwater crisis.

Nitrate pollution is getting worse in over half of NZ's monitored rivers.[20] More than two thirds of monitored rivers are unswimmable.[21] 72% of native freshwater fish are threatened with extinction.[22] 44% of monitored lakes are in heavily polluted (eutrophic) states.[23]

Over half (53%) of NZ's drinking water comes from groundwater.[24] There are already monitored groundwater sites where nitrate concentrations breach human health limits, in many regions of NZ.[25] Worryingly, levels much lower than the current human health limit have now been linked to increased likelihood of bowel cancer.[26]

Dairy cows are the biggest nitrogen polluter into NZ's waterways with direct synthetic nitrogen fertiliser pollution coming in as the third biggest, after sheep. [27] According to the Ministry for the Environment nitrate pollution is increasing *"due to increases in dairy cattle numbers (& therefore urine which contains nitrogen) & nitrogen fertiliser use"* [28]

Dairying also pollutes waterways with E.coli, sediment and phosphorous. It is the country's single largest user of water through irrigation. This negatively impacts on the river flows necessary for the healthy functioning of aquatic ecosystems.

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[19] https://www.fonterra.com/nz/en/our-stories/media/fonterra-partners-with-government-on-roadmap-to-low-emissions-future.html

[20] Ministry for the Environment & Stats NZ 2017: New Zealand's Environmental Reporting Series: Our fresh water 2017

[21] NIWA (2017)) Technical Background for 2017 MfE 'Clean Water' Swimmability Proposals for Rivers

[22] Ibid

[23] Schallenberg, M., de Winton, M.D., Verburg, P., Kelly, D.J., Hamill, K.D. and Hamilton, D.P., 2013. Ecosystem services of lakes. *Ecosystem services in New Zealand: conditions and trends. Manaaki Whenua Press, Lincoln*, pp.203-225.

[24] Ministry for the Environment. 2018. Review of National Environmental Standard for Sources of Human Drinking Water. Wellington: Ministry for the Environment

[25] Ministry for the Environment 2009 - National groundwater quality indicators update: state and trends 1995-2008
Note: Monitored groundwater sites measured are not currently used for drinking water.

[26] Schullehner, J., Hansen, B., Thygesen, M., Pedersen, C.B. and Sigsgaard, T., 2018. Nitrate in drinking water and colorectal cancer risk: A nationwide population-based cohort study. *International journal of cancer*, *143*(1), pp.73-79.

[27] Ministry for the Environment & Stats NZ 2017: New Zealand's Environmental reporting series : Freshwater and nitrogen leaching. http://archive.stats.govt.nz/browse_for_stats/environment/environmental-reporting-series/environmental-indicators/Home/Fresh%20water/nitrogen-leaching-agriculture.aspx

[28] Ibid

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This freshwater crisis is seriously impacting on the physical, cultural and emotional wellbeing of New Zealanders. Many mahinga kai sites and waterways of cultural significance are now polluted. Fishing, swimming and freshwater recreation are all being severely limited.

Nitrate contamination of aquifers in particular, is an intergenerational issue, which, if allowed to continue unabated, will severely diminish the health and wellbeing of future generations.

To reduce pollution getting into our waterways we must reduce cow numbers and eliminate synthetic nitrogen fertiliser use. The DIRA must, in the very least, enable this reduction.

Economic "benefits" of the dairy industry

The DIRA consultation paper frequently refers to the economic benefits delivered by the dairy industry. It states that "The New Zealand dairy sector has provided, and continues to provide substantial economic benefit to New Zealand."

The discussion document does not specify who has benefited and who has been left behind. Nor does it mention the financial cost of dealing with dairy's environmental pollution and degradation, which has been left to New Zealand's taxpayers to deal with.

Moreover the fiscal cost to taxpayers of subsidising the emissions of the dairy sector under the Emissions Trading Scheme run to hundreds of millions of dollars per year - a subsidy that other sectors of the economy are forced to support through taxes.

These points must be taken into consideration when balancing the costs and benefits of this and any other industry

The first study that measured the costs of environmental externalities against economic benefits of the dairy industry found that:

"At the higher end, the estimated cost of some environmental externalities surpasses the 2012 dairy export revenue of NZ$11.6 billion and almost reaches the combined export revenue and dairy's contribution to Gross Domestic Product in 2010 of NZ$5 billion…. This assessment is in fact extremely conservative as many impacts have not been valued, thus, the total negative external impact of intensified dairying is probably grossly underestimated."[29]

It should also be noted that economic growth and GDP are not measures of wellbeing and the government has indicated that they will no longer be treated as such a measure.[30] The water and climate pollution caused by the dairy industry is negatively affecting the health and wellbeing of present and future generations and this should also be taken into account.

Global context

Another purpose of the review is to consider where DIRA remains fit-for-purpose given the global and domestic challenges and opportunities.

[29] Foote, K.J., Joy, M.K. and Death, R.G., 2015. New Zealand dairy farming: milking our environment for all its worth. *Environmental management*, *56*(3), pp.709-720.
[30] https://www.budget.govt.nz/budget/2018/economic-fiscal-outlook/budget-2019-focus-on-wellbeing.htm

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In order to fight climate change and feed the world's growing population a growing chorus of scientists and reports are calling for a global transition away industrial livestock farming into more plant-based food production and consumption.

In the most thorough research paper on the issue to date, scientists used data from every country to assess the impact of food production on the global environment. They found that "GHG emissions cannot be sufficiently mitigated without dietary changes towards more plant-based diets."[31]

Plant-based milks have emerged as a strong competitor to cow milk. In the UK for example, the Guardian reports that plant-based milk sales have increased 30% while reduced demand and falling prices for cow's milk between 2013-2016 has led to the closure of 1,000 dairy farms.[32]

In this changing global context, the DIRA will not be fit for purpose if it continues to enable the growth of the dairy industry.

ENDS

[31] Springmann, M., Clark, M., Mason-D'Croz, D., Wiebe, K., Bodirsky, B.L., Lassaletta, L., de Vries, W., Vermeulen, S.J., Herrero, M., Carlson, K.M. and Jonell, M., 2018. Options for keeping the food system within environmental limits. *Nature*, 562(7728), p.519.

[32] https://www.theguardian.com/news/2019/jan/29/white-gold-the-unstoppable-rise-of-alternative-milks-oat-soy-rice-coconut-plant

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Friday, 8 February 2019

To: DIRA review team
Agriculture, Marine and Plant Policy
Policy and Trade Branch
Ministry for Primary Industries
PO Box 2526
Wellington 6140
New Zealand

Submission on: MPI discussion document Paper No: 2018/13

Review of the Dairy Industry Restructuring Act 2001 and its impact on the dairy industry

From: Happy Valley Milk Limited

Contact:

Randolph van der Burgh	David McCann
Director	Director
s 9(2)(a)	
s 9(2)(a)	s 9(2)(a)

Submission on the review of the Dairy Industry Restructuring Act 2001 and its impact on the dairy industry

1. Introduction

1.1 This submission is made by Happy Valley Milk Limited (HVM) in response to the Ministry for Primary Industries' November 2018 discussion document.

1.2 Happy Valley Milk is an independent, Otorohanga-based, New Zealand dairy company established to develop a grass to glass milk processing, blending and packaging plant which specialises in consumer-ready Infant Milk Formula and other nutritional milk powder formulas using A2, organic, and pasture fed milk.

1.3 At the time of writing its submission HVM is in the final stages of attaining its remaining resource consents from the Waikato Regional Council, having received all requisite consents from the Otorohanga District Council.

1.4 While not yet operational HVM views it as important to submit on this discussion document given it will be subject to this iteration of the DIRA framework once its plant is operative.

1.5 HVM also views it as important to submit on this discussion document so as to ensure the interests of its future supplying farmers are protected (read: optionality) and the DIRA continues to provide the opportunity for regional communities, including our Otorohanga and wider Waikato community, to prosper.

2. Executive Summary

2.1. HVM supports the purpose, direction and intent of the DIRA and is largely supportive of the ongoing validity of the original policy as outlined in the discussion document.

2.2. HVM notes that the existence of DIRA promotes competition in the farm gate milk market and as such serves to put pressure on Fonterra, as the market dominator, and other large processors to be efficient and innovative, and deliver for its suppliers**.**

2.3. Given farmers are vital to the New Zealand economy and the wellbeing and prosperity of their local communities, HVM seeks an efficient, open market which enables them to have the options (brought on by competition at the farm gate) to run a sustainable, intergenerational business.

2.4. Open Entry is key to this and our view is that the DIRA should enable farmers to retain their ability to move to a new processor with confidence, safe in the knowledge that if said supplier does not deliver for them there remains a dominant player, which has a strategy based on volume, to whom they can supply their milk. This freedom of movement serves to ensure that <u>all</u> processors are under pressure to be efficient and innovative.

2.5 HVM views that the DIRA should promote innovation and as such small processors, who are at the heart of innovation, should retain their right to access DIRA milk especially given the volumes taken are not relevant to Fonterra's overall strategy and as such cannot pointed to as a reason for the dominant player's poor performance in the value add space. As above, it is important that DIRA serves to promote innovation which benefits New Zealand, and this provision allows for this.

2.6 From HVM's perspective while the current DIRA provisions are sufficient to manage Fonterra's dominance we note the significant costs new entrants to the market face as a direct result of, amongst other tactics, Fonterra's covert delay tactics targeted at new entrants seeking to obtain Resource Management Act consents (refer for example 8th February 2018 Decision by Independent

Hearing Commissioners Appointed by Otorohanga District Council regarding the Land Use Consent Application by Happy Valley Milk, in particular section 7.4 pages 53 and 54).

Happy Valley Milk Limited's response to Chapter 3: The effects of the DIRA and other factors on industry performance

3. The effects of the DIRA and other factors on industry performance and DIRA's role in encouraging industry growth

3.1 In response to the questions raised in sections 3.1 and 3.2 HVM views the DIRA as having been largely effective in preventing Fonterra from using its dominance to create barriers for milk and land flowing to their highest value users.

3.2 In doing so DIRA has encouraged and enabled industry growth as exemplified by the number of competitors who have entered the market and subsequently found and maintained a measure of success.

3.3 However, Fonterra indisputably remains the overwhelmingly dominant player in the market at a national level and engages in monopolistic behaviour as a result. While there are some instances of a wider variance at a regional level this is by and large due to Fonterra choosing not to invest in processing capital in these areas e.g. the west coast of the South Island thereby opening the door to other processors and providing for the statistics as to Fonterra's regional market dominance to be skewed in its favour.

3.4 As such if industry growth, especially in the form of efficiency and innovation, is to continue to be encouraged it is absolutely vital that Open Entry is maintained, ensuring farmers are able to move freely between processors. This has the dual effect of also putting the onus on processors to pay their suppliers a fair milk price and in doing so pushes them to innovate in order to create maximum value from that milk.

3.5 In terms of the costs imposed on Fonterra HVM views these as reasonable if DIRA is to be consistent with its stated intentions.

3.6 Any argument from Fonterra that their responsibilities under DIRA have directly led to their inability to create significant value add for their shareholders would be misleading. Instead this issue clearly stems from internal failings as highlighted in a November 2018 independent assessment which described Fonterra's financial performance since its inception as 'unsatisfactory'.

3.7 That said HVM believes there are ways to mitigate these costs without impacting on the effectiveness of DIRA such as imposing restraints on the number of years large, export focussed processors are able access DIRA milk. Doing so would encourage them to build their own supply and increase competition at the farm gate.

4. DIRA's impact on the industry's environmental performance

4.1. In response to questions raised in section 3.4 HVM agrees that environmental issues are best dealt with through the Resource Management Act rather than the DIRA however we believe that the DIRA framework can provide added provisions.

4.2 From our perspective processors should have a greater responsibility to implement international best practice standards throughout their supply chain rather than rest on their laurels by championing their implementation of national best practice standards (which in many cases are inferior to international standards).

5. Does the DIRA incentivise inefficient entry by large dairy processors?

5.1. In response to questions raised in section 3.5 HVM considers that large dairy processors should continue to be eligible to purchase regulated milk from Fonterra under the Raw Milk Regulations albeit with the current 50 million litre cap in place and the extra provision of a strictly enforced timeframe during which they can access this regulated milk. Doing so would encourage these processors to work to attain their own supply and provide greater farm gate competition.

5.2 HVM views the entrance pathway provided under DIRA as vital to driving competition and therefore innovation and efficiency. The inferred rationale that it should be removed because it i working is highly illogical especially when considering Fonterra's continued market dominance

6. Does the DIRA promote sufficient confidence in the base milk price calculation

6.1. In response to questions raised in section 3.6 HVM considers that given most processors use Fonterra's milk price as the basis upon which they pay their suppliers and that one of Fonterra's co-operative principles is to pay its farmers the highest sustainable milk price any processor with their farmers' best interests in mind should have a level of confidence in the base milk price calculation.

6.2 If we take the viewpoint that farmers (and by extension the communities in which they live) should be benefiting the most from DIRA then it is important to maintain a milk price benchmark that seeks to pay supplying farmers the highest sustainable amount.

Happy Valley Milk Limited's response to Chapter 4: Options for change

7. Options for the DIRA open entry requirements

7.1 In response to questions raised in section 4.1 HVM considers it vital to maintain the DIRA Open Entry requirements as they serve to promote competition at the farm gate.

7.2 It is important that farmers retain complete optionality in terms of which processor they want to supply. Should a farmer want to supply a new processor the current DIRA provisions provide farmers' with a level of confidence to be able to do so, confident in the knowledge that if this new processor does not deliver for them there remains a dominant player, which has a strategy based on volume, which will accept their milk.

7.3. This freedom of movement serves to ensure that <u>all</u> processors are under pressure to be efficient and innovative.

7.4 Of the options laid out in the discussion document HVM is comfortable that 4.1.3 would maintain the intent of the DIRA while casting an important lens on the environmental performance of individual farmers.

8. Options for access to regulated milk for large dairy processors

8.1. In response to questions raised in section 4.2 while HVM views the entrance pathway for new processors, as is provided under the current legislation, as being vital we believe this access should be for a pre-determined number of years only.

8.2 Doing so would force these processors to attain their own supply and in doing so create greater competition at the farm gate, something farmers, and the communities in which they live, would welcome.

6. Options for the base milk price calculation

6.1. In response to section 4.3, of the options laid out in the discussion document HVM views 4.3.1 as the most acceptable with the proviso that the Commerce Commission has a clear understanding and level of comfort as to Fonterra's calculation as regards the "practical feasibility" of the asset beta assumption, and the extent to which Fonterra may choose to change its assumptions, inputs and processes for the base milk price calculation, in the future.

7. Options for access to regulated milk for Goodman Fielder and smaller processors

7.1. In response to questions raised in section 4.2. HVM's view is that while it is important that the needs of the New Zealand consumer market are met Goodman Fielder's unending access to and reliance on significant quantities of DIRA milk could be inadvertently serving to stunt competition in the New Zealand consumer market given there are significantly greater costs associated with attaining supply than in simply taking regulated milk.

7.2 HVM feels very strongly that smaller processors should reta n th ir right to access DIRA milk.

7.3 Large companies are often borne from small companies an it is hese smaller processors which are generally at the heart of innovation, providing niche pro ucts and driving much-needed competition in the New Zealand consumer market and, in some cases, overseas.

7.4 If one of the intents of DIRA is to encourage innovation then it is vital that smaller, innovative processors are encouraged and nurtured, and DIRA, through its providing access to regulated milk, is the key component of this.

8. Options for the DIRA review and expiry provisions

8.1 In response to questions raised in section 4.5 HVM, of the options laid out HVM views option 4.5.2 as the most acceptable given the speed at which the industry is moving.

9. Summary

9.1 We appreciate the opportunity to submit on this key piece of legislation recognising the importance of the dairy industry to New Zealand's economic, environmental and social well-being.

9.2 We feel stro gly that Fonterra maintains a clear and significant dominance in the New Zealand marke and th t in order to promote true competition both Open Entry and access to DIRA milk, especially for small processors, must be protected.

9 3 We would welcome the opportunity to speak further on this submission as and when the opportunity presents.

Sincerely,

Randolph van der Burgh Director Happy Valley Milk Limited	David McCann Director Happy Valley Milk Limited

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MEMORANDUM

To:	Ministry of Primary Industries
Submission on:	Review of the Dairy Industry Restructuring Act 2001
From:	Landcorp Farming Limited
Date:	8 February 2019
Contact:	Simon King, Head of Communications and Engagement (kingsi@landcorp.co.nz; [redacted] s 9(2)(a)

[redacted]

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1. Introduction

1.1 Landcorp Farming Limited ("Pāmu") welcomes the opportunity to submit on the Ministry of Primary Industries (MPI) Discussion Document "Review of the Dairy Industry Restructuring Act (DIRA) 2001 and its impact on the dairy industry".

1.2 This submission's focus is on the proposed 'Open Entry' option for change within Chapter 4 of the discussion document. Comment is not made on any other aspect of the discussion document.

1.3 Pāmu has had the benefit of reading a draft of the Federated Farmers submission and supports the general tenor of their submission on open entry.

1.4 Pāmu submits that the original rationale for the DIRA open entry and exit regime still exists, however we concur with the Federated Farmers submission regarding Option 4.13 on Open Entry <u>that the DIRA regime be amended to allow Fonterra more flexibility than it currently has but that any ability to decline applications to supply are limited and clearly expressed</u>.

2. General discussion on the DIRA – Open Entry and Exit Provision

2.1 As set out in the Discussion Document, the DIRA open entry regime was designed to serve a particular purpose: as one tool within DIRA to manage milk suppliers' options given Fonterra's market majority. Pāmu believes that DIRA has contributed to the achievement of that purpose and, moreover, that this purpose remains as relevant in 2019 as 2001, despite Fonterra's national market share reducing from 96% in 2001 to 80.5% in 2018 (i.e. still above the 70% suggested as a dominant factor in the MPI review document).

2.2 Fundamentally, DIRA facilitates competition in an industry with high barriers to entry. As one of the country's largest dairy farmers and with dairy farms in many regions of the country, Pāmu supplies all major milk processors. Pāmu appreciates that it is in a unique position in terms of its scale and geographic spread but submits that all farmers ultimately benefit from choice of supply and a regime that ensures that processors cannot unfairly leverage market power to the detriment of non-supplying dairy farmers. For that reason Pamu:

(a) Does not support Option 4.1.2 to repeal DIRA's open entry requirements. Pamu agrees with MPI that the alternative – regulation of competition through the Commerce Act – would not be effective.

(b) Supports the retention of DIRA with amendments to achieve a balance between security and certainty for farmers and increased flexibility for Fonterra within clearly defined circumstances. Federated Farmers submission usefully articulates robust proposals to achieve this balance.

(c) We support Federated Farmers submission with regards to the protection of existing Fonterra shareholder supplying farms both from the geographically remote perspective and the transfer of shareholding being not deemed "new milk".

(d) We are also comfortable with the Federated Farmers approach that Fonterra have discretion past a date stipulated on accepting milk from new conversions.

(e) We concur with Federated Farmers that any amendment to open entry needs specific terms to be set in DIRA that allow Fonterra to reject new supply and this needs to be coupled with clear communications around the dispute resolution processes through the Commerce Commission, and addressing the time limit to no more than 10 working days.

3.

3.1 Pāmu generally concurs with the conclusions set out in Chapter 3 of MPI s Discussion Document (the effect of DIRA). On DIRA's impact on the environment, Pāmu acc pts that there is science based evidence confirming the intensification of agricultural practices (including the growth of the dairy industry) has had negative impacts on the environment. Pāmu acknowledges that the extent to which dairy has contributed to environmental degradation emains a source of debate within the industry and community.

3.2 Pāmu concurs with MPI's view that the DIRA regime has not in itself been a significant contributor to industry growth and the flow on effects to the env ronment. Pāmu agrees that DIRA is not an appropriate tool for managing environmental outcomes, and that other tools, in particular the Resource Management Act, and governmen policy reflected in national standards or regulatory change, are a better means of addressing the environmental consequences of the growth of the dairy industry (and other intensive land use practices). In addition, issues such as climate change and animal welfare, while important, are similarly not appropriately dealt with through DIRA.

4. About Pāmu Farms

4.1 Pāmu is the brand name for Landcorp Farming Limited. Pāmu stands for best practice in sustainable and safe farming, and for he unique provenance of New Zealand foods, nutrition products and fibre on global markets

4.2 Landcorp Farming Limited is a State-Owned Enterprise with a nationwide portfolio of farms that produc milk, eef, lamb, wool, venison, deer velvet, wood and more. Pāmu strives to be a leader in farming natural resources sustainably to produce premium, high margin food and fibre products..

Mataura Valley Milk

Feedback on MPI's Discussion Document for

REVIEW OF THE

DAIRY INDUSTRY RESTRUCTURING ACT 2001

AND ITS IMPACT ON THE DAIRY INDUSTRY

8 February 2019

SUBMITTER

Mataura Valley Milk is the vision of local, founding shareholders who saw the need to add more value to farmer and shareholder returns than the traditional New Zealand dairy farming/processing model. This vision is shared by our New Zealand and overseas investment partners to produce exceptional nutrition for a growing world. Construction and c mmissioning of our nutrition plant at McNab, near Gore, is complete as part of a $240 million investment to manufacture and produce premium nutritional powders and creams for high-end markets. Ou p rpose-built nutrition plant, one of the world's most technologically advanced, employs 65 fulltime staff, with production underway since August 2018.

As a new entran in the New Zealand dairy industry, with significant investment committed to the venture, Mataura Valley Milk is highly interested in the industry's future. We are grateful for the opportunity to contribute t the future of the industry, and the regulatory framework within which it operates.

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Executive Summary

MVM has strong evidence that the competitive farm-gate milk market enabled by DIRA has benefited the entire industry, predominantly dairy farmers, by nearly NZ$3 billion per annum in efficiency gains. This benefit extends to all current Fonterra suppliers, not just those supplying independents. It translates to roughly $1.79 per kilogram of milk solids. This underlines the importance of DIRA's pro-competition provisions. Against these benefits, the cost of providing regulated milk to new entrants is negligible. We estimate this regulated milk to new dairy companies doesn't exceed 1% of Fonterra's collections. We also suggest that the regulator should not be concerned if the least efficient dairy companies fail to procur sufficient milk to operate at capacity. This simply evidences the regulation is operating as intended.

In terms of the continuation of DIRA's pro-competition regulations, MVM urges the regulato to conside international precedents for competition and antitrust regulation. The European and United St tes regulators use well-defined quantitative measures such as market share and the Herfindahl index (HHI). On this basis we suggest that until Fonterra's market share falls below 50%, or the HHI below 0.25, there is no justification for challenging DIRA's necessity. The regulator must also be aware of the moral hazard in asking current market participants whether a pathway for new entrants is necessary.

The proposed diagram of the regulatory framework must be revised to include the DIRA Raw Milk Regulations. This is vital because while farmers do indeed need 'open entry and open exit' provisions so that they can act on Fonterra's performance, they must also have the pportunity to do so. i.e. There must be alternative milk processors for them to supply if they so choose. The Raw Milk Regulations are part of the pathway for new entrants to provide farmers with options. They ar also an important signal to both farmers and investors of the regulator's commitment to a competitive fa m-gate milk market notwithstanding the presence of a dominant, hostile incumbent.

In regards to the specific options presented in the MPI discussion document, MVM's position is summarised in section 3 of this response, with answers to the detailed questions provided in the attachments.

In addition to the foregoing paragraphs, we are particularly concerned at the suggestion DIRA is somehow preventing Fonterra from managing fa mer's environmental performance. Our main concern is that this conveniently leverages a real issue (farm environmental performance) to achieve Fonterra's real but separate aim (retention of milk by any mean possible). We respectfully suggest the need for scepticism, and also consideration of alte native explanations and remedies. In the unwelcome event that the regulator decides to amend the DIRA open entry requirements to allow Fonterra to decline to accept applications from new and existing farmer if Fonterra considers their supply is unlikely to comply with Fonterra's terms of supply, we make specific recommendations about how this must be done. It is vital that the regulator ensure a transparent process in wh ch farmers can have the confidence to supply their milk to its best economic use. This is best achieved with an independent determination of eligibility, ideally via an inquisitorial rather than adversarial system. In our view such a change will also require additional regulations concerned with supplier eligibility fo additional milk payments based on tenure or some other basis where such payments could make future exit and re-entry more uncertain and less attractive.

Finally, in regards to the base price milk calculation we echo the concerns of other independent dairy companies that Fonterra has enjoyed too much freedom in its ability to set the regulated milk price. In addition to that, we note that Fonterra's choice of forecast milk price as a basis for forward pricing of eg lated milk may also be used to materially harm the cash-flows of recipients of regulated milk. We welcome any change to this regime that would see greater independence and transparency.

Contents

1.0 DIRA Benefits

In making this submission, MVM seeks to clearly establish the benefits that DIRA has delivered to the whole NZ dairy industry, particularly dairy farmers, are of the order NZ$3 billion per annum. These benefits have been delivered through the mechanism of farm-gate competition, which is enabled by the DIRA regulations. These benefits extend to all Fonterra suppliers, not just those farmers who have supplied milk to independent dairy companies. Furthermore, we can show that farm-gate competition is effective in shifting milk to its highest value use, and that the most efficient and/o value creating processors are increasing their milk collections through higher net milk payments. Finally, we need to be clear that the regulated DIRA milk which has been so contentious is in fact a very small volume compared to the enormous benefits arising from its regulation. Specifically, regulated raw mi k supplied to new independents has been less than one percent of Fonterra's total milk collection in any year.

1.1 DIRA Enables Farm-Gate Competition

DIRA was carefully designed so that despite the decision to create a dominant dairy company, farmers would remain free to supply milk to its highest value use. In practise, this means facilitating competition for raw mi k at the farm gate.

The first part of this aim is achieved by the open entry and exit regime The reason for open exit is obvious, insofar as Fonterra is compelled to allow farmers to eave if they choose. The open entry requirement is more subtle, designed to give farmers who are considering their options the assurance that they can always return to supply Fonterra. Th s removes the obvious risk of being held to ransom if their new arrangement does not succeed[1]. It also m tigates against Fonterra pressuring its current farmer members with the threat of potential d scrimination if they choose to leave.

The second aspect of the DIRA recognises tha not only should farmers have freedom to choose, but that for this to be meaningful the opportunity must actually exist. This leads to parts of the DIRA Raw Milk Regulations which provide for ind pend nt dairy companies to access a limited volume of regulated milk for their establishment (i.e. 50 million litres per annum, for three years) at a regulated price (based on the Fonterra Milk Price). DIRA therefore facilitates the establishment of new dairy companies by removing some (bu not all) of the start-up risks. It is important to note that 50 million litres per annum isn't nearly sufficient volume to operate an economic milk powder drier at full capacity. However it does signal to potential investors in new dairy companies that their business is welcome in the New Zea and dairy industry notwithstanding the presence of a dominant and hostile incumbent.

The third aspect of the regulation is that which provides farmers with transparent performance informatio about Fonterra on which they can base their decisions. This is embodied in the DIRA base milk pri e regime and the DIRA TAF provisions.

W suggest the following revised diagram of the DIRA regime which includes the requirement for viab e alternatives to Fonterra.

[1] The case in point is the experience of farmers who supplied New Zealand Dairies Limited at Studholme, Canterbury (now in Fonterra ownership). When the company went into receivership and was sold to Fonterra, Fonterra attempted to penalise the supplying farmers (they asked the farmers to sign supply agreements that paid them 5 cents less per kilogram of mi ksolids and would not let them buy shares in the co-operative for the first year). It was only prevented from this by a ruling in the Supreme Court which found they had breached section 6 of DIRA, which proh bits discrimination between new entrants and existing shareholders.

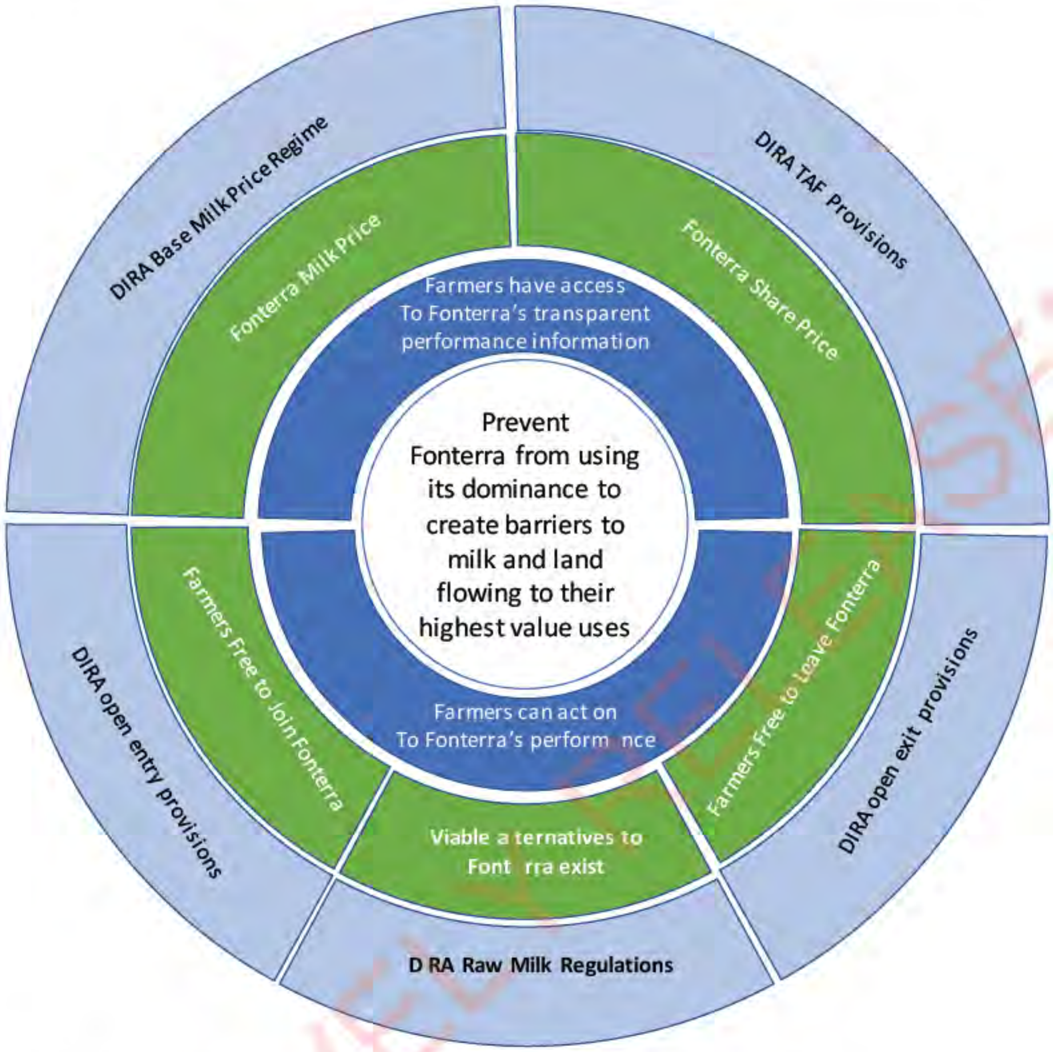


Diagram representing th core purpose and elements of DIRA regulation

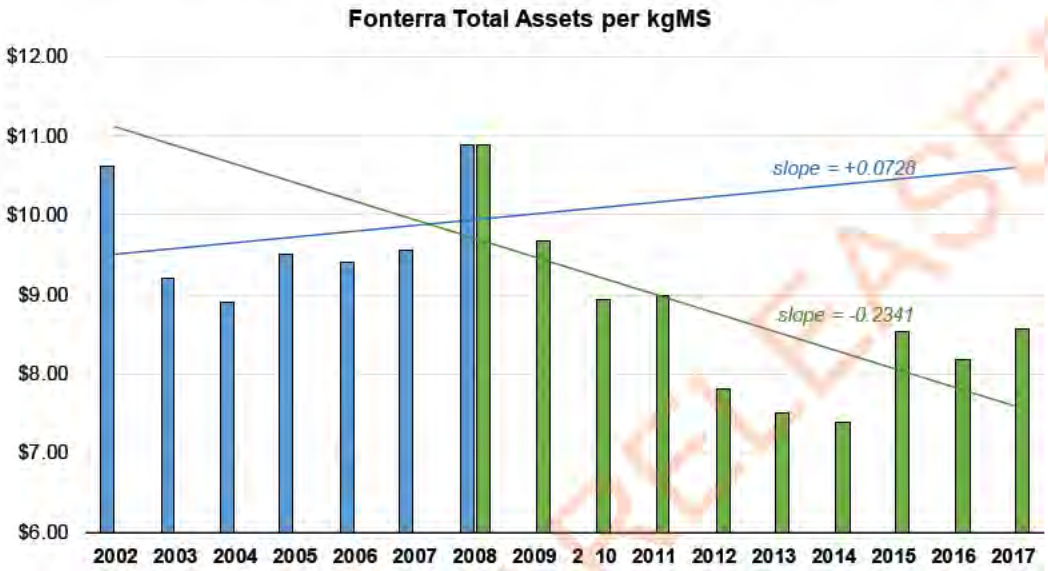
1.2 Benefits of Farm-Gate Competition

This review of the DIRA regulation must consider the beneficial value it has created for the sector and its participants Economics suggests that competition drives efficiency. The question is whether farmers b ing able to choose which dairy companies they supply has actually created value for the whole ector. i.e. how much value has been created by the development of farm gate competition.

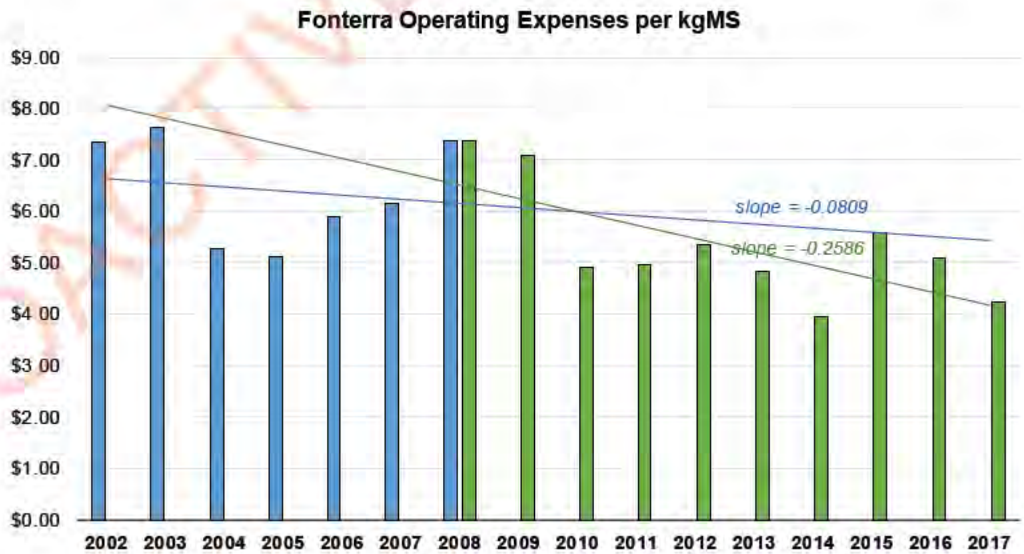
To address this question, we have completed a quick analysis across dairy companies' share of raw milk and also Fonterra's financial statements. Fonterra's share of raw milk in New Zealand commenced in 2001 at 96%. The remainder was held by the Westland and Tatua dairy cooperatives. By 2008 Fonterra still had 94%, with Open Country and Synlait Dairies just getting established – but most farmers in most regions having no option but to supply Fonterra. However, as these companies grew and other new entrants including Miraka and Oceania got established, Fonterra's share of raw milk fell to 85% by 2015. This history provides an excellent opportunity to consider the efficiency gains for the sector over two distinct periods:

- 2001-2008: DIRA exists, but farm-gate competition highly restricted by lack of alternatives
- 2008 – 2017: DIRA exists AND the opportunity to choose an alternative is greatly increased

The following analysis of Fonterra's total assets and operating expenses shows that on a per kilogram-milksolids basis there was a definite improvement from 2008 onwards[2]. In terms of assets, the period 2002-2008 saw the asset ratio actually increasing at an average rate of just over 7cents/kgMS every year. In contrast, with the onset of farm-gate competition, from 2008 to 2017 this trend reversed and showed an average improvement of over 23cents/kgMS per year. This net 30 cents /kgMS per year difference accumulates over the nine-year period to $2.76 per kgMS in 2017, which conservatively represents an annual capital cost saving of $0.14 per kgMS, or $211 million total.



A similar result is apparent in Fonterra's operating expenses. The period 2002-2008 saw the operating expenses slowly decrease at an average rate of 8 cents/kgMS every year. In contrast, with the onset of farm-gate competition, from 2008 to 2017 the average improvement lifted to nearly 26 cents/kgMS per year. This 17.8 cents/kgMS per year difference accumulates over the nine-year period to $1.60 per kgMS in 2017. This represents an annual saving of $2,443 million total.



[2] The 2014-15 year has a suddenly higher result than 2013-14. We hypothesise that this is partly attributable to the acquisition of BeingMate for $755 million in March 2015. We also note the additional capital made available to the cooperative through 'Trading Amongst Farmers' (2012-13), which raised approximately $800 million, and could then leveraged to $1.6 billion with borrowings. i.e. approximately $1.05 per kgMS.

Hence the benefit of competition to Fonterra's profits has been of the order of $2,650 million per annum. If we extrapolate that across all of New Zealand's dairy industry the benefit is $3.2 billion per annum.

A far more comprehensive and rigorous economic analysis of the New Zealand dairy industry has been recently undertaken by researchers at the Auckland Business School. Their findings, as reported in a draft paper[3] 'Independent Processors: Good or Evil? An Empirical Analysis of the Efficiency Impact of Independent Processors on New Zealand Dairy Industry' shows a 20% efficiency improvement resulting from farm-gate competition in the period 2008-2015:

> *The financial ratio efficiency[4] analysis reveals that contract supply to independent processors enabled by the introduction of GDT in 2008 improves the efficiencies of the combined IOF and cooperative processing facilities by 20% in areas where milk is contested by both the cooperative and IOF processors.*

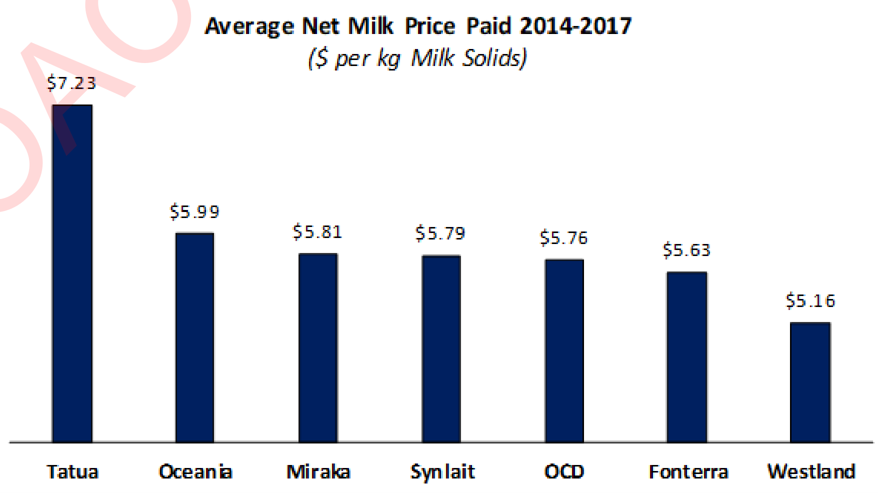
This efficiency improvement equates to a whole of industry benefit of $2,895 million per annum (or $1.79 per kilogram of milk solids) in 2015. While this is slightly lower than the result from the previous analysis, it is based on a more robust approach and so we suggest this is the figure that should be accepted.

The overwhelming conclusion is that the New Zealand dairy industry has benefitted enormously from farm-gate competition. The main beneficiaries of this efficiency are the dairy farmers, including all those supplying Fonterra, whose milk payments are significantly higher than if there had been no farm-gate competition.

1.3 Farm-Gate Milk Competitive Outcomes

The expected outcome for a competitive farm gate milk market is that supply will prioritise the best (highest) priced offer for milk payment. This means that the dairy companies with the highest farm-gate milk should be at full capacity, while those paying the least should have under-utilised processing assets. The following analysis establishes that this is the case, and disproves any notion that DIRA regulation has somehow facilitated an "unfair" outcome at the farm-gate.

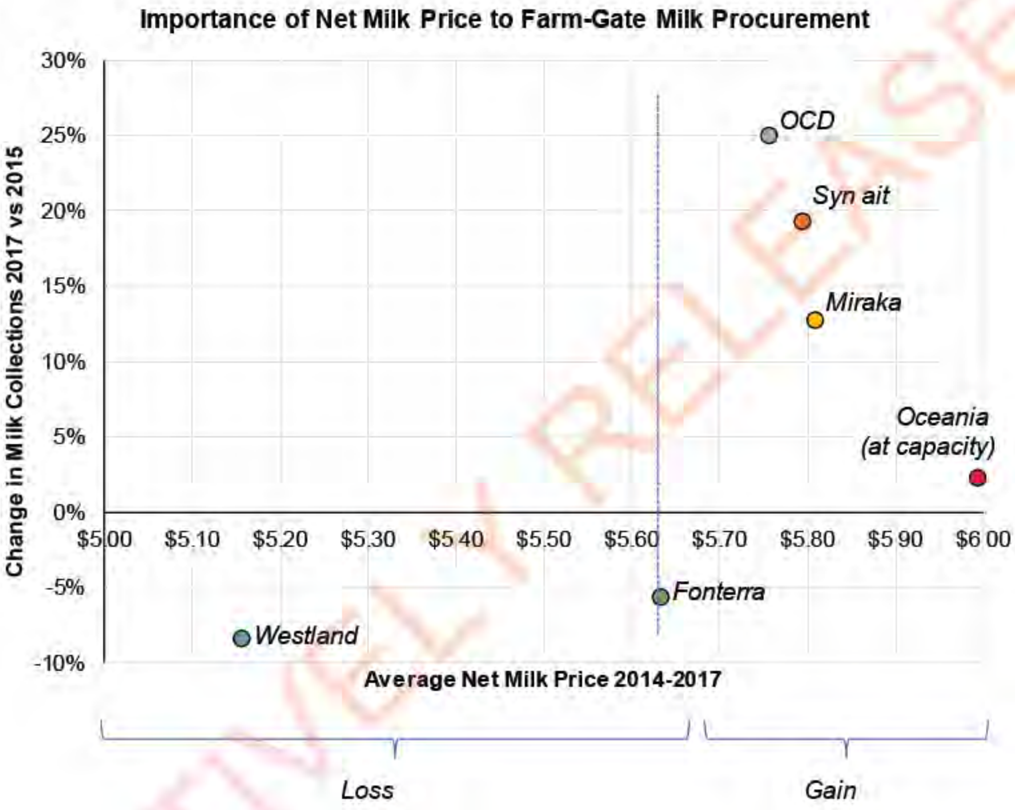
A fair comparison of farm-gate milk prices needs to take into account the price that farmers actually receive including dividends excluding retentions, and taking into account the cost of any share capital. It is also fair and sensible to conduct this evaluation over a reasonable period of time. We have calculated this "Net Milk Price" for the market participants present over the period 2014 – 2017 as shown below



[3] Wang, C. (2018, December) Independent Processors: Good or Evil? An Empirical Analysis of the Efficiency Impact of Independent Processors on New Zealand Dairy Industry, *Working Paper submitted in partial fulfilment of requirements for PhD*
[4] The "financial ratio" is defined here as "total payout before interest and tax, divided by total assets employed"

The effect of these companies' net milk prices is to either gain, or lose, milk supply. As 2015 represented the peak milk production for this period, with declines in 2016 and 2017, it is particularly useful to look at this effect because it clearly demonstrates the impact on capacity utilisation. The main exception to this is Tatua (a closed cooperative) who has not sought additional farm-gate milk but instead purchases additional milk and milk components from other dairy companies.

The figure below clearly shows that the companies whose average net milk prices were greater than Fonterra's all succeeded in gaining mi k even as overall supply contracted. In comparison, both Fonterra and Westland (whose net milk price was lowest) lost supply over this period.



This competitive farm-gate market creates pressure for dairy companies to generate a higher return from milk by bein more efficient and/or increasing the revenue from their products. One result of inefficient/ neffect ve companies losing milk supply is that their processing assets may become under-utilised. The concerned parties might describe these assets as being "stranded", but from an industry perspective that is beneficial so long as the milk supply has gone to a better economic use. The only "st anded asset" problem that should concern the industry and the regulator is if otherwise economic dairy farms are left without any dairy company available to collect and process their milk.

1.4 DIRA Benefits Exceed Costs

An important question is whether the clear benefits of DIRA (of the order NZ$3 billion per annum in efficiency gains) are outweighed by the costs imposed on participants.

In the first instance, it is difficult to see how costs of managing the regulatory regime could approach this figure. For example, Fonterra's entire administration costs in the 2017 financial year were 810 million.

One specific area that does need to be examined is the question of the 50 million litres per annum of raw milk available to independent dairy companies under the DIRA raw milk regulations. The recipients of this milk are required to pay Fonterra the regulated mi k price plus collection and delivery costs. They are also required to take this quantity according to the seasonal profile on which Fonterra's total mi k is collected.

This regulated milk is contentious, as it represents a possible opportunity cost to Fonterra (assuming Fonterra could have made better economic use of the milk) as well as potentially leaving existing assets under-utilised. The very fact that Fonterra has delivered the second lowest average net mi k price argues against there being any opportunity cost.

In regards to asset utilisation, Fonterra has only been required to supply this volume to as many as three new independent dairy companies at any one time (excluding Goodman Fielder as a separate issue), i.e. 150 million litres per annum. Compared to Fonterra's 2017 New Zealand milk collections of 17,848 million litres this is a very small amount. Specifically, it represents less than one percent o Fonterra's milk collections. In this context, it seems to represent a very minor inconvenience especially in the context of the very much greater gains made through farm-gate c mpetition It is difficult to imagine any company that would not willingly surrender one percent of ts raw materials supply in exchange for a twenty percent efficiency gain.

2.0 DIRA Threshold

This DIRA review is one of a series of major exercises undertaken where serious consideration is given to the idea that DIRA has served its purpose, that competition has been created, and the regulation should now be removed. This argument is self-serving and ignores both the very principles that underpinned the 2001 dairy industry restructure, and also international norms in competition laws and anti-trust policy.

2.1 DIRA Thresholds

The original DIRA regulation contained a threshold of 10%, i.e. that when competitors gained 10% or greater share of milk in either the North or South Island this would trigger expiry of the pro-competition DIRA provisions within a set timeframe unless there was a legislative change made before that time.

It is unclear how this 10% threshold was arrived at. Enquiries to those who drafted the regulations, as well as with the late Craig Norgate, did not yield any clear explanation other than this was a negotiated outcome. There is no evidence that it was derived from any market competition theory or international precedents.

In any event, the 10% threshold was reached quite rapidly in the South Island and the threshold subsequently reset to 20%. Then when this second threshold was crossed in 2014/15 the subsequent 2015/2016 DIRA reviews recommended that the threshold should instead trigger a further review rather than expiry of DIRA. All of these resets have been stop-gap measures rather than proper resolutions of the situation.

2.2 Precedents and International Norms

Most countries have competition laws (also called antitrust laws). Competition law protects and promotes competition between firms, to make sure that they act ethically towards each other and consumers. Not surprisingly, the area of competition and anti-trust has long been a focus for both law-makers and economists seeking to quantify when competition is sufficient to achieve these goals.

The simplest way to measure whether any firm has achieved market dominance, to the extent that it threatens to inhibit competition is market share. This is essentially the approach taken in the original DIRA regulation. According to the European Commission, market shares provide a useful first indication of the structure of any market and of the relative importance of the various undertakings active on it. In paragraph 15 of the Guidance on A102, the European Commission state that a high market share over a long period of time can be a preliminary indication of dominance. In Hoffman-La Roche v Commission, the Court of Justice said that large market shares are ‘evidence of the existence of a dominant position’ which led to the Court of Justice decision in AKZO v Commission that when there is market share of at least 50%, without exceptional circumstances, there will be a presumption of dominance that shifts the burden of proof on to the undertaking[5]. The European Commission has affirmed this threshold in cases since AKZO.

A more sophisticated approach applies the Herfindahl–Hirschman Index (HHI). This is an economic concept widely applied in competition and antitrust law. It is defined as the sum of the squares of the market shares of each individual firm. As such, calculated using decimals it can range from 0 to 1 (or alternately if using whole percentages, from, 0 to 10,000). A market with many small firms thus results in a low HHI figure, while one with just a few large firms results in a much larger HHI figure.

According to the United States Department of Justice (2010)[6], HHI calculated using decimals resulting in a figure above 0.25 represents a market that can be considered to have high concentration, a value between 0.15 and 0.25 represents a market of moderate concentration and a value below 0.15 represents a market that is not concentrated. Transactions that increase the HHI by more than 0.02

[5] EUR-Lex - 61976CJ0085 - EN - EUR-Lex". eur-lex.europa.eu.

[6] United States Department of Justice, 2010. Horizontal Merger Guidelines. Issued: 19 August 2010. U.S. Department of Justice and the Federal Trade Commission

points in highly concentrated markets are presumed likely to enhance market power under the Horizontal Merger Guidelines issued by the Department of Justice and the Federal Trade Commission.

2.3 Market Dominance in The New Zealand Dairy Industry

Fonterra currently still has over 80% of milk collections in New Zealand, and so according to the European Commission would definitely be regarded as dominant.

Furthermore, with the market HHI for New Zealand farm-gate mi k calculated at 0.660 this is still well above the threshold for having a high concentration as defined by the United States Department of Justice.

In consideration of these points, we must conclude that Fonterra continues to be si gularly dominant in the New Zealand dairy industry.

Dairy Company	**2018 Collections** *000 kgMS*	**Share**	**Herfindahl Index** *(HHI)*
Fonterra	1,505,111	81.2%	0.660
Open Country Dairy	137,583	7.4%	0.006
Synlait	63,611	3 4%	0.001
Westland	63,222	3 4%	0.001
Miraka	26,833	1.4%	0.000
Oceania Dairy	20,917	1.1%	0.000
Tatua	14,694	0.8%	0.000
Other Dairy Companies	7,750	0.4%	0.000
Total	**1,839,722**	100%	**0.6683**

2.4 Conditions for Future D RA Reviews

There are clear thresholds that international precedent would suggest are suitable conditions for expiry of the pro-c mpetition DIRA provisions. These are either:

1. Fonterra has less than 50% market share of farm-gate milk, and/or
2. The HHI falls below 0.25

MVM respectfully suggests that until these conditions are met, DIRA's pro-competition provisions r mai absolutely vital. To make this clear, it would be extremely helpful for these conditions to be included explicitly in the legislation. This would also bring New Zealand into line with competition regu ations in other, larger jurisdictions.

3.0 Summary of Response to Options for DIRA

This section provides an overview of MVM's position on the various options suggested in the MPI discussion document.

3.1 Options for the DIRA open entry requirements

Option 4.1.1: Status quo: retain the existing DIRA open entry (and exit) requirements.
Option 4.1.2: Repeal the DIRA open entry requirements.
Option 4.1.3: Amend the DIRA open entry requirements to allow Fonterra to decline to accept applications from new and existing farmers if Fonterra considers their supply is unlikely to comply with Fonterra's terms of supply.

MVM Points:

- MVM has a clear preference for option 4.1.1 (status quo).
- If any changes to open entry are contemplated, especially in regards to option 4.1.3, then MVM recommend the regulation is designed to include the following provisions:
  - A fair and transparent process for determining supply eligibility based on previous milk supply performance irrespective of which company has been supplied (and not permitting Fonterra discretion in whether to accept them or not), and
  - Open eligibility for any milk incentive payments, including the requirement that these cannot be based on tenure of supply to Fonterra (that would act as an effective barrier to open entry and exit).
- This would involve establishing general criteria for the eligibility of farms to supply Fonterra, <u>and</u> eligibility for any Fonterra incentive payments, based on their previous milk supply record irrespective of which processor they have been supplying.
- The process of determining eligibility should also be impartial and inquisitorial. i.e. not an adversarial system adjudicated by the regulator. This is necessary to avoid a protracted process which could only harm the desired outcome of a competitive farm-gate milk market.

3.2 Options for access to regulated milk for large dairy processors (except Goodman Fielder)

Option 4.2.1: Status quo: retain the existing eligibility provisions for regulated milk in the Raw Milk Regulations.
Option 4.2.2: Amend the eligibility provisions in the Raw Milk Regulations to exclude large dairy processors.

MVM Points:

- As a matter of principle, MVM prefers Option 4.2.1 (status quo)
- MVM is concerned by the suggestion that access to regulated milk for some new entrants (so-called 'large dairy processors') may no longer be necessary.
- There is a very real risk of moral hazard, i.e. that practically all the influential stakeholders participating in this review have an obvious self-interest in raising the barriers to entry for future new entrants.
- Accordingly, consensus on this issue between current stakeholders provides no assurance that it is the correct conclusion for the regulator.
- As to the necessity of access to regulated milk facilitating a pathway for new entrants, MVM makes the following points:
  - The quantum of 50 million litres per annum is less than 0.4% of Fonterra's collections and thus represents no great burden for the dominant incumbent
  - For the first farmer considering switching supply to an independent, the assurance that the independents annual milk pool already comprises 50 million litres gives them significantly greater confidence in the new enterprise

  - This aspect of the DIRA regulation also provides an important signal to investors in new dairy companies that the NZ dairy industry regulatory regime is benign (notwithstanding the obvious presence of a large, hostile incumbent).
- Finally, the nearly $3 billion per annum benefits attributable to farm-gate competition underline the imperative of ensuring that the pathway for new entrants remains intact.

3.3 Options for the base milk price calculation

Option 4.3.1: Status quo: retain the existing DIRA provisions for Fonterra's base milk price calculation and Commerce Commission monitoring.
Option 4.3.2: Amend the DIRA to provide additional statutory guidance on the meaning of the term "practically feasible".
Option 4.3.3: Amend the DIRA to give the Commerce Commission statutory power to set the base milk price for the dairy industry.

MVM Points:

- MVM prefers any option that curtails Fonterra's broad discretion in setting the base milk price, and would make it more accountable to the regulator.
- MVM's concerns relate specifically to how the base milk price affects independent processors.
- The primary concern is one of whether the base milk price is fair:
  - Risk of Fonterra farmer politics influencing/interfering in commercial process
  - Impact on cash-flows for dairy companies
  - Detrimental to investment off-farm
- A further concern, which has a direct impact on MVM, is the effect on regulated DIRA milk:
  - The final milk price determination
  - The latitude that Fonterra has in the forecast milk price as basis for regulated milk invoices, and the real impact that this has on cashflows for recipients of regulated milk
- We appreciate that others have gone to considerable length to demonstrate where Fonterra has been unreasonable in its calculation of the base milk price. This is evidenced in the many submissions made by various independent dairy companies, which MPI already has.
- We also appreciate the recent Commerce Commission finding in April 2018 that the 'asset beta' Fonterra Cooperative Group uses to determine the farmgate milk price say it may be too low, meaning its farmer-shareholders are receiving a bigger payout than warranted under the company's enabling law. We suggest this is indicative of the wider problem, rather than being the sole issue at stake.

3.4 Options for access to regulated milk for Goodman Fielder and smaller processors

Option 4.4.1: Status quo: retain the existing provisions in the Raw Milk Regulations as they apply to Goodman Fielder and smaller processors.
Option 4.4.2: Amend the Raw Milk Regulations to update the terms on which Goodman Fielder can access regulated milk from Fonterra.
Option 4.4.3: Amend the Raw Milk Regulations to gradually reduce Goodman Fielder's eligibility for regulated milk over time.
Option 4.4.4: Amend the Raw Milk Regulations to remove limits on the amount of regulated milk available to dairy processors supplying New Zealand consumer markets.
Option 4.4.5: Amend the Raw Milk Regulations so that the terms on which dairy processors supplying New Zealand consumer markets can access regulated milk mirror the terms on which Fonterra supplies its own New Zealand consumer business.

MVM Points:

- The fundamental issue remains Fonterra's dominance in the raw milk market and its large share of the domestic consumer market, the combination of which enables anti-competitive behaviours
- MVM does not see a satisfactory resolution (other than retaining the status quo) until that dual position is resolved
- MVM is also concerned that the regulation is largely focussed on just one competitor to Fonterra (i.e. Goodman Fielder), when it seems likely that regulation designed on that basis could be overtaken by events.
- In any case, the current regulation may have entrenched a milk-supply dependency in Goodman Fielder which is unhelpful to competitive market outcomes.
- The business interests of Goodman Fielder and Fonterra are also potentially so enmeshed in downstream operations (e.g. offtake agreements) as to affect competition. Nothing short of a full review of competition in the domestic consumer dairy sector would suffice to address this.

3.5 Options for the DIRA review and expiry provisions

Option 4.5.1: Status quo: no statutory provision for review and/or expiry of the DIRA regulatory regime in legislation.

Option 4.5.2: Amend the DIRA to require periodic reviews of competition in the dairy industry to determine whether the DIRA regulatory regime should be retained, repealed or amended.

Option 4.5.3: Amend the DIRA to require a review of competition n the dairy industry to determine whether the DIRA regulatory regime shou d be retained, repealed or amended, to be undertaken when a set market share thr shold has been reached.

Option 4.5.4: Amend the DIRA to provide for its automatic expiry from a nominated date or when a set market share threshold has been reached.

MVM Points:

- MVM suggests DIRA is absolutely required while Fonterra has industry dominance (as per the HHI Index, see section 2) A simple market share test is not sufficient but may form part of the criteria.
- We recommend that the egulator look to the market dominance benchmarks used by the European Commiss on a d/ r the United States Department of Justice as useful precedents.
- An amended option 4 5.4 could be designed on this basis, i.e. to trigger the expiry of DIRA's pro-competiti n provis ons when:
  - onterra's market share of farm-gate milk falls below 50%, and/or
  - The Herfindahl index (HHI) for the farm-gate milk market falls below 0.25
- On no account should option 4.5.4 be contemplated unless it does use these internationally accepted thresholds.
- A ernately, the option for a periodic review as per option 4.5.2 would represent simply another deferment of the problem as have been done in every previous DIRA review.

ATTACHMENTS

These attachments provide specific responses to the questions posed in the MPI discussion document. They are to intended be read in conjunction with the preceding main sections.

A1: MVM Response to Objectives and Purpose
A2: MVM Response to Performance of the Dairy Industry
A3: MVM Response to the Effects of DIRA
A4: Options for Change

A1: MVM Response to Objectives and Purpose

A1.1 Review Objectives

The DIRA Discussion Document[7] states that the purpose of this DIRA Review is to ensure that the DIRA:

- is effective at achieving its regulatory purpose and remains fit-for-purpose;
- does not create unintended consequences; and
- does not stay in place for longer than necessary.

MVM comments:

MVM suggests that DIRA achieving the regulatory purpose and remaining fit-for-purpose is the main objective. Ideally, the second and third points should be addressed without compromising the main objective. Especially in areas where other legislation and regulation exists to manage issues (i.e. arising from 'unintended consequences'), we should not also attempt address those issues within DIRA.

A1.2 DIRA Regulatory Purpose

The DIRA Discussion Document clearly and succinctly articulates the regulatory purpose, in particular the importance of:

(a) Farmer access to Fonterra's transparent performance information (i.e. milk price and share price)
(b) Farmers freedom to act on Fonterra's performance information (primarily freedom to join or leave the Fonterra cooperative).

Review Question 1:

- Do you agree with our description of the DIRA regulatory regime and its original policy rationale? Do you consider the original policy rationale is still valid?

MVM Response to Question 1

MVM is in general agreement with the description of the DIRA regulatory regime and its original policy rationale. The policy rationale is still valid, and remains so while Fonterra is dominant.

In considering the diagram (on pages 6 and 15) MVM suggests that a corollary of farmers' freedom to act is that there must be opportunity to do so. The diagram articulating DIRA's regulatory purpose does not include this explicitly, although it is implied in the text, i.e.

> *"The DIRA also facilitates an entrance pathway for new dairy processors and supports competition in the domestic consumer dairy markets through the Raw Milk Regulations. These provide for independent processors without their own viable milk supply to have access to a limited quantity of regulated milk from Fonterra".*

MVM considers the Raw Milk Regulations as they apply to independent processors are absolutely vital to achieving the purpose of DIRA, and that the diagram should be somehow amended to include this facet of the regulation. We have included a suggested revised framework diagram accordingly (see also section 1.1).

[7] Paper No: 2018/13, published November 2018

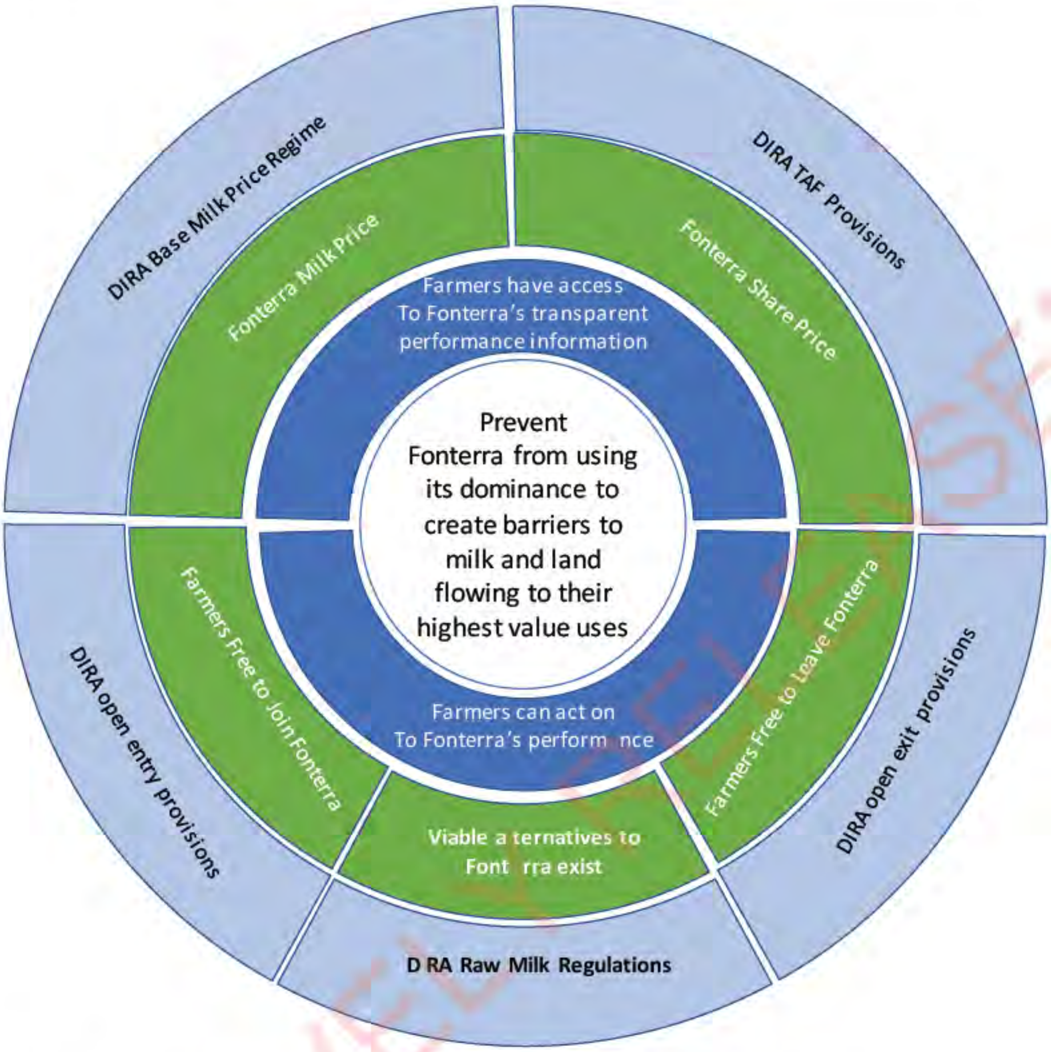


Diagram representing th core purpose and elements of DIRA regulation

It is also vital that the integrity of DIRA regulatory purpose is not undermined by its execution. Just as farmers require transparent information, so too do independent processors. Equally important to transparency is the fairness of the milk price regime. This raises issues of recourse for industry participants when transparency and fairness are not evident. At present MVM believes the intent of the regulation can be (and has been) frustrated where Fonterra has enjoyed both relative freedom in determining the inputs to the milk price calculation, and also discretion to ignore the result of the cal ulation.

We welcome the recent Commerce Commission finding in April 2018 that the 'asset beta' Fonterra Cooperative Group uses to determine the farmgate milk price say it may be too low, meaning its farmer-shareholders are receiving a bigger payout than warranted under the company's enabling law. We suggest this is indicative of the wider problem, rather than being the sole issue at stake.

A2: MVM Response to Performance of the Dairy Industry

Review Question 2:

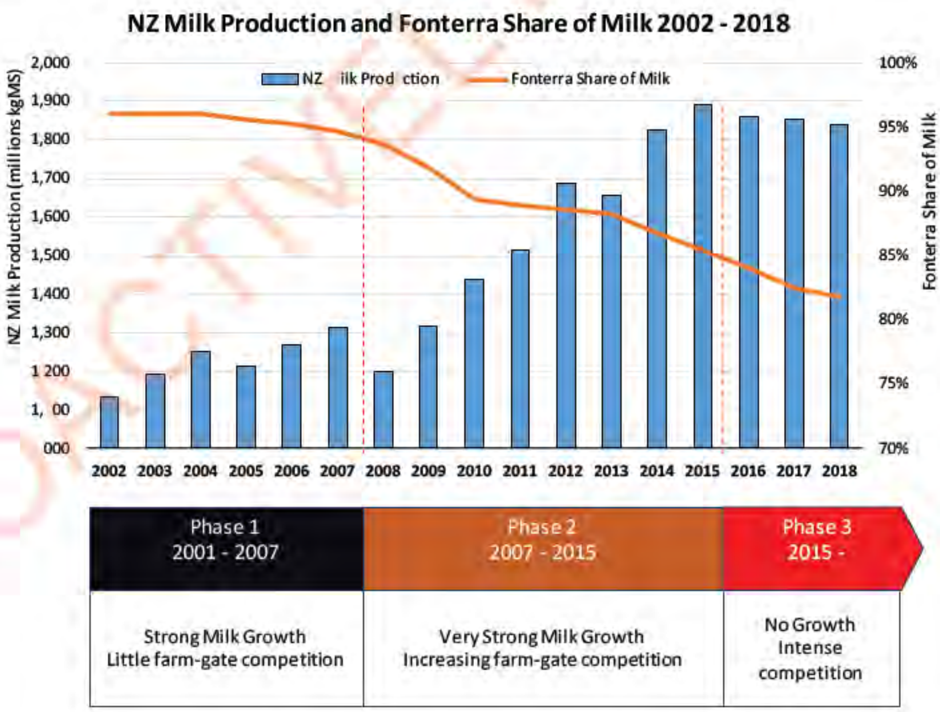
- Are there any other dairy industry developments or industry performance indicators that are not captured in Chapter 2, Appendix 1, or the reports by Frontier Economics? Please provide details and supporting evidence.

MVM Response to Question 2:

MVM considers the review must give further thought to industry performance and efficiency since 2001, specifically the NZ$3 billion per annum benefits (see section 1) that can be attributed to the real commencement of farm-gate competition for raw mi k circa 2007/2008 (and the obvi us absence of improvement prior to that time). Stating the obvious: in the absence of farm-gate ompetition, there was no incentive for the incumbent to improve, and no evidence that they did so. This outcome demonstrates that real farm-gate competition for raw milk is the key to improving industry performance beyond the farm gate.

MVM suggests that MPI must do more to communicate to all dairy farme s, including Fonterra suppliers, that farm-gate competition has benefited them directly by an estimated $1.79 per kilogram of mi k solids due to gains in efficiencies

MVM also re-states its view that DIRA must be forward looking, and that this requires consideration of how the industry will unfold over the next decade and b yond The New Zealand dairy industry has now entered a new and crucial third phase of developm nt as per the figure below characterised by lower (or zero) milk growth, and the high likelihood of over-capacity in processing. New industry dynamics will emerge as a result, and DIRA should be designed accordingly. Retrospective analysis is not sufficient by itself to inform this design[8].



[8] The analysis supporting this position was also provided in MVM's earlier submission.

A3: MVM Response to the Effects of DIRA

3.1 Has the DIRA been effective at managing Fonterra's dominance in the market for farmers' milk, and is it still needed?

Review Question 3:

- Do you consider the DIRA has been effective at achieving its core regulatory objective of preventing Fonterra from using its dominance to create barriers to farmers' mi k and land flowing to their highest value uses? If not, please provide reasons and supporting information/evidence.

<u>MVM Response to Question 3:</u>

The entrance and continued growth of new independent dairy companies, whose verage net milk price exceeds Fonterra's (see section 1.3), provides strong evidence of two thi gs:

- *that DIRA has been effective in managing Fonterra's domin nce*
- *That at least some milk is flowing to its highest value use*

The enormous economic benefits estimated at $2.9 billion per annum fo the whole industry arising from farm-gate competition are established in section 1.1 n tw sepa ate pieces of analysis.

We note that DIRA is not the only factor in achieving this result but we do not think it could have been achieved without the free exit and entry provisions and the r w milk regulations creating a pathway for new entrants.

Review Question 4:

- Do you think Fonterra is still dominant in the market for farmers' mi k, at the national and regional levels?

<u>MVM Response to Question 4:</u>

Fonterra is still dominant (82% share) in the market for farmers milk at a national level. This is clearly demonstrated in section 2. MVM recommends a rigorous quantitative approach, and that the regulator should dopt the benchmarks used in other jurisdictions' competition and antitrust laws. These suggest that Fonterra will remain dominant while it has more than 50% market share and/or an HHI equal or greater than 0.25.

We concede that Fonterra has a less dominant position in certain regions such as South Canterbury and th Waikato where multiple competitors now operate. However, it collects more than 50% of milk in those egions and its national dominance also provides it with a further advantage of scale. By any standard this means Fonterra is also dominant regionally.

Review Question 5:

- Do you think the DIRA imposes unreasonable costs on Fonterra? If so, please provide supporting information/evidence?

MVM Response to Question 5:

No. We think it is unreasonable to suggest that the imposed costs of DIRA have any merit when compared against the enormous benefits of farm-gate competition.

In any case, the 50 million litres per annum stipulated in the raw milk regulations represents le s than 0.4 percent of Fonterra's total milk collections in 2018.

Review Question 6:

- Are there ways for the costs imposed on Fonterra to be mitigated w h ut imp cting on the effectiveness of the DIRA regulatory regime? If so, please provide supporting information?

MVM Response to Question 6:

None. MVM reserves the right to comment further on whatever new options are proposed if they differ from what has already been suggested as options outlined in the MPI discussion paper.

Review Question 7:

- Are there any other regulatory tools that, in y ur opinion, would be more effective than the current DIRA provisions at managing Fonterra's dominance? If so, please provide examples and supporting information/evidence?

MVM Response to Question 7:

None. MVM reserves the right to comment further on whatever new options are proposed if they differ from what has already been suggested as options outlined in the MPI discussion paper.

Review Question 8:

- Are there ther factors you consider need to be taken into account when considering the effectiveness of the DIRA regime and whether it is still needed?

MVM Response o Question 8:

The benefits of farm-gate competition as outlined in this submission.

3 2 Does the DIRA encourage industry growth?

Review Question 9:

- Do you agree with our preliminary assessment of the extent to which the DIRA encourages industry growth? If not, please provide reasons and supporting information/evidence?

MVM Response to Question 9:

We agree that industry growth has been primarily driven by international market demand which has in turn led to relatively high milk returns and certainly a higher return on capital for dairy farms versus dry-stock farming.

Obviously, milk growth has been facilitated by a historical approach to land-use change leading to large-scale conversions to dairy farming (i.e. by land-owners seeking a higher economic return). This has been mainly the responsibility of Regional Councils, and is not due to DIRA.

3.3 Does the DIRA influence Fonterra's strategy?

Review Question 10:

Do you agree with our preliminary assessment of the extent to which Fonterra can influence mi k supply volumes through price, notwithstanding the DIRA open entry requirements?

MVM Response to Question 10:

We consider that DIRA was designed to address competition around the conventional seasonal milk production curve, and generally treats all milk as equal[9]. As Winter milk and Spec alty milks c mmand a premium above the base milk price, this has been left to "the market" to resolve. To this extent we agree that Fonterra has the freedom under DIRA to offer incentives to farme s to supply milk with specific requirements as needed to meet valuable market opportunities. Fonterra s i vestment in organic milk (specialty) and UHT milk (non-seasonal) clearly demonstrates this

However, MVM anticipates that Fonterra could potentially create an anti competitive environment circumventing the DIRA open entry and open exit provisions by offering special premiums based on such things as tenure of supply. i.e. Farmers exiting the cooperative could lose entitlement to such premiums even if they chose to return again. This could be subtle, i.e. it could take 5 years to become fully qualified in a "farm excellence scheme" that brings with t spe ial premiums. MVM suggests that the regulator needs to anticipate and be fully aware of such de elopments.

Review Question 11:

- Are there other factors that you consi er should be taken into account? Please provide detailed comment in support of your views?

MVM Response to Question 11:

See above RE: potential undermining of open entry and exit provisions.

Review Question 12:

- Do you consider that the DIRA provisions governing Fonterra's base milk price calculation and Commer e Commission monitoring may be preventing or disincentivising Fonterra from deviating from the base milk price calculation for strategic or commercial reasons?

MVM Response to Question 12:

As per above, we consider that Fonterra demonstrably has the freedom to deviate from the base milk price calculation for strategic or commercial reasons. Expansion of Fonterra's organic and UHT milk businesses are clear evidence of this.

Review Question 13:

- If the DIRA is not driving Fonterra's business and investment strategy, what is? Please provide detailed comment in support of your views?

MVM Response to Question 13:

Economics and farmer politics.

[9] Actually, this detail of seasonality had to be incorporated retrospectively when Fonterra quite rightly pointed out the unfairness of independents being able to DIRA demand regulated milk should all be delivered on the shoulders of the season, not the peak.

3.4 Does the DIRA impact on the industry's environmental performance?

Review Question 14:
- Do you agree with our preliminary analysis of the DIRA's impact on the industry's environmental performance? If not, please provide your reasons and supporting evidence.

MVM Response to Question 14:

Yes.

Review Question 15:
- Do you agree with our view that environmental issues are best dealt with through the Resource Management Act and not the DIRA regime?

MVM Response to Question 15:

Yes.

Review Question 16:
- Are there other environmental issues that you c nsider should be addressed either through the DIRA review or some other means?

MVM Response to Question 16:

No.

3.5 Does the DIRA incentiv se inefficient entry by large dairy processors?

Review Question 17:
- Do you agree with our preliminary analysis of the impact the DIRA has on new processor ent y? If not, please provide your reasons and information/evidence in support of your views.

MVM Response o Question 17:

Yes.

In section 1.3 we have clearly articulated how the independent dairy companies established since 2001 have delivered higher net prices to farmers in the period 2014-2017, and that this argues strongly against any suggestion that their entry has been "inefficient".

As to the necessity of access to regulated milk facilitating a pathway for new entrants, MVM also makes the following points:
- *The quantum of 50 million litres per annum is less than 0.4% of Fonterra's collections and thus represents no great burden for the dominant incumbent*
- *For the first farmer considering switching supply to an independent, the assurance that the independents annual milk pool already comprises 50 million litres gives them significantly greater confidence in the new enterprise*
- *This aspect of the DIRA regulation also provides an important signal to investors in new dairy companies that the NZ dairy industry regulatory regime is benign (notwithstanding the obvious presence of a large, hostile incumbent).*

Finally, the nearly $3 billion per annum benefits attributable to farm-gate competition underline the imperative of ensuring that the pathway for new entrants remains intact.

Review Question 18:

- Do you consider that large dairy processors should continue to be eligible to purchase regulated milk from Fonterra under the Raw Mi k Regulations or not? Please provide detailed comment in support of your views.

MVM Response to Question 18:

Yes.

In addition to our response to question 18, we also make the point that there is a very real risk of moral hazard, i.e. that practically all the influential stakeholders participating in this eview have an obvious self-interest in raising the barriers to entry for future new entrants.

3.6 Does the DIRA promote sufficient confidence in the base milk price calculation?

Review Question 19:

- Do you consider that greater confidence in the base milk price calculation outcomes could be achieved if additional legislative guidance on the term "practically feasible" were to be provided for in the DIRA? Please provide d tailed comment in support of your views.

MVM Response to Question 19:

Yes.

Review Question 20:

- Do you consider that the base mi k price should be set by an independent body (e.g. the Commerce Commiss on)? If so, please provide supporting information.

MVM Response to Question 20:

MVM considers that key inputs to the base milk price calculation should be set by the Commerce Commission. The asset beta is an obvious example.

3.7 Does the DIRA support competition in New Zealand consumer dairy markets?

Review Question 21:

- Do you agree with our preliminary analysis of the DIRA impact on the domestic consumer dairy markets? Please provide your reasons and information/evidence in support of your views.

MVM Response to Question 21:

Yes. Please refer to comments in section 3.4.

Review Question 22:

- Are there any other factors that should be taken into account regarding the dome tic consumer dairy markets? Please provide your reasons and informa io /evide ce in support of your views.

MVM Response to Question 22:

MVM recommends that rather than addressing this issue in the current exercise, there should be a full review of competition in the NZ domestic consumer dairy sector.

3.8 Summary of Issues

The preliminary analysis of stakeholder concerns indicates that the DIRA is:

- ✓ effective at achieving its core regulatory objective of managing Fonterra's dominance;
- ✓ still relevant and needed at this stage; and
- ✓ unlikely to be encouraging inefficient industry growth or preventing Fonterra from pursuing a value-add strategy.

But, the DIRA appears to be:

- ✗ preventing Fonterra from effectively managing some aspects of its farmers' environmental performance, thus producing unintended consequences; and
- ✗ providing access to regulated mi k for large dairy processors for whom it may no longer be necessary, thus not being fit-for-purpose.

In addition, there is an opportunity to consider whether the DIRA should be amen ed to:

- promote greater confidence in the base milk price calculation; and
- preserve competition in the domestic consumer dairy markets in the short term, while discouraging any undue regulatory dependency in the longer term.

<u>MVM comments:</u>

MVM is in general agreement with the first three points concerning DIRA's effectiveness, relevance and suitability.

However, MVM is concerned at the suggestion DIRA is somehow preventing Fonterra from managing farmer's environmental performance. Our main concer i that this conveniently leverages a real issue (farm environmental performance) to achieve F nterra's real but separate aim (retention of milk by any means possible). We respectfully suggest the need for scepticism, and also consideration of alternative explanations and remedies. We e aborate on this point further in our commentary on the recommendations.

MVM is also concerned by the suggestion that access to regulated milk for some new entrants (so-called 'large dairy processors') may no longer be necessary. There is a very real risk here of moral hazard, i.e. that practically a l the nfluential stakeholders participating in this review have an obvious self-interest in raising the barriers to entry for future new entrants.

MVM agrees that greater confidence is needed in the milk price calculation. MVM goes further to suggest that greater confidence is needed in milk price <u>determination</u>. i.e. who has the final say in determining the actual milk price.

A4: Options for Change

There are five areas where options for change are identified. MVM's preferred options and rationale are discussed.

A4.1 Options for the DIRA open entry requirements

Option 4.1.1: Status quo: retain the existing DIRA open entry (and exit) requirements.
Option 4.1.2: Repeal the DIRA open entry requirements.
Option 4.1.3: Amend the DIRA open entry requirements to allow Fonterra to decline to accept applications from new and existing farmers if Fonterra considers their supply is unlikely to comply with Fonterra's terms of supply.

MVM General Comments:

MVM prefers option 4.1.1.

MVM does not consider option 4.1.2 feasible to meet the intent of the regulation.

MVM is also very concerned that option 4.1.3 will, if selected undermine the effectiveness of the 'open entry and exit' provisions of DIRA. MVM suggests that proponents of this change are leveraging the real issue of environmental and animal welfare performance to achieve a resolution of their own milk retention problem.

Review Question 23:

- Are there any other options for the DIRA open entry requirements that you think should be considered? Please provide sufficient detail when describing any alternative options as well as reasons for considering these.

MVM Response to Question 23:

No. MVM has a clear preference for option 4.1.1 (status quo).

If any changes to open entry are contemplated, especially in regards to option 4.1.3, then MVM recommend the regulation is designed to include the following provisions:

a) *A fair and transparent process for determining supply eligibility based on previous milk supply performance irrespective of which company has been supplied (and not permitting Fonterra discretion in whether to accept them or not), and*
b) *Open eligibility for any milk incentive payments, including the requirement that these cannot be based on tenure of supply to Fonterra (that would act as an effective barrier to open entry and exit).*

This would involve establishing general criteria for the eligibility of farms to supply Fonterra, and eligibility for any Fonterra incentive payments, based on their previous milk supply record irrespective of which processor they have been previously supplying.

The process for determining eligibility must also be transparent, independent, and inquisitorial (rather than adversarial).

Review Question 24:

- What costs and benefits would each of the options for the DIRA open entry requirements create for your business? Please provide quantitative information if possible.

MVM Response to Question 24:

MVM's business relies on attracting milk according to its quality and seasonal requirements. The main cost is the milk premium that MVM uses to achieve this result.

The overall benefits of the contestability of farm-gate milk are established in section 1 of this response. i.e. $2.9 billion per annum for the New Zealand dairy industry.

Review Question 25:

- How well do you think each of the options for the DIRA open entry requirements would perform against the principles of good regulatory practice of promoting certainty and predictability of regulatory outcomes, transparency, cost-effectiveness and timeliness of regulatory processes?

MVM Response to Question 25:

Option 4.1.1 is the most straightforward. See our discussion in section 3.1.

Review Question 26:

- What is your preferred option for the DIRA open entry requirements? Please provide your reasons and information/evidence in support of your views.

MVM Response to Question 26:

Option 4.1.1

A4.2 Options for access to regulated milk for large dairy processors (except Goodman Fielder)

Option 4.2.1: Status quo: retain the existing eligibility provisions for regulated milk in the Raw Milk Regulations.
Option 4.2.2: Amend the eligibility provisions in the Raw Milk Regulations to exclude large dairy processors.

MVM General Comments:

MVM is concerned by the suggestion that access to regulated milk for some new entrants (so- alled 'large dairy processors') may no longer be necessary. There is a very real risk here of moral hazard, i.e that practically all the influential stakeholders participating in this review have an obvious self nterest in raising the barriers to entry for future new entrants. Accordingly, consensus on this issue between current s akeholders provides no assurance that it is the correct conclusion for the regulator.

Review Question 27:

- Are there any other options for access to regulated mi k for la g dairy processors that you think should be considered? Please provide sufficient detail when describing any alternative options as well as reasons for considering these.

MVM Response to Question 27:

No. MVM has a clear preference for option 4.2.1.

Review Question 28:

- Do you consider that the proposed 30 million litres threshold is too high or too low? If so, what would you consider the righ threshold to be, and why?

MVM Response to Question 28:

30 million litres is too low, at least 50 million litres is required. Even this represents less than half of what is required for an economic milk processor. Please refer to our discussion in section 3.2.

As to the necessity of access to regulated milk facilitating a pathway for new entrants, MVM makes the following points:

- *The quantum of 50 million litres per annum is less than 0.4% of Fonterra's collections and thus represents no g eat burden for the dominant incumbent*
- *For the first farmer considering switching supply to an independent, the assurance that the independents annual milk pool already comprises 50 million litres gives them significantly greater confidence in the new enterprise*
- *Th s aspect of the DIRA regulation also provides an important signal to investors in new dairy companies that the NZ dairy industry regulatory regime is benign (notwithstanding the obvious presence of a large, hostile incumbent).*

Review Question 29:

- What costs and benefits would each of the options for access to regulated milk for large dairy processors create for your business? Please provide quantitative information if possible.

MVM Response to Question 29:

See our response in section 3.2.

Review Question 30:

- How well do you think each of the options for access to regulated milk for large dairy processors would perform against the principles of good regulatory practice of promoting certainty and predictability of regulatory outcomes, transparency, cost effectiveness and timeliness of regulatory processes?

MVM Response to Question 29:

Excluding large processors risks de-railing the entry pathway for new processors and undermining the benefits arising from farm-gate competition.

Review Question 31:

- Do you have a preferred option for access to regulated milk for large dairy processors? Please provide your reasons and information/evidence in support of your views

MVM Response to Question 31:

MVM has a clear preference for option 4.2.1.

A4.3 Options for the base milk price calculation

Option 4.3.1: Status quo: retain the existing DIRA provisions for Fonterra's base mi k price calculation and Commerce Commission monitoring.
Option 4.3.2: Amend the DIRA to provide additional statutory guidance on the meaning of the term "practically feasible".
Option 4.3.3: Amend the DIRA to give the Commerce Commission statutory power to set the base milk price for the dairy industry.

MVM General Comments:

MVM appreciates the many previous submissions made by other independent dairy companies n this ssue in previous exercises. These should inform the regulator of the key issues.

We also appreciate the reluctance of the regulator to step in and set milk prices. However, a balance must be struck and currently we suggest Fonterra has far too much leeway to set base mi k pr ce in its favour.

Review Question 32:

- Are there any other options for the base milk price calculation t at you think should be considered? Please provide sufficient detail when desc ibing any alternative options as well as reasons for considering these.

MVM Response to Question 32:

MVM considers that the principle issue here is that indepen ent dairy companies who are materially affected by decisions that Fonterra might make in deviating from normal practices in its calculated base milk price have no recourse other than the courts. This is expensive and unhelpful for all parties.

From an independent dairy company perspective, it would be less onerous if the regulator actually took a firm hand in setting the rules and insisting that Fonterra comply.

Review Question 33:

- What costs and bene its would each of the options for the base milk price calculation create for your business? Please provide quantitative information if possible.

MVM Response to Question 33:

No comment.

Review Que tion 34:

- How well do you think each of the options for the base milk price calculation would perform against the principles of good regulatory practice of promoting certainty and predictability of regulatory outcomes, transparency, cost-effectiveness and timeliness of regulatory processes?

MVM Response to Question 34:

No comment.

Review Question 35:

- Do have a preferred option for the base mi k price calculation? Please provide your reasons and information/evidence in support of your views.

MVM prefers Option 4.3.3.

A4.4 Options for access to regulated milk for Goodman Fielder and smaller processors

Option 4.4.1: Status quo: retain the existing provisions in the Raw Mi k Regulations as they apply to Goodman Fielder and smaller processors.
Option 4.4.2: Amend the Raw Milk Regulations to update the terms on which Goodman Fielder can access regulated milk from Fonterra.
Option 4.4.3: Amend the Raw Milk Regulations to gradually reduce Goodman Fielder's eligibility for regulated milk over time.
Option 4.4.4: Amend the Raw Milk Regulations to remove limits on the amount of regulated milk available to dairy processors supplying New Zealand consumer markets.
Option 4.4.5: Amend the Raw Milk Regulations so that the terms on which dairy processors supplying New Zealand consumer markets can access regulated milk mirror the terms on whi h Fonterra supplies its own New Zealand consumer business.

MVM General Comments:

The fundamental issue remains Fonterra's dominance in the raw milk market and its large share of the domestic consumer market, the combination of which enables anti-competitive behaviours. MVM does not see a satisfactory resolution (other than retaining the status quo) until that dual position is resolved.

MVM is also concerned that the regulation is largely focussed on just one competitor to Fonterra (i.e. Goodman Fielder), when it seems likely that regulation designed on that basis could be overtaken by events. In any case, the current regulation may have entrenched a milk-supply dependency in Goodman Fielder which is unhelpful to competitive market outcomes. The bu iness interests of Goodman Fielder and Fonterra are also potentially so enmeshed in downstream op rations (e g. offtake agreements) as to affect competition. Nothing short of a full review of competition in the domestic consumer dairy sector would suffice to address this.

Review Question 36:

- Are there any other options for ac ess to regulated milk for Goodman Fielder and smaller processors that you th nk should be considered? Please provide sufficient detail when describing any alternative options as well as reasons for considering these.

MVM Response to Question 36:

No response.

Review Question 37:

What costs and benefits would each of the options for access to regulated milk for Goodman Fielder and smaller processors create for your business? Please provide quantitative information if possible.

MVM Response to Question 37:

No response.

Review Question 38:

- How well do you think each of the options for access to regulated milk for Goodman Fielder and smaller processors would perform against the principles of good regulatory practice of promoting certainty and predictability of regulatory outcomes, transparency, cost-effectiveness and timeliness of regulatory processes?

MVM Response to Question 38:

No response.

Review Question 39:

- Do you have a preferred option, or a combination of options, for access to regulated milk for Goodman Fielder and smaller processors? Please provide your reasons and information/evidence in support of your views.

<u>MVM Response to Question 39:</u>

We suggest status quo is maintained (option 4.4.1) until a full review of competition in the domestic consumer dairy sector has been completed.

A4.5 Options for the DIRA review and expiry provisions

Option 4.5.1: Status quo: no statutory provision for review and/or expiry of the DIRA regulatory regime in legislation.
Option 4.5.2: Amend the DIRA to require periodic reviews of competition in the dairy industry to determine whether the DIRA regulatory regime should be retained, repealed or amended.
Option 4.5.3: Amend the DIRA to require a review of competition in the dairy industry to determine whether the DIRA regulatory regime should be retained, repealed or amended, to be undertaken when a set market share threshold has been reached
Option 4.5.4: Amend the DIRA to provide for its automatic expiry from a nominated date or when a set market share threshold has been reached

MVM General Comments:

- MVM suggests DIRA is absolutely required while Fonterra has industry dominance (as per the HHI Index, see section 2). A simple market share test is not sufficient but may form part of the criteria.
- We recommend that the regulator look to the market dominance benchmarks used by the European Commission and/or the United States Department of Justice as useful precedents.
- An amended option 4.5.4 could be designed on this basis, i.e. to trigger the expiry of DIRA's pro-competition provisions when:
  - Fonterra's market share of farm-gate milk falls below 50%, and/or
  - The Herfindahl index (HHI) for the farm-gate milk market falls below 0.25
- On no account should option 4.5.4 be contemplated unless it does use these internationally accepted thresholds.
- Alternately, the option for a periodic review as per option 4.5.2 would represent simply another deferment of the problem as have been done in every previous DIRA review.

Review Question 40:

- How best do you consider "market dominance" could be measured? For example, are there certain criteria (other than a market share threshold) that could be provided for in legislation as a trigger for review and/or expiry of the DIRA.

<u>MVM Response to Question 40:</u>

The Herfindahl–Hirschman Index, HHI. See section 2 for a full analysis.

Review Question 41:

- Are there any other options for the DIRA review and expiry provisions that you think should be considered? Please provide sufficient detail when describing any alternative options as well as reasons for considering these.

<u>MVM Response to Question 41:</u>

An amended option 4.5.4 could be designed on this basis, i.e. to trigger the expiry of DIRA's pro-competition provisions when:

- *Fonterra's market share of farm-gate milk falls below 50%, and/or*
- *The Herfindahl index (HHI) for the farm-gate milk market falls below 0.25*

On no account should option 4.5.4 be contemplated unless it does use these internationally accepted thresholds.

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Review Question 42:

- What costs and benefits would each of the options for the DIRA review and expiry provisi ns create for your business? Please provide quantitative information if possible?

MVM Response to Question 42:

Premature expiry of DIRA would be disastrous for the industry, with a real economic cost.

Review Question 43:

- How well do you think each of the options for the DIRA eview and expiry provisions would perform against the principles of good regulatory p actice f promoting certainty and predictability of regulatory outcomes, transparen y, c st-effectiveness and timeliness of regulatory processes?

MVM Response to Question 43:

See discussion above.

Review Question 44:

- Do you have a preferred optio or a combination of options, for the DIRA review and expiry provisions? Please provide your easons and information/evidence in support of your views?

MVM Response to Question 44:

MVM has a clear preference for an amended option 4.5.4 designed to trigger the expiry of DIRA's pro-competition provisions when:

- *Fonterra's market share of farm-gate milk falls below 50%, and/or*
- *The Herfindahl index (HHI) for the farm-gate milk market falls below 0.25*

On no account should o tion 4.5.4 be contemplated unless it does use these internationally accepted thresholds

Alternately, the option for a periodic review as per option 4.5.2 would represent simply another deferment of the problem as have been done in every previous DIRA review.

8 February 2019

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Agriculture, Marine and Plant Policy
Policy and Trade Branch
Ministry for Primary Industries
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Miraka Submission: Review of the Dairy Industry Restructuring Act 2001 and its impact on the dairy industry – Discussion Document November 2018

Preamble:

1. Miraka appreciates the opportunities provided to consult dir ctly with the DIRA Review Team and this further opportunity to now submit in response to the DIRA Review Discussion Document. Miraka is available to further clarify or elaborate on this submiss on.

Submission Description:

2. This submission responds to all sections of the Discussion Document. Where relevant to Miraka, specific responses are given to the questio s raised in the Document. No specific response is offered for questions 2, 6 through 8, 13, 21, 22, 27 through 31, and 36 through 39.

3. **Part A** of this submission add esses he overview assessment of the DIRA provided in Chapters Sections 2.1 to 3.1 of the Discussion Document.

4. **Part B** of the submission r sponds to the “Options for Change” in Chapter 4. Rather than follow the sequence in the Discussion Document, issues of higher priority to Miraka are addressed first. The relevant preamble and associated questions in Chapter 3 of the Discussion Document are merged as relevant in he response to each of the “Options for Change”.

5. Questions osed in the Discussion Document are reproduced directly from the Document (green background); Miraka responses follow below the questions.

PART A: DIRA FRAMEWORK, OBJECTIVES AND IMPACT ON THE INDUSTRY

Discussion Document: "2.1: 2001 Structural reform to enable the industry to drive strategic change"

6. The Discussion Document describes the DIRA as a framework:

- to enable the efficient allocation of dairy industry resources in the face of Fonterra's dom nance, ability and incentive to create barriers having the effect of undermining that efficient allocation; and
- to mitigate risks:
  - to dairy farmer earnings and earnings of the overall economy; and
  - to the domestic consumer dairy market (product availability/range/price)

7. The DIRA attempts to achieve these outcomes:

- by incentivising Fonterra to use price signals to manage the volume of milk supply (Sub-part 5A);
- the open entry/exit rules; and
- the rules requiring Fonterra to make certain volumes of milk ("regulatory milk") available to other processors.

Question 1:

1. Do you agree with our description of the DIRA regulatory regime and its original policy rationale? Do you consider the original policy rationale is still valid?

8. Miraka agrees with the description and policy rationale. Miraka also agrees with the conclusion in 3.1 of the Discussion Document explaining why the policy rationale is still valid:

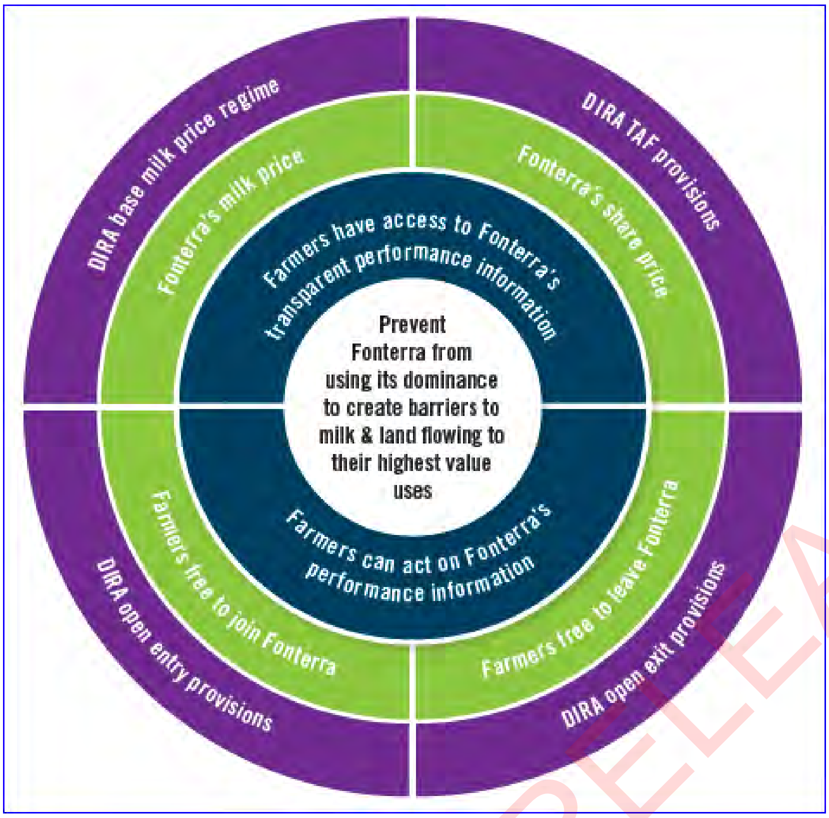
> "the potential for Fonterra to create barriers to farmer switching, the relatively low costs the DIRA imposes on Fonte ra, and the difficulties involved in deterring potential anti-competitive behaviour under the Commerce Act all suggest that the DIRA is still needed".

Discussion Document: "3.1: Has the DIRA been effective at managing Fonterra's dominance in the market for farmers' milk and is it still needed?"

Question 3:

3. Do you consider the DIRA has been effective at achieving its core regulatory objective of preventing Fonterra from using its dominance to create barriers to farmers' milk and land flowing to their highest value uses? If not, please provide reasons and supporting information/evidence.

9. At 2.1 the Discussion Document includes the following diagram to describe how the DIRA achieves its regulatory objectives:



10. DIRA is unique in terms of competition policy in that it employs an endogenous pricing regime permitting the dominant firm Fonterra to set its own milk price (referred to as the 'base milk price'). Given Fonterra's continued dominance in he market for farmers' raw milk (approximately 80 percent market share), the reality is whatever Fonterra pays for farmers' raw milk becomes the de facto benchmark for the industry farm-gate milk price.

11. The original rationale for an endogenous milk pricing regime was centred on the open entry/exit provisions and comprised two rationale, namely:

a. A mechanism to facilitate farmer switching on a 'no arguments' basis;[1]
b. To provide Fonterra with a set of "commercial disciplines" so that it would be incentivised to establ sh an 'efficient' farm-gate milk price.[2]

12. Miraka considers the DIRA switching regime has been effective in allowing the relatively free movement of milk through the open entry/exit provisions. Miraka does not, however, consider sw tching is adequately supported by "transparent performance information" or that the supposed

Farmer switching changed the nature of competition for milk supply from between 'factory gates' (i.e. inter-firm competition) to the farm gate (i.e. the contestable supply of farmers' fresh milk). This was a logical progression as DIRA otherwise effectively eliminated the farm gate competition with the result being the creation of a near-perfect monopsony.

[2] if Fonterra systemically under priced the milk (unlikely for a monopsony farmer-owned cooperative) it was presumed farmers would exit Fonterra thereby leaving it with a stranded asset problem; however, if the opposite occurred and Fonterra systemically over-priced the milk it was assumed Fonterra would face a 'tsunami' of milk, resulting in production and market clearance problems from inefficient supply. The corollary is that it was believed that as a result of farmer switching, Fonterra would be incentivised to price milk efficiently (i.e. no too low or too high but 'about right').

"commercial disciplines" have ever been effective.[3] To the contrary, Fonterra is incentivised to inflate the milk price because of its co-operative form and to foreclose competition for milk supply.

13. The result is a 'stretched' milk price, with the 'stretch' coming from two distinct mechanisms, namely:

  a. *Organisational form and market structure*: Supplier own cooperatives are a pragmatic institutional adaption to manage commercial and contracting risk associated with the supply of a highly perishable product. Moreover, when created, Fonterra was a near perfect monopsony. While a monopsony with market power would normally use that power to drive down input prices a farmer owned monopsony cooperative is assumed to maximise the input price (farmers' milk) rather than company profits (investor dividend streams and/or shareholder value).

  b. *The use of a 'Hypothetically Efficient Competitor' (HEC) to set the base milk price* Fonterra's base milk price is derived from use of the modelled performance of a "hypotheti ally efficient competitor" or HEC. The HEC is "super-charged" by the manner in which Fonterra applies the DIRA safe harbours.

The combined effect of these mechanisms results in a higher milk price tha would be higher than the counterfactual of a competitive market in equilibrium and also higher than justified by Fonterra's own commodity business.

14. The inflated or 'stretched' milk price means:

- an element of vertical foreclosure of competit rs is occurring;
- price signals are encouraging more milk growth than warranted by commodity outcomes;
- profitable non-commodity processing is undervalued and added value investment disincentivised;
- investment in processing to handle incr ased milk is directed into increased commodity production;
- the inflated milk price becomes capitalised in higher land prices while processor share prices are undervalued. [4]

15. The employment of the HEC is elaborated further at in the section "Regulation of the Base Milk Price" commencing at paragraph 58 (below) and is a key concern for Miraka in terms of this Review. For the avoidance of doubt, Miraka has never supported the use of a HEC to set Fonterra's base milk price. However, irrespective of the arguments for or against the use of a HEC, Miraka is especially concerned at the way the HEC has been employed and the inability of the Commerce Commission, as a monitoring (and ultimately enforcement) agency to remedy these actions – which Miraka considers are inconsistent with, and negate, the competition policy purpose of DIRA.

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[3] Th reaso for this is quite simple. Irrespective of the supply elasticity of milk production (and previous analysis by MAF suggest this is relatively low) as a cooperative farmers that increase their milk production must buy additional shares to match that milk supply. The corollary being for Fonterra, new milk is 'naturally hedged' in that it provides its own equity in order to fund new processing assets. The result is the 'check' envisaged by the architects of DIRA did not actually exist, but the concerns about a dominant cooperative 'shading up' the milk price provided to be prescient and correct.

[4] This is an important point. Fonterra has argued that a stretched milk price is not only important to ensure its own (productive) efficiency, but also to stop inefficient entry by new processors. In reality, new processors will not enter, or remain in, the market unless they can meet their cost of capital – so it is Miraka's view (and experience) the risk of inefficient processor entry is minimal. However, the same cannot be said of inefficient supplier entry – as witnessed by the large-scale dairy conversions outside of traditional areas and often on environmentally unsuitable land. In Miraka's view environmental outcomes – and in particular water quality – has been a key causality of Fonterra's practice of systemically over pricing raw milk.

Question 4:

4. Do you think Fonterra is still dominant in the market for farmers' milk, at the national and regional levels?

16. Miraka agrees with the Discussion Document preliminary analysis at 3.1 ("Is Fonterra Still Dominant?") that:

> "In the absence of the DIRA, the barriers to entry and expansion by independent processors could become significant. This is particularly so given that milk supply appears to have r ached its limits, which, in turn, is likely to lead to more intense competition for farmers' milk".

This is also supported by the analysis in Appendix 1 of the Document.

5. Do you think the DIRA imposes unreasonable costs on Fonterra? If so, please provide supporting information/evidence.

17. Miraka agrees with the preliminary analysis in the Discussion Document hat the D RA does not impose unreasonable costs on Fonterra. A prerequisite to Fonterra forming was statutory approval (given its monopoly position in the New Zealand market) and minimum regulation to address market power. Costs of that regulation were a necessary part of the licence to incorpo ate and must be considered against the enormous benefits accruing to Fonterra as a result. In any event, Miraka considers the costs for Fonterra are unlikely to be substantially different to those that it would incur in the absence of regulation. For example:

   a. For example, Fonterra has shown strong support for regulation of the milk price and has indicated it would continue with largely the same processes even if Sub-part 5A was repealed. In the case of its obligations to supply regulatory milk, the volume of milk actually supplied is a tiny proportion less than 1.5%[5] of its total milk supply

   b. Miraka also considers it is unlikely that he open entry requirement leads to Fonterra holding more excess capacity than it would otherwise hold. This is especially because rather than discourage milk supply, Font rra continues an aggressive policy of securing as much of the national milk supply as it can. This strategy can be expected to be more relevant to its capacity planning than the open entry/exit requirements.

[5] Public notices provided by Fonterra in accordance with Clause 24 (2) of the DIRA (Raw Milk) Regulations indicate it is contracted to supply 250 million litres under the DIRA regulations for the 2018/19 Season. It is assumed this excludes supply to Goodman Fielder because it is understood that supply is actually provided by a separate contract independent of DIRA.

PART B: OPTIONS FOR CHANGES TO THE DIRA

DIRA Open Entry/Exit Requirements

Discussion Document: “3.3: Does the DIRA influence Fonterra’s strategy?”

18. The Discussion Document makes a preliminary assessment that the DIRA “does not appear to create unintended consequences in terms of driving Fonterra’s overall business and investment strategy and, therefore, does not prevent Fonterra from being able to manage its milk supply volumes in a way that aligns with its chosen strategic direction”. The Document describes four ways in which Fonterra can use price to influence milk volumes and these are unimpeded by the DIRA. These are Fonterra s:

- milk price
- terms of supply
- shareholding requirements
- dividend policy

19. The Document suggests that to the extent that Fonterra has used these leve s hey have either tended to incentivise milk production growth (especially in the case of shareholding requirements and dividend policy).

20. The Document suggests that:

> “adjusting its milk price to manage the volumes of milk Fonterra receives presents a significant management challenge”.

This is attributed to Fonterra’s chosen corporate form as a co-operative, and is not due to any requirement of the DIRA. Miraka does not fully agree with the conclusion. Fonterra does appear to be reluctant to use price variations to manage member milk volumes in target geographies. However, elsewhere in this submission Miraka points out that Fonterra is incentivised to inflate the milk price and is facilitated and invited to do so by Sub-part 5A of the DIRA. The resulting inflated milk price is the result of Fonterra Board decisions, actively encourages milk production (including inefficient milk production given the emergent environmental issues) and can at least partially be attributed to the DIRA.

Question 10

> 10. Do you agree with our preliminary assessment of the extent to which Fonterra can influence milk supply volumes through price, notwithstanding the DIRA open entry requirements?

21. Miraka agrees with this assessment. There is little evidence that Fonterra’s ability to influence supply has been used to restrict or discourage milk supply at a national or local level. Rather, Miraka considers that Fonterra has actively sought milk volume growth, and open entry has therefore had little impact on the overall milk volume that Fonterra acquires (beyond the failure of the “commercial disciplines” outlined in paragraph 11 ff). On the other hand, DIRA Sub-part 5A has facilitated Fonterra to inflate the milk price and to therefore encourage milk supply. It is thus difficult to reconcile Fonterra’s lobbying to remove open entry and exit requirements on the basis of forcing undesirable milk purchases, where it does not use existing mechanisms to achieve that outcome but rather has used them to incentivise milk production by its suppliers.

Question 11

> 11. Are there other factors that you consider should be taken into account? Please provide detailed comment in support of your views.

22. Fonterra's co-operative structure, culture and perceived competitive imperatives are more relevant to its strategy in managing milk price and volumes, than is the DIRA itself. This leads Fonterra to:

- Default to a uniform milk price across the country (consistent with co-operative principles that al members are treated equally), rather than use differential pricing as a means of discouraging undesirable or uneconomic milk supply, or even to impose a differential transport charge
- Protect and enhance the co-operative by pursuing strategies to maximise membership and milk supply
- Maximise and favour rewards to members (via the milk price) over rewards to other stakeholders. It is notable that maximising the milk price is explicitly required by the "Milk Price Principles" in the Fonterra constitution[6], including a requirement to reflect

  > "the benefits that arise from the collective selling power of Shareholde s as suppliers to the Company, and from the scale and other economies the Company enjoys in production and sales".

23. The Fonterra Constitution further includes the extraordinary requirement that the milk price assume Fonterra is "a properly managed and efficiently run sus ainable co-operative". This requires non supplier investors to subsidise supplier shareholders to the extent Fonterra does not meet that standard. While that arguably mirrors the DIRA, it is extraordinary it was enshrined in the Fonterra constitution at the same time that Fonterra was changing the constitution to encourage outside equity investment (TAF). It adds weight to the view that Fonterra is unable to balance supplier interests with other stakeholder interests. It is, for example, entirely consistent with its co-operative priorities that the Fonterra constitution does not seek to balance maximising of the milk price against a fair and equitable return to non-supplier investors.

Discussion Document: "4.1: Options for DIRA open entry requirements"

24. As noted in paragraph 12, Miraka considers the farmer switching component of the open entry and exit regime is working well and as such, does not need amendment. To the contrary, it is Miraka's view that tampering with farmer switching is dangerous and risks undermining the very part of DIRA that is not only working well, but is working as originally envisaged.

25. DIRA for es Fonterra to be an open cooperative, and as long as farmers can afford to purchase the req ired vo ume of shares to back their milk supply and the farm is not impose onerous transport costs relati e to the next closest farm, Fonterra must accept them. This situation can be summarised as 'f rmers choose Fonterra'. It would therefore be a dramatic change to the farmer switching provisions if the outcome was some version of 'Fonterra chooses farmers'.

26. It is Miraka's view the competition policy risk lies not only with open entry/exit, but also with the prospect of 'open re-entry' – this occurs if a farmer leaves the cooperative but, for whatever reason, wants to return at a later date. In reality if a farmer is unable to return – or that return becomes difficult or doubtful, then farmers are much less likely to leave Fonterra in the first place. From a competition policy perspective the result is potentially chilling – as a market that already has limited competition would be faced with a substantial decline in contestability as well.

[6] Annexure 1 of Fonterra Constitution

27. The Discussion Document poses 3 options:

- Option 4.1.1: Status quo: retain the existing DIRA open entry/exit requirements.
- Option 4.1.2: Full repeal of the DIRA open entry/exit requirements.
- Option 4.1.3: Amend the DIRA open entry requirements to allow Fonterra to decline to accept applications from new and existing farmers if Fonterra considers their supply is unlikely to comply with Fonterra's terms of supply.

28. The Discussion Document favours option 4.1.3 (amendment). This is on the grounds that an amendment is required to address supposed "unintended consequences of preventing Fonterra from being able to effectively manage reputational risks in having to accept milk from farmers who are unlikely to be able to comply with Fonterra's terms of supply".

29. Miraka does not support option 4.1.3 and considers this "amendment" risks undermining open entry/exit – leaving it at Fonterra's discretion to determine if suppliers are merely "unlikely" to be able to comply with terms of supply. The Document suggests three ways in which potential Fonterra over-reach with this discretionary power would be limited; Miraka considers would be ineffective.

   a. The Document suggests the amendment could include:

      > "the types of standards Fonterra could include in its terms of supply. This could make explicit, for example, that Fonterra's terms of supply can relate to, and price differentiate on, matters such as environmental (including climate change) impact of the production of milk, health and safety, animal welfare, or hygiene".

      The scope of the suggested limits to terms of supply are so wide that it is debateable they would provide any limit on Fonterra discretion at all. In any event, Miraka considers the amendment inappropriate and would invite further "unintended consequences" should the DIRA attempt to prescribe or limit Fonterra's terms of supply.

   b. The Document states Fonterra would continue to be unable to discriminate in its terms of supply between a new entrant and a shareholding farmer in the same circumstances. This would however be largely meaningless given Fonterra could choose to reject a supplier it *believed* "unlikely" to achieve terms and conditions, while at the same time there is nothing to prevent it from accepting supply from an existing non-compliant supplier in an identical circumstance. In effect, the outcome of non-discriminatory terms of supply can and could be different between a new and an existing supplier as it remains Fonterra's decision on whom and when enforcement is enacted.

   c. The Document points out that any Fonterra decision to reject a supplier would be subject to the existing dispute resolution mechanism in the DIRA (i.e. to seek a Commerce Commission determination of the decision). However, the timeframe, cost and risk of an adverse decision means the appeal mechanism is not feasible for an individual farmer. In addition, the appeal mechanism does not provide any interim arrangement for milk collection both pending a decision and after a decision has been made (any decision being unlikely to align to the rigid timetable for farmers moving between processors). The suggested dispute mechanism is therefore infeasible and ineffective.

30. Miraka considers Fonterra's claims of reputational risk arising from open entry and exit are overstated. The claims also lack credibility when balanced against its response (unrestricted by DIRA) to "effectively manage reputational risks" arising from the behaviour of *incumbent* suppliers/members.

31. For example, the Discussion Document notes (at Appendix 1) there has been "an erosion of the Dairy Sector's social licence in New Zealand" as a result of the environmental impact from growth in dairying. Given Fonterra's dominance of the sector, much of the blame for this erosion must be placed with Fonterra. A Waikato Regional Council report from 2017[7] concluded that only 23 percent of 1,174 inspected farms were in full compliance with effluent consents; 33 percent either did not comply (or were only partially compliant) and the balance were "provisionally compliant". The bulk of the 33 percent non-compliant/partially compliant farms will be Fonterra suppliers. This is significantly more serious than simply failing to comply with Fonterra's terms of supply as these farmers are contravening legal limits and, as a result, breaking the law. The Waikato experience is unlikely to be unique.

32. To the extent that Fonterra suffers reputational risk it is Miraka's view this comes in large part from its non-compliant *existing* suppliers[8] rather than possibly problematic *potential* suppliers. Weighed against the Fonterra response to those non-compliant suppliers (Fonterra can choose to eject them but seldom does), Fonterra's claim that open entry causes reputational risk lacks credibility or reasonableness. It is also notable that Fonterra has:

   a. not pursued other options available to incentivise sustainable milk production (such as price incentives for desirable behaviours or penalties for non-desirable behaviours)
   b. actively supported large-scale irrigation projects, often in environmentally sensitive areas that are unsuitable for intensive dairy farming (e.g. Ruataniwha, Hurunui, Hunter Downs)
   c. actively campaigned against attempts by regional councils to impose harsher environmental conditions on dairy farmers (e.g. Horizon's One Plan).

33. MPI has published various Fonterra responses to its information requests. In relation to terms of supply Fonterra states:

> "As we have previously indicated, in the absence of open entry Fonterra would look to strengthen its entry requirements and supply terms to support environmental sustainability and restrict milk growth in sensitive areas".[9]

34. Fonterra seems here to be suggesting it would bypass regulatory processes such as the RMA for determining and approving environmentally sustainable land use. It would "look to" do so if open entry was repealed. This also illustrates Fonterra intentions if the proposed amendment proceeds. The RMA provides the appropriate framework for independent and accountable decisions on sustainable land use. Fonterra should not be able to override RMA approvals for land use, or to use that as a pre-text to block open entry.

Question 23

[7] https://www.stuff.co.nz/business/farming/95059380/less-than-one-quarter-of-all-waikato-dairy-farms-meet-their-effluent-obligations
[8] In comparison, Miraka places considerable weight on concepts such as kaitiakitanga, which is one of the five posts (or pou) of Te Ara Miraka (covering the environment, animal welfare, people, prosperity and milk)
[9] Paragraph 28.1, "Fonterra Response to MPI questions on Fonterra's ability to deviate from the Farmgate milk price calculated under the milk price manual and to influence its milk supply"

23. Are there any other options for the DIRA open entry requirements that you think should be considered? Please provide sufficient detail when describing any alternative options as well as reasons for considering these.

35. The Discussion Document adequately covers the options available. Miraka notes that the option in 4.1.3 is left wide open when it proposes that the amendment could include "the types of standards Fonterra could include in its terms of supply".

Question 24

24. What costs and benefits would each of the options for the DIRA open entry requirements create for your business? Please provide quantitative information if possible.

36. In the absence of a counterfactual, costs and benefits of the DIRA open entry requirements cannot be objectively assessed. Rather, Miraka assesses the open entry and exit requ rements from the perspective of milk supply risk. It is Miraka experience that Fonterra aggr ssively seeks to protect, if not expand, its milk supply. This is neither surprising nor inappropriate. However given Fonterra's market dominance, the DIRA open entry/exit requirements remain c ucial to limiting the extent to which it can influence supplier decisions to move between Fonterra and other dairy processors.

37. In the absence of these requirements, it would be consistent with Fonterra behaviour (and its inward focussed co-operative culture) to refuse re-entry in the event a supplier exits Fonterra for another processor, or to signal re-entry would only be made on discriminatory terms. Importantly, this is not a theoretical or hypothetical matter of conjecture: it is a matter of record. Even with the current DIRA protections, Fonterra attempted to send a signal of this nature through the discriminatory terms of supply it offered to farmers strand d fol owing the liquidation of NZ Dairies Ltd. Fonterra fought and appealed legal actions against its supp y terms all the way to the Supreme Court (where it lost as well). This lesson – and the aggressivenes by which Fonterra will pursue appeal options – will not have been lost on individual farmers and illustrates the ineffectiveness of the dispute mechanism noted in support of Option 4.3 1

Question 25

25. How well do you think each of the options for the DIRA open entry requirements would perform against the principles of good regulatory practice of promoting certainty and predictability of regulatory outcomes, transparency, cost-effectiveness and timeliness of regulatory processes?

Option 4.1.1 (status quo):

38. Certainty and predictability have been demonstrated through existing practice (including the general ability of new processors to secure supply), and reinforced by the Supreme Court ruling against discriminatory supply terms in the case noted above (concerning former suppliers of NZ Dairies Ltd).

39. As noted in the Discussion Document (page 20), in its 2016 review of the DIRA the Commerce Commission "found the DIRA open entry requirements had not had a material effect on the excess capacity Fonterra has to hold".

40. Miraka strongly supports this option.

Option 4.1.2 (full repeal):

41. Repeal would be premature and would enable Fonterra to exert market power to reduce competitor access to milk supply. It would not be "good regulatory practice".

42. Miraka opposes this option.

Option 4.1.3 (amendment):

43. Miraka considers that amending the open entry/exit requirements in effect to respond to environmental concerns is misplaced, unnecessary, and will not achieve the indicated outcome. Furthermore it risks giving Fonterra uncontrolled discretion to 'pick and choose' new suppliers and accordingly, to undermine the open entry/exit purpose of the DIRA.

44. As stated elsewhere in this submission, sustainable land and water use need to be addressed directly and through appropriate environmental legislation such as the RMA.

45. Miraka opposes this option.

Question 26

26. What is your preferred option for the DIRA open entry requirements? Please provide your reasons and information/evidence in support of your views.

46. Miraka preferred option is the status quo (Option 4.1.1). This has demonstrably resulted in the relatively free movement of suppliers between dairy processors. By contrast, Fonterra's continuing dominant position means repeal or weakening of the open entry/exit requirements would come at considerable risk for existing and potential competitors. This risk will increase as environmental standards and competing land use cause the expected levelling out and even decline in national milk production.

47. As already explained, Miraka does not support the amendment option (Option 4.1.3). Nevertheless, should the DIRA Review still conclude it is necessary to amend open entry/exit to avoid reputation risk to Fonterra, Miraka considers any assessment must be based on an external and independent party separate to Fonterra. For example, grounds for exclusion might include:

- any supplier that has been successfully prosecuted for failing to meet a legal obligation relating to the production and supply of raw milk; or
- any supplier that has received a warning for two consecutive seasons for failing to meet a legal obligation relating to the production and supply of raw milk.
- In either case, a stand down period of (say) one season could be included so that the supplier can demonstrate the problem or problems leading to the prosecution or warnings have been remedied.

48. Also to fully protect Fonterra from reputational risk from incumbent suppliers, DIRA should be further amended to make it clear that Fonterra can issue a notice to expel suppliers that either were successfully prosecuted or received two consecutive warnings – again including a season's grace to make good.

Dairy Industry Environmental Performance

Discussion Document: "Section 3.4: Does the DIRA impact on the industry's environmental performance?"

Question 14

> 14. Do you agree with our preliminary analysis of the DIRA's impact on the industry's environmental performance? If not, please provide your reasons and supporting evidence.

49. The Discussion Document notes that the expansion of the dairy industry has in some cases resulted in adverse environmental impacts. While concern has been expressed that the open entry requirements have contributed to these adverse environmental impacts, the document concludes the industry expansion has been due to opportunities created by increasing global demand. While open entry provides a suitable environment for expansion, the DIRA does not of itself prevent Fonterra (or other processors) from encouraging sustainable dairy production (e.g. through price signals).

50. Miraka agrees that open entry has had negligible impact on the expansion of the dairy industry. More importantly, Miraka agrees that the DIRA does not inhibit dairy processors from leading the sustainable development of the industry. In our case and reflecting values of Māori ownership and milk supplier base, the core value of kaitiakitanga is embedded in Miraka business culture. Miraka has provided a leadership role in the clean streams accord and sustainable manufacturing practices. Our farming excellence program, Te Ara Miraka, incentivises sustainable dairying with our suppliers. Miraka see no reason why the DIRA stands in the way of similar values and policies being replicated across the industry.

51. While the open entry and exit regime has had a negligible impact on the expansion of the dairy industry, the same cannot be said for the milk price manual and use of a HEC to produce a 'stretch' milk price. A systemically higher milk price is likely to have enabled inefficient dairy expansions and conversions by making marginal and generally unsuitable land commercially viable.

52. The Discussion Document also reflects Fonterra concerns that the open entry requirements might impose a residual reputational risk on Fonterra on the basis that Fonterra has limited grounds to reject supply (e.g. from farmers with a record of poor on farm practice) or is unable to impose financial penalties or other terms of supply to discourage or reject production. As described in paragraph 30 (above) Miraka considers this concern is over-stated and lacks credibility. Any residual reputational risk is a result of Fonterra supply strategy and is not due to the open entry requirements.

Question 15

> 15. Do you agree with our view that environmental issues are best dealt with through the Resource Management Act and not the DIRA regime?

53. Miraka strongly agrees that environmental issues should be addressed through the RMA and associated regulatory processes. Miraka considers the RMA provides the appropriate framework to

control unsustainable land use. To the extent that open entry might have enabled instances of undesirable dairy expansion this can and should have been prevented by the RMA.

54. Miraka also considers that dairy processors, including Fonterra, can discourage undesirable dairy expansion if they are prepared to establish appropriate terms of supply, pricing policies, business culture and supplier management processes. Miraka in particular rejects any notion that open entry should be repealed on the basis of environmental concerns. This canard diverts attention from the proper tools and processes to address those environmental issues, while attempting to undermine the key pro-competition feature of the DIRA.

Question 16

> 16. Are there other environmental issues that you consider should be addressed either through the DIRA review or some other means?

55. The DIRA was not established or designed to address environmental issues. Instead, its purpose is to "promote the efficient operation of dairy markets in New Zealand by regulating the activities of new co-op to ensure New Zealand markets for dairy goods and services are contestable" (S. 4 (f)).

56. In comparison, environmental issues, including sustainable land and water use, require the weight of purpose of the RMA and associated processes. Miraka considers it a mistake to muddle the DIRA purpose with achievement of environmental objectives. Miraka supports the approach in the Discussion Document which is intended to prevent this from occurring.

57. Miraka is actively engaged in the Clean Streams Accord and with the Ministry for the Environment and has developed the world leading Te Ara Miraka farm excellence programme. Miraka considers such work programmes provide the appropriate forums for the industry to raise and address environmental concerns.

Regulation of the Base Milk Price

Discussion Document: "3.3 Does the DIRA influence Fonterra's strategy?"

Question 12

> 12. Do you consider that the DIRA provisions governing Fonterra's base milk price calculation and Commerce Commission monitoring may be preventing or disincentivising Fonterra from deviating from the base milk price calculation for strategic or commercial reasons?

58 Consistent with the Discussion Document, this submission refers to the milk price calculated in accordance with Sub-Part 5A of the DIRA as the "base milk price" (BMP). There is no requirement for Fonterra or any dairy processor to actually pay the BMP. Fonterra, however, typically employs the BMP and it is therefore the key reference milk price for the whole NZ milk processing industry.

59. Fonterra does appear reluctant to deviate from the BMP but this is for reasons of its own making rather than the impositions of the DIRA:

- On the one hand Fonterra is driven by its constitution, and the priority of its more influential supplier investors to maximise the milk price; this coincides with and is thus reinforce by Fonterra's objective to protect and maximise market share by placing pressure on competitor profits.
- On the other hand Fonterra needs to represent a fair assessment of profit and dividends to non-supplier investors in Fonterra; it is therefore reluctant to pay a milk price higher than calculated by the milk price manual.

60. It is Miraka view that Fonterra responds to these conflicting pressures by using Sub-part 5A as a screen behind which it is able to inflate the BMP above the level justified by its commodity business, thus in effect prioritising the interests of its supplier shareholders (as required by its constitution) over those of non-supplier investors. This is achieved by:

- The use of stretch targets in the BMP cost and efficiency assumptions on the baseless grounds this will incentivise Fonterra efficiency;
- Exploiting the "safe harbour" provisions of the DIRA (refer 79. ff below);
- Defaulting to assumptions favouring a higher milk price (highest selling price /lowest costs) when facing choices in the BMP calculations.

61. Thus where there should be a fair "balancing" of supplier versus shareholder interests, Fonterra favours the interests of its suppliers. At the same time, sub-part 5A and the Commerce Commission reviews provide a shield against transparent assessment of Fonterra commodity business performance, and makes opaque the subsidy between Fonterra's added value business and the milk price. Some illustrations of this behaviour include:

- Fonterra has long argued for a cost of capital at the very lowest end of what might be appropriate, rather than targeting the mid-point of a feasible range and which would balance interests of suppliers and non-supplier shareholders. Fonterra has unerringly maintained this position despite evidence from the Commerce Commission and others that a higher cost of capital is more appropriate.
- Fonterra uses the safe harbour to claim what are almost certainly unrealistic production yields for the Notional Producer (refer paragraphs 78. And 81. below).

62. Because Fonterra manages and controls the calculation of the base milk price, it is almost obliged to play this game, trading off interests of equity investors against its more influential supplier shareholders. Miraka considers this is bad for Fonterra as well as the wider industry.

Discussion Document: "3.3 Does the DIRA promote sufficient confidence in the base milk price calculation?"

63 The Discussion Document (page 32) explains that the DIRA does not regulate the milk price as such but intends (through Sub-Part 5A) to promote transparency, and confidence (efficiency and contestability) in the milk price. The Discussion Document offers a view that the DIRA "contestability" purpose means the base milk price should be:

- high enough to incentivise Fonterra efficiency; and
- low enough to be still practically feasible for an efficient processor.

64. The document questions whether there is:

- sufficient confidence in the milk price setting process;

- sufficient independence in the process for determining the base milk price;
- undue discretion (and lack of definition) for establishing "practical feasibility"

Question 19

19. Do you consider that greater confidence in the base milk price calculation outcomes could be achieved if additional legislative guidance on the term "practically feasible" were to be provided for in the DIRA? Please provide detailed comment in support of your views.

65. Legislative guidance on the term "practically feasible" would be welcome but of itself would not provide the necessary confidence in the BMP process and calculations.

66. Section 150A (1) requires that the base milk price should provide an incentive for Fonterra t "operate efficiently" while at the same time providing for contestability in the national market. The efficiency requirement is specific to Fonterra while the contestability requirement casts a wider but ultimately empty net. The "practically feasible" test ("practically feasible for an e ficient processor") of Section 150A (2) provides the only benchmark for assessing that the BMP is consis ent with the contestability requirement. The Discussion Document summarises the relationship between the market contestability and Fonterra efficiency requirements by the "high enough" and "low enough" boundaries noted in paragraph 63 (above). This unfortunately efaults to the same position adopted by both Fonterra and the Commerce Commission: a milk price based on stretch targets will incentivise Fonterra while the practical feasibility test caps that "inc ntive".

<u>It should be noted that DIRA itself does not impose or even suggest this interpretation.</u>

67. The interpretation has been challenged many times by Miraka and other independent processors in submissions to the annual Commerce Commission reviews of the BMP. The interpretation is rooted in the assumption that the efficient performance of Fonterra (a <u>co-operative</u>) will be incentivised by measured (accounting) profit in the same way as other profit motivated businesses. Accordingly a "difficult" (high) milk price target is presumed to incentivise Fonterra to be efficient (to ensure it is "profitable"). Alternatively an "easy" (low) milk price will make profits more easily achieved and would be presumed to dampen efficiency. This has given rise to the Notional Processor (NP) on which the BMP is based to be modelled as a "hypothetically efficient competitor".

68. This interpretation does not stack up with the real world of co-operatives; and especially does not stack up with Fonterra priorities and behaviour. Fonterra supplier shareholders are its most substantial and its most influential stakeholders. Their priority is to maximise the milk price. As already not d this priority was confirmed at the time TAF was introduced. Supplier shareholders were concerned TAF would increase the priority of profits over the milk price. To address this concern the Font ra constitution was amended to enshrine a requirement for Fonterra to maximise the milk price.

69. While there has been growing concern with Fonterra's poor profit and dividend performance, supplier shareholders, who control Fonterra, remain focussed on maximising the milk price and assess Fonterra performance primarily on that basis. By contrast, and including because they have to share profit and dividends with non-supplier stakeholders, poor profit performance attracts more muted criticism from supplier shareholders.

70. Miraka considers that the first priority for Fonterra management and Board remains its constitutional imperative to maximise the milk price, especially in relation to the commodity business. This is not

surprising or inappropriate. It does, however, highlight a fundamental error in assuming a milk price based on stretch targets will incentivise Fonterra efficiency. The incentive driving efficiency is the imperative to deliver a high milk price.

71. If the milk price setting process itself allows Fonterra to inflate its measured commodity performance (by inflating the milk price), rather than incentivise efficiency it is more likely to dampen it.[10] It has the further adverse effect of providing a disincentive for investment in higher value non-commodity business, because the true performance of that business is undervalued by the need to subsidise an inflated milk price of the commodity business.[11]

72. To be clear, Miraka is not advocating that the milk price should be discounted or set deliberately low. Rather, Miraka contends that the assumption that the milk price should be difficult high, or inflated to comply with the DIRA efficiency requirement is deeply flawed, and is more likely to undermine efficiency in commodity processing and in investment decisions; it also damages the credibility of the BMP process and outcome.

73. The interpretation of the efficiency dimension, coupled with the "safe harbour" provisions of Section 150B have had the effect of making the "practically feasible" test largely redundant. This failure of Sub-part 5A is at the heart of a lack of confidence in the BMP. This is elaborated in the following paragraphs but in summary:

- the production drivers for determining cost and efficiency are mismatched against revenue assumptions thus inflating margins
- stretch targets and safe harbours further understate costs by comparison to revenues and further inflate margins
- stretch targets are deemed practically feasible because Fonterra is assumed able (if efficient) to achieve them; this is regardless whether Fonterra actually achieves the targets or its business model is able to achieve the targets
- safe harbours trump the practical y feasible test and thus sanction what are only theoretically feasible cost and efficiency assumptions
- claimed or actual comm rcial sensitivity of key assumptions and metrics in the base milk price calculations renders opaque any proper assessment of practical feasibility by the wider industry

<u>The "efficiency dimension" of S150A (1)</u>

74. The assum tion that the milk price calculations need to reflect stretch targets to incentivise Fonterra "to strive to be more efficient" focuses on cost and efficiency assumptions. This results in a mis-match of r venu and cost assumptions, an over-statement of margins before deducting milk cost, and inflates the milk price after deducting capital charges.

<u>Revenue assumptions:</u>

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[10] A fact borne out by the recent Northington Partner's financial report for the Fonterra Shareholders' Council, which shows Fonterra is barely achieving its cost of capital and the returns from its 'value add' business are poor and only marginally above the commodity returns: https://www.interest.co.nz/sites/default/files/embedded_images/Independent%20report%20on%20Fonterra%20since%20beginning.pdf).

[11] This helps explains Fonterra's poor performance in moving up the value chain to high end ingredients and fast moving consumer goods – Fonterra lacks the financial strength to effectively fund those strategies with an excessive proportion of free cash flows channelled into the stretch milk price. The result is a highly indebted, cash-starved cooperative.

75. The NP sells a materially larger volume (and smaller range) of commodity products than sold by Fonterra itself. For example:

According to its statutory accounts for the year ending July 2018, Fonterra sold 1.794 million MTs of "reference products"[12]. By contrast, the NP is deemed to have produced and sold 2.886 million MTs of comparable commodity products from 2017/18 Season production[13] (i.e. 61% more by volume). Not only is this more than Fonterra produces, it is also more than is produced in New Zealand *in total*. Included in the NP volume was 1.856 million MT of Wholemilk Powder. For the comparable period it is estimated Fonterra shipped only 338 thousand MT of WMP from GDT sales[14]. GDT prices set the selling price for 55% of the NP sales in the 17/18 Season; for the remaining 45% of sales the pr ces on GDT are "materially representative of the prices used in the Farmgate Milk Price calculation [15].

76. Despite these volume differences, the NP selling prices are assumed to be the same as Fonterra commodity sales prices.[16] The huge scale difference between NP and Fonterra sale of itself confirms this is not commercially feasible. Prices would be materially lower if the NP actually existed and increased exports of NZ commodities in the manner assumed in the milk price model. It should also be self-evident that the NP as literally constructed could not be sustainable in the current environment. This is of course why Fonterra, which processes the same scale of milk, has an overall product mix and business model which is vastly different.

77. None of this should be controversial and Miraka is not advocating that the NP selling prices should somehow be discounted to account for the larger volum . NP revenue must in fact be based on objective and verifiable selling prices, capturing the oft n rapidly changing value of products in international commodity markets. Miraka supports the use of GDT prices to achieve this purpose. At the same time however, to derive a meaningful assessment of the surplus available from that revenue, the NP cost and efficiency measures should be commensurate with the sales pool from which selling prices are derived. This purpose is frustrated by the "stretch targets" (which Miraka argues are misplaced and have a contrary effect to the DIRA purpose) and the safe harbours.

Cost and business efficiency assumptions

78. The NP is assumed to enjoy advantages of scale arising from its large production volume and narrow product range; al ng with an overlay of "stretch targets" this magnifies scale advantages that Fonterra actually achieve Cost and efficiency advantages are often only theoretical or at least cannot be shown to be feasible because the NP neither exists, nor could it exist in any sustainable commercially feasible sen e. For example:

[12] Pg 37, Fonterra Annual Results Presentation 2018 (13 September 2018)
[3] Attachment 2, Farmgate Milk Price Statement for the Season Ending 31 May 2018
[14] Analysis completed by Miraka; details can be provided to MPI if required.
[15] As confirmed by Fonterra when it announced the policy change for the 16/17 season to include off-GDT sales in NP selling prices: Pg 8, Fonterra Reasons Paper submitted to the Commerce Commission in support of the 2016/17 Milk Price Manual.
[16] The way the milk price model converts Fonterra selling prices into the NP selling prices is itself controversial: it results in the NP average prices being different to Fonterra average prices for the same product and same time period. This is due to different averaging assumptions. As with many of the BMP assumptions, the impact of this difference in averaging is not disclosed despite it having no commercial sensitivity. This is consistent with the generally obstructive approach Fonterra takes with transparency.

- the assumed very long production runs (facilitated by consolidation of milk across and within catchment areas) deliver very high production yields. These rely on the inflated production volume and the narrow product range even though this exceeds commodity production of Fonterra and indeed New Zealand as a whole[17]
- GDT regressive commission rates mean the NP inflated sales volume results in a materially lower average commission rate compared to any real world GDT seller (including Fonterra which is by far the largest)[18]; in the 2017/18 Season for example, this alone resulted in NP cost rates lower than Fonterra by equivalent 0.5 cents/kg MS. This provides a simple illustration of the way in which **unit** costs and **unit** revenues are mismatched.

Safe harbours (S 150B)

79. The safe harbours were intended to preserve certain advantages of scale that had been enjoyed by the legacy co-operative dairy industry. They give Fonterra the option (they are not mandatory) to continue to reflect those advantages in the milk price.

80. Rather than merely preserve those advantages however, the safe harbours have been used by Fonterra to enhance them, justifying the use of what are only theoretically feasible cost and yield assumptions in the BMP calculations. Because the safe harbours do not "detr ct from the achievement of the purpose set out in section 150A"[19], assumptions which rely on them t ump the "practically feasible" test.

81. In particular, items (a) and (d) of the safe harbours are used by Fonterra to justify what are otherwise a commercially infeasible scale of operations (o produce the RCPs), resulting in commercially infeasible costs and efficiencies (e.g. production yi lds and sales costs noted in paragraph 78. above).

82. Miraka contends it was never the intention of the safe harbours to provide advantages over and above those actually available to Fonter a. The safe harbours should therefore at most only be able to preserve advantages that Fonterra can demonstrate it actually achieves. They should not be able to override the "practically feasible" test. For example, the NP should not be able to enjoy product yields which are in excess of Fonte ra actual yields. It seems that restricting the safe harbours in this manner would require legislativ chang [20].

The contestability dimension of S150A and the practical feasibility test

83. The contestability dimension and the "practically feasible" test are in effect subservient to the efficiency dimension because:

[17] Again a lack of disclosures/transparency means the impact of this assumption is unknowable. Fonterra understand bly does not disclose its own production yields; however Fonterra also refuses to disclose the assumed NP yields or even meaningful information (product compositions) from which yields could be assessed. Limited analysis possible from the data available suggests the yields are not commercially feasible. The Commerce ommission considers the yields are technically feasible because they can be illustrated to be achievable under certain conditions at Fonterra plants. That is not the same as being achievable within a real world commercial environment dealing with seasonal milk production and a commercially realistic production plan (volume, product range, product variants, and production timing to meet customer shipment requirements – all of which underpin Fonterra (and therefore the NP) actual revenue achievement.

[18] According to Fonterra's 2017/18 Farmgate Milk Price Statement, 55% of NP sales are assumed transacted through GDT. That amounts to 1.587 million MTs. By comparison, for the comparable period Fonterra is estimated to have shipped 0.579 million MTs of comparable products through GDT.

[19] S. 150 B

[20] The Commission accepts that Fonterra's interpretation of the safe harbours is consistent with S150B as written.

- practical feasibility is considered be met if Fonterra alone (or another feasible processor) could achieve the relevant outcome
- the efficiency dimension has been interpreted to require "stretch targets" to be reflected in the cost and efficiency assumptions
- because the stretch targets could in principle be achieved by Fonterra, they are deemed practically feasible even if Fonterra does not achieve them or is unlikely to achieve them in its current business model; the fact that no existing or even possible Fonterra competitor could achieve the targets is not taken into account.
- this circularity renders the "practically feasible" test largely redundant.
- other theoretically feasible cost and efficiency assumptions depend on the safe harbours (e.g. cost and efficiency assumptions depending on the NP scale) and trump the "practically feasible" test altogether.

84. The effect of the milk price model is to deliver lower costs, better yields, and a higher milk price than is justified by Fonterra actual commodity performance. Because Fonterra usual y sets its price in line with the BMP[21] this results in a subsidy from Fonterra's non-commodity bus ness to its supplier shareholders – in effect a transfer from Fonterra investors to its milk supp iers. Because Fonterra sets the market price for milk this effect is replicated across the wider p ocessing ndustry. By corollary this dilutes the incentive for added value investment in the dairy process ng industry and ultimately undermines a key influencer for sustainable and high milk pri es

85. Page 14 of the Discussion Document provides the following description of the purpose and intent of the regulated milk price:

> "The base milk price calculation and monitoring requirements provide for a transparent ***benchmark of the value*** of farmers milk in global dairy markets during the particular season. This benchmark provides farmers with a reference point against which Fonterra's and other dairy processors milk price offers can be assessed".

86. While this exactly describes Miraka und standing of the intent of Subpart 5A, the way Sub-Part 5A is implemented falls well short of that intent. This cannot be corrected by providing guidance on the practically feasible test Rathe it requires a change in the way the efficiency dimension is interpreted, and the scope of the safe harbours would need to be restricted to measures that only capture Fonterra demonstrable real world advantages.

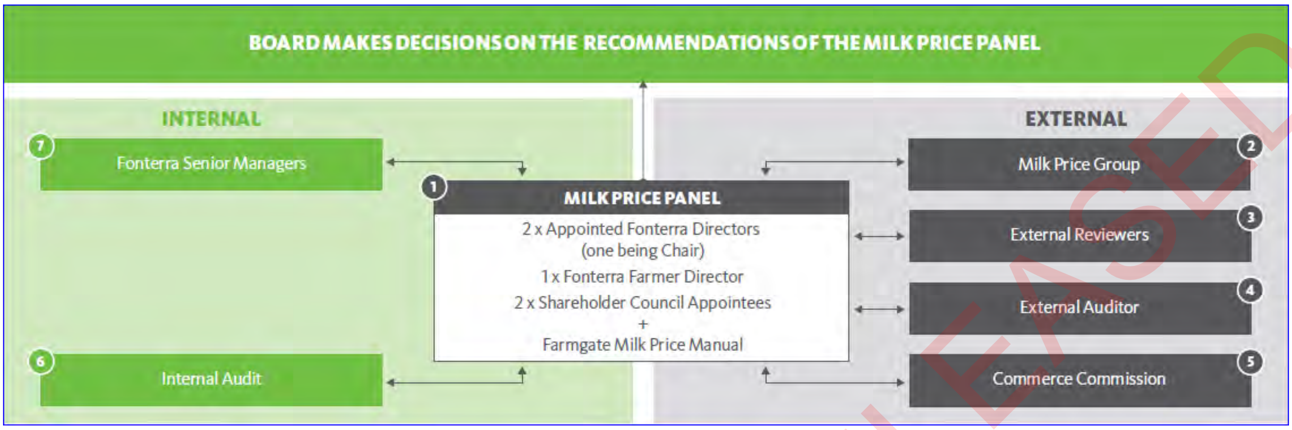
87. At the same time it ould add clarity if the definition of practical feasibility were expanded to require commercial feasibility (including in the case of the safe harbours). A high standard of evidence for feas bility would be required. Actual (demonstrated) measures would meet that standard. Technically feas ble measures might be permitted (e.g. to ensure the efficiency purpose) but would require compelling evidence to explain why they could, but are not, reflected in actual commercial outcomes.

Question 20

20. Do you consider that the base milk price should be set by an independent body (e.g. the Commerce Commission)? If so, please provide supporting information.

[21] Fonterra milk price has been the same as the base milk price in four of the six completed seasons since the current legislation was enacted (commencing the 2012/13 season).

88. Fonterra represents the governance framework for the base milk price process as shown in the below chart[22] (the full table including Notes 1 to 7 is copied in Appendix 1). The Commerce Commission is just one of several external parties with which the Milk Price Panel must interact and deliberate on its findings. It is unambiguously clear from the chart that the Fonterra Board is the final arbiter on decisions concerning the BMP. Miraka considers the chart properly describes how the BMP is governed in practice.



89. MPI has published Fonterra responses to queries it has made during t e review. In Appendix I of the "Fonterra response to MPI queries on Fonterra's ability to devi te from the base milk price", Fonterra states that "the Milk Price Panel must include a majority of members who are independent from Fonterra including the chair". This misstates the rules fo composition of the Panel. Consistent with Section 150 E of the DIRA, the Fonterra constitu on merely requires the majority of the 5 member panel to be "independent". While DIRA define " ndependent" to exclude certain classes of person (e.g. shareholding farmers) it is clear that the Milk Pr ce Panel as composed is not independent "from Fonterra" nor does the DIRA require it to b

90. The Panel comprises 5 members three of which are Fonterra directors (including the chair). All directors are of course accountab e for directing the co-operative consistent with its constitution ("maximise the milk price") Furth rmore, while the remaining two members are appointed by the shareholders council (and ther fore "independent" of Fonterra), 100% of the shareholders council is elected by Fonterra supplier shareholders.

91. There could be no doub that the shareholders council is no less aligned to the Fonterra constitutional requirement to "maximise the milk price" than are Fonterra directors themselves. It is therefore wrong, and Miraka considers misleading, to characterise the milk price panel as "independent from Fon erra". This incorrectly suggests the Panel can be relied on to perform its role in a balanced and bje tive manner.

92 It is unreasonable to expect the governance structure for the BMP to do anything but favour Fonterra interests and to use the milk price settings to maximise the milk price. Fonterra behaviour has provided ample evidence that it cannot be relied on to objectively manage and set the base milk price. Examples:

<u>*Asset beta:*</u>

93. Fonterra shows a clear preference for supplier investors over unit holders in setting milk price assumptions – e.g. Fonterra has made a considerable and continuing investment across several years to justify a low and commercially infeasible asset beta and WACC. This is even where the Commerce

[22] 2017/18 Farmgate Milk Price Statement (pg 13)

Commission and other experts have provided evidence that at best the WACC is at the lower end of a technically feasible range[23]. If Fonterra properly balanced interests of suppliers with shareholders, it would at least have recognised the need to move to the mid-point of a technically feasible range even if that range might be subject to disagreement. To date Fonterra has refused to budge on the issue.

Off-GDT Sales:

94. Fonterra has shown a willingness to ignore due process where it might inconveniently prevent it from making changes which favour increasing the milk price. A graphic illustration was provided at the time Fonterra expanded the use of off-GDT sales to determine the NP selling prices for wholemilk powder, skimmilk powder and anhydrous milkfat. Fonterra made the change regardless that it was inconsistent with the milk price manual. Rather than justify the change, Fonterra simply changed the milk price manual (without explanation). At the time Miraka also considered Fonterra made misleading claims about the effect of the change.

95. This almost cynical disregard for due process was addressed by Miraka in its submission (8 September 2016) to the Commerce Commission on the 2016/17 Farmgate Milk Price Manual. The relevant part of that Miraka submission is included as Appendix 2. Many of Miraka concerns raised in that submission have been borne out.

96. For example Fonterra suggested the impact of off-GDT sales would be to increase NP selling prices by US$20/MT; by comparison the average impact on the relevant products in the 2017/18 Season was 60% higher at US$32/MT[24]. Miraka believes that at the time Fonterra indicated an off-GDT sales impact of US$20/MT, it was not in fact in a position to make that claim because the process for determining off GDT sales had not been developed. Miraka considers this remains the case today (e.g. criteria are open ended, cannot be objectively interpreted or applied consistently, and lend themselves to flex as needs require[25]). It is unsurprising that the impact of off-GDT sales is materially higher than Fonterra originally signalled.

97. A case might be able to be made for including off-GDT sales prices to determine NP revenue. However, failures in the introduction and implementation of the policy change to include off-GDT sales should disqualify there on-going inclusion.

Transparency

98. Fonterra will "sweeten" changes to BMP calculations by committing to increase disclosures, but then falls short on those commitments. Fonterra gets away with this again apparently cynical approach because the Commission's annual reviews do not consider failures of transparency when assessing compliance with the DIRA. This failure has again been illustrated by the difference between commitments Fonterra made at the time it advised of the change to increase off-GDT sales, and its actual practice. For example compare:

- [Fonterra Reasons Paper (1 August 2016) on the 2016/17 milk price manual, pg 8]:

[23] Low WACC means lower costs, increased surplus available from revenues, and higher milk price/lower profit.
[24] US$32/MT is derived from data in the 2017/18 Milk Price Statement and is the average impact of off-GDT sales on WMP, SMP and AMF prices.
[25] See for example section 1.6 of the Miraka submission (16 November 2018) to the Commerce Commission draft report on the 2018/19 milk price manual. In its final report (14 December 2018), the Commerce Commission gave some support for the Miraka view, agreeing "further clarity" for the criteria for off-GDT sales "could be provided" by the change recommended by Miraka.

"We understand this change in approach [use of off-GDT selling prices to determine the NP selling price for WMP, SMP and AMF] will raise some concerns for the Commission and external stakeholders about a potential reduction in transparency…. We will publish each quarter the average year-to-date difference between the average prices used in the calculation [of the FGMP] and the relevant average GDT reference price"

- [Commerce Commission Final Report on the 2018/19 Milk Price Manual, Para 20]:
  "As noted in our final report on the 2017/18 milk price calculation review, Fonterra has not consistently met its commitment to publish quarterly forecasts of the cents per kgMS impact from the inclusion of off-GDT sales of WMP, SMP and AMF in the Milk Price calculation. The Commission expects Fonterra to meet the commitments it has made and therefore encourages this quarterly forecast information to be published going forward"

99. This failure of transparency in both the introduction of the policy to include off GDT sales and in disclosures following the introduction should be measured against the impact of that policy change: in the 2017/18 Season it had the effect of increasing the base milk price by 8 cents (equivalent to 14% of the NP EBITDA[26]). Miraka is not here arguing that off-GDT sales should necessarily be excluded from NP revenues (although there are good reasons to do so). The point here is that Fonterra shows a bias towards increasing the milk price without properly demonstrating that increase is well founded, and leaves the strong impression it is not.

Spirit of the DIRA

100. Fonterra fails to respect the spirit of the DIRA to "ensure New Zealand markets for dairy goods and services are contestable"[27]. For example in its 9 May 2018 response to the CEPA report commissioned by the Commerce Commission on the asset beta for the base milk price[28], Fonterra submitted evidence that a low asset beta for the NP is justified because the NZ dairy market lacked competition (i.e. muddled logic based on the opposite outcome sought by the DIRA). This earned the following understated reprimand from CEPA:

"In our view Fonterra's and its advisors' statements indicate that their proposed risk profile, and therefore asset beta, for the NP is only achievable if the NP benefits from its position of market power and a lack of competition. We find these points difficult to align to the requirement that the asset beta reflect that of a practically feasible efficient processor."[29]

101. The reprimand was well founded, and demonstrates Fonterra lacks self-awareness of the duty to set the BMP in accordance with the DIRA purpose: to steal from the obvious analogy, this fox that has been appointed to guard the henhouse unashamedly claims the henhouse as its restaurant.

102. The BMP for the 2017/18 Season was $6.74. At page 11 of the Farmgate Milk Price Statement for the 2017/18 Season, Fonterra assesses that the 2017/18 BMP would have been just $6.23 (lower by $0.51) had it been calculated using the 2009 Milk Price Manual. This is not the result of changes in external measures (e.g. selling prices) but as a result of changes in calculations and assumptions. To place this in context, $0.51 of the milk price is equivalent to 94% of the NP EBITDA in 2017/18. It is of course not unreasonable to see changes in the BMP calculations and assumptions. It is however completely

[26] The comparison to the NP EBITDA is provided here as a reflection only of the scale of impact this may have had on the wider industry.
[27] Section 4 (f) – Purpose of the DIRA
[28] Dairy Notional Processors' asset beta (28 March 2018), prepared for the NZ Commerce Commission by Cambridge Economic Policy Associates Pty Ltd in association with Freshagenda Pty Ltd.
[29] Dairy Notional Processor's asset beta – response to submission New Zealand Commerce Commission (4 June 2018), prepared for the Commerce Commission by "Cambridge Economic Policy Associates Pty Ltd in association with Freshagenda Pty Ltd".

unreasonable to expect Fonterra to provide independent judgement to manage a model that can result in changes of this magnitude on the price paid for milk in New Zealand.

103. Miraka contends there is ample evidence that Fonterra cannot be relied on to deliver a BMP which is fair and objective. Miraka therefore supports the intent in Question 19 that the BMP should be set by an independent body. Miraka also considers the responsibility to set the BMP has had a damaging impact on Fonterra strategic choices. The role of setting the BMP combined with its constitutional priority to maximise the milk price means Fonterra is virtually compelled to exploit the DIRA to inflate the milk price. At the same time it means Fonterra is unable to properly reward and the efore incentivise capital growth.

104. Taking responsibility for the BMP price away from Fonterra is therefore not only good for the wider dairy industry it is also healthy for Fonterra itself.

105. While Fonterra should not have responsibility for setting the BMP, the current gove n nce framework could largely remain the same but with certain changes in participants, roles and priorities.

106. Miraka offers the following "straw man":

- The role of the Fonterra Board would be replaced by the role of the egulatory agency (which could for example be the Commerce Commission, Treasury, MPI o MBIE or an appointed Board).
- The milk price panel would comprise representatives of t e dai y processing industry (including but not only Fonterra), milk producers and the governme t (wider economic interests). It would have an advisory rather than decision making role It would facilitate liaison between the Milk Price Group and parties providing information and data.
- The Milk Price Group would be accountable to the regulatory agency. It would produce the annual milk price statement and any other reporting around the BMP.
- The regulatory agency (through he Milk Price Group) would create and distribute forecasts of the BMP on a regular basis (at least quarter y). This would include the distribution of the relevant key metrics in sufficient detail to enable individual processors to benchmark their own projections of the BMP.
- The regulatory agency wou d interpret legislation and set processes and assumptions based on recommendations from the Milk Price Group.
- The Milk Pric Panel would provide its consensus view on these recommendations to the regulatory agency. Individual members could submit separately where the Panel was unable to come to a consensus vi w but this would be discouraged.
- Fonte ra would be free to set its own forecasts and forecasting timetable.
- onterra would continue to be required to explain variations between its final milk price and the BMP
- There would be maximum transparency of the milk price calculations and assumptions, including at an appropriate level of aggregation to protect genuinely commercially sensitive data.
- The Sub-part 5A efficiency requirement would be repurposed to provide assurance of a fair commodity milk price for milk producers so that (in the words of the Discussion Document):

  "The base milk price calculation and monitoring requirements provide for a transparent ***<u>benchmark</u> of the <u>value</u>*** of farmers milk in global dairy markets during the particular season. This benchmark provides farmers with a reference point against which Fonterra's and other dairy processors milk price offers can be assessed".

- The safe harbours would be retained but limited to including confirmed measures of Fonterra actual performance (e.g. production yields). They would be included in the milk price calculations to the

extent these measures are more favourable to the milk price than would otherwise be calculated. The safe harbours would continue to be utilised at Fonterra's discretion.
- The definition of practical feasibility would be clarified to include commercial feasibility as described in paragraph 87. above.

107. Should this DIRA Review nevertheless conclude the status quo should remain for setting and reviewing the base milk price, at the very least the DIRA would need to be amended to:

a. Address the efficiency dimension, safe harbours and definition of practical feasibility as described above
b. Provide the Commerce Commission with the powers to provide a substitute any metric, calculation or assumption which it considers not "practically feasible". Because neither Fonterra nor any dairy processor is compelled to pay the BMP, there would be no need for appeal rights for any such substituted metric.

DIRA Review and Expiry Provisions

Discussion Document: "4.5: Options for the DIRA review and expiry provisions"

108. The Discussion Document offers options for determining whether or if further DIRA reviews should be carried out. Options range between:

- automatic expiry of the DIRA based on a nominated date or a market share threshold; through to
- specific criteria which would trigger a review of the DIRA (with any proposes to change the DIRA being subject to government/parliamentary approval); possible criteria include market share or time based triggers, or ad hoc reviews as and when decided by Government.

Question 40

40. How best do you consider "market dominance" could be measured? For example, are there certain criteria (other than a market share threshold) that could be provided for in legislation as a trigger for review and/or expiry of the DIRA?

109. Market dominance is unlikely to be determined with certainty by any single criteria. At the time of an earlier assessment of the DIRA triggers, NERA Economic Consulting noted that "recent economics literature finds that market share analysis is at best a "crude first step" in competition analysis"[30].

110. On the other hand, market share remain a pragmatic, simple and transparent metric which provides insight into changes in market dominance and so remains an appropriate metric to *trigger* a review of the DIRA.

Question 41

41. Are there any other options for the DIRA review and expiry provisions that you think should be considered? Please provide sufficient detail when describing any alternative options as well as reasons for considering these.

111. The range of options are sufficiently addressed in the Discussion Document.

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[30] Section 6.1, An Assessment of the DIRA Triggers (30.3.10), NERA Economic Consulting (prepared for the NZ Ministry of Agriculture and Forestry)

Question 42

> 42. What costs and benefits would each of the options for the DIRA review and expiry provisions create for your business? Please provide quantitative information if possible.

112. Since mid-2015, Miraka has actively engaged in two government reviews of the DIRA. Miraka is a small dairy processing business and engagement has represented a significant commitment of management time and business resources. Miraka considers the first of the latest two reviews was a poor allocation of resource because of the scope limitations placed on it. In particular there was no opportunity for substantive review of Sub-part 5A (milk price).

113. A key determinant of the benefit of reviews is therefore the degree to which they are able to address emerging issues relevant to all industry participants. Miraka remains committed to engagement in future reviews but seeks statutory provision to ensure there is not undue scope l mitation in those reviews.

114. The benefit of DIRA must be balanced against the cost of the reviews. The "light-handed" nature of the DIRA regulation and the relatively low cost it imposes on Fonterra need to be taken in to account when considering the impact of any risk associated with the DIRA remaining in place for longer than might be absolutely necessary. Miraka considers this shou d lead to a bias towards a longer than a shorter period between reviews. In the event of a major issue that needs urgent attention in the intervening period, there is always the backstop of discretionary government action.

Question 43

> 43. How well do you think each of the options for the DIRA review and expiry provisions would perform against the principles of good regulatory practice of promoting certainty and predictability of regulatory outcomes, transparency, cost-effectiveness and timeliness of regulatory processes?

Option 4.5.1: Status Quo

115. Miraka considers there should be a more certain framework for ensuring review processes occur and so does not support this option. The document suggests the option risks DIRA regulation being removed at th wrong time (too late or too soon). Miraka greater concern is that the DIRA would not evolve to add ess changing issues as for example has occurred with the unsatisfactory regulation of the BMP.

O tion 4.5.2: Time triggered review

116. A time triggered review provides the certainty of reviews and of timing of reviews. It runs the risk however once set of triggering a review before it is necessary. In Miraka view, the cost of triggering a review too early is less than the risk of being reviewed later than might be warranted.

Option 4.5.3: Market threshold triggered review

117. While again providing some certainty that reviews will occur at some time, this again runs the risk of triggering a review prematurely.

Option 4.5.4: Automatic expiry triggered by a nominated date or market share threshold.

118. A market share threshold trigger for expiry has previously been included in the DIRA and was subsequently removed. Miraka sees no reason to revert to that position. A date based automatic DIRA expiry would be even worse: there is no necessary link between some arbitrary future date and the likelihood that DIRA would no longer be required.

Question 44

> 44. Do you have a preferred option, or a combination of options, for the DIRA review and expiry provisions? Please provide your reasons and information/evidence in support of your views.

119. Miraka prefers future DIRA reviews be triggered by a combination of option 4.5.2 (time threshold) and option 4.5.3 (market share threshold). Both thresholds should balance the cost of reviews (o both the government and the industry) against the relatively low risk of adverse effects from the DIRA regulation continuing longer than necessary.

120. In Miraka view, future reviews should be triggered by the earlier of:

- Five years following the date that government completes action resu ting from the immediately previous review; and
- Fonterra market share drops below 60% across the full NZ milk cat hment;
- To avoid a review that might be triggered at any five year threshold but which was otherwise considered unnecessary, the government should at its di cretion be able to defer any review if the market share threshold had not also been reached. This provides an appropriate level of certainty tempered by "at the time" discretion to ensur DIRA reviews proceed at appropriate intervals.

121. The suggested 60 percent market share is on the low end of a possible range. In the previously noted NERA assessment of potential DIRA review triggers,[31] market thresholds ranging from 60 percent ("the literature would suggest that in many instance a cooperative with an output market share of above 60% would hold significant marke power") to 75 percent were discussed. NERA settled on a 75 percent market share threshold. Miraka conside s that by also including the time based trigger (5 years) the market threshold can safely be set a 60% or the lower end of the range.

Access to regulated milk for domestic and export market processors

122. Miraka purchased regulatory milk in its initial years of operation. That regulatory volume was quickly disp aced by "own supply" milk. Miraka recognised the importance of quickly moving to an "own supply" base for sustainable profit and growth. The initial access to regulatory milk was however imp rtant to soften the impact of structural challenges new processors face when entering the industry including:

- a rigid timetable for suppliers transferring between processors (established by standard industry practice and contracts)
- seasonal milk production
- pre-requisite requirements for funding providers (contracted access to milk AND customers)
- pre-requisite requirement to contract supply to customers (contracted access to milk)

[31] Section 6.1, An Assessment of the DIRA Triggers (30.3.10), NERA Economic Consulting (prepared for the NZ Ministry of Agriculture and Forestry).

- an initial critical mass of milk supply to establish credibility for contracting “own supply”

123. Miraka no longer has access to regulatory milk nor would it anyway be important for Miraka’s ongoing success. Miraka accordingly does not wish to present a view on any ongoing access to regulatory milk for the wider industry. Miraka nevertheless offers the following input to the issues raised.

Discussion Document: “3.5: Does the DIRA incentivise inefficient entry by large processors”

Question 17

> 17. Do you agree with our preliminary analysis of the impact the DIRA has on new processor entry? If not, please provide your reasons and information/evidence in support of your views.

124. The preliminary assessment concludes that:

- neither open entry/exit nor access to regulatory milk have encouraged inefficient entry by “large” processors; and
- access to regulatory milk by “large” dairy processors has not undermined any Fonterra competitive advantage in export markets.

125. Miraka agrees with this assessment. Miraka though disagrees with the description of the dairy processors benefiting from regulatory milk as “large”.

Question 18

> 18. Do you consider that large dairy processors should continue to be eligible to purchase regulated milk from Fonterra under the Raw Milk Regulations or not? Please provide detailed comment in support of your views.

126. Miraka does not wish to offer a view on whether there should be ongoing access to regulatory milk to any class of processo s. Miraka would however be uncomfortable with the precedent that processors should be discriminated against simply on the basis of their size. This concern is exacerbated by the suggestion that a proce sor would be classified as “large” and thus subject to discrimination by the DIRA once it reaches 30M litres own supply. 30M litres represents some 0.2% of Fonterra current season forecast supply.[32] A processor of that scale cannot be described as large. It could perhaps best be described as tiny and even inconsequential in relation to the DIRA purpose of mitigating adverse effects of F nterra market power.

127 Miraka considers it is both unnecessary and inconsistent with the stated policy intent for regulatory supply to discriminate against access to regulatory milk on the basis of the size of a dairy processor. This is addressed further in paragraphs 130. ff below.

128. DIRA access to regulatory milk to date has not in fact supported the entry of any “large” processors. Rather it has supported the entry of minimum size processors which have the potential to compete with Fonterra. None of these can be described as “large” compared to the dominant market participant, and they were certainly not “large” at the time they commenced operations.

[32] In the current 2018/19 Season, Fonterra is forecasting a supply of 1.55 billion kilograms of milksolids. That equates to some 17.5 billion litres of milk.

129. Miraka considers the impact of blocking access to regulatory milk for new entrants to the processing market:

- should have only minimal impact in the case of new dairy processors where foreign investment also brings an associated access to markets through vertical integration
- could have a more significant impact on new entrants (of any size) funded by direct New Zealand investment (such as was largely the case for Miraka) and targeting commodity production as a platform for entry to the processing market; such processors are less able to overcome the structural barriers noted in paragraph 122 (above).

Discussion Document: "4.2: Options for access to regulated milk for large dairy processors (except Goodman Fielder)

Question 27 to 31

QUESTIONS:

27. Are there any other options for access to regulated milk for large dairy processors that you think should be considered? Please provide sufficient detail when describing any alternative options as well as reasons for considering these.

28. Do you consider that the proposed 30 million litres threshold is too high or too low? If so, what would you consider the right threshold to be, and why?

29. What costs and benefits would each of the options for access to regulated milk for large dairy processors create for your business? Please provide quantitative information if possible.

30. How well do you think each of the options for access to regulated milk for large dairy processors would perform against the principles of good regulatory practice of promoting certainty and predictability of regulatory outcomes, transparency, cost-effectiveness and timeliness of regulatory processes?

31. Do you have a preferred option for access to regulated milk for large dairy processors? Please provide your reasons and information/evidence in support of your views.

130. Miraka does not wish to offer a view on whether there should be ongoing access to any processors. The following owever provides observations which might be useful to addressing the above questions

131. The Discussion Document states that to be fit for the purposes of the DIRA, access to regulatory milk should be "targeted at dairy processors who (sic) need it to be able to enter *<u>and compete</u>* in New Zealand dairy markets" (emphasis not in original). It discusses two options for rights to access regulatory milk:

- Option 4.2.1: Status quo: up to 50 million litres per year until or unless own supply is 30 million litres or more for three consecutive seasons.
- Option 4.2.2: "Large" processors would no longer be able to access regulatory milk. A "large" processor is defined as one with own supply of 30 million litres or more. Processors with "own supply" below that volume would indefinitely retain an annual entitlement of up to 50 million litres of milk.

132. Rather than block access to "large" processors, the effect of option 4.2.2 is to block access to <u>all</u> processors except for the very smallest; these latter are offered the status quo of indefinite access to regulatory milk up to 50M litres per annum[33]. This leave access to regulatory milk (putting aside milk for Goodman Fielder) more correctly described as a support mechanism for small or niche operators which would otherwise **<u>NOT</u>** be able to compete for a supply of milk.

133. Should Option 4.2.2 proceed, its purpose and outcome would therefore need to be restated. This includes revisiting the overall policy objective for the supply of regulatory milk generally. There would then be no need to explicitly discriminate against so-called "large" processors.

134. In the event option 4.2.2 were implemented for the very smallest processors the proposed mechanism is faulty. For small processors to grow above the proposed 30M litre threshold, they wou d have to achieve a step-change in 'own supply" to displace their lost eligibility for (up to) 0 million litres of regulatory milk. This would be a disincentive for growth and would leave any small processor languishing and facing business risk through dependence on the goodwill of the DIRA. A phase-out period such as the current three year period seems essential to avoid that outcome. It is possible that a three year phase-out period coupled with a lower threshold could bo h support the very smallest niche processors, and otherwise block access to regulatory milk.

Discussion Document: "4.4 Options for access to regulated milk for Goodman Fielder and smaller processors"

135. Miraka agrees it is important that there is assured supply and competition in NZ consumer markets. The fact that this continues to rely on regulato y support 18 years after DIRA was implemented suggests a regulatory failure. This potentially includ s a failure to address structural issues in the farm gate market which might restrict the ab lity of suppliers to the domestic market from competitive access to raw milk supply.

136. Miraka supports regulatory change to reduce and ultimately eliminate dependence on regulatory support. Miraka, however, considers this will not occur without wider changes in the raw milk market. This might for example address pricing mechanisms (annual pricing of milk creates rigidities in the market), and barriers to the development of a secondary, wholesale, or milk brokering market.

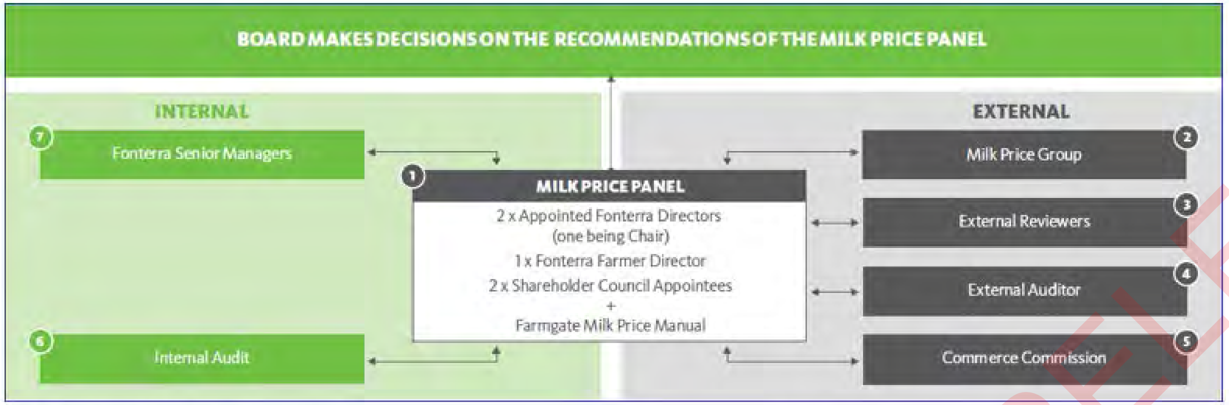
137. Miraka does no wish to comment further other than to note that the status quo option (4.4.1) is incorrectly stated. I the case of "smaller domestic processors", access to 50 million litres regulatory milk p.a. only applies to processors with own supply up to 30 million litres, which then eliminates on the three year phase out rule for own supply exceeding 30 million litres (or would be blocked immediate y 30 million litres are reached if option 4.2.2 is adopted). It is also probable that a higher th eshold than 30 million litres would be needed if it is intended to target support even "small" competitors in the Fonterra/Goodman Fielder dominated domestic market.

____

Richard Wyeth
Chief Executive Officer
Miraka Ltd.

[33] Somewhat ironically this would result in such "small" processors having more milk to process (up to 80M litres) than some "large" processors that might only 30M litres to process.

Appendix 1 – Fonterra rendition of governance of the base milk price setting process (2017/18 Farmgate Milk Price Statement (pg 13)



1 MILK PRICE PANEL

The Milk Price Panel plays a key role in overseeing the integrity of the Farmgate Milk Price. It has five members. Two are Fonterra-appointed directors (one of whom is the Chair), one is a Fonterra farmer-elected director and two are appropriately qualified nominees of the Fonterra Shareholders' Council.

The current members of the Panel are: Scott St John (Chair) and Bruce Hassall, who are appointed Fonterra directors; Brent Goldsack, who is a farmer-elected Fonterra director; and Andrew Wallace and Bill Donaldson, who are nominees of the Fonterra Shareholders' Council.

The Panel oversees the governance of the Farmgate Milk Price and the Manual, including changes to the Manual and verification by independent external experts of key parameters (such as resource usage rates, product yields and fixed manufacturing costs).

The Panel is responsible for:

- Overseeing the calculation of the Farmgate Milk Price and making a recommendation on it to the Fonterra Board.
- Providing recommendations to the Fonterra Board on changes to the Manual.
- Providing assurance to the Fonterra Board that the Farmgate Milk Price has been calculated each year in accordance with the Manual.

The Fonterra Board is responsible for the forecast of the annual Farmgate Milk Price.

2 MILK PRICE GROUP

The Milk Price Group is a working group established by Fonterra. The Head of the Milk Price Group is independent of Fonterra's management and reports directly to the Chair of the Milk Price Panel. The role of the Milk Price Group includes:

- Ensuring that the Farmgate Milk Price is calculated in accordance with the Manual and making recommendations in respect of the Farmgate Milk Price to the Panel.
- Considering any proposed amendments to the Manual, including those the Milk Price Group itself considers are appropriate, and ensuring they are in accordance with the Milk Price Principles in Fonterra's Constitution.
- Providing assurance to the Fonterra Board over the calculation of the forecast of the Farmgate Milk Price.
- Managing engagement with external reviewers.
- Engaging with the Commerce Commission, including to ensure full disclosure of all material aspects of the Farmgate Milk Price derivation each year.

The functions of the Milk Price Group are contracted out to Ernst & Young and other technical experts who are not employees of Fonterra.

3 EXTERNAL REVIEWERS

External reviewers provide expert advice on various inputs, as well as assurance over the accuracy of financial models. In addition, they participate in reviews of key parameters of the Farmgate Milk Price at regular intervals (which can be up to four years).

4 EXTERNAL AUDITOR

The external auditor audits the Farmgate Milk Price each year and provides assurance that the Farmgate Milk Price has been determined in accordance with the Milk Price Principles, Methodologies and Detailed Rules of the Farmgate Milk Price Manual. Fonterra's external auditor is PricewaterhouseCoopers.

5 COMMERCE COMMISSION FARMGATE MILK PRICE OVERSIGHT

Subpart 5A of DIRA, which was passed into law in July 2012, gives the Commerce Commission an oversight role with respect to Fonterra's Farmgate Milk Price.

The purpose of Subpart 5A is to promote the setting of a Farmgate Milk Price that provides an incentive to Fonterra to operate efficiently, while providing for contestability in the market for the purchase of milk from farmers (section 150A). Each year, the Commission is required to review and report on the extent to which the Manual and Fonterra's actual Farmgate Milk Price are consistent with this purpose:

- The Commerce Commission's final report on the Manual for the 2017/18 Season was released on 15 December 2017 and can be found at https://comcom.govt.nz/regulated-industries/dairy/milk-price-manual-and-calculation/milk-price-manual/milk-price-manual-201718-season
- The final report on the F18 Farmgate Milk Price calculation was released on 14 September 2018 and can be found at https://comcom.govt.nz/regulated-industries/dairy/milk-price-manual-and-calculation/milk-price-calculation/milk-price-calculation-201718-season

6 INTERNAL AUDIT

Fonterra's internal audit team provides assurance over the processes and controls relating to Fonterra data used in the calculation of the Farmgate Milk Price.

7 FONTERRA SENIOR MANAGERS

Fonterra senior managers provide internal oversight of the calculation of the actual and forecast Farmgate Milk Price in accordance with the Manual and detailed models and procedures.

Appendix 2: Extract from "Miraka Comments on review process and Fonterra 2016/17 Manual" (8 September 2016)

Note that footnote numbering in this Appendix is changed from the original document. It continues the sequence contained in this current document.

4.0 **Off-GDT Sales of WMP, SMP and AMF**

4.1 Fonterra has advised that for the 2016/17 Season it will include prices of "selected" off-GDT sales of its WMP, SMP and AMF sales to determine the prices achieved by the Notional Producer. This is a substantial change to Milk Price assumptions and represents a fundamental change in policy. The significance of this change is not properly represented by Fonterra in the Reasons Paper.

4.2 At page 7 of the Reasons Paper Fonterra explains that "the primary reason for making this change is that it has become increasingly clear in recent years that GDT sets the 'base' price for sales of RCPs, with sales undertaken off GDT almost invariably being transacted at higher prices". Fonterra does not make clear what it means by 'base' price and Fonterra's use of quotation marks ('base') suggests Fonterra itself is undecided on what it means. Fonterra does however confirm it will continue to use GDT pr ces to provide "a benchmark" to measure sales team performance[34]. Miraka considers this reconfirms that Fonterra considers GDT prices are appropriate benchmark prices for commodity products.

4.3 Fonterra further states (at page 7) that "the practical implication of this change is to align the approach … [for WMP, SMP and AMF] to the approach currently used for Butter and BMP". This attempts to add weight to the change to include off-GDT sales for WMP, SMP, and AMF by indicating it is in line with current practice for butter and BMP. This misrepresents the situation: until now the policy intent has been to do the reverse (i.e. to progressively align the process for butter and BMP to the process for WMP, SMP, and AMF). The change for WMP, SMP and AMF is in fact as a result of a fundamental change in policy. The Fonterra Reasons Paper has skirted this change.

4.4 Consistent w th Manuals for previous years, Section 4.3 (Overview of Methodology – Farmgate Milk Price Revenue) of the <u>2015/16</u> Manual stated:

> "Benchmark selling prices should:
>
> - Reflect actual prices realised by Fonterra on the sale of Reference Commodity Products across a range of contract terms which is consistent with prevailing market conditions.
> - Result in Fonterra facing strong incentives to optimise its product Mix.
> - Result in Fonterra facing strong incentives to maximise its Benchmark Selling Prices.
>
> <u>*These objectives should eventually be fully achieved if Benchmark Selling Prices are based on prices achieved through Global Dairy Trade"*</u> [highlighting not in original]

[34] Reasons Paper page 8.

4.5 The highlighted section above has simply been deleted from the 2016/17 Manual. Thus whereas previously the policy intent was to "eventually" replace any remaining off-GDT selling price data with GDT data, it is no longer considered that GDT prices can achieve the objectives for the Benchmark Selling Prices. Fonterra would seem to have avoided active disclosure of this policy change and has not explained why it has been made.

4.6 Fonterra has explained the change to use off-GDT prices for WMP, SMP and AMF on the grounds that those prices are higher than GDT prices. This explains the effect of the change. It does not explain the reason (other than by a cynical interpretation). Taken at face value this explanation for including off-GDT sales is not sanctioned by the Manual. The process for determining Notional Producer prices continues to default to GDT prices. Section 4.3 of Part A of the Manual (and mirrored in Rules 5 and 8 of Part B) prescribes the circumstances where GDT would be supplemented with off-GDT sales:

- where GDT "does not cover a sufficient volume of sales" to provide a reliable benchmark price"; or
- "where prices on GDT are not … *materially representative* of the prices Fonterra and its competitors should generally be able to achieve for sales of the Reference Commodity Products"

4.7 The first of the above does not apply to WMP, SMP and AMF since those have previously been deemed to include "sufficient volumes". Fonterra hints but does not state that the second of the above has been triggered for WMP, SMP and AMF (page 7 and 8 of the Reasons Paper) but contradicts this further down on page 8 where it states "prices achieved on GDT will continue to be *materially rep esentativ* of the prices used in the FGMP calculation".

4.8 Fonterra indicates that had off GDT prices been included in the milk price calculation between 2013 and 2016 prices would have been within USD20 of the GDT based prices actually used[35]. For the 4 Seasons ending 2014/15, a difference of US$20/MT would amount to less than 0.6% of the GDT based selling prices. Rather than trigger a need for including off-GDT sales in the milk price calculations, this outcome provides evidence the GDT prices ARE "materia ly representative" and there is no reason under Rules 5 and 8 for including off-GDT sales It goes without saying that any approach Fonterra could use to select off-GDT prices could not match the advantage that GDT provides in assuring the Notional Producer prices a e based on independent, transparent and neutral prices. Departures from the use of GDT p ices on the basis they are not "materially representative" would demand a much igher hurdle than the 0.6% implied by Fonterra's analysis.

4.9 Miraka contends it is widely accepted (including by Fonterra) that GDT sets an international benchmark price for commodity dairy products. Where Fonterra achieves prices from commodity sales which are different to the benchmark price, this must necessarily be attributed to the differentiation that Fonterra itself offers. This includes its ability to offer a wide range of products (far wider than the Notional producer can offer[36]) and services to

[35] Fonterra Reasons Paper page 8.
[36] For example, Fonterra relationship with a customer extends well beyond that which is possible from the RCP product range. That ability to service a much wider range of customer needs will affect the price relationship Fonterra has with that customer including for products which might be classified as RCPs.

customers, and Fonterra's investment in product and market development. All of these enable Fonterra to obtain prices which are differentiated from the benchmark commodity prices. The Notional Producer does not resemble these qualities which enables Fonterra to differentiate prices nor has any effort been made to realign the Notional Producer to the far more sophisticated Fonterra business model. It is therefore not practically feasible to consider the Notional Producer prices can include prices that Fonterra generates from its more sophisticated business model.

4.10 Fonterra however claims at page 8 of the Reasons Paper that the Notional Producer prices would remain practically feasible in aggregate because the prices would still be lower than Fonterra achieves on sales not included in Milk Price calculation. This is circular logic and must be dismissed. It also suggests a lack of coherent policy in the process Fonterra is using to select off-GDT sales for inclusion in the milk price calculations. The reason that Fonterra would exclude certain sales from the milk price calculations is because Fonterra would consider those sales are not practically feasible for the Notional producer. It is then circular logic to say the Notional Producer prices are practically feasible because they are lower than the prices for excluded sales.

4.11 Fonterra indicates "a sample of prices"[37] from off-GDT sales will be included in the calculations of the Notional Producer prices. Fonterra provides no explanation of the parameters for selection of those prices, how that selection will be controlled, nor how off-GDT prices will be merged with GDT prices for purposes of calculating the Notional Producer prices. Fonterra advises that the inclusion of ff-GDT prices from 2013 to 2016 would have resulted in an increase in selling prices of US$20/MT[38] and an increase in the FGMP by NZ$0.04 to NZ$0.05[39]. On the other hand separate analysis published by the Commission[40] indicates Fonterra "price ach evement" for reference commodity products (and proxies) is $0.22/kg MS higher than the Notional Producer in 2014/15. A further difference of $0.21/kg MS in revenues of Fonterra ref rence commodity products above the GDT based Notional Producer prices is unable to be explained (or "pinned down"). This suggests that the change in policy to include off-GDT sales offers Fonterra considerable and unacceptable new flexibility to manage the level at which the FGMP is set.

[37] Fonterra Reasons Paper page 8
[38] Fonterra Reasons Paper pg 8.
[39] Fonterra advice to financial markets of changes in the 2016/17 FGMP Manual.
[40] Addendum to the Commission's draft report: Review of Fonterra's 2015/16 base milk price calculation.

This submission is submitted by Evan Smeath (Chairman) and Suzanne Brocx (Administrator/Committee Member), Northland College Farm Committee, on behalf of the Northland College Board of Trustees. Being Fonterra Shareholders s 9(2)(a)
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Chapter 2: Performance of the dairy industry

Section 2.1 2001 structural reform to enable the industry to drive strategic change

Please refer to [Section 2.1] of the discussion document.

(1) Do you agree with our description of the DIRA regulatory regime and its original policy rationale? Do you consider the original policy rationale is still valid?

We agree that when set up the rationale behind DIRA was valid at the time. However the "dominance" that the document outlines is no longer valid.

Section 2.2 Industry performance since the restructure

Please refer to [Section 2.2] of the discussion document.

(2) Are there any other dairy industry developments or industry performance indicators that are not captured in the discussion document or its supplementary material? Please provide details and supporting evidence.

Page 61 and 62 detail the extent of foreign investment in New Zealand milk processors. The growth of this investment since DIRA is not tabled as well as other areas of investigation within the report.
In fairness, it would have been beneficial to read about observations of the other milk processors for readers to fairly gauge the holistic viewpoint.

Chapter 3: The effects of the DIRA and other factors on industry performance

Section 3.1: Has the DIRA been effective at managing Fonterra's dominance in the market for farmers' milk, and is it still needed?

Please refer to [Section 3.1] of the discussion document.

(3) Do you consider the DIRA has been effective at achieving its core regulatory objective of preventing Fonterra from using its dominance to create barriers to farmers' milk and land flowing to their highest value uses? If not, please provide reasons and supporting information/evidence.

Farmers have the option to make farming decisions to maximise their income. DIRA has played a part in this but more importantly as an exporter we believe the NZ exchange rate has more influence on farmers incomes

(4) Do you think Fonterra is still dominant in the market for farmers' milk, at the national and regional levels?

Farmers now have a choice of who to supply their milk to which has created the competition that DIRA was set up for – to moderate Fonterra's perceived dominance. If competition continues to flourish, there is potential that it will have reverse impact and fragment the milk industry within NZ – which would be circular as this was the core reason for the establishment of Fonterra – to create greater global marketing and exporting opportunity.

(5) Do you think the DIRA imposes unreasonable costs on Fonterra? If so, please provide supporting information/evidence.

DIRA has regulated open entry and exit. There is no/little risk to the entering and exiting farmers with this option. The risk and liability is held and mitigated by the remaining shareholders (if a farmer leaves) or the current shareholders (if a farmer joins and shares up over time). The equity of the cooperative is effectively diluted by those leaving. Farmers may make the decision to leave, realise it was not a good decision then reverse that decision and re-join and if so Fonterra is obligated to take their milk – open entry. There is no penalty for this option. This is regardless of processing capacity. This could potential create transport costs by having to move milk elsewhere for processing or building more plant to enable this to occur. Other processors have the "option" to accept or decline entry to their operation. This is not equitable across the same market.

Under DIRA regulations, Fonterra must supply milk to start up companies. This, once again puts the risk on the Fonterra shareholders. There is no risk to the start up company as they can create their own markets at the expense of Fonterra milk. They effectively have a favoured entry conditions to the market – something Fonterra farmers do not have Fonterra could use this DIRA milk to create higher value product but cannot due to the obligations under the DIRA act.

Some of the processors have made no effort to create their own supply chain since the formation of Fonterra and DIRA regulations were put in place.

Independent processors have set up in high value dairying land and have the opportunity to "cherry pick" suppliers close to their factories. This forces Fonterra to pick up the remainder of the milk incurring higher transport costs in doing so

(6) Are there ways for the costs imposed on Fonterra to be mitigated without impacting on the effectiveness of the DIRA regulatory regime? If so, please provide supporting information.

We believe that the time for open entry and exit via DIRA has reached its time. Processors should be able to determine who they accept for supply at any time regardless of DIRA regulations – Fonterra included. Processing capacity availability will be a determining factor is many instances and this is good business.

(7) Are there any other regulatory tools that, in your opinion, would be more effective than the current DIRA provisions at managing Fonterra's dominance? If so, please provide examples and supporting information/evidence

(8) Are there other factors you consider need to be taken into account when considering the effectiveness of the DIRA regime and whether it is still needed?

DIRA regimen needs to impact all milk processors fairly going forward. It has done what it was set out to do and the Fonterra's supply percentage has fallen from 96% to currently 80%. Consideration has to be given to continuation of regulations that could in effect result in fragmentation of the industry in New Zealand which goes against the DIRA regime

Section 3.2: Does the DIRA encourage industry growth?

Please refer to [Section 3.2] of the discussion document.

(9) Do you agree with our preliminary assessment of the extent to which the DIRA encourages industry growth? If not, please provide reasons and supporting information/evidence.

DIRA has encouraged industry growth (pg60), but some of this growth could have been organic without DIRA e.g part of evolution of higher value product and volume growth. This has not been quantified in the report.

Section 3.3: Does the DIRA influence Fonterra's strategy?

Please refer to [Section 3.3] of the discussion document.

(10) Do you agree with our preliminary assessment of the extent to which Fonterra can influence milk supply volumes through price, notwithstanding the DIRA open entry requirements?

The volume arm of the Fonterra strategy we believe was driven by DIRA's influence. Going forward Fonterra should not be forced to taken all milk.

(11) Are there other factors that you consider should be taken into account? Please provide detailed comment in support of your views.

(12) Do you consider that the DIRA provisions governing Fonterra's base milk price calculation and Commerce Commission monitoring may be preventing or disincentivising Fonterra from deviating from the base milk price calculation for strategic or commercial reasons?

Fonterra and Independent processors should work by the same base milk price calculation. This would make all calculations transparent and equal.

(13) If the DIRA is not driving Fonterra's business and investment strategy, what is? Please provide detailed comment in support of your views.

DIRA has an influence on Fonterra's business and investment strategy as the certainty of supply cannot be determined or managed due to the open entry/exit.

Other processors planning and strategies have more finite certainty. This is inequitable to Fonterra.

Section 3.4: Does the DIRA impact on the industry's environmental performance?

Please refer to [Section 3.4] of the discussion document.

(14) Do you agree with our preliminary analysis of the DIRA's impact on the industry's environmental performance? If not, please provide your reasons and supporting evidence.

In our opinion, DIRA should not have any regulatory impact on the industry environmental performance There are sufficient other avenues to monitor and regulate this e.g. RMA. The RMA is holistic and inclusive and is applicable to urban AND rural alike. Having environmental issues addressed in DIRA could be perceived to be political in nature and lobbying AGAINST farmers by a government body.

(15) Do you agree with our view that environmental issues are best dealt with through the Resource Management Act and not the DIRA regime?

Yes

(16) Are there other environmental issues that you consider should be addressed either through the DIRA review or some other means?

No

Section 3.5: Does the DIRA incentivise inefficient entry by large dairy processors?

Please refer to [Section 3.5] of the discussion document.

(17) Do you agree with our preliminary analysis of the impact the DIRA has on new processor entry? If not, please provide your reasons and information/evidence in support of your views.

Yes

(18) Do you consider that large dairy processors should continue to be eligible to purchase regulated milk from Fonterra under the Raw Milk Regulations or not? Please provide detailed comment in support of your views.

No, the largest processor has had sufficient time to procure milk sources and yet has chosen to continue to purchase milk from Fonterra under DIRA.

Section 3.6: Does the DIRA promote sufficient confidence in the base milk price calculation?

Please refer to [Section 3.6] of the discussion document.

(19) Do you consider that greater confidence in the base milk price calculation outcomes could be achieved if additional legislative guidance on the term "practically feasible" were to be provided for in the DIRA? Please provide detailed comment in support of your views

Fonterra Farmers currently have confidence in the milk price formula. There is also a Milk Commissioner in place that oversees any complaints from farmers We upport legislation which regulates that all processors are to provide a transparent calculation of their milk price as currently regulated for Fonterra. The purpose of this would be to enable farmers to have a transparent comparison of milk payments across all p ocessors.

(20) Do you consider that the base milk price should be set by an independent body (e.g., the Commerce Commission)? If so, please provide supporting information.

No.

Section 3.7: Does the DIRA support competition in New Zealand consumer dairy markets?

Please refer to [Section 3.7] of the discussio document.

(21) Do you agree with our preliminary analysis of the DIRA impact on the domestic consumer dairy markets? Please provide your reasons and information/evidence in support of your views.

There has been an impact on the domestic consumer dairy markets, but the majority of the milk price sold to consumers is not returned the farmers. This is not public perception. Supermarkets make more money than the farmers for the milk.

(22) Are there any o her factors that should be taken into account regarding the domestic consumer dairy markets? Please provide your reasons and information/evidence in support of your views.

Chapter 4: Options for change

Section 4.1: DIRA open entry requirements

Please refer to [Section 4.1] of the discussion document.

(23) Are there any other options for the DIRA open entry requirements that you think should be considered? Please provide sufficient detail when describing any alternative options as well as reasons for considering these.

We believe another option should be that Fonterra can decline a request to supply due to limitations in processing capacity with no time restrictions.

We support option 4.1.3

(24) What costs and benefits would each of the options for the DIRA open entry requirements create for your business? Please provide quantitative information if possible.

New milk may be uneconomic milk for the cooperative therefore having a negative influence on our bottom line.

(25) How well do you think each of the options for the DIRA open entry requirements would perform against the principles of good regulatory practice of promoting certainty and predictability of regulatory outcomes, transparency, cost-effectiveness and timeliness of regulatory processes?

(26) What is your preferred option for the DIRA open entry requirements? Please provide your reasons and information/evidence in support of your views.

As above

Section 4.2: Access to regulated milk for large dairy processors (except Goodman Fielder)

Please refer to [Section 4.2] of the discussion document.

(27) Are there any other options for access to regulated milk for large dairy processors that you think should be considered? Please provide sufficient detail when describing any alternative options as well as reasons for considering these.

The litreage available to supply should be decreased and limited to a certain number of companies providing consumer markets within New Zealand only. All exporting companies should source their own milk independent of Fonterra.

(28) Do you consider that the proposed 30 million litres threshold is too high or too low? If so, what would you consider the right threshold o be, and why?

Too high. If it is sourced for a NZ consumer market only, 10million litres/year should be adequate.

(29) What costs and benefits would each of the options for access to regulated milk for large dairy processors create for your business? Please provide quantitative information if possible.

(30) How well do you think each of the options for access to regulated milk for large dairy processo s would perform against the principles of good regulatory practice of promoting certainty and predictability of regulatory outcomes, transparency, cost-effectiveness and timeliness of regulatory processes?

(31) Do you have a preferred option for access to regulated milk for large dairy processors? Please provide your reasons and information/evidence in support of your views.

As above

Section 4.3: Options for the base milk price calculation

Please refer to [Section 4.3] of the discussion document.

(32) Are there any other options for the base milk price calculation that you think should be considered? Please provide sufficient detail when describing any alternative options as well as reasons for considering these.

Status quo but applicable to all processors. Asset Beta is minor in our opinion.

(33) What costs and benefits would each of the options for the base milk price calculation create for your business? Please provide quantitative information if possible.

(34) How well do you think each of the options for the base milk price calculation would perform against the principles of good regulatory practice of promoting certainty and predictabi ity of regulatory outcomes, transparency, cost-effectiveness and timeliness of regulatory processes?

(35) Do have a preferred option for the base milk price calculation? Please provide your reasons and information/evidence in support of your views.

Section 4.4: Options for access to regulated milk for Goodman Fielder and smaller processors

Please refer to [Section 4.4] of the discussion document.

(36) Are there any other options for access to regulated milk for Goodman Fielder and smaller processors that you think should be considered? Please provide sufficient detail when describing any alternative options as well as reasons for considering these.

Goodman Fielder should be excluded from DIRA.

(37) What costs and benefits would each of the options for access to regulated milk for Goodman Fielder and smaller processors create for your business? Please provide quantitative information if possible.

(38) How well do you think each of the options for access to regulated milk for Goodman Fielder and smaller processors would perform against the principles of good regulatory practice of promoting certainty and predictability of regulatory outcomes, transparency, cost-effectiveness and timeliness of regulatory processes?

(39) Do you have a preferred option, or a combination of options, for access to regulated milk for Goodman Fielder and smaller processors? Please provide your reasons and information/evidence in support of your views.

As above

Section 4.5: Options for the DIRA review and expiry provisions

Please refer to [Section 4.5] of the discussion document.

(40) How best do you consider "market dominance" could be measured? For example, are there certain criteria (other than a market share threshold) that could be provided for in legislation as a trigger for review and/or expiry of the DIRA?

We support option 4.5.2. A periodic review with certain triggers could be in place. *Measuring market dominance based on market share is static, looking at what determines "the market" eg. Domestic and export market as well as "the market share" e.g. shareholders.* *We believe that anything decreasing the milk price will similarly decrease farmers profit.*

(41) Are there any other options for the DIRA review and expiry provisions that you think should be considered? Please provide sufficient detail when describing any alternative options as well as reasons for considering these.

(42) What costs and benefits would each of the options for the DIRA review and expiry provisions create for your business? Please provide quantitative information if possible.

(43) How well do you think each of the options for the DIRA review and expiry provisions would perform against the principles of good regulatory practice of promoting certainty and predictability of regulatory outcomes transparency, cost-effectiveness and timeliness of regulatory processes?

(44) Do you have a preferred option, or a combination of options, for the DIRA review and expiry provisions? Please provide your reasons and information/evidence in support of your views.

As above

Economic Analysis of Base Milk Price Framework under the Dairy Industry Restructuring Act

Report to Open Country Dairy Limited

February 2019

Acronyms and Abbreviations

AMF	Anhydrous milk fat
BMP	Buttermilk powder
Calculation	Milk Price Calculation
Commission	Commerce Commission
DIRA	Dairy Industry Restructuring Act 2001
FGMP	Farmgate Milk Price
GDT	Global Dairy Trade
Manual	Milk Price Manual
MBIE	Ministry of Business, Innovation, and Employment
MPI	Ministry for Primary Industries
OCD	Open Country Dairy
Review	MPI's Review of DIRA and its impact on the dairy industry
RCP	Reference commodity products
WACC	Weighted Average Cost of Capital
WMP	Whole milk powder

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Executive Summary

The Ministry for Primary Industries (MPI) is carrying out a review of the Dairy Industry Restructuring Act 2001 (DIRA) and its impact on the dairy industry. MPI has issued a discussion document and requested submissions from stakeholders. DIRA provided for the establishment of Fonterra as the dominant dairy processing and marketing company in New Zealand but in return included provisions that regulate Fonterra's conduct not only to prevent the use of Fonterra's market power to damage competition but to actively promote more competitive outcomes.

One of the cornerstone provisions of DIRA is the base milk price setting regime contained in Part 5A. The regime is intended to promote contestability in the market for milk processing by sending farmers efficient and consistent price signals about the value of raw milk and the returns achieved by the processors. Since the New Zealand dairy industry is dominated by Fonterra (a cooperative), an externally supervised milk price mechanism is necessary to separate the combined cooperative payout into a milk price and dividend in order to enable farmers to make an informed decision about who they wish to supply. As a dominant milk processor in New Zealand, if left unchecked Fonterra would have the ability to set a raw milk price in pursuit of any commercial objective it wished. Some of Fonterra's commercial objectives may be consistent with the interests of economic efficiency, but as is the case with any dominant firm, some will not be.

Under the base milk price setting regime, Fonterra publishes a Milk Price Manual which is approved every year by the Fonterra Board. At the end of each season, a milk price calculation takes place, based on the Manual to determine the Farmgate Milk Price (FGMP). Both the Manual and the calculation are subject to high-level Commerce Commission monitoring, with limited enforcement mechanisms.

The Manual calculates the milk price by subtracting costs incurred by a hypothetical processor from the revenues of a specified basket of commodities. In a competitive market with free entry by processors, there would be no expected economic rent from processing raw milk into internationally traded commodities and hence the price of raw milk in the absence of cooperative structures would be set by the difference between the actual revenues from the commodities and the actual efficient costs of processing. The Manual is intended to approximate that outcome by estimating the costs of a hypothetical processor and subtracting those costs from revenues of a basket of commodities produced by such a processor. As we explain in this report, however, the less realistic the construction of costs of a hypothetical processor, and the more opaque the calculation of revenues, the less likely it is that the calculations under the Manual would approximate market outcomes.

The MPI discussion document further states that the base milk price regime under DIRA incentivises Fonterra to use price signals as the means of managing the volume of its milk supply. We note that in a competitive market, milk price would provide medium-term signals over the supply of milk depending on the trends in global commodity prices relative to the cost of processing. However, in such a market, no single processor would have the market power to set a milk price at their discretion in order to manage their own milk supply. Rather, a secondary market for raw milk would enable processors to trade unders and overs and ensure that milk supply to each processor is matched to respective processing capacities.

Key question for this report

Open Country Dairy Limited (OCD) has commissioned Castalia to review the milk price setting regime under DIRA and provide an economic assessment of Fonterra's conduct. In particular, we ask whether Fonterra's application of the regime complies with DIRA's objectives and is consistent with what would be expected in a reasonably competitive market. Our approach is to review every element of the base milk price regime over which Fonterra has practical discretion and has exercised that discretion, and to ask what the best explanation for that exercise of discretion may be.

We note that Fonterra has, in its public relations statements, advanced various explanations for its actions in relation to the raw milk price. Various recent statements by Fonterra's directors indicate that Fonterra aims to set the raw milk price in New Zealand to match raw milk prices paid to farmers in the EU and the US. While global consistency appears an attractive message, the objective has no economic basis. Raw milk is not traded globally, and hence differences in raw milk price between New Zealand and other producing countries do not have any effect on raw milk supply. The only relevant question is whether the raw milk price covers the cost of raw milk production in each country. If the raw milk price falls below the cost of local production, supply will decline and if the price increases, supply will grow.

Conclusion of this report

We find that Fonterra consistently and strategically uses the discretion available to it to influence the Milk Price Manual and the calculations carried out under the Manual to increase the FGMP. The most likely explanation for this behaviour of consistently and apparently single-mindedly increasing the FGMP is to weaken competition in the market for the processing of raw milk. Setting an artificially high milk price is one of the most direct ways for Fonterra to act on its incentive to weaken processor competition. A small increase in the FGMP has a very significant impact on the earnings of independent processors – in the order of a $1.55 million reduction in earnings for OCD for every 1 cent increase in FGMP.

An alternative explanation that Fonterra seeks to influence FGMP in order to manage the supply of milk to achieve efficient utilisation of its processing capacity is not consistent with the factual reality. Fonterra continued to make discretionary adjustments to the application of the Milk Price Manual, which resulted in higher FGMP even in years when it complained about local over-supply. Moreover, the hypothetical processor construct makes it unlikely that Fonterra could use the estimated costs for the hypothetical processor as a target to drive its internal efficiency. In fact, as our analysis shows, some of the parameters for the hypothetical processor have been set at levels that are not practically possible—an exercise of discretion consistent with the logic of increasing FGMP but not consistent with using the Milk Price Manual as an internal benchmarking tool.

A systematically inflated milk price damages efficiency in the dairy sector by suppressing the ability for independent processors to compete with Fonterra and for potential new processors to enter the market. This reduces contestability in the market and reduces incentives for greater efficiency because competitive pressure on Fonterra is weakened. Indeed, the moderate degree of change in industry structure since the introduction of the base milk price framework supports this conclusion. We find that the high-level external monitoring currently provided by the Commerce Commission does not appear to provide any material constraint to Fonterra's pursuit of a higher raw milk price than would be consistent with logical application of the requirements for the Milk Price Manual set out in DIRA.

Analysis of policy options

Overall, we conclude that Fonterra's revealed behaviour shows that the reasons for the regulatory oversight of the setting of raw milk price by Fonterra built into DIRA remain valid. However, our review of experience under the current regime also shows that Fonterra has such a wide degree of discretion as to make regulatory oversight largely ineffective. If regulatory oversight is needed overall, then it also is needed for all aspects of the regime. Leaving wide areas for discretion effectively abandons oversight.

MPI presented three options in its discussion document to address the base milk price regime. We find that the only option that would fulfil policy objectives and result in net positive outcomes (taking into account regulatory costs) would be an independent price setting mechanism administered by the Commerce Commission or by a new indep ndent dairy authority.

1 Introduction

The Ministry for Primary Industries (MPI) is carrying out a review of the Dairy Industry Restructuring Act (DIRA) and its impact on the dairy industry (the Review). The Review has a broad mandate, and covers all aspects of DIRA, the role of Fonterra, as well as other regulations and policies that impact the dairy industry. MPI released its discussion document on the Review in November 2018 and has requested feedback on its preliminary findings and in response to specific questions by 8 February 2019.

Open Country Dairy Limited (OCD) is the largest independent dairy processor in New Zealand. OCD has commissioned Castalia to analyse DIRA's milk price monitoring regime and the Review's preliminary findings.

DIRA provides for Commerce Commission monitoring of Fonterra's Milk Price Manual (Manual) at the beginning of the season, and Milk Price Calculation (Calculation) at the end of the season. This framework requires that Fonterra use the Manual to calculate the Farmgate Milk Price (FGMP). The FGMP is effectively a New Zealand-wide benchmark for the price paid to farmer-suppliers. The Commerce Commission (Commission) monitors and reports on Fonterra's finalisation of the Manual at the commencement of each season and the Calculation at the conclusion of each season.

In addition, DIRA provides for open entry to Fonterra for any dairy farmer-supplier that meets the minimum requirements and purchases sufficient shares. Open exit rules enable farmers to more freely switch from Fonterra to supply another processor or convert the land to another use.

1.1 Key Question for the Review on Milk Price Monitoring

A key question for the Review and the key question for this report is whether the current milk price monitoring regime is meeting important public policy objectives for the dairy sector and how the regime interacts with other aspects of DIRA, such as open entry and exit. It is important to explore whether the base milk price framework gives Fonterra, as the dominant processor, excessive discretion to set the FGMP. Concerns about discretion arise if the available discretion is consistently used to promote outcomes that reduce competition in the market.

MPI's Discussion Document as well as the Frontier Economics report[1] that supports it appear to assume that Fonterra is primarily concerned with volume risk when it sets the FGMP under the base milk price framework:

> MPI's Discussion Document:
>
> *Higher prices for farmers' milk and a lower cost of shareholding tend to incentivise increased milk production. If Fonterra sets a milk price that is "too high" and the cost of shareholding in Fonterra that is "too low" it risks incentivising farmers to produce excessive volumes of milk. Of necessity, excessive milk production will require investment in additional processing capacity that is capable of managing large volumes (i.e. commodity processing).*[2]
>
> Frontier Economics report:

[1] Frontier Economics, 2018 DIRA Review: Analysis of industry performance, August 2018

[2] Ministry for Primary Industries, Review of the Dairy Industry Restructuring Act 2001: Discussion Document, November 2018, page 13:

> *If Fonterra sets a price too high for milk, it will receive inefficiently high volumes of milk from farmers as the high price will provide farmers with the incentive to enter and/or expand. DIRA requires Fonterra to accept all entry. On the other hand, if Fonterra set a price too low, then farmers may exit Fonterra to supply independent processors and/or new independent processors may enter to compete against the low milk price.*[3]

Frontier Economics also assume that the current institutional and market arrangements have "*likely helped*" to ensure that farmers receive an efficient price for their milk.[4] Frontier Economics' conclusion appears to rely on the Commission's assessment of its own performance in monitoring the base milk price framework. It is therefore also necessary to compare, with reference to empirical evidence, the behaviour of Fonterra under the base milk price regime to the expected behaviour if the policy objectives were being met

1.2 Structure of this Report

This report sets out our analysis in the following sequence:

- We summarise the role of the base milk price framework in the dairy industry and explain the formation of the FGMP by Fonterra (including where Fonterra has discretion for inputs)
- We set out possible hypotheses for the incentive that would drive Fonterra's use of discretion in the base milk price framework. Either:
  - Fonterra wants to use the FGMP to manage milk supply flow in a way that efficiently aligns with its investment program, or
  - Fonterra aims to create barriers to potential new processors by increasing the milk price.
- We test and analyse the evidence of drivers of the milk price and Fonterra's use of discretion in the base milk price framework:
  - Short and long term drivers of milk prices and supply
  - Fonter a's observed use of discretion in base milk price framework
  - Evidence of Fonterra using the notional processor cost calculations as a benchmark to manage its own costs and efficiency
- We revi w the industry's structural change and market forces and whether this has reflected an effective base milk price framework whereby the right incentives exist for Fonterra to set an efficient and practically feasible milk price
- We conclude that Fonterra does use its discretion in the FGMP process to increase the milk price in order to harm its processor competitors and potential new entrants
- Finally, we evaluate the options for reform of the milk price setting mechanism against key policy criteria, finding that an independent, transparent mechanism is needed.

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[3] Frontier Economics, 2018 DIRA Review: Analysis of industry performance, August 2018, page 19.

[4] Frontier Economics, p. 50

2 Base Milk Price Mechanism for Fonterra's Farmgate Milk Price

It is important to precisely explain the role of the base milk price framework for the dairy processing industry. The base milk price framework was introduced with certain policy intentions under the DIRA amendments in 2012. In addition, it is important to understand Fonterra's role in setting the FGMP under the framework through the Manual and Calculation.

The interpretation by MPI[5] of the purpose of the base milk price regime appears to diverge somewhat from the original intention of the 2012 amendments to DIRA which was to promote a price that would arise in a contestable market for farmers' milk. In a contestable market, farmer suppliers would be able to choose between multiple processors. Processors would need to set a raw milk price that attracts enough supply. Since more efficient processors would be able to pay a higher price, a contestable market would drive the overall efficiency of the processing industry in the interests of farmers.

We note that a New Zealand raw milk price consistent with contestable market outcomes may have no relationship to raw milk prices in other geographic markets.

In practice, the FGMP is a de-facto benchmark for the processing industry. While independent processors may occasionally deviate from the benchmark, such deviations cannot be sustained over the medium term. This is an important fact which must precede analysis of Fonterra's pricing conduct.

2.1 Base Milk Price Framework in the Dairy Industry

In this section we look in more detail at the background and role of the base milk price framework and show how the FGMP sets an industry benchmark.

Components of the FGMP

The concept of a notional processor, as opposed to Fonterra itself, is used to determine the FGMP under the base milk price framework. The conceptual basis for this is that a notional processor sets a more objective benchmark of what is efficient and practically feasible for the purposes of determining input costs, efficiencies, and revenues.

The notional processor produces five commodity products on a manufacturing plant footprint the same as Fonterra's. A combination of actual Fonterra data and key assumptions are used to determine the notional processor's milk price.

The inputs into the FGMP calculation are:

- Revenue from converting all the raw milk supplied to Fonterra into a portfolio of reference commodity products (RCPs), and sold on international dairy markets

less

- Operating costs, including collection costs, processing costs, transport costs, cost of sales, administration costs and tax
- Capital costs of the notional processor including depreciation of fixed assets, return on and capital investment, and working capital.

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[5] Ministry for Primary Industries, Review of the Dairy Industry Restructuring Act 2001: Discussion Document, November 2018, page 13

Original intention for the milk price framework

The FGMP is an important element in ensuring an efficient dairy processor market exists. It was introduced from 2009, after Fonterra unbundled the price paid for raw milk and the returns on equity capital to its farmer-shareholders. It is intended to reflect the price that the notional, efficient processor would pay for raw milk. The monitoring of Fonterra's setting of the FGMP occurred from 2012, after DIRA was amended.

The published original intent of the milk price framework was to "*promote transparency of, and confidence in, Fonterra's milk price setting process and to promote a price that would arise in a contestable market for farmers' milk*."[6] This differs slightly from MPI's current interpretation. MPI interpret the framework as follows: "*the chief way in which the DIRA intervenes in the industry dynamics is by incentivising Fonterra to use price signals as the means of managing the volume of its milk supply*."

The FGMP is the price that Fonterra pays for milk solids calculated under the Milk Price Manual (Manual). The Manual and Calculation prepared by Fonterra are reviewed by the Commerce Commission separately each year. Fonterra's final milk price paid to farmers only deviates from the FGMP in exceptional situations.[7]

The FGMP was intended to provide for a mechanism for setting milk prices that is independent of Fonterra's competitive incentives. It was designed to provide transparency in how Fonterra calculates the price it pays for raw milk and whether that price is efficient.[8] The reality is that the FGMP is not an outcome of pure market dynamics. Since Fonterra is by far the largest processor, and the only processor present in all dairy regions, it has a dominant role in price setting. Instead, the FGMP is determined by Fonterra (with Commission oversight) with reference to notional and actual metrics.

Benchmarking role of the FGMP

The FGMP sets out to approximate the outcomes of a competitive market for the price of raw milk but in practice determines market outcomes whether it is a good approximation or not. Both the prices paid and the timing of price announcements of Fonterra's independent processor competitors are determined with reference to the FGMP. Independent processors generally match the amount of the FGMP set by Fonterra. Figure 2.1 below illustrates the price-matching behaviour. The timing of the announcement of independent processors' prices also tends to follow shortly after Fonterra's FGMP announcements of public price forecasts and final price announcements (although OCD has recently changed to pre-empting Fonterra's FGMP announcements after carrying out its own analysis of Fonterra's likely FGMP).[9]

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[6] In MPI's Departmental Report to the Primary Production Select Committee considering the Dairy Industry Amendment Bill 2012, MPI stated: "The objective of the regime is to promote transparency of, and confidence in, Fonterra's milk price setting process and to promote a price that would arise in a contestable market for farmers' milk." (available at: https://www.parliament.nz/resource/en-NZ/50SCPP_ADV_00DBHOH_BILL11262_1_A240504/20bb7440f168fab89f3dde2ef672a7662932386f)

[7] Raw milk with special characteristics, such as organic milk and winter milk is priced with reference to the FGMP. However, the majority of milk supplied to Fonterra is priced at the FGMP.

[8] Ministry for Primary Industries (2012), Dairy Industry Restructuring Amendment Bill, Departmental Report for the Primary Production Select Committee, available at: https://www.parliament.nz/resource/en-NZ/50SCPP_ADV_00DBHOH_BILL11262_1_A240504/20bb7440f168fab89f3dde2ef672a7662932386f

[9] Open Country Dairy (2015), Submission to Commerce Commission's Review of the State of Competition in the New Zealand Dairy Industry, Fig. 1, p. 2. Available at: https://comcom.govt.nz/__data/assets/pdf_file/0025/88324/Open-Country-Dairy-Submission-on-Dairy-Competition-Review-10-July-2015.PDF

Independent processors have limited interest in paying a milk price to their suppliers that is higher than the FGMP. They are highly incentivised to match Fonterra's price under the FGMP. Oceania Dairy, however, has a policy to pay a premium to Fonterra's announced milk price, as a strategic choice to build market share.[10]

There are risks to the independent processors from paying a milk price that is significantly lower than the FGMP announced by Fonterra. Open entry and exit rules under DIRA mean that farmers[11] can generally switch to Fonterra from season to season if they perceive that the independent processor will underpay relative to the price paid by Fonterra.

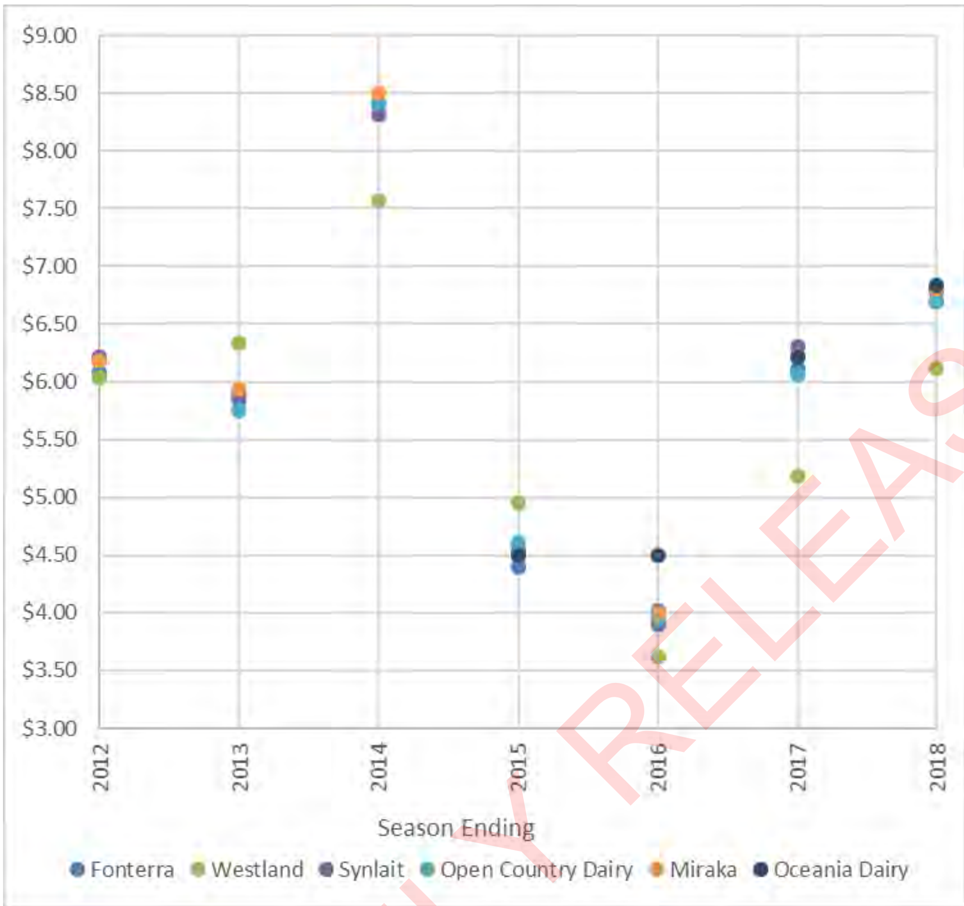
We understand that farmers do quickly switch to Fonterra from an independent if the Fonterra price is higher than the price paid by an independent processor. For exampl we understand that OCD lost 30 percent of its suppliers after the 2011 season after its payout was 4 cents[12] lower than Fonterra's.

[10] Oceania Dairy's premium to the announced Fonterra price has been between 15 and 60 cents since the 2014/15 season. Dairy Company Pay-Out History, available at: https://www.interest.co.nz/rural-data/dairy-industry-payout-history

[11] In geographic areas where supply to Fonterra and another processor is possible (that is, excluding parts of West Coast/Buller where Westland Dairy is the only processor and Wairarapa and Northland where only Fonterra is active).

[12] https://www.interest.co.nz/rural-data/dairy-industry-payout-history

Figure 2.1: Independent processors' price-matching behaviour



Source: Interest.co.nz "Dairy industry payout history", available at: https://www.interest.co.nz/rural-data/dairy-industry-payout-history (accessed 24 January 2019)
Note: Westland operates mainly in a region where there are no alternative processors for the region's farmer-suppliers

2.2 Fonterra s Farmgate Milk Price-Setting Process

Fonterra finali es and publishes the Manual and applies it in its annual Calculation to determine the FGMP In doing so, Fonterra has some discretion with regard to the inputs into the FGMP

Fonterra ha discretion in its preparation and amendments to the Manual and also in the application of the Manual in the annual Milk Price Calculation (Calculation). Both Manual and Calculation incorporate a range of variables to determine the FGMP of a notional milk processor.

As outlined above, the FGMP is the residual of the revenues the notional processer would earn from selling a basket of commodities (the RCPs) less the costs of sales. Fonterra has discretion both on the revenues and costs inputs to the FGMP equation.

Fonterra's Discretion on Revenue Inputs

Fonterra sets the revenues in the Calculation with reference to a basket of commodity milk products (the reference commodity products or RCPs). The RCPs include whole milk powder (WMP) and skim milk powder (SMP), and their by-products which are buttermilk powder (BMP), butter and anhydrous milkfat (AMF).

In order to determine the revenues, Fonterra takes its actual milk supply in a season, converts it into the five RCPs, makes certain yield assumptions, and multiplies the quantities by a chosen sale price.

Fonterra has discretion regarding the reference sale prices it uses for the RCPs in the Calculation. It can use publicly quoted Global Dairy Trade (GDT) auction platform prices. It has also used non-public bilateral contract prices from its actual sales to customers. These are the so-called "off-GDT" sales. For the 2016/17 season, Fonterra amended the Manual to give it further discretion to select the sale price it uses in this calculation.

Both the choice of GDT versus off-GDT sales, and proportions of each in the Calculation are discretionary. The Commission takes a view in its review of the Calculation whether the use of off-GDT sales (and proportion as compared to publicly quoted GDT sales) is practically feasible for the purposes of section 150A DIRA.

The timing of sales of the RCPs, so-called sales phasing, influences the revenues earned. Fonterra can align the notional processor's sales with its own phasing of sale. This means that the phasing is commercially confidential, and unknown to independent processors. Because of the peakiness of the New Zealand dairy season, and effect on global prices, the sales phasing can be important for the revenues earned.

Fonterra also has discretion to make yield assumptions in the calculation. In the process of converting raw milk to RCPs, there is variation in raw milk supplied, and loss of valuable component products (fats and proteins). Therefore, when determining the amount of processed RCPs, Fonterra has to make yield assumptions.

Finally, Fonterra has discretion on the foreign exchange rates (forex) used to calculate the revenues in New Zealand dollars that the notional processor makes for the sold RCPs. Since the RCP sales are made by the notional processor, Fonterra must assume the applicable rate which means that the timing of the RCP sale transaction is important.

Fonterra's Discretion on Costs Inputs

Fonterra also has discretion to determine which costs inputs to use in the calculation to set the FGMP. The base milk price regime determines the FGMP as a residual of revenues from processed milk products, less costs. The costs are capital costs and cash operating costs. Capital costs are mostly fixed but will include a range of discretionary variables such as risk assumptions for cost of capital. Operating costs include all the variable costs associated with getting the milk to the processing plants and converting it into the RCPs for sale.

Fonterra determines the level of the following cost inputs, with reference to either actual or an assumed notional reference point:

- Estimated asset beta for the weighted average cost of capital (WACC) with reference to the assumed notional processor
- Operating cost inputs assumptions based on a notional processor's footprint, but Fonterra's actual milk supply
- Asset values used in capital charge calculation, based on a notional processor's plant footprint
- Energy costs based on notional unit cost rates and notional usage
- Collection and transport costs, based in part on Fonterra's actual costs, but variable in the assumptions used for transporting to and from various factories

- Costs of procuring winter milk (if any) with reference to the assumed notional processor
- Costs of providing financial support to farmers with reference to the assumed notional processor.

Fonterra's discretion on the application of the Milk Price Manual

Fonterra has discretion whether or not to actually follow the Manual-compliant price when it finalises the actual final milk price payment it pays to its farmer-suppliers. Once the FGMP is determined following the Calculation in accordance with the Manual (including use of Fonterra's discretionary inputs discussed above), Fonterra then faces a choice on whether to actually pay its suppliers the resulting price, or to deviate from it. Under the Fonterra constitution, the Fonterra Board can elect not to pay farmers the Manual compliant FGMP, if it is in the best interests of the cooperative.

In most seasons, Fonterra has paid its farmers a milk price the same as th Manual-compliant FGMP. Since the base milk price framework was introduced in 2012, it has only deviated from the FGMP twice. This occurred for the 2013/14 season where Fonterra adjusted the milk price actually paid to farmers downwards by 55 cents. It also occurred in for the 2017/18 season with a much smaller adjustment of 5 cents.

3 Analysis of Fonterra's Use of Discretion in the Base Milk Price Framework

Given the stated purpose of the base milk price regime, and Fonterra's discretion to adjust variables in the calculation to determine the FGMP, we examine the instances of Fonterra's use of discretion, and the possible explanations for the exercise of discretion.

We wish to test two hypotheses as to why Fonterra would use discretion to adjust inputs into the FGMP.

- The first hypothesis is that Fonterra seeks to manage its own milk volume risk and set an efficient price for milk. If this hypothesis is correct, then we would expect Fonterra to be using its discretion within the base milk price framework to influence the efficient supply of milk in both directions. That is to say, if the residual FGMP under the base milk price regime was indeed set at an efficient level, then we would expect the discretionary inputs to be used to influence the price both upwards and downwards.
- The alternative hypothesis is that Fonterra wants to influenc the price that its competition pays for milk and therefore the level of competition it receives from independent processors and potential new process r competitors. If this hypothesis is correct, then we would expect Fonterra to be using its discretion to increase the FGMP.

We test the two hypotheses by reviewing a range of th following information:

- Short and long-term drivers of milk prices and supply (section 3.1)
- Fonterra's observed use of discretion in base milk price framework (section 3.2)
- Evidence of Fonterra using th notional processor inputs as a benchmark for its own costs and effici ncy (section 3.3)

Finally, we reach a conclusion on a balance of probabilities of the direction of the exercise of discretion (section 3.4)

3.1 Short- and Long-Term Drivers of Milk Price and Supply

There are different possible drivers of milk price which can be determined by analysing the relationship between milk price signals and milk supply. We examine the short-run drivers of milk production (supply) and the long-run drivers of milk supply. We then discuss the factors that milk processors must take into account given the short- and long-run supply drivers.

Short-run drivers of milk production and supply

In the short-run, farmers have only limited ability to alter milk supply in respon e to changes in price. The milking season runs from around August to April, so that milking of cows can coincide with the optimum grass growing period. Accordingly, there is a significant peak in supply in October and supply declines until cows are 'dried off' in May.

The national dairy herd remains more or less fixed once the season has begun If there is any change in the milking herd, it can only decrease. Suppliers can increase production in limited ways in response to high prices. Supplemental feed can boost production somewhat. Cows can be milked for longer, rather than 'dried off' earlier

However, large step changes in production are not possible within the eason as investment necessarily precedes the production season (cows must be bred, additional land converted, additional milking capacity built and installed).

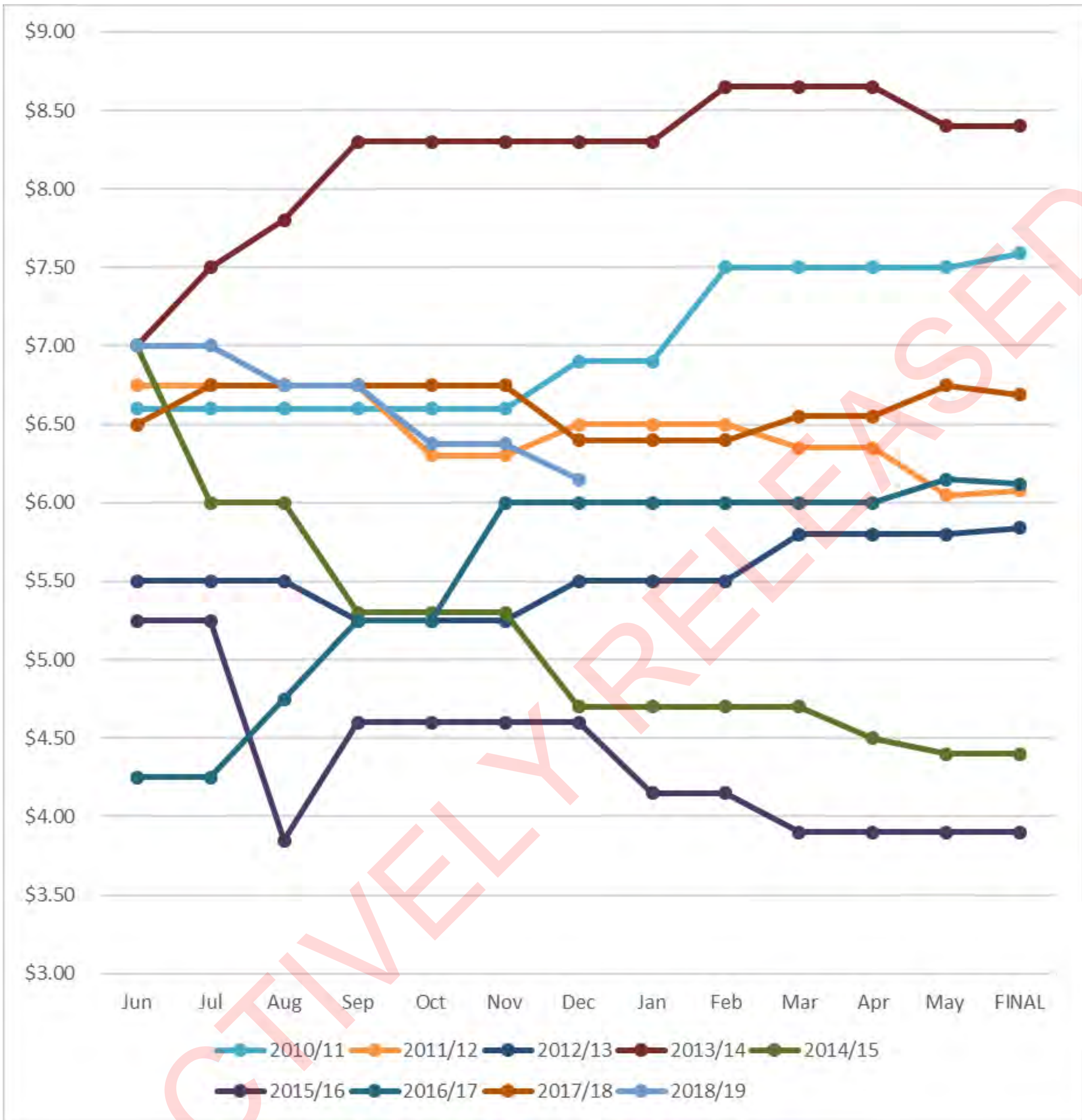
Increases in supply during a season tends to have a mixed effect on the final milk price. Climatic conditions also contribute signific ntly to the seasonal milk production. Favourable climatic conditions can increas supply greatly, and suppress the price paid.[13]

Farmers are only advised of the final FGMP with certainty at the end of the season (after the peak). During the season there are price fo ecast announcements by processors as well as forecasts by banks and other market commentators. Therefore, suppliers have only a limited, and uncertain, price signal during the season on which to base any operational decisions that would change milk production.

Price forecasts exhibit high variability over the season, and are just as likely to be lower than the final price, as they re higher. Figure 3.2 illustrates Fonterra's price forecasts throughout the season, with the final price confirmed for June. There has been significant variation betw en for cast prices and the final June amount. In 2013/14 the highest and lowest forecast varied by $1.65. The average variation from the mean forecast price between the 2010/11 season and the current 2018/19 season is 35 cents.

[13] For example, climatic conditions that increase milk production can have a negative effect on the milk price. ASB's chief rural economist reported in October 2018 that record milk production in the (current) 2018/2019 season meant ASB lowered its forecast by 25 cents to $6.25.

Figure 3.1: Fonterra's Milk Price Forecasts and Final Price



Source: ASB Ba k rural economics data, Fonterra public announcements

Long-run drivers of milk supply

In the long-run, farmers can make investment decisions to make more significant changes in milk production. The evidence shows that over a longer time frame, farmers respond to high price expectations from high demand with higher milk supply.

In the long-run, higher milk prices incentivise higher production, all else equal. Frontier Economics in their report for MPI note that development in global dairy markets since the formation of Fonterra (that is, an increase in demand) has driven an expansion of production, both on existing dairy farms and through conversion of land to dairy farming.[14]

[14] Frontier Economics (2018), 2018 DIRA Review: Analysis of industry performance, Report for MPI, p. 15: "the significant growth in the value of the New Zealand dairy sector since 2001 appears to have been driven largely by global demand for dairy products, rather than large and sustained increases in global dairy prices."

Essentially, the global demand for processed dairy products and commodities, relative supply of milk around the world, and relative supply in New Zealand has driven the growth in New Zealand milk supply.

As MPI and Frontier Economics note, the long-run trend since the creation of Fonterra was an increase in demand, which manifested in periods of higher raw milk prices. The New Zealand dairy industry responded to this with increased investment and subsequent increased production. Farmers were incentivised to expand existing farming operations or enter new land into production. The long-run higher milk prices led to greater intensity production on existing dairy land as well conversions of previously non-dairy land to dairy farming.

Processors' decision-making given farmers' production incentives

Processors invest in capacity to cope with peak milk production periods. As discussed above, the production profile of New Zealand's dairy season results in the largest flows of milk in October and November. Processors (especially Fonterra) must invest for peak production of around 80 million litres of raw milk per day. Milk flows in June/July in contrast are around 5 million litres of raw milk per day.

The 'peakiness' of the season makes volume risk a material concern for processors. Since processing facilities can remain unused for much of the year, processors are concerned with optimising investment in plant over the long term.

Given the largely long-run nature of farmers' supply response to higher (or lower) prices, processors' interest in volume risk is largely a long-run matter. Plant investment is managed over the long-run.

Processor capacity can be accessed via secondary milk market

Finally, processors have the ability to cope with milk oversupply by selling raw milk into the secondary market. If a processor were to gain significant new supply due to switching, milk can be on-sold to other processors. Generally speaking, the overall processing capacity of the industry would remain in place from one season to another. So where one processor gains significant milk supply volume as a direct result of suppliers switching from another processor, the other processor is likely to have free processing capacity. That processor can take on the excess milk in the secondary market, avoiding waste.

3.2 Fonterra's Observed Exercise of Discretion in Base Milk Price Framework

As set out in section 2 above, Fonterra can use discretion to amend certain inputs for the FGMP. Fonterra can make changes to the Manual, as well as make discretionary changes to the Calculation. It can adjust inputs and variables in both the calculation of revenue from RCPs and the costs component.

In the following we review the instances where Fonterra has exercised its discretion within the base milk price framework. More detailed discussion of Fonterra's use of discretionary inputs in the base milk price framework is set out in Appendix A. We address:

- Fonterra's exercise of discretion on the revenue inputs
- Fonterra's exercise of discretion on the cost inputs
- Fonterra's exercise of discretion to depart from the Manual-compliant FGMP and pay a different milk price.

We draw a distinction about the exercise of discretion within the Milk Price Manual framework—something that potentially is subject to regulatory oversight and produces outcomes with lasting, strategic effects—and the exercise of discretion to deviate from FGMP altogether, which at present does not attract any regulatory oversight but potentially is limited in impact to one season.

As we explain below, while there are instances of on-off deviations from the Milk Price Manual-compliant FGMP which involved reductions in raw milk price, every single adjustment to the Milk Price Calculations has resulted in upward changes to the FGMP.

3.2.1 Fonterra's Exercise of Discretion on Revenue Inputs

Fonterra has used its discretion to adjust the revenue inputs in the base milk price framework in a manner that has increased the FGMP. It has exercised discretion over the reference prices for the RCPs. It also uses the actual (commercially confidential) Fonterra seasonal sales curve, rather than a notional curve to determine the timing of sales of RCPs

Off-GDT sales to determine the revenue component

As set out in section 2 above, in order to assess the revenues from sales of the RCPs of the notional processor, Fonterra derives prices from transactions that it is involved in that include the RCPs. It has discretion to use GDT prices or off-GDT sales.[15] GDT sales are public and closely followed by the industry and economic commentators The sale price, volume, and exact specifications of the RCP are all publicly discl sed. Off-GDT sales are bilateral contracts and confidential. The sale price, volume, exact product specifications, and delivery and payment terms are not public.

Fonterra has used off-GDT sales figures in its revenue calc lation since 2012/13 as set out in the following table.

Table 3.1: Fonterra's Use of Off-GDT Sales in Base Milk Price Framework

Season	Proportion of off-GDT sales	Comment
2012/13	10 percent	Fon erra justified the use of off-GDT sales by the fact that 90% of the milk price revenue was derived from WMP, SMP, and AMF. The remaining 10 percent was butter. Butter was not traded on GDT and therefore it was reasonable for Fonterra to use a sample of off-GDT reference prices.[16]
2013/14	Approx 7 percent	Fonterra amended the Manual in this season to give it slightly more discretion to use off-GDT sales (replaced "will" for "should" on page 19, and introduced "terms that are comparable to those applying to sales on GDT" in Rule 5.[17] Fonterra included some BMP and butter off-GDT prices in its calculation.
2014/15	10 percent	Fonterra included some BMP and butter off-GDT prices in its calculation. The Commission noted in its 2015/16 Manual

[15] Rule 5 of the Manual permits Fonterra's Board the discretion to determine whether it is appropriate to derive prices for RCPs with reference to GDT sales, provided some subjective criteria are complied with.

[16] Commerce Commission, Final Report on Review of Fonterra's 2012/13 Milk Price Manual, 14 December 2012, page 52.

[17] Commerce Commission, Final Report on Review of Fonterra's 2013/14 Milk Price Manual, 16 December 2013, page 31.

		review that 10 percent of the notional processors' reference sales were off-GDT.
2015/16	10 percent (estimate by OCD)	The Commission commented in its review of the Calculation for the 2015/16 season that Fonterra was now selling a higher proportion of RCPs off-GDT. Fonterra claimed it was achieving higher sale prices off-GDT.
2016/17	Approx. 45 percent[18]	Fonterra expanded the use of off-GDT sales to cover WMP, SMP, and BMP prices. Fonterra claimed that using off-GDT sales was necessary because GDT sets the 'base' price for sales of RCPs, with sales undertaken off GDT almost invariably being transacted at higher prices.[19] The resulting increase in the FGMP was 6 cents per kgMS.[20]
2017/18	45 percent	Fonterra again used a high proportion of off-GDT sales.

Source: Commerce Commission and Fonterra

As Table 3.1 illustrates, Fonterra increased the proportion of off-GDT sales over time. Off-GDT sales can include non-standard variables or other contractual terms which differ from the publicly-disclosed terms for on-GDT sales. The use of off-GDT sale reference prices has tended to produce a higher revenue number that would have been the case if the GDT market-traded prices were used. In the 2017/2018 season Fonterra used off-Global Dairy Trade (GDT) RCP trade data in its FGMP calculations. The proportion of off-GDT sales in 2017/2018 is significant. It was 45% (by volume) of the basket of commodity reference products used in the FGMP calculation. Fonterra confirmed in its Milk Price Statement for 2017/18 that the effect of using off-GDT sales was to increase the FGMP by 8 cents per kgMS.[21] Other reported statements from Fonterra's Milk Price Panel members state the consequent increase in FGMP is 10 cents per kgMS.[22]

We note that off-GDT prices are consistently higher than GDT prices and this is why increasing the proportion of off-GDT sales results in higher FGMP. The consistent upward bias of off-GDT prices compared to GDT is surprising from an economics point of view. If both platforms represent sales of identical commodities on identical conditions, any differences should be arbitraged away. The persistence of price arbitrage opportunities

[18] Not disclosed explicitly, however Fonterra stated that the proportion was similar as for the 2017/18 season, see Commerce Commission, Final Report on Review of Fonterra's 2017/18 Milk Price Calculation, 14 September 2018, para 2. 1

[19] Fonterra Reasons Paper for Milk Price Manual 2016/17 Season, available at: https://comcom.govt.nz/__data/assets/pdf_file/0011/60032/Fonterras-Reasons-Paper-in-support-of-Milk-Price-Manual-for-the-2016-17-Season-1-August-2016.PDF

[20] Fonterra Farmgate Milk Price Statement for the season ended 31 May 2017, page 10 (available at: https://www.fonterra.com/content/dam/fonterra-public-website/phase-2/new-zealand/pdfs-docs-infographics/pdfs-and-documents/milk-prices/pdf-fonterra-farmgate-milk-price-statement-2017.pdf)

[21] Fonterra Farmgate Milk Price Statement for the season ended 31 May 2018, page 6 (available at: https://view.publitas.com/fonterra/https-view-publitas-com-fonterra-farmgate-milk-price-statement-2018/): "For the 2018 Season, the inclusion of off-GDT sales of WMP, SMP and AMF resulted in an increase of NZD 8 cents per kgMS inclusion of off-GDT sales of WMP, SMP and AMF resulted in **an increase of NZD 8 cents per kgMS**." (emphasis added),

[22] Fonterra Milk Price Panel member Brent Goldsack is reported as stating that "more than 40% of the reference products are now sold off the Global Dairy Trade platform and the effect is to add more than 10c to the milk price." Farmers Weekly, "Milk price guardian fights back", 24 September 2018, available at: https://farmersweekly.co.nz/section/dairy/view/milk-price-guardian-fires-back

indicates that the off-GDT platform may involve different (likely enhanced) terms and conditions of sale, and hence may be a less reliable representation of commodity prices.

3.2.2 Fonterra's Exercise of Discretion on Cost Inputs

Fonterra exercises its discretion over a range of cost inputs in the milk price calculation, relating to both the notional processor's costs and assumptions derived from Fonterra's actual costs.

Fonterra exercises discretion to select an asset beta for determining its WACC

Fonterra has to determine a weighted average cost of capital (WACC) for the notional processor in the Manual and apply this in the Calculation. The WACC forms part of the capital costs of the notional processor. The WACC calculation includes an asset beta, which is a measure of risk in the notional processor's business.

Fonterra has adopted an asset beta of 0.38 to determine the notional processor's WACC since at least the 2012/13 season. This asset beta has been the subject of intense debate between Fonterra and the Commission. The Commission eventually held that the 0.38 asset beta is unlikely to be practically feasible under section 150A of DIRA.[23] The Commission also reached an 'emerging view' that an asset beta of 0.45 to 0.58 was more appropriate.

Furthermore, in the Commission's annual review of the Manual, and also in the annual Calculation monitoring and review, the independent processors have all disputed the level of asset beta, arguing that a higher asset beta, more reflective of Fonterra's own risk or risk of a comparable large dairy processor is appropriate.

The discretionary use of the asset beta of 0.38 has a material effect on the FGMP determined in the milk price calculation. A 0.1 change in asset beta will have an approximate 3-4 cents effect on the FGMP. This is material for dairy processors, as Fonterra's Milk Price Panel has confirmed.[24] A 0.1 change in asset beta translates to a $45 to $60 million impact on earnings for Fonterra and has a proportionate impact on smaller independent processors.

Fonterra's use of discretion over excluded costs, such as farmer support costs

In the 2015/16 season, Fonterra offered interest-free loans to its farmer-suppliers due to a forecast milk price that was much lower than previous seasons. This was to support farmers with cash-flow shortfalls, during periods when the milk price was low.

The provision of interest-free loans is costly to Fonterra for the period until all of the capital is repaid (the opportunity cost of the capital). Fonterra's CFO advised that the farmer support loans cost the cooperative $390 million, plus an additional $20 million in interest that would have been avoided if the capital had been applied to reduce debt.[25]

Fonterra elected not to include the support payments in the Manual. The cost of this farmer support has not been recognised in the Manual since, nor has it been recognised in

[23] Commerce Commission, Final Report on Review of Fonterra's 2017/18 Milk Price Calculation, 14 September 2018, available at: https://comcom.govt.nz/__data/assets/pdf_file/0027/96606/Final-report-Review-of-Fonterras-2017-18-base-milk-price-calculation-14-September-2018.pdf

[24] Fonterra Milk Price Panel member Brent Goldsack is reported as stating that "anything that could move the milk price by 0.1c [has] a $1.5 million effect on the business." Farmers Weekly, "Milk price guardian fights back", 24 September 2018, available at: https://farmersweekly.co.nz/section/dairy/view/milk-price-guardian-fires-back

[25] National Business Review, "ComCom argues Fonterra's support loans should be included in milk price calculation", 15 December 2015, available at: https://www.nbr.co.nz/article/comcom-argues-fonterras-support-loans-should-be-included-milk-price-calculation-b-183010

the Calculation to determine the FGMP. The effect of the exclusion of these farmer support costs has been to increase the FGMP.

Fonterra's use of discretion over the operating cost inputs

Fonterra has discretion over the operating cost inputs for the FGMP, such as packaging, collection/transport, energy, and effluent costs. It appears Fonterra has used cost inputs over certain seasons that had the effect of increasing the FGMP.

In the 2017/2018 season, cost inputs were materially reduced from previous years. Packaging costs (3.4 per cent reduction) and effluent costs (13.3 per cent reduction) were both reduced. Any reduction in cost contributes to an increased FGMP.

Fonterra asserted that the cost reductions were a result of lower volumes of milk processed. This is an unreasonable explanation. The cost variance cannot be explained, because

- Lower milk volumes do not lead to a decrease in variable costs per kgMS
- Packaging costs remain relatively constant as reductions in demand for one type of product (anhydrogenous milk fat) would be counterweighed by increase in demand for another (butter), leading to packaging costs staying fairly constant.

Fonterra's use of discretion over other inputs

Fonterra has also adopted other discretionary variables and made assumptions in the milk price setting process that appear to have had the effect of pushing the FGMP upwards. These include the following, and are addressed in more detail in Appendix A:

- Assumed plant and fixed capital costs
- Repairs and maintenance costs
- Buffer plant capacity (a cost)
- Exchange rate selected for purposes of determining sale price of the RCPs
- Asset stranding risks (a cost)
- Season shoulder losses
- Premiums paid to winter milk suppliers
- Farmer support costs.

3.2.3 Fonterra's Exercise of Discretion on Whether to Apply the Milk Price Manual

Fonterra's Board has also exercised discretion to adjust the milk price from the Manual-compliant calculated price. In the 2013/14 season, Fonterra's final payout to farmers was adjusted downwards. The downward adjustment was a 55 cents/kgMS reduction in the Manual-compliant milk price determined under the base milk price framework.

The adjustment was made because Fonterra could not match its actual production profile to the products demanded in global markets. The actual revenues to Fonterra deviated significantly from the notional processor's revenues. The 2013/14 season involved exceptionally high demand for the whole milk powder commodity, largely from China. However, Fonterra's actual plant could not produce the commodity products in the same volumes as anticipated by the Manual. The Manual assumes that the notional processor converts all raw milk supply into the RCPs. The Manual also requires that the RCPs are produced in proportions that reflect Fonterra's actual allocation of raw milk to different RCPs. However, due to the very high volumes of raw milk, Fonterra allocated some to cheese and casein processing facilities. Cheese and casein sales achieved lower prices per kgMS of raw milk and are not RCPs and therefore not reflected as a source of the notional producer's revenues. There were also actual additional costs incurred by Fonterra in processing the high volumes of milk in the 'super flush' season.

In announcing that it intended to pay a forecast milk price adjusted downwards from the FGMP, Fonterra's CEO stated:[26]

> *"Doing nothing, and forecasting a Farmgate Milk Price that is higher than we can afford to pay at this stage in the season, is not an option. We will maintain our financial discipline and not pay the Milk Price out of borrowings – particularly in a year when we are forecasting a record payout for our farmers."*

The downward adjustment in price does not appear to be a result of Fonterra seeking to send an appropriate price signal on milk volumes to its farmers. Rather, from Fonterra's public statements, it appears to be driven by the practical constraints of Fonterra's processing facilities in a season when the actual dairy product demand did not match Fonterra's capacity. It also reflects balance sheet concerns. The discretionary adjustment effectively used Fonterra's farmer-suppliers to support the Font rra balance sheet in circumstances where the Board could make a discretionary adjustm nt without risking major disapproval from the different stakeholder groups (farmer-suppliers, farmer-shareholders and unitholders).

3.3 Fonterra's Use of Notional Processor's Inputs as Benchmark

The use of notional processor inputs as a 'benchmark' for Fonterra to match or better is one possible function of the base milk price framework. The Commission cites this benchmarking as a reason for using notional va ues:[27]

> *Using notional data provides Fonterra with a benchmark to beat. This increases transparency to shareholders about whether Fonterra is achieving efficiency gains relative to the alternative of using dat on Font rra s actual performance to set the base milk price.*

The evidence we have reviewed makes this difficult to justify. Fonterra appears to adjust the notional processor's inputs to benchmark values that are impossible to achieve. Such optimistic inputs in cost fact rs tends to increase the FGMP.

Fonterra has used discretion to make yield assumptions for the notional processor each year for a number of years. A yield target is a sensible benchmark for efficiency if it reflects the actual production possibility of Fonterra. A target for losses is also sensible, again, provided it reflects the actual possible production efficiency of Fonterra.

Processing raw milk into commodities results in different yields, depending on a range of factors. The FGMP calculations include a set of yield variables based on assumptions about the composition targets for each commodity produced by the reference notional processor. Modelling by OCD has demonstrated that the yields assumed for the notional processor were materially lower than would be possible, even assume zero yield losses. Fonterra appears to have improved its assumptions about plant optimisation.

Fonterra also assumes a zero level of losses in the milk supply to the notional processor's plants. It is impossible to achieve zero losses.

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[26] https://www.fonterra.com/content/dam/fonterra-public-website/phase-2/new-zealand/pdfs-docs-infographics/pdfs-and-documents/milk-prices/pdf-2014-05-28.pdf

[27] Commerce Commission, Our approach to reviewing Fonterra's Milk Price Manual and base milk price calculation, 15 August 2015, page 11.

3.4 Conclusion on the Direction of Fonterra's Use of Discretion

The facts analysed in section 3 above indicate that Fonterra appears to use its discretion to adjust variables in the base milk price framework in a way that has the effect of increasing the FGMP. The bias tends toward an increase in the FGMP, rather than any lowering. It appears unrelated to Fonterra's ideal efficient milk volume supplied or an efficiency benchmark Fonterra is seeking to match.

Fonterra's bias is toward increasing the FGMP when there is the discretionary ability to do so within the base milk price framework. The bias holds in high production seasons. Even in the season when it adjusted the payout amount downwards from the Manual-compliant FGMP calculation, this was for reasons unrelated to sending an efficient price signal to farmers.

The relationship between the FGMP and incentives on farmers to produce milk is weak. A range of other factors influence the global price of milk. The factors that appear to mostly drive milk prices include climatic conditions, relative global supply and global demand. Global demand was highlighted as the primary driver of the growth in supply in MPI's Frontier Economics report.

Fonterra has only made an adjustment to its milk payment amount (that is, it adjusted the Manual-compliant milk price downwards after calculating a FGMP) twice. The 2013/14 season adjustment was the largest and related to exceptional circumstances where the actual returns from sales of processed milk products did not match the notional processors RCP sales by a significant margin. The second adjustment for 2017/18 was similarly linked to financial performance of Fonterra itself (including its overseas investments), and not the efficiency of its New Zealand processing business.

If Fonterra did use the base milk price framework to send price signals to manage an efficient volume of milk, then we would expect the use of discretion under the base milk price framework to be downward or neutral. In the record volume 2014/15 season,[28] it exercised discretion to decrease costs (asset beta, failed to include cost allowance for processing peak flows, and used actual permeate costs) and increase revenues (off-GDT sales).

Fonterra cannot possibly use the notional processor's yield efficiency as a benchmark. The notional processor's benchmarks that Fonterra applies are impossible to achieve. Likewise, the assumptions of zero losses are unachievable for even the most sophisticated dairy processors.

[28] DairyNZ (2018), New Zealand Dairy Statistics 2017-18, p. 5

4 Fonterra's Incentives to Increase Milk Price

We have discussed Fonterra's discretion to amend the inputs to the FGMP, and how it has a bias toward amending inputs that have the effect of increasing the FGMP. In this section, we examine the underlying incentives for Fonterra's behaviour in respect of the FGMP.

4.1 Context for Fonterra and Dairy Processors' Corporate Incentives

Fonterra remains by far the largest processor in New Zealand and is the most significant marketer of New Zealand dairy products in overseas markets. It is substantially a farmer-owned co-operative. There are a minority of non-farmer unitholders who hold approximately 6 percent of the equity capital in the listed Fonterra Shareholders Fund. The farmer-shareholders receive both a milk price payment and dividend payment from Fonterra each year. The dividend payment is dependent on the earnings performance of Fonterra from its sales of processed milk products, after paying for supply of raw milk.

Independent processors compete with Fonterra for milk supply. Where there is choice between processors, farmers select processors based on expected milk price, dividend payments (for cooperative processors and based on the processor's corporate performance), and other services offered. Other services could be the timing of milk price payments, farmer support payments, and other ancillary benefits. In the case of Fonterra, it must accept any new supply (with limited exceptions) under open entry and exit rules and may (but chooses not to) charge transport costs.

4.2 Fonterra's Discretionary Bias is Related to Competitive Incentives

Fonterra most likely has an incentive to ensure that the FGMP is as high as possible, within the base milk price framework, relative to its processor competitors. This incentive likely arises from four sources:

- Fonterra wants to retain and attract suppliers over the long-run and uses discretionary changes in the milk price for this purpose
- The extent to which it can make its existing competitors' business more difficult (through a higher milk price), the more straightforward Fonterra's own corporate strategy can be
- Fonterra also has incentives to avoid market entry by new processors as these can be more efficient than the notional processor, thereby forcing Fonterra to be more proactive in its investment for innovation and greater efficiency
- Fonterra has asymmetric incentives from its ownership structure.

We deal with these in turn:

Incentive to retain and attract supply

A FGMP that is consistently high in the long-run relative to the competing independent processors ensures that suppliers choose Fonterra and remain loyal, relative to other processors. This incentive is confirmed by the Commission's assessment that in the absence of DIRA, there is a risk that Fonterra would engage farmers in long-term supply contracts, and possibly prejudice against any farmers that left the cooperative and sought to return. The Commission has also confirmed that Fonterra "*may have an incentive to restrict [independent processors] from accessing farmers*".[29]

Fonterra likely faces fewer costs (including effort) in using discretion to increase the FGMP to retain suppliers. The alternative would be that it had to constantly ensure its strategy kept it at the efficient frontier of the processor industry, able to pay a competitive milk price, and generate returns for shareholders.

Furthermore, Fonterra places high importance on projecting to its farmer-suppliers that it is increasing the milk price it pays to them over time. The cooperative regularly promotes the increase in milk price payments which it argues it has "*strengthened*"[30] and "*achieved*".[31] This is inconsistent with the purpose of the base milk price framework, which s t determine a FGMP as the residual of the revenues less costs of an efficient processor.

Incentive to weaken existing competition

An artificially high milk price also weakens existing competition by forcing price matching. Even a small increase in the FGMP has a significant impact on the earnings of independent processors; a 1 cent increase translates to around $1.55 million in reduced earnings for OCD. Increased operating costs for processors reduce the scope for growth investments, and innovation in the industry.

New processors could rival Fonterra in commodity production, or innovate in product mix, processing investment, and marketing. Fonterra is incentivised to limit its competition in export markets. An incentive exists for Fonte ra to weaken its domestic processor competitors if this would also weaken existing or potential competition in export markets.

To the extent that Fonterra is the largest and most prominent New Zealand marketer of dairy products in international markets, it has an incentive to capture any New Zealand brand value on international dairy markets. It can do this by weakening other New Zealand processors.

Incentive to reduce scope for future processor market entry

Fonterra is also likely to be mo ivated by an incentive to discourage new processors to enter the market. New independent processors are discouraged from entry if the milk price they must match is non-tran parent and subject to discretionary changes that are unrelated to efficiency reasons. Currently, any new entrant in the processor industry would have to match or better the efficiency of the notional processor (that is, its costs), and Fonterra's actual revenues (increasingly from non-transparent off-GDT sales). Even a highly efficient new market entr nt would face uncertainty that its efficiency levels would be sufficient to cope with a milk price subject to discretionary changes.

New independent processors generally make life more difficult for Fonterra. Additional independent processors would provide farmer-suppliers with more choice. This would make Fonterra's job of keeping suppliers happy (in terms of milk price and quality of service levels) more difficult.

[29] Commerce Commission, "Review of the State of Competition in the New Zealand Dairy Industry: Final Report (1 March 2016), paras X32-X36.

[30] Fonterra Annual Results 2018 Presentation, 13 September 2018, page 19, available at: https://www.fonterra.com/content/dam/fonterra-public-website/phase-2/new-zealand/pdfs-docs-infographics/pdfs-and-documents/180913_Annual_Presentation_FY18.pdf

[31] Otago Daily Times, Former Fonterra Leader Farewelled, 3 February 2019, available at: https://www.odt.co.nz/rural-life/dairy/former-fonterra-leader-farewelled

Incentive to increase FGMP arising from capital structure

There are asymmetric benefits to Fonterra from inflating the FGMP. A higher FGMP reduces the cost of Fonterra shares, thus both easing entry into the cooperative and reducing the cost for existing suppliers of increasing (share-backed) milk supply. This helps ensure a secure supply of milk for Fonterra's sunk investment in capacity. Security of milk supply is crucially important for dairy processor survival.

However, a higher FGMP only slightly weakens its capital structure by reducing the amount of equity paid in by suppliers. This may also lead to slightly higher borrowing costs. The non-farmer unitholders would also oppose any reduction in value of Fonterra shares from increases in the milk price.

The Fonterra Shareholders' Fund (FSF) unitholders make up approximately 6 percent of Fonterra's equity, and FSF unitholders do not have any voting rights. This is likely to g ve FSF unitholders limited influence over the capital structure effects of a high milk price compared with Fonterra's farmer shareholders.

5 Industry Structure Change and the Farmgate Milk Price Regime

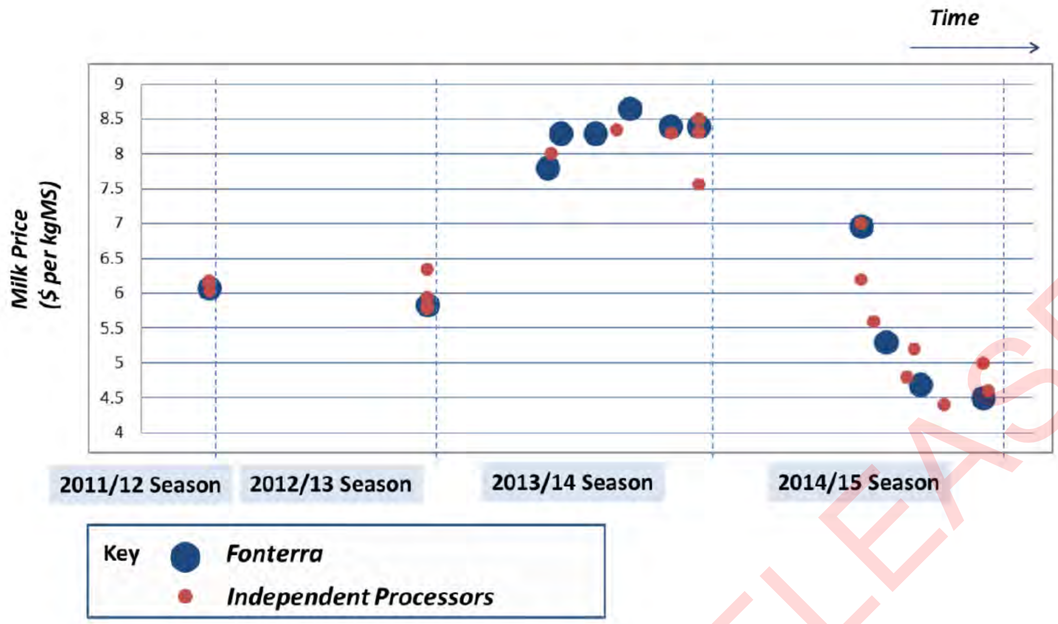
We can assess how well the base milk price framework has performed against the objectives for it by assessing the structural change in the processor industry. As already outlined, the objectives of the base milk price framework are to promote transparency and generate a milk price at an efficient level. If the milk price has been set consistently at an efficient level, then we would expect to observe a somewhat changed industry structure, and behaviour of processors that reflected an allocatively and dynamically efficient industry.

There has been some change in industry structure since the formation of Fonterra in 2001. If the policy objectives were being met, then we would expect entry by new processors, innovation in processing technology, and innovation in processed dairy products. The degree of change (if any) since the introduction of a base milk price framework could provide evidence of its policy effectiveness.

It is difficult to say with certainty the extent of processor entry and gr wth that may have been hampered by Fonterra's use of discretion to increase the FGMP. However, certain observations support the conclusion:

- Fonterra remains the dominant processor. It has grown the amount of milk it collects at the same time as independent proc ssors also grew capacity. However, these developments have not led to a workably competitive market in the dairy processor industry.
- New entrants to the sector have ailed (New Zealand Dairies) or had to undertake radical pricing strategies to gain market share that appear uneconomic (Oceania Dairy, which has a policy to pay a milk price well above the FGMP).
- Fonterra continues to set he market price for milk, Figure 2.1 above illustrates the close matching of pric s to Fonterra's milk price. If the FGMP had been set without an upwards b as, we may have seen a more dynamic development in new processors of various scales.
- Fonterra s milk price announcements are also closely followed in time by the independent pr cessors. Figure 5.1 illustrates this. This indicates that Fonterra still sets a benchmark in a way which is non-transparent or discoverable by the indep ndent processors' approximating the efficient price outcome.

Figure 5.1: Price-matching to Fonterra by Independent Processors



Source: Open Country Dairy Limited

Amendments to DIRA since Fonterra's formation have not changed the incentive to use discretion to increase the FGMP

Supporting policy measures under DIRA have not imposed enough discipline on Fonterra to outweigh the preponderance to use discretion to increase the FGMP. Fonterra does not face strong market discipline on the split of returns between the milk price and dividend payment. As discussed above, non-farmer unitholders only hold 6 percent of the equity of Fonterra and have no voting rights This means that any incentive to accurately reflect an efficient split of earnings among the price for milk and dividend is moderate at best.

Further loss of market share is unlikely to remove the incentive to use discretion to increase the FGMP

Fonterra had appr ximately 96 percent market share in 2001 and this has fallen to around 82 percent in 2017. Fonterra's share of the farmgate milk market has fallen, but its total volume of milk collected has increased.[32] Even if Fonterra's market share dropped further, there would still be a need for a milk price setting mechanism that was robust and independent.

The processing industry would still have the issue that the majority of farmers are still members of supplier-owned cooperatives. In each season, those farmer-owners receive a p yment for milk and a return on capital invested in the processor. Since farmers are indifferent whether the cashflows are labelled "milk price" or "dividend", a blended return can be paid resulting in a lack of transparency on actual milk price. This opens up the ability for larger farmer-owned cooperatives to use the milk price in a tactical manner to weaken competitors.

We would also expect processors to lock farmers into longer-term supply contracts, as a market where raw milk can be supplied and traded over shorter time periods is unlikely to emerge (not least because of the perishable nature of raw milk).

[32] Frontier Economics, 2018 DIRA Review: Analysis of Industry Performance, August 2018, page 21

6 Conclusion: Fonterra's Discretion Appears to be Used to Control Entry and Competition

The only logical explanation for Fonterra using its discretion within the milk price monitoring regime to increase the FGMP is to influence entry and competition in the processor market.

A systematically inflated milk price would cause more damage to efficiency than a systematically lower one. A high milk price harms the dairy sector by suppressing the ability for independent processors to compete with Fonterra and for potential new processors to enter the market. This reduces contestability in the market and reduces incentives for greater efficiency because competitive pressure on Fonterra is weakened.

Fonterra's dominant incentive is to act in ways that reduce competition for raw milk and reduce competition in downstream markets which use raw milk as an input.[33] Setting an artificially high milk price is one of the most direct ways for Fonterra to respond to that incentive.

The change in industry structure since the introduction of the base milk price framework does not support the notion that the framework has been effective at promoting a transparent and efficient milk price that is sufficient to enable industry growth and dynamic change.

[33] Evans, L., & Quigley, N., "Watershed for New Zealand Dairy Industry", July 2001, ISCR Monographic Series.

7 Evaluation of MPI's Options for the Base Milk Price Calculation

MPI have set out three options in its Discussion Document for the base milk price calculation:

- Status quo: retain the existing DIRA provisions for Fonterra's base milk price calculation and commerce commission monitoring (Option 4.3.1)
- Amend the DIRA to provide additional statutory guidance on the meaning of the term "practically feasible" (Option 4.3.2)
- Amend the DIRA to give the Commerce Commission statutory power to set the base milk price for the dairy industry (Option 4.3.3).

We evaluate the options against criteria in order to achieve the policy objectives behind DIRA.

7.1 Criteria for Evaluation

There are four appropriate criteria for the evaluation of proposed options. In addition, the requirement from section 52G of the Commerce Act can apply here too, that the benefits of any additional regulation exceed the costs (including the regulatory overheads).

Promoting policy objectives for the dairy sector

Dairy industry policy for the farm gate milk price ought to achieve efficiency and a contestable farm gate market.

The efficiency objective is one linked to New Zealand's economic performance, because an economically efficient dairy industry contributes to greater national economic wellbeing. Policy should drive allocative efficiency so that capital and natural resources flow to their highest value use. Productive efficiency is also a goal, whereby the industry is producing the maximum outputs at the lowest possible cost.

It is also highly desirable that the farmgate market is reasonably contestable for existing and new entrant processors. This drives efficiencies in processing firms, encouraging innovation with processing techniques (value-add and so on), marketing, and product development.

Minimise discretion

It is highly desirable that the price is generally derived via a process that cannot be manipulated or adjusted for reasons that are unrelated to the policy objectives. Discretion ought to be minimised, so that the price emerges from objective factors.

To the extent necessary, discretion must be the informed discretion of an impartial price-setter

If there is any discretion, then this must be exercised by a party that has an informed and knowledgeable position. That price-setter must also have neutral incentives regarding any change in the price.

Transparency of decision-making and pricing inputs

Transparency in the decision-making process and over the pricing inputs can give market participants certainty. When market participants are more certain about the milk price, they will tend to make investment decisions with greater confidence.

Benefits of any regulation should exceed costs

The overarching test from section 52G of the Commerce Act should also apply here. The benefits of regulating the goods or services in order to meet policy objectives should materially exceed the costs of regulation.

7.2 Application of Evaluation Criteria to Options

Of the three options, we find that independent monitoring and price setting of the notional processor by the Commerce Commission is most likely to deliver the efficiency and contestability goals of DIRA.

Option 1 would not solve underlying problem of Fonterra's incentive to increase FGMP

As established above, Fonterra has real incentives to increase the FGMP within the base milk price framework. It acts on those incentives and displays a clear bias to increasing (rather than decreasing) the FGMP. The question then becomes whether the existing regulatory monitoring regime that lies with Commission will be sufficient to hold Fonterra's bias in check.

The Commission's current role of mere monitoring has not been effective in countering the incentive and revealed behaviour for Fonterra to use its discretion to increase the FGMP. The Commission has found that the 0.38 asset beta is unlikely to be consistent with the asset beta of a comparable notional processor. The Commission also underestimates the impact of an under-stated asset beta, and the impact when Fonterra understates other costs of the notional processor. It believes that a 1 to 3 cent increase in the FGMP is "*immaterial*".[34] Such a change in an independent processor's largest input cost is highly material.

The only sanction for sustained increases in the milk price has been public comment by the Commission. Fonterra continues to be able to set the FGMP with discretionary inputs, and in a non-transparent way.

As established above, the outcome of a persistently higher FGMP is that the policy goals of the milk price-setting regime have not been met. Retaining the status quo will entrench the reduction in contestability of the processing sector, and hence detract from the dynamic efficiency.

The costs of retaining the status quo would be reflected in the efficiency losses in the processing sector from the persistently high FGMP. The absence of productivity gains resulting from improved contestability and industry dynamic change would be further economic costs of retaining the status quo.

The existing regulatory costs of Commission monitoring and overheads would continue, for no benefit.

Option 2 has already been litigated in Commission's FGMP proceedings without success

As established above, Fonterra retains a strong incentive to use the FGMP process as a strategic tool to weaken existing processor competition and create barriers for new entrants. Additional guidance would not remove this underlying incentive. Additional guidance risks merely narrowing the range of known areas in the FGMP process where discretion could be exercised.

[34] Email correspondence between Commissioners Sue Begg, Stephen Gale and Elisabeth Welson with Commerce Commission staff, dated 6 and 7 August 2018.

As this report details, the Commission-led process to determine what "practically feasible" means has been litigated over many years, with limited resulting changes. In particular, the use of non-transparent off-GDT sales data and lower asset beta have consistently been presented to the Commission as being inconsistent with "practical feasibility". In the case of the asset beta, the Commission has made clear that Fonterra's discretionary asset beta in the FGMP calculation is not practically feasible. Fonterra has failed to alter the asset beta.

Therefore, there is a high likelihood of a continuation of a lack of contestability, with associated efficiency losses in the overall processing sector.

The regulatory costs for the Commission would increase. There would also be additional regulatory costs during the inevitable adversarial process to determine a definition of "practical feasibility".

We note that the Commission found in its final report of its Review of the State of Competition in the Dairy Industry that the costs associated with the DIRA milk price monitoring regime would likely exist without a DIRA regime.

Option 3 presents most effective (published) option, where benefits of additional regulation exceed costs

Independent monitoring will remove the incentive to increase the FGMP. This promotes entry by independent processors. This in turn improves contestability in the sector and drives overall industry efficiency. The credible threat of entry by new processors can also drive greater industry innovation and efficiency, however, this threat is less credible if Fonterra can artificially inflate prices.

Market entry and contestability promotes innovation, experimentation, and diversification of product mix and markets. This is critical for the long-term sustainability of the New Zealand dairy industry and its contribution toward national productivity growth.

Even if volume risk were a valid reason to increase the FGMP (of the notional processor), there is no reason why an effective independent price setting process focussed on efficiency and contestability would skew the FGMP in a way that created unmanageable volume risk for Fonterra.

There is no question that the benefits of an independent price monitoring regime with determinative power would materially exceed the costs of establishing additional regulatory expertise and related overheads at the Commerce Commission or other independent body created for this purpose.

The marginal increase in regulatory costs would be modest. The Commission is already a repository of expertise on price monitoring for Part 4 regulated businesses. The Commission already has a very good oversight and understanding of milk pricing, and the inputs necessary, in order to meet the legislative objectives of DIRA. Even if an independent body was created (outside of the Commission), it could build on the Part 4-type expertise already present at MBIE, the Commission, and elsewhere.

Therefore, even if a new entity were to be created (this is not foreseen in MPI's option), the marginal additional regulatory overhead would be slightly higher.

7.3 Conclusion on Options Evaluation

Given the strong underlying incentive to use discretion to alter the FGMP upwards for competitive reasons, the status quo and imposition of additional regulation is likely to continue to result in efficiency losses for the dairy processing industry.

The only published option that would remove the incentive and create an independent and transparent mechanism is a Commission-led determination process.

There are other options which would strengthen the independence of the authority determining the FGMP. An independent statutory authority with power to set prices of a notional processor based on disclosures from Fonterra and other processors would likely have slightly higher costs that Commission authority. This option would still result in benefits that exceed the costs, which would be a modest increase in regulatory overhead in the context of a significant national industry.

Appendix A

- Table summarises the times when Fonterra has exercised discretion to either change Manual variables or inputs in the Calculation that has had the effect of increasing the FGMP.

Table 7.1: Summary of Fonterra's Exercise of Discretion in FGMP Proceedings

Season	Manual or Calculation	Description of issue	Effect on FGMP
2012/13	Manual	Submitters questioned practical feasibility of several inputs, (but Commission was unable to form a view as part of Manual review). These permit Fonterra a degree of discretion to alter the FGMP: ▪ Product yields ▪ Off-GDT contract prices ▪ Operating costs.	A lack of transparency in the calculation methodology permi s Fonterra to use discretion to influence the price upwards
2012/13	Calculation	Commission concluded that assumptions on energy usage rate not practically feasible.[35]	If ene gy rates reflected the likely a nual average usage rates, the base milk price would have been lower.
		Commission was unable to conclude whether calculation of asset beta was p actic lly feasible.	A relatively low asset beta contributes to consistently higher FGMP regardless of market conditions
		C mmission was unable to conclude on whether assumed costs of manufacturing plant assets were practically feasible.	Commission was unable to conclude on direction of FGMP impact, but potentially 6.92 cents.[36]
		Commission considered yields and selection off-GDT contracts for pricing to be practically feasible.	
201 /14	Manual	Commission expressed general concern about the flexibility of interpretation of the Manual.	A lack of transparency and flexibility in the calculation methodology permits Fonterra to use discretion to influence the price upwards.
		Fonterra significantly revised rule on calculation of repair and	Miraka expressed a concern that changes to repairs and

35 https://comcom.govt.nz/__data/assets/pdf_file/0032/63968/Final-Report-Review-of-Fonterras-2012-13-base-milk-price-calculation-16-September-2013.pdf at 2.11

36 https://comcom.govt.nz/__data/assets/pdf_file/0032/63968/Final-Report-Review-of-Fonterras-2012-13-base-milk-price-calculation-16-September-2013.pdf at 2.14

		maintenance costs to give it more discretion.	maintenance costs (and a signalled change to finished goods freight) would reduce cost rates of the notional producer compared to Fonterra's costs (whose are higher as its assets are older than those of NP).[37]
		Commission was again unable to conclude on practical feasibility of asset beta due to insufficiency of information from Fonterra.	A relatively low asset beta contributes to lower cost of capital, and a higher FGMP.
2013/14	Calculation	Fonterra made an adjustment downwards to the FGMP by 55 cents. Fonterra's reasons for this included: Increase in demand from China for WMP, asset footprint constraints limiting the processor's ability to switch to WMP production, physical capacity constraints at certain plants leading to additional transportation costs, other physical capacity constraints	
		The Commission concluded that the adjusted FGMP was n t consistent with the s150A efficiency dimensi n. However, it was consistent with the contestability dimension because the downward p ice adjustment took into account a cost allowance for he risk that 'super flush' milk flows could exceed the processing capacity of the processor.	
		Commission was unable to conclude on whether three components were practically feasible.	Fonterra overstated FGMP by 2 cents per kgMS, according to Commission's energy expert.[39]
		(1) Commission's expert concluded that energy usage rates were not practically feasible	Commission thought that a different approach to fixed asset valuation would, on balance, lead to a lower FGMP – "our expert's review in 2012/13 estimated a range of up to 6.5 cents per kgMS

[37] https://comcom.govt.nz/__data/assets/pdf_file/0031/59737/Final-Report-on-the-Review-of-Fonterras-2013-14-Milk-Price-Manual-16-December-2013.pdf at 17-18

[39] https://comcom.govt.nz/__data/assets/pdf_file/0030/63966/Final-report-Review-of-Fonterras-2013-14-base-milk-price-calculation-15-September-2014 PDF at 36

		(2) Commission was unable to conclude on the practical feasibility of the fixed asset capital costs (3) No cost allowance for 'super flush' peak milk flow costs.[38] Fonterra also used actual permeate costs, when the notional processor's costs would be higher Commission was again unable to conclude on practical feas bility of asset beta.	reduction in the Manual consistent milk price".[40] Commission assessed that there would have been a reduction in the FGMP.[41] Analysis (also set out in section 3.2 above) shows that Fonterra has been understating its capital costs. A lower asset beta for the notional processor increases the level of he FGMP. By not assuming a cost allowing for capacity and excess milk disposal in high-production seasons, Fonterra underestimates costs of the hypothetical processor in normal'/expected production seasons. A relatively low asset beta contributes to lower cost of capital, and a higher FGMP.
2014/15	Manual	The Commission was concerned that Fonterra made a series of amendments to the Manual that increased its discretion The following factors in the manual were highlighted as remaining non-transparent and hence increasing discretion: ▪ Cash costs ▪ Capital costs ▪ Buffer plant capacity ▪ Inclusion of winter milk ▪ Repair and maintenance costs ▪ Mechanism for providing for stranded asset risk.	Any discretion to minimise costs has the effect of increasing the FGMP.

[38] https://comcom.govt.nz/__data/assets/pdf_file/0030/63966/Final-report-Review-of-Fonterras-2013-14-base-milk-price-calculation-15-September-2014 PDF

[40] https://comcom.govt.nz/__data/assets/pdf_file/0030/63966/Final-report-Review-of-Fonterras-2013-14-base-milk-price-calculation-15-September-2014 PDF at 36

[41] https://comcom.govt.nz/__data/assets/pdf_file/0030/63966/Final-report-Review-of-Fonterras-2013-14-base-milk-price-calculation-15-September-2014 PDF at 36.

2014/15	Calculation	The Commission was equivocal about Fonterra's transparency in calculating the price.	Any discretion to minimise costs has the effect of increasing the FGMP.
		OCD submission noted that Fonterra's consistently choses to minimise costs when given option: ▪ Assumed processing capacity in excess of manufacturer specifications ▪ Used challenging product loss targets ▪ Did not use spot exchange rate.	Any minimisation of costs has the effect of increasing the FGMP.
		The Commission was also unable to conclude on practical feasibility of asset beta and noted the reduction in asset beta for the notional producer of 0.38 (compared to Fonterra's actual business of 0.48).[42]	An inappropriately ow asset beta increases the FGMP.
2015/16	Manual	Transparency of information in the calculation was again an issue with the Commission noting there remained a disconnect between the rules in the Manual and th actual inputs to the Calculation. It noted six substantive issues which had the potential to materially impact the FGMP: ▪ transp rency of selling prices achieved other than on GDT; ▪ how the notional producer deals with asset stranding; ▪ the addition of a new rule to cover non-recurring costs (Rule 19); ▪ the addition or removal of manufacturing sites; ▪ the application of the WACC risk free rate; and ▪ changes to the reference basket.	A la k of transparency in the calculation methodology permits Fonterra to use discretion to influence the price upwards.
		The Commission also identified that winter milk payments and farmer support payments were not provided for in the manual, although were a feature of what would be an efficient processor	By excluding winter milk payments and farmer support, Fonterra understated costs and this would result in a higher FGMP.

42 https://comcom.govt.nz/__data/assets/pdf_file/0028/63964/Final-report-Review-of-Fonterras-2014-15-base-milk-price-calculation-15-September-2015.pdf at 6.2.1

2015/16	Calculation	Fonterra continued in its use of a lower than industry peer asset beta. The asset beta of 0.38 was found to be inappropriately low for a dairy commodity processing business (Castalia report). Fonterra used a greater share of off-GDT sales to inform the notional producer's prices. This led to a consequential increase in the base milk price of between four to five kgMS. In addition: ▪ No allowance for some variable losses that may occur during the shoulder periods of the season. ▪ Winter milk premiums were not included as cost for notional producer.[43] ▪ Costs of farmer support loans should be included in calculations.	A lower asset beta increases the FGMP. Off-GDT sales are non-transparent, and when compared to GDT sales, had the effect of increasing the FGMP. Loss allowances would increase costs. Therefore not allowing for losses increased the FGMP. Not including winter milk premiums understated costs and increased the FGMP. Not including support payments understated costs and increased the FGMP.
2016/17	Manual	Fonterra continued to use off-GDT sales to determine revenues. Fonterra also continued to omit farmer support costs, although the Commission found this to be not material. The manual included a methodology to calculate lactose costs that enabled Fonterra to retrospectively pick costs.	OCD's analysis suggests the off-GDT sales led to a FGMP premium. Not including support payments understated costs and increased the FGMP. The discretion to pick lactose costs retrospectively could enable Fonterra to increase the FGMP.
2016/17	Calculation	Fonterra used an asset beta much lower (0.38) than the Commission's estimated asset beta (0.5-0.58). Commission was unable to conclude whether the asset beta was practically feasible, but it did think it was a substantial departure.[44]	Lower asset beta leads to a relatively higher FGMP. The Commission estimated the impact to be material and an increase of five cents.

[43] https://comcom.govt.nz/__data/assets/pdf_file/0028/63964/Final-report-Review-of-Fonterras-2014-15-base-milk-price-calculation-15-September-2015.pdf at 78.

[44] https://comcom.govt.nz/__data/assets/pdf_file/0038/59978/Final-report-Review-of-Fonterras-201617-base-milk-price-calculation-15-September-2017.PDF at X10

		Fonterra amended the manual to include off-GDT sales for reference pricing. Commission concluded that amendment to include off-GDT sale for reference pricing is practically feasible. [45]	Off-GDT sales allow are non-transparent and if sale price is a premium to GDT, the FGMP is inflated.
2017/18	Manual	Commission found Fonterra's farmer support payments and lack of transparency on capacity of its standard plants were both inconsistent with s150A. Commission also thought more consistency desirable around: ▪ consistency over time - disclosure requirement; ▪ actual FX rates assumed; ▪ base milk price on standard terms; and ▪ proposal for sales criteria clarity. Fonterra again used off-GDT sales.	Excluding farmer support payments increased the FGMP. A lack of transparency in the calculation methodology permits Fonterra to use discretion to influence the price upwards. Commission does not discuss the direction of impact on FGMP. In practice, divergence between GDT and off-GDT prices leads to relative increase in FGMP.
	Calculation	Commission concluded asset beta of 0.38 unlikely to be practically feasible.[46] Commission identified several material cost variances, all downwards, including reduction in packaging costs by 3.4% and decrease in effluent costs by 13.3%. However, Commission does not appear to object to these decreases.[47]	By lowering the asset beta, the NP's capital costs reduce thereby leading to a higher FGMP. OCD submission notes that a 0.10 decrease in asset beta results in an 0.03-0.04c increase in FGMP.[49] Decreases in cost components lead to higher FGMP.

[45] https://comcom.govt.nz/__data/assets/pdf_file/0038/59978/Final-report-Review-of-Fonterras-201617-base-milk-price-calculation-15-September-2017.PDF

[46] https://comcom.govt.nz/__data/assets/pdf_file/0027/96606/Final-report-Review-of-Fonterras-2017-18-base-milk-price-calculation-14-September-2018.pdf at 2.6

[47] https://comcom.govt.nz/__data/assets/pdf_file/0022/91336/Draft-report-Review-of-Fonterras-2017-18-base-milk-price-calculation-15-August-2018.pdf at 2.29

[49] https://comcom.govt.nz/__data/assets/pdf_file/0023/96224/Open-Country-Dairy-Submission-on-review-of-Fonterra-base-milk-calculation-draft-report-31-August-2018.pdf at 1

		Commission noted that it had found off-GDT sales to be consistent with contestability in previous Calculation review. However, Commission stated that it continued to consider that there should be more transparency around determination of off-GDT sale prices.[48]	Fonterra acknowledged in its 2017/18 season Farmgate Milk Price Statement that the use of off-GDT sale prices resulted in a 8 cents increase in the FGMP.

48 https://comcom.govt.nz/__data/assets/pdf_file/0027/96606/Final-report-Review-of-Fonterras-2017-18-base-milk-price-calculation-14-September-2018.pdf at 2.44

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Review of the Dairy Industry Restructuring Act
Submission of Open Country Dairy on MPI's Discussion Document

1 Introduction

The Ministry of Primary Industries (MPI)'s review of the Dairy Industry Restructu ing Act (DIRA) is a critical opportunity to move closer towards regulatory best practice and lock in long-term value from New Zealand's dairy markets. Open Country Dairy Limited (Open Country) welcomes the release of MPI's November 2018 discussion document (Discussion Document). This submission sets out our views on the issues raised in the Discussion Document and our responses to MPI specific requests for information.

It is vital that the review lay the regulatory and governance foundations for a successful dairy sector going forward.

Close analysis demonstrates that Fonterra has consistently e ercised its discretion under the Milk Price Manual to effect price increases, never to effect price decreases. It has even exercised its discretion illegitimately to do so in a number of cases, such as the asset beta and yield assumptions.

We commissioned from Castalia economic analysis to further ascertain why Fonterra has behaved this way. Castalia examined two main alternatives:

- to influence the volume of supply of raw milk; or
- to inhibit entry, expansion and contestability in raw milk processing markets.

That evidence shows that Fon erra most likely consistently and strategically uses its discretion to increase the base milk price in orde to inhibit entry, expansion and contestability in raw milk processing markets. This economic evidence demonstrates the true nature of Fonterra's incentives in practice, but it also forms an important part of the intervention logic informing the review. Any reform proposal needs to address Fonterra's incentives and ability to manipulate the base milk price so that aligns with contestable market standards.

We set out de ailed discussion of the key issues as we see them in the main body of this submission, and gi e speci c responses to MPI's questions in Schedule A.

2 Summary

In he Discussion Document, MPI's analysis underestimates the extent of Fonterra's dominance in the sector and overestimates the effectiveness of the DIRA regulatory regime (in particular, the price-setting and monitoring aspects), to address that dominance. In this submission we set out precisely why regulatory reform is needed, and what effective reform will look like.

Our key contentions and findings as set out in this submission are:

- the prevailing market context is one of limited entry, and diminishing future opportunities for entry or expansion;
- not only are Fonterra's incentives misaligned with the DIRA objectives of efficiency and contestability, Fonterra has consistently and strategically acted on those incentives when setting the base milk price to interfere with entry, expansion and contestability in raw milk processing markets;
- Fonterra is able to leverage its market dominance into the legislative price setting regime largely unchecked, due to significant weakness in the subpart 5A milk price monitoring regime;
- open entry and exit serves its broad purpose within the DIRA regime, and must be retained to ensure contestability;
- the weaknesses in the regime change incentive properties and have major f na cial impacts for all market participants, which only serve to harm the policy goals of processor efficiency and market contestability;
- effective reform must directly address the excessive discretion with th milk price monitoring regime as well as satisfying MPI's criteria for regulatory quality; nd
- conferring statutory power on the Commerce Commission o determine the base milk price, subject to a statutory (or regulatory) milk price methodology is the only option that addresses the issue of Fonterra's market dominance and exces discretion within the price setting regime.

Many of these points have already been made in our previous submissions on the review's terms of reference. We do not repeat those points verbatim, but focus on providing additional context and evidence that further support our view that t e case of substantial reform of the milk price monitoring regime is imperative to establishing efficient and contestable dairy markets.

We note also note from the outset that t e success of any reforms will to a large extent depend on the legislative and policy detail of those reforms. For instance, there is little to be gained by conferring statutory power on an independent decision-maker to determine the base milk price each season if this merely results in replication of the current flawed process of substantial *de facto* delegation to Fonterra with limited regul tory oversight. Both MPI's review and the submissions it receives are necessarily framed in broad terms. It will be vital to continue to work with industry participants and experts to distil the core p inciples of an effective and sustainable regime so that the policy goals of efficient and contestable dairy markets can be realised.

3 Market context

It is important that MPI's review is framed against the context of the current market conditions. This includes Fonterra's continued dominance across the market as a whole and a very limited degree of con es bility to keep that dominance in check.

Fonterra's market dominance

The extent of Fonterra's dominance in domestic dairy markets is staggering. At the national level Fonterra controls over 80% of the total milk supply. To place this in context, competition law analysis tends to view market concentration levels with serious concern if more than 40% of the market is in the effective control of a single player.[1] Exacerbating this extremely high market concentration is that

1 See Commerce Commission *Merger Review Guidelines* (Wellington, 2003).

there is no single competitor to Fonterra of any significant size at the national level. No independent processor accounts for more than 10% of the total milk supply.

This is precisely the type of market scenario where competitive market dynamics break down. As the dominant player in the market, Fonterra sets the *de facto* price for raw milk supply. This affords Fonterra significant control over a material input cost for its competitors. The ability to control competitors' costs in this way directly impacts on competitor margins, both in absolute terms and by interfering with the predictability of costs and margins over time. This exacerbates the scale advantages Fonterra obviously enjoys, giving it considerable influence over the commercial operations of its competitors.

Regionally, we recognise that there are some areas where Fonterra faces more competition to secure farmgate supply than others. In Waikato, Canterbury and Southland in particular, Fonterra is forced to compete with independent processors, including some who are now well established. However, this localised competition means that Fonterra is still the sole processor in Northland, Gisborne, Hawke's Bay, Marlborough and the Nelson-Tasman regions. Farmer-suppliers in these regions — and the vast majority of the country — do not face any genuine prospect of current or future competition for the supply of their raw milk.

Limited contestability

This market context can only be fairly described in terms of a lack of meaningful contestability. Fonterra does not seriously have to out-compete its competitors through superior performance because it can secure advantages over them in other, more strategic ways.

We anticipate that Fonterra will seek to challenge this obvious characterisation of the market by pointing to successful entry by several independent processors over the last 20 years. This is a highly simplistic position to take which ignores a number of important factors about the nature and extent of the entry that has occurred:

- New entry has been very limited in terms of geographical scope. Outside of Waikato, Canterbury and Southland there has been no meaningful entry to speak of. In a genuinely contestable market new entry and expansion would be wide-spread.
- New entry has not always been successful, or only achieved by operating outside of contestable market parameters:
    - New Zealand Dairies Limited was forced to exit the market through a receivership process, despite hundreds of millions of dollars of investment and what was (at the time) the largest overseas investment in the New Zealand dairy sector. This example highlights the significant entry and exit costs associated with investment in new processing capacity, which limit the contestability of the market.
    - Oceania Dairy Limited has followed other new entrants by adopting a radical initial pricing strategy in order to secure a foothold in the market. We understand that this involves paying up to 15 cents per kgMS over and above the base milk price. It is difficult to understand how this approach could be consistent with the dynamics of a contestable market.
- Successful new entrants have in some cases won a significant share of new supply coming onstream as a result of new dairy conversions. However, very little of Fonterra's existing supplier base has had the confidence to move to an independent processor. This feature of the market is of particular moment now that growth in supply appears to have peaked, as it suggests that there is even less scope for new entry or expansion than was previously the case. In a genuinely competitive market, Fonterra's existing base of supply would be vulnerable to its competitors but in reality, this is simply not the case.

- In some cases, new entry has been very limited in terms of the scope of processing activities undertaken. Rather than representing a genuine competitor to Fonterra for the supply of raw milk, the strategy is to leverage New Zealand's brand value as a marketing exercise targeted at overseas consumers.[2] Open Country has been made aware that this practice is currently occurring in New Zealand. This is not entry that contributes to the contestability of the market for supply of domestic farm gate milk.

This is a market environment where Fonterra's titanic scale and influence over its competitors allow it to dominate the domestic market, contrary to the goals of efficiency and contestability that DIRA is intended to promote. Against this market context, the DIRA regime can be seen to be a critical protection for facilitating competitor entry and promoting market efficiencies that risk being stifled by a dominant market participant. It is vital that DIRA serves this function effectively.

4 Fonterra's incentives and conduct

The need for a robust and effective DIRA is all the more critical because Fonterra has consistently demonstrated that it has strong incentives to inhibit the contestability of dairy markets and will act on those incentives. Coupled with its market dominance and unchecked by the risk of new entry, Fonterra's incentives are directly interfering with DIRA achieving its policy goals. The primary way in which Fonterra has sought to do this is by setting a base milk price that serves its own short-term strategic interests rather than the DIRA objectives of efficiency and contestability.

Open Country acknowledges that understanding Fonterra's incentives is far from straight-forward. In our previous submission,[3] we noted that:

- Fonterra's managers and executives face a complex mix of incentives; and
- The available evidence, including public statements by Fonterra's representatives and the 29.6 cents effective increase of Milk Price Manual changes since 2009,[4] was strongly indicative of a preference for a higher than efficient base milk price.

Open Country acknowledges that the precise balance of incentives needs to be tested as an empirical question. While unlikely given the prevailing market context and previous evidence, it is possible that changes in the base milk price are legitimately initiated by Fonterra to reflect efficient market conditions (for example by allowing Fonterra to manage its own milk volume risk). For that reason, we have commissioned economic consultancy Castalia to undertake an economic analysis of the discretion exercised by Fonterra and underlying incentives.

Castalia finds that the only credible explanation for Fonterra's behaviour in milk price setting proceedings is that it is acting on underlying incentives to limit entry, expansion and contestability. In summary, that finding is based on:

- The limited short-term influence of price signals on milk volumes, which inhibit its ability to act as a tool to manage supply effectively.
- Empirical observation of Fonterra's exercise of (considerable) discretion with respect of the setting of the base milk price over time. The evidence shows a consistent, systematic pattern

2 This approach is enabled by the Animal Products (Labelling Requirements for Exports of Dairy Based Infant Formula Products and Formulated Supplementary Foods for Young Children) Notice 2014 that allows imported milk powders to be processed in New Zealand and then marketed and sold as "Made in New Zealand". We note that domestic Fair Trading rules on this do not apply to exports. Open Country does not want the DIRA Review to be distracted by this issue but is happy to take this up separately with MPI.

3 Open Country Dairy *Review of the Dairy Industry Restructuring Act*, section 2.

4 Fonterra *Farmgate Milk Price Statement* (2018) at 11. We note in addition that addition interest and tax rate reductions have led to a further systemic increase of 22.2 cents in the milk price since 2009. This 51.8 cent increase in the base milk price over time reflects a transfer from Fonterra's value-added operations to its commodities business of around $750 million in the last 2017/2018 season. This must also have a negative share price impact

of pushing the base milk price away from contestable market levels, rather than balanced calibration (which would be expected if managing milk supply risk was a primary driver).

- Fonterra exercising Board discretion to lower its final payout to farmers without reducing the regulated base milk price. This has the effect of lowering Fonterra's seasonal costs, but maintaining high input costs for Fonterra's competitors who purchase raw milk based on the regulated base milk price.
- Fonterra's incentives that serve its own interests rather than the policy goals of DIRA, including:
  - an incentive to attract and retain supply over the long-term;
  - an incentive to weaken competition by interfering with its competitors' businesses;
  - an incentive to reduce new market entry and expansion through non transparent pricing that departs from efficiency standards; and
  - an incentive to increase the base milk price (relative to the dividends) arising from Fonterra's capital structure.
- The failure of the DIRA framework to mitigate Fonterra's ability to le erage its dominance. That regulatory framework has not been effective at promoting a t ansparent and efficient milk price that enables contestable levels of entry, growth and dynamic change because Fonterra's dominance takes effect from within that framework

Castalia's economic evidence strongly supports Fonterra having the incentive and ability to act in its own short-term strategic interest in its setting of the base milk price rather than replicating an efficient price derived under contestable market conditions.

From a regulatory policy perspective, the Castalia evid nce also demonstrates the high level of risk associated with the current market and regul tory arrangements. A base milk price that is misaligned with the efficiency and contestability objectives suppresses the ability of independent processors to compete with Fonterra and prevents new processors from entering the market. The competitive pressure on Fonterra to achieve effici ncie within its business operations is consequently weakened. Further, it is widely accepted that he base milk price only needs to be marginally misaligned in order to undermine efficient entry and expansion, and to erode contestability.[5] All of this points to the need for an effective regulatory regime hat neutralises Fonterra's ability to act on its strategic incentives and achieves an efficient price which would have been derived under contestable market conditions.

5 Strengths and weaknesses in the DIRA regulatory regime

The economic eviden e compiled by Castalia is also an important means of assessing the quality and effectiveness of the DIRA regulatory regime. In that respect, the evidence is clear that the base milk price calculation process is not currently serving the objectives of the DIRA regime. Castalia's analysis conf rms that the core function of any reforms to the DIRA regulatory regime must be to mitigate any incentives on Fonterra to impede contestability and compromise on efficiency.

Our previous submission noted that open entry and exit requirements and a base milk price consistent with prices produced by a contestable market provide a strong theoretical starting point for an effective regulatory regime. But it is vital that both of these elements work effectively if the DIRA regime is to achieve its policy goals.

5 Commerce Commission *Review of Fonterra's 2017/2018 base milk price calculation* (draft report, 15 August 2018) at [B33].

Open entry and exit

We explained in our previous submission on the terms of reference why Fonterra's open entry and exit requirements are essential for contestability.[6] The obligation on Fonterra to accept supply on an all-comers basis directly enables farmer-suppliers to enter into supply arrangements with independent processors. The option of returning to Fonterra if supply to a competitor is ultimately unsuccessful mitigates the risk of supplying to an independent processor.

Fonterra has acted punitively against farmer-suppliers in the past where they have sought to return to the co-operative,[7] and it will likely do so again in the absence of regulatory protection. Protecting against this type of opportunistic behaviour in the past has directly enabled several independent processors to enter the market. Maintaining this protection will be essential to promoting meaningful contestability in dairy markets in the future.

These considerations mean that there is absolutely no question of unwinding Fonterra's open entry and exit as part of the current review. In saying this, we are of course aware of the potential criticisms of these requirements, but these criticisms are either misplaced or seek to achieve objectives that are best promoted by other means.

We recognise that from Fonterra's perspective, the open entry and exit requirements represent significant costs to the business. These include collection costs and investment in processing capacity that might not otherwise be required. However, we note the following:

- The appropriate standard for assessing existing collection costs is whether these are unreasonable in light of avoided deadweight losses to society from foregone entry and expansion by Fonterra's competitors. There is no credible evidence that this is the case. In any event, existing collection costs are not inhibiting Fonterra's ability to consistently raise the base milk price, indicating that the impacts on Fonterra's operations are minor.
- Investment in additional processing capacity is not required where there is a functioning secondary market for raw milk, which is the case in New Zealand. If Fonterra collects supply in excess of its processing capacity that raw milk can be efficiently allocated among other processing plants. It is unclear why over-investment in processing capacity (or, conversely, under-investment in value-added activities) would result from the open entry and exit requirements.

We also acknowledge that there is a view that open entry and exit requirements mean that the full environmental impacts of dairy conversions are not internalised by new farmer-suppliers. The damaging consequences of these externalities are then exacerbated by the ease of entry of new supply in a market with a guaranteed buyer. Open Country is incredibly sensitive to these environmental concerns. Our firm policy is that we do not collect milk from suppliers unless they can demonstrate compliance with all environmental regulations, and we regularly audit our suppliers to ensure that this is the case. In respect of the relationship between open entry and exit requirements and environmental concerns, again we note the following two points to place these concerns into their proper perspective:

- The key driver of over-investment in farmer supply is actually a base milk price that is consistently higher than contestable market levels over time. As we have already made clear in our previous submissions, a more accurate base milk price would ensure that dairy conversions on marginal land will only occur where the additional value is sufficiently high that it outweighs any associated costs.
- Comprehensive environmental legislation is necessary to address environmental concerns in the dairy sector. Removing open entry and exit requirements, or any other aspect of the DIRA

6 Open Country Dairy *Review of the Dairy Industry Restructuring Act*, section 4.1

7 *McIntyre and Williamson Partnership v Fonterra Co-operative Group Limited* [2015] NZHC 3012 at [113].

regime that promotes contestable dairy markets, would be a poor substitute for targeted environmental regulation and would carry its own unintended consequences.

Setting the base milk price

While by and large the open entry and exit requirements have been effective (and so must be retained), our previous submission traversed the weaknesses of the regulation of the base milk price in some detail. In short, the DIRA regime fails to restrain Fonterra from determining a base milk price that is misaligned with the purposes of the DIRA regime because:

- DIRA lacks meaningful enforcement powers and regulatory standards;
- there is insufficient time to carefully assess Fonterra's determination;
- there is a lack of accountability within the regime for determinations made by Fonterra and the Commerce Commission; and
- there are insufficient independent resources to review Fonterra's processes effectively.

The success of the current review will turn on whether these identified weaknesses are appropriately and fully addressed by any reforms. That is because, as Castalia's detailed economic evidence demonstrates, the impact of these weaknesses is pervasive. Despite the implementation of the milk price monitoring regime:

- Fonterra has remained dominant, and has increased the amount of milk it collects;
- new entrants have failed or been forced to adopt radical pricing strategies to a secure supply;
- Fonterra continues to set the *de facto* price for raw milk supply throughout New Zealand; and
- independent processors are reactive to Fonterra's pricing due to an acute lack of transparency.

We also note that Castalia does not consider that further loss of market share by Fonterra will change the need for a robust milk price setting and monitoring framework.

It is important to understand precisely how Fonterra's dominance exposes the weaknesses within the milk price monitoring regime in practice. The regime anticipates that the base milk price will reflect the price that would be achieved by an efficient processor operating in a contestable market (the 'notional producer'). In reality, it reflects Fonterra's strategic interests where those come into conflict with contestable market outcomes.

Excessive discretion

The base milk price setting process leaves significant room for interpretation and adaptation in its application season to season. As a result, Fonterra has discretion to determine cost inputs and operating assumptions, which is often exercised in strategic or patently unrealistic ways. Taking the last 2017/18 season as an example:

- Fonterra's treatment of farmer support payments and lack of transparency on capacity of its standard plants in the Milk Price Manual have both been found to be inconsistent with the promotion of the DIRA policy objectives.[8] Fonterra has, however, maintained these features of the Milk Price Manual, as they afford Fonterra additional discretion to move the base milk price as the season progresses.
- In respect of the base milk price calculation, Fonterra recorded several material cost variances in respect of items such as packing costs, effluent costs, supply chain costs, capital charges, and losses, which all led to an increased milk price. There is no publicly available justification for

8 Commerce Commission *Review of Fonterra's 2017/18 Milk Price Manual* at [X8].

these costs variances, even though the result was a significant shift in the resulting base milk price away from contestable market levels.

- Fonterra based its calculation on production yield assumptions that are physically impossible to achieve. Even if Fonterra assumed zero percent yield losses, which is a fanciful level of efficiency and manifestly not practically feasible, it still could physically not achieve the yields claimed.
- Fonterra based the make-up of its portfolio of reference commodity products on an assumption of a protein:fat ratio of 0.7554. This was treated as being practically feasible despite being well under the estimated national average, which is a protein:fat ratio of between 0.7650 and 0.7764.

Fonterra's ability to manipulate these key variables unchecked effectively gives it full control over the setting of the price for raw milk for the entire sector each season. This situation cannot be described as contestable or appropriate from the perspective of regulatory quality.

Ambiguous statutory criteria

These strategic and unrealistic assumptions set out above are enabled by ambiguous statutory criteria, which inhibit the effectiveness of regulatory monitoring. We set out in our previous submission that the practical feasibility standard in particular is amorphous, is not calibrated to the underlying policy goal of contestability (as it sets the notional producer up as a 'super-competitor'), and is misapplied in practice. When departures from clear industry performance standards, physically impossible levels of efficiency and undemonstrated cost adjustments are effectively endorsed by the regulatory regime, the standards against which the regime is applied need to be recalibrated and strengthened.

Lack of transparency

Fonterra is able to mask the exercise of discretion to favour its own strategic interests by adopting increasingly opaque methods for determining commodity revenues. For example:

- More and more revenue is assumed to be derived from off-GDT sales, away from the transparency of the GDT global auction platform. Fonterra consistently asserts without public evidence that it is able to secure higher prices for precisely the same commodity products simply by selling them in a less transparent fashion, which is simply a remarkable claim for any business to make (especially given the Global Dairy Trade sets the global benchmark for Dairy products and is widely publicised and accessible). Further, Fonterra claims it is able to achieve these additional revenues without incurring additional sales costs. This seems improbable at the very least, and we are concerned that Fonterra is classifying the cost differential to make product variants at a higher price or return when in reality it covers additional dairy solids or operational costs of production and does not deliver a higher return. In any case it is certainly a claim that calls for close, independent scrutiny but such scrutiny is not a feature of the current regulatory regime.
- This trend of increasing opaque sales continued in the 2017/18 season, when as much as 45% of sales were effectively unaccounted for by the regulatory regime because they occurred 'off-GDT'. This is particularly concerning given:
    - The Commission initially accepted the inclusion of off-GDT sales in the Milk Price Manual on the basis that GDT sales would remain the primary reference point for determining the base milk price.[9] No-one in the sector contemplated this minor additional category being extended to 45% of total sales, although Fonterra moved to make this recalibration almost immediately.

9 Commerce Commission *Review of Fonterra's 2016/17 base milk price calculation*, at [2.107].

- o The Commission has insisted on, and Fonterra has committed to, providing disclosure of off-GDT sales results throughout the season.[10] This has simply not occurred with respect to the current 2018/2019 season.

- Sales phasing throughout the season can have a significant impact on revenues. However, the sales phasing data that informs that base milk price is treated as commercially sensitive information to Fonterra, and accordingly is not disclosed to the market. This leaves competitors guessing with respect to a major component of their end-of-season costs that simply cannot be reliably anticipated.

Lack of enforcement options

The Commission has no control over Fonterra's final determination of the base milk price, and Fonterra is not compelled to adjust its base milk price determination in response to the Commission's assessment of it. This represents a completely lack of regulatory enforcement options.

In the 2017/18 season, the Commission exhaustively demonstrated that Fonterra s det rmination of the notional producer's cost of capital was artificially low, thereby artificially shifting t e base milk price away from contestable market levels. The Commission's own estimates put he change in the base milk price at somewhere between 3.6 and 8 4 cents, or a transfer of $54-120 million away from Fonterra's shareholders for that season (we estimate around $440 million over the 6 years since the issue was first raised with the Commission for scrutiny).

Fonterra's response was to simply ignore the Commission's evidence, because it has no incentive to pursue the efficiency and contestability objectives of the egime The Commission has no statutory or administrative enforcement power to bring Fonterra's base milk price into line with the efficiency and contestability goals of DIRA, despite egregious and flagrant departures from contestable market standards of this kind.

Weak regulatory accountability

If the Commission does not discharge its review functions in the manner that is most consistent with, or best promotes, the efficiency and contestability goals of DIRA, then there will be no meaningful regulatory accountability. This is because s andard legal accountability measures are difficult to apply as a result of:

- the relevant statu ory crit ria being open to interpretation;
- in the absence of effective review, excessive *de facto* discretion being conferred on a private-sector deci ion-maker;
- a lack of a requi ement to consult with affected parties; and
- the Commission's functions being limited to a light-handed review rather than a deeper substanti e assessment.

Thes unique features mean that the usual regulatory accountability mechanism, judicial review, is diffi ult to apply in all but the most severe departures from the statutory scheme. The threshold for justiciability is likely to be considered high, with the judicial review process not seeking to ascertain the *right* substantive answer *vis-a-vis* the purposes of DIRA.

In relation to this final point, MPI may be aware that Open Country has filed judicial review proceedings in respect of the Commerce Commission's review of Fonterra's 2017/18 base milk price determination. While we are confident in the substantive merits of our claims (and that they meet the high threshold referred to above), we cannot ignore the structural barriers to effective review imposed by the DIRA regime. In any case, judicial review is a poor accountability mechanism in the context of the base milk

10 Commerce Commission *Review of Fonterra's 2016/17 base milk price calculation*, at [X15].

price, where it is critically important for the sector and the New Zealand economy to get the substance of any pricing determination correct each season. Open Country can exhaust the review options available to it in order to try and repair the base milk price regulatory regime, but a fit-for-purpose accountability mechanism remains the first-best solution.

6 Impacts for the dairy sector and independent processors

There are two broad impacts for the dairy sector and independent processors that result from Fonterra's practice of exploiting the weaknesses in the base milk price setting regime. These are a lack of transparent, credible market price, and an inefficient allocation of market funds.

Fonterra's practice of aligning the base milk price with its own strategic interests results in apparently arbitrary and unpredictable pricing decisions. There was a clear example of this in the 2017/18 season. On 21 March 2018 Fonterra announced an estimated final base milk price of $6.55 per kgMS. Market participants and analysts internalised this pricing guidance, but on 23 May 2018 Fonterra revised its estimate to $6.74 per kgMS. Market participants and analysts were confused by this revision, and could not point to any evidence to justify the change. Fonterra informed the market (without supporting evidence) that the change was the result of it earning higher revenues due to changes in commodity prices. However, the market was largely unable to verify the basis for this change.

The scepticism of market observers was vindicated when Fonterra finalised its base milk price at the end of the 2017/2018 season. While the final base milk price officially remained at $6.74 per kgMS, Fonterra's Board exercised its residual discretion to lower the actual payment to its farmer-suppliers to $6.69 per kgMS. As it turned out, Fonterra did not have the financial capacity to pay the full amount of its revised base milk price estimate, and it was forced to return to a final payout that was more aligned with market expectations.

While Fonterra was able to mitigate the cost impact of its unprincipled forecasting through the exercise of Board discretion, Fonterra's competitors do not have the same opportunity. Market practice is that raw milk supply contracts reference the regulated base milk price, not the actual Fonterra price, determined for the season. As a result, Fonterra's competitors all faced inflated costs as a result of the lack of transparency afforded to Fonterra's estimating and price determination processes. This inflated cost poses a significant risk to any independent processors business as:

- independent processors are in fact often required to pay a 'switching premium' for raw milk supply over and above the regulated base milk price, which can be as high as 15 cents per kgMS; and
- the risk to an independent processor of setting a price that is too low is highly tangible as it can result in a loss of suppliers for the following season (we understand this can rise as high as 30% of suppliers lost on a seasonal basis).

This arbitrary and unjustified change in the base milk price estimate shapes market expectations and impacts on independent processor operations. Artificially inflating milk price estimates away from market fundamentals inhibits competition for supply of raw milk among processors, and potentially bifurcates suppliers to Fonterra and suppliers to other processors. In essence, a premium is attached to raw milk supplied to Fonterra, when the very purpose of the DIRA regime is to avoid any such artificial premium. The effect on independent processors is an increase in supply costs, and a consequent squeeze on margins, conferring on Fonterra a clear anti-competitive advantage.

This was the second occasion that Fonterra had exercised Board discretion to lower its actual payout relative to the regulated base milk price in this way. In the 2013/2014 season the Fonterra Board lowered its payout by 55 cents. This caused significant repercussions for the sector given the cost implications for independent processors. Whatever Fonterra's motivation for this practice, there is no way it should have occurred if the regulatory price monitoring regime was effective at restraining the arbitrary exercise of discretion and the strategic leveraging of Fonterra's dominance.

These are two rare examples of where Fonterra's manipulation of the base milk price is made apparent. The insidious feature of Fonterra's usual practice is that it is camouflaged, and the full long-term effects may never be quantified or known. We can, however, get a sense of the scale and impact of the misallocation of market funds season to season by aggregating estimates of known unjustified movements in the base milk price. For example, known departures from the DIRA standard by Fonterra in the milk price setting process in respect of the 2017/2018 season are set out in the following table:

Fonterra's manipulation of the base milk price for the 2017/2018 season

Component	Change to FGMP	Cost misallocation[11]
Farmer support payments	Unable to verify[12]	Unknown
Plant capacity assumptions	Unable to verify[12]	Unknown
Production yield assumptions	Unable to verify[12]	Unknown
Protein:fat ratio	Unable to verify[12]	Unknown
Off-GDT sales	11 cents	$165 million
Asset beta (WACC)	3.6-8 cents[13]	$54-120 million
Packing, effluent and variable supply costs	1 cent	$15 million
Capital charge reduction	1.5 cents	$22 million
Over-estimate[14]	5 cents	$75 million
Interest and tax rate reductions	22.2 cents	$333 million
Total	>46.4 cents	>$664-730 million

This is a staggering amount of funds potentially misallocated each season, which cannot help but have a direct effect on the incentives faced by Fonterra and the industry as a whole. Simply put, the incentive structure for one of New Zealand's most important set of markets is misaligned by an amount approaching three-quarters of a billion dollars each year (and potentially more, if the unverified impacts have the value we have estimated in footnote 12).

This same artificial and unjustified shift in the base milk price also represents an arbitrary increase in Open Country's cost base of around $70 million for the 2017/2018 season. Given the addition of unverified impacts, the true cost inflation is even higher. Other independent processors will be similarly affected. This creates nothing more than a drag on the sector, delaying or outright preventing the capital investment that would drive sustainably higher milk prices over the medium to long term.

11 Based on public statements by Fonterra that each 0.1 cent movement in the base milk price correlates to $1.5 million in bottom line revenue: see https://farmersweekly.co.nz/section/dairy/view/milk-price-guardian-fires-back

12 These unverified figures contribute to the publicly reported 29.6 cent per kgMS increase in the base milk price since 2009. Based on the available information these unverified amounts likely represent approximately 6.4 cents per kgMS (or $96 million for the 2017/2018 season).

13 Range calculated from Commerce Commission estimates of an impact of 3-4 cents added to the base milk price for every 0.1 change in the asset beta.

14 Reflected in Fonterra's Board decision to decrease the final payout to its farmer-suppliers without reducing the regulated base milk price.

Fonterra effectively controls access to farmgate milk through its ability to set the base milk price. This skews the efficiency of its own incentives, as it transfers wealth away from value-added activities, but it also sends shockwaves through the entire dairy sector. Fonterra uses its dominance and discretion to raise costs to its competitors by a phenomenal amount, and independent processors are unable to plan for these cost shocks season-to-season because of the almost complete lack of transparency Fonterra imposes. There is nothing contestable or efficient about these arrangements, and they must be resolved with firm regulatory action.

7 Criteria for evaluating reform

MPI has proposed the following criteria as an indicative list for assessing the quality of any proposed DIRA regulation:

- certainty;
- predictability;
- transparency;
- cost-effectiveness; and
- timeliness.

These are, of course, useful standards against which regulatory regimes can be assessed. However, they are not a list of criteria for choosing among regulatory proposals. Rather, they speak to the parameters of the detail of the design and implementation of a regime, ensuring that it is structured and put into effect in the most responsible way.

Selecting among different regulatory options requires reference to criteria that measure the *effectiveness* of the proposed regime against the principal alternatives. In the first place, this must include the ability of the regime to secure or promote the underlying policy objectives of the regime. In the case of the DIRA regime, it is not controversial that these policy objectives are efficiency and contestability (in the sense of the regime filling in the gaps left by the absence of market forces).

We have demonstrated at length in our previous submission that the terms 'efficiency' and 'contestability' need to be understood broadly if they are to have any meaning as policy objectives.

Given the weaknesses of DIRA regulation of the setting of the base milk price, an effective regime is also likely to directly address the issue of Fonterra having the incentive and ability to leverage its dominance by setting a base milk price that does not align with the price that would be expected in a workably competitive market (that is, an efficient and contestable market). To achieve that, an effective regulatory regime would:

- minimise the extent of any discretion in the implementation of the regime, and especially any opportunity for the exercise of discretion by market participants;
- where residual discretion remains, ensure the independent and impartial application that discretion so as to best promote the regime's policy objectives; and
- where the regime relies on cost information and other inputs from market participants, ensure that these are only accepted where they are demonstrably justified, including transparency over those inputs to all market participants.

Once the framework of an effective regulatory regime that satisfies these points is adopted, then the regime can be designed in the most appropriate way to promote certainty, predictability, transparency, cost-effectiveness and timeliness.

8 Evaluation of policy options

In the Discussion Document, MPI suggests three policy options as the basis for possible reform. These are:

- maintaining the status quo;
- providing statutory guidance on the meaning of 'practical feasibility'; and
- conferring on the Commerce Commission the statutory power to set the base milk price.

In addition, Open Country proposes consideration of the following options:

- the establishment of an independent dairy authority; and
- the promulgation of a statutory (or regulatory) milk price methodology.

These additional two options meet the criteria of an effective regulatory regime, as set out above, and may strengthen it. As a result, they ought to be considered as options along with those already identified by MPI.

Status quo

Maintaining the status quo is not a credible option in light of the obvious and xtensive weaknesses in the DIRA regime. The best evidence we have, including the expert economic evidence provided by Castalia, is that the status quo allows Fonterra to manipulat th base milk in a way that benefits Fonterra' own strategic interests rather than replicating an eff cient price derived under contestable market conditions. This is damaging to the dairy sector, and must be categorically resolved.

Guidance on 'practical feasibility'

The base milk price setting regime can only benefit fr m principled guidance as to the meaning of 'practical feasibility'. As we have set out above that term has been applied in a way that acts as a barrier to achieving contestable market outcomes, rath r than promoting those outcomes.

Any further guidance needs to emphasise hat the need for independent processor entry and expansion under real-world market conditions of New Zealand's actual dairy markets is the standard against which practical feasibility is to be ass ssed. These features are the defining features of contestability, and so those features need to inform any statutory guidance of the standard to be achieved. This includes:

- a shift in emphasis away from what Fonterra is deemed to be able to achieve with its secure supply, access to international markets and immense scale to what a real-world challenger can realistically achieve; and
- recognition that Fonterra's incentive and ability to manipulate the base milk price impacts directly on independent processor operations, including the financial capability to invest in entry and expansion.

However, improved guidance on practical feasibility is not sufficient to establish a credible and effective regulatory regime, because it does not address the issue of Fonterra's discretion to set a base milk price out ide of contestable market parameters, the transparency of how the milk price is calculated, or the effectiveness of the monitoring of Fonterra. The clearest evidence of Fonterra's abuse of its discretion is Fonterra's recent refusal to set the notional producer's cost of capital at contestable market levels despite the Commerce Commission's monitoring of the base milk price concluding that this was required. There has been absolutely no contrition on Fonterra's part for misallocating $441 million over the last six years. Greater guidance may better expose Fonterra's sharp practice with regard to contestable market outcomes, but it will not serve to address that sharp practice.

Statutory power to set the base milk price

Of the three policy options suggested in the Discussion Document, conferring a statutory power on the Commerce Commission to determine the base milk price is the only option that addresses the issue of Fonterra's market dominance and excessive discretion within the price setting regime. In this sense, this option is the minimum that is required to ensure a credible regulatory regime.

Empowering the Commission in this way achieves a number of positive outcomes for the regime:

- it moves any discretion over the base milk price away from a market participant (who has a vested strategic interest in the outcome) to an independent decision-maker whose only commitment is to the fidelity of the regulatory regime;
- it provides an opportunity to specify with greater clarity the goals of the regime, so that the Commission is able to directly promote those objectives through the base milk price;
- it provides an opportunity to develop a regulatory decision-making process that aligns with best practice, including an incentive to resource dairy market regulatory governance appropriately, adequate time for consideration of the issues, and meaningful consultation with market participants;
- it promotes greater accountability over Fonterra, as the Commission can scrutinise any Fonterra inputs and exercise its own discretion on the matter; and
- it promotes greater regulatory accountability with clear standards and goals that can be assessed to appropriate legal (that is, judicial review) and political accountability standards.

Much will turn on the precise detail of the statutory framework to ensure that the goals of regulatory quality and effectiveness are realised. That said, determination of the base milk price by an independent regulator (whether the Commission or, as we suggest below, an independent dairy authority) is a bottom line for credible reform.

Milk price methodology

The option of promulgating a statutory (or regulatory) milk price methodology builds on the option of providing more guidance on the meaning of practical feasibility. It is a tested and effective way of promoting transparency and predictability while minimising the scope of any discretion that might frustrate the policy objectives of the DIRA regime.

Open Country has taken inspiration for a milk price methodology from the input methodology regime in Part 4 of the Commerce Act. That regime sets out a number of regulatory processes and calculation in systematic form with the express purpose of promoting market certainty. These input methodologies are determined by the Commerce Commission, and are applied by the Commission or regulated businesses as appropriate. The expectations among the regulatory community and the full range of market participants is abundantly clear as a result.

There is particular value from this type of approach in terms of limiting Fonterra's current dominance has over the base milk price determination process, and in this respect it measures up well against the criteria of market certainty, regulatory predictability and process transparency. There would be an initial concentration of regulatory effort to determine the milk price methodology, but once established its operation would be largely mechanical. Over the medium-to-long term, it would therefore be cost-effective and extremely timely.

Further, we do not anticipate that the initial regulatory effort would be as all-consuming as the initial establishment and implementation of the Part 4 input methodologies. The broad approach to determining the base milk price is now well established and understood, and it would be possible to draw on much of the existing practice documented in the Milk Price Manual. In that context, statutory provision for the determination of a milk price methodology would be a relatively straight-forward and principled addition to any new Commission powers to determine the base milk price.

Independent regulatory authority

Open Country considers that it is also necessary to consider the establishment of an independent regulatory authority. The Commerce Commission has struggled with an inadequate regime without resources or appropriate statutory powers, but its implementation of the regime has also contributed to a transitory mindset that works against DIRA achieving long-term efficiency and contestability. As explained in our previous submission, two features have contributed to this transitory mindset:

- the fact that dairy markets are not subject to conventional natural monopoly characteristics, where the Commerce Commission has traditionally regulated markets for workable competition over the long term; and
- the existence of statutory expiry provisions.

A step change is now needed away from an implicit assumption that dairy markets will be deregulated in the short term to effective long-term market governance arrangements. The creation of a newly established independent agency with a clear long-term mandate may be a necessary or desirable step for this change in mindset.

Whether an independent regulatory agency is to be preferred to the option of conferring additional powers on the Commerce Commission will likely be determined by the weight placed on MPI's timeliness and cost-effectiveness criteria. An independent agency with a clear statutory mandate has the potential to dramatically improve on market certainty, regulatory predictability and process transparency. However, it will be both time and resource intensive to bring the new agency to the point where it is functioning effectively as intended. Whether the incremental benefits in regulatory quality outweigh these financial costs and timeliness constraints is a matter that MPI will have to weigh carefully in the balance.

9 Conclusions

This review is critical to the New Zealand dairy sector, a sector responsible for employing tens of thousands of New Zealanders and billions of dollars to the New Zealand economy. We deserve a national champion business that exploits its scale in international markets to benefit all of us without compromising the effective operation of domestic dairy markets.

We have detailed extensively in this submission and elsewhere the fundamental flaws in the milk price monitoring regime, and how those flaws can be efficiently and effectively remedied. We look forward to a principled and effective set of proposals from MPI that will carry Fonterra and the entire dairy sector through the 21st Century.

Best regards

Steve Koekemoer
Chief Executive Officer, Open Country Dairy Limited.

Schedule A – Responses to specific questions

MPI question	Open Country response
1. Do you agree with our description of the DIRA regulatory regime and its original policy rationale? Do you consider the original policy rationale is still valid?	Open Country broadly agrees with MPI's description of the DIRA regulatory regime and the underlying policy rationale. These policy concerns are clearly still valid, and should be directly shaping the next iteration of the DIRA regulatory regime. The regulatory regime remains necessary because of Fonterra's market dominance. Fonterra is the de facto price-setter for the entire market, and enjoys economies of scale and scope that are not available to new entrants or established challengers. To the extent that the DIRA regulatory regime was originally intended to mitigate the effects of this market dominance that policy rationale remains valid (and indeed highly relevant). It is valuable that all parties recognise that a key objective of the creation of Fonterra was to "facilitate the emergence of new competition and new strategies in the dairy industry". After almost 20 years, it is clear this has not been satisfactorily achieved. The focus on low administrative costs is a product of its time. It was part of an overstated concern that government regulation would stifle industry development. That concern fails to consider the far greater costs of a inefficient and non-competitive industry structure. The reality is that the greater risk comes from Fonterra abusing its dominance, and government intervention now needs to be viewed in the context of the market outcomes it helps facilitate. The industry has manifestly not achieved a contestable dynamic of its own accord, and more fit-for-purpose regulation is needed. New entry, when it occurs, is extremely beneficial for the sector. It makes available new capital structures for farmers, and through competitive constraint works to ensure that Fonterra operates efficiently. These effects are complementary to, not an alternative to, an accurate base milk price. As noted, Open Country's primary concern is with the setting of the base milk price. The discussion paper notes that the intention of the DIRA price setting regime is "that Fonterra is incentivised to set its milk price and cost of shareholding in a way that produces an optimal volume of milk to run its existing processing capacity (i.e. its sunk investment) while directing further investment to higher value use/product lines". We completely agree that this is the appropriate function for the price setting regime. If done appropriately, this price setting also addresses Fonterra's market power and its incentives to act anti-competitively towards competitors and farmer-suppliers. As noted in this submission and elsewhere, our concern is that the DIRA price-setting regime does not fulfil this function at all in practice.

MPI question	Open Country response
	This is a direct result of Fonterra using the base milk price to restrict and dete competition for raw milk supply, not as a market signal of the value of raw milk that impacts the volume of supply a ailable or any other purpose that might be consistent with a contestable market dynamic. It is also notable that the Discussion Document refers to transpar ncy of the base milk price. This has been an ongoing concern with the regime, especially for independent processors The Commission has itself noted on several occasions that more transparency from Fonterra would improve the regim , although it lacks the formal powers to compel Fonterra to provide this needed transparency. The result is that F nterra regularly commits to providing greater in-season transparency but fails to deliver that transparency in practice. This fail re to promote predictability in the base milk price results in a one-sided competitive dynamic where the dominant market participant secretly shapes the cost structure of its competitors. This dynamic is antithetical to a contestable market an cannot be allowed to continue.
2. Are there any other dairy industry developments or industry performance indicators that are not captured in Chapter 2, Appendix 1, or the reports by Frontier Economics?	Open Country agrees that most of the key developments and performance indicators have been identified in MPI's analysis. However, we would augment that analysis in at least two respects. First, we would characterise the cur ent market dynamics in a way that exposes Fonterra's ongoing dominance in the sector. Entry and expansion from Fonterra's competitors has been confined to specific geographic areas (primarily Waikato, Canterbury and Southland), nd has been effective at targeting new growth in supply rather than Fonterra's existing farmer-suppliers. This has allowed Fonterra to increase the volume of raw milk collected even as its share of the farmgate supply has fallen. n addition, the scope of entry has been limited in some cases, with the aim being to leverage New Zealand's bra d value as a marketing initiative rather than to commit the necessary investment in sustainable processing capacity tha might be expected from an active competitor for supply. This market context does not represent meaningful contes ability, where entry and exit can readily occur in a manner that disciplines the incumbent, let alone workable competition. Fonterra is still dominant, and the vast majority of farmer-suppliers face no realistic prospect of competition for their raw milk. Second, we refer to the economic evidence provided by Castalia. This evidence shows a deliberate and systematic raising of the base milk price by Fonterra over time. As the Castalia report indicates, the purpose is most likely to be to restrict and deter competing supply for Fonterra's own benefit. It is not a reflection of international milk prices. The DIRA regime has been ineffective in constraining Fonterra's ability to act on its anti-competitive incentives. This is a key reason for the absence of contestability in the market context outlined above.

MPI question	Open Country response
3. Do you consider the DIRA has been effective at achieving its core regulatory objective of preventing Fonterra from using its dominance to create barriers to farmers' milk and land flowing to their highest value uses? If not, please provide reasons and supporting information/evidence.	No. DIRA has not been effective at achieving its core regulatory objective of pre enting Fonterra from using its dominance. In our previous submission, we pointed to a number of examples which clearly demonstrate Fonterra is still able to rely on its market dominance. These examples included Fonterra's transfe s of value to the base milk price (and away from shareholder returns) unchecked,[15] its ability to avoid transparency and scrutiny with respect to sales practices (by moving transactions off the GDT platform), and the fact that it has ignored ustained criticism and evidence that its approach to cost of capital calculations is unjustifiable.[16] The economic evidence provided by Castalia now demo strates that Fonterra's market conduct is dictated by incentives to act anti-competitively, and that the DIRA price- etting mechanism is a key means of exercising that dominance. DIRA affords Fonterra considerable discretion in respect of the determination and application of the Milk Price Manual each season, and the lack of transparency over key cost and revenue inputs masks this discretion even further. What the DIRA regime has done is ocus how Fonterra can leverage that market power. In the absence of close scrutiny of, or repercussions for, its pricing deci ions it is free to exercise its market power in its own interests through the DIRA regime itself. The veneer of Commerce Commission scrutiny allows Fonterra to disavow that its market power or strategic objectives have any influe ce over the base milk price calculation, but the reality is that these are the driving factors for the base milk price calculatio under the prevailing market governance arrangements. It is worth emphas sing the cynical approach Fonterra has adopted here. While shaping the base milk price to serve its own strategic interests and ignoring the regulator's concerns that it has disregarded the contestable market standard, public Fonterra co tinues to claim that it is tightly regulated and that the final based milk price is mechanically set by a legislative framework.[17] In reality Fonterra acts arbitrarily through the considerable discretion the regime affords it, or by ignoring the regime al ogether. This completely undermines the effectiveness of the DIRA regime and its ability to promote its core policy objec ives.

15 See, for example, https://farmersweekly.c .nz/ ection/dairy/view/wilson-spierings-argue-valid-comparisons-value-add.

16 See Commerce Commission Revie of Fo terra's 2017/2018 base milk price calculation: Emerging views on asset beta.

17 See, for example, the comments of Br nt Goldsack reported here: see https://farmersweekly.co.nz/section/dairy/view/milk-price-guardian-fires-back.

MPI question	Open Country response
4. Do you think Fonterra is still dominant in the market for farmers' milk, at the national and regional levels?	The evidence is absolutely clear that Fonterra remains dominant in all geographic markets, whether defined on a regional or national basis. Fonterra may argue that because its competitors operate in certain regions, it faces meaningful or effective competition in these areas. This would be a serious mischaracterisation of the reality of the situation. As we have outlined in the body of our submission, the market context is one of Fonterra dominance and limited contestability. Genuine contestability has only occurred with respect to growth milk, and even then only because independent processors have taken on the additional risk and cost of paying well above market prices to secure initial supply. With the forecast decline of growth milk contestability will be further limited, and the vast majority of farmer-suppliers will face no competition for their raw milk. There is only competition in the limited sense that Fonterra can still win supply back from independent processors. This dynamic does discipline the market to an extent, but it is a feature of Fonterra's dominance rather than a genuinely competitive dynamic. Open Country notes MPI's preliminary view that "in the absence of DIRA, the barrier to entry and expansion by independent processes could become significant". Barriers to entry and expansion remain *despite* DIRA, and this needs to be addressed in any proposed reforms. The limited entry and expansion that has occurred is fragile in the absence of open entry and exit requirements, and in any case is likely to stall under prevailing market and regulatory conditions (given the slowing growth in raw milk supply).

MPI question	Open Country response
5. Do you think the DIRA imposes unreasonable costs on Fonterra?	No. There are two issues to consider here: (1) the absolute cost of the DIRA regime, and (2) the proportion of the cost that is borne by Fonterra. The absolute cost of the DIRA regime is modest. While it require Fonterra to adopt certain internal processes and structures, such as maintaining the Milk Price Panel, these arrangements are not materially different from market expectations for a large, well-run co-operative business. The externa costs (which are met by levies on Fonterra as well as government appropriations) are very small. The regime is ov rseen by the equivalent of fewer than 3 FTE regulatory staff. This is a fraction of the 30 FTE regulatory staff that o ersee Ne Zealand's electricity sector, which is dwarfed by the dairy industry in terms of the size and significance to the New Zealand economy and does not face the same complex challenges of a grossly dominant incumbent with the incentive and ability to act strategically in its own interests. These modest costs could only be considered 'unreasonable' in any material sense if they outweighed the dead-weight losses to the New Zealand economy as a whole of a dairy sector plagued by inefficient pricing, foregone investment and completely unchecked monopsony power. There is absolutely no evidence that this is the case. The highest cost element from Fonterra's perspective may be the open entry requirements, which is referred to by MPI in the Discussion Documen as the "key additional cost", but it is difficult to understand these as material let alone unreasonable. Any costs are significantly mitigated by secondary markets for milk, meaning that raw milk can be efficiently allocated to process ng capacity.
6. Are there ways for the costs imposed on Fonterra to be mitigated without impacting on the effectiveness of the DIRA regulatory regime?	Open Country's strong view, supported by numerous pieces of evidence provided to this review, is that the DIRA regime is not effective Merely seeking to mitigate the costs of the current regulatory and market governance settings ignores both the pol cy obje tives of DIRA and the purposes of the current review.

MPI question	Open Country response
7. Are there any other regulatory tools that, in your opinion, would be more effective than the current DIRA provisions at managing Fonterra's dominance?	Yes. MPI should closely consider pricing input methodologies, information dis losure obligations, and transferring price-setting and review functions to an independent Dairy Authority. Open Country agrees with MPI that the generic competition protection provisions in the Commerce Act are highly unlikely to be effective at addressing Fonterra's market dominance. However, we categorically disagree with the unsupported as ertion that the provisions of the DIRA regime are "relatively clear-cut and are relatively easy to enforce". The lack of obje tive legislative or regulatory standards and an absence of effective enforcement options has been detailed in our previous submission. In summary: • there is an absence of meaningful regula ory powers, both in terms of depth of scrutiny of Fonterra's conduct and material consequences for breaches of regulatory standards; • the policy objectives of the statutory regime have not been translated into clear and unambiguous regulatory standards; • the Commerce Commission lacks both the time and the standing resource to undertake meaningful assessment of Fonterra's claims, assumptio s and inputs; and • there is a lack of independence in the price setting function (where Fonterra is the primary decision-maker) and a lack of accountability thr ugh very high judicial review thresholds and only cursory engagement with Fonterra and third parties For these reasons, other regulatory tools will be a necessary part of any proposed reforms to the DIRA regime. In our previous submission, we proposed: • pricing input methodologies; • information disclosure obligations in relation to Fonterra's price-setting practices; and • independent price-setting and review functions (potentially by a newly established Dairy Authority). These policy recommendations consciously draw on the Part 4 regulatory regime set out in the Commerce Act. As such, they directly target market power in a way that promotes transparency and predictability for all affected parties. We appreciate that they may appear novel in the context of dairy markets, but close consideration of all credible options should be a pre-requisite for the current review. The regulatory solution must be effective, which means directly targeting the acute issue of Fonterra's market dominance and excessive discretion under the prevailing regulatory regime.

MPI question	Open Country response
8. Are there other factors you consider need to be taken into account when considering the effectiveness of the DIRA regime and whether it is still needed?	It is critical to the success of the regime that discretionary aspects of its implementation are identified and scrutinised carefully. Under the current iteration of the regime, Fonterra retains a very high degree of de facto discretion. We see clear evidence of this in Fonterra's determination of: • the ever-changing product mix for determining global dairy prices and revenue; • selective processing plant scale and location assumptions; • non-standard and unsupportable cost of capital assumptions and depreciation schedules; • inconsistent definitions of ancillary costs; and • physically impossible yield assumptions Each time Fonterra exercises discretion in respect of these matters it has an opportunity to abuse its dominant market position. They exert a considerable influence over final pricing. Even a 1 or 2 cent increase in the final base milk price has a considerable anti-competitive effect, as it dds millions of dollars in arbitrary costs for each of Fonterra's competitors. Addressing these discretionary elements within the regime requires careful regulatory design encompassing the following steps: • minimising the discr tion within the regime by prescribing legislative standards (or, where necessary, making provision for the regulator to determine regulatory standards); • conferring respon ibility for residual discretion on an independent and impartial decision-maker (including obligations of over-arching fidelity to the statutory regime and its objectives rather than the interests of any one market participant); and • where Fonterra-sourced inputs remain vital to the credibility of the regime, full transparency to the regulator, market participants and other interested parties.

MPI question	Open Country response
9. Do you agree with our preliminary assessment of the extent to which the DIRA encourages industry growth?	Open Country broadly agrees with MPI's assessment. We would perhaps emphasise that DIRA itself has done little to directly promote growth in the sector. Growth has occurred, but inves ment has not gone into the most valuable parts of sector. This reflects the misalignment of incentives and weak price signals (by which we mean weak *vis-à-vis* price signals in a genuinely contestable market). The primary growth driver does indeed appear to be international demand for commodity dairy products. This international demand growth can only be served by increases in both domestic processing capacity and farmgate supply. It is unclear whether, as MPI appear to assume, that DIRA itself has enabled growth in processing capacity and supply. To a limited extent, because of the open entry requirements on Font rra and the need for Fonterra itself to invest in processing capacity to secure new supply, this 'growth milk' has been subject to a degree of competition among processes in restricted geographical areas. However, it is far from clear that price signals to farmers have been efficient, and new processing capacity may well have been a product of ove -supp y in response to a higher than efficient base milk price.
10. Do you agree with our preliminary assessment of the extent to which Fonterra can influence milk supply volumes through price, notwithstanding the DIRA open entry requirements?	The Discussion Document acknowledges that "DIRA leaves Fonterra with an ability to control its milk supply volumes from farmers through the price it pays them for their milk". As Castalia demonstrate in their report, the base milk price is a blunt signal in this context. It fails to act as n effective short-term incentive to increase or decrease supply. Castalia do acknowledge that Fonterra's Board has used its discretion to deviate from the base milk price, by lowering it, on two occasions. Howe er, again the motivation appears to be a factor other than controlling volumes. Indeed, as the final price is set at the end of th season there can be no direct influence over volumes supplied in that season. Open Count y does not share concerns about the open entry and exit requirements. Across the board, processing capacity is commensurate with raw milk supply, and a secondary market for raw milk exists. There is no reason for Fonterra to over-invest in processing capacity unless it is influenced by incentives to constrain supply to independent processors.

MPI question	Open Country response
11. Are there other factors that you consider should be taken into account? Please provide detailed comment in support of your views.	Fonterra's co-operative structure builds in an imperative to determine a base milk price higher than would be anticipated in a genuinely contestable market. Further, it has the discretionary power to ealise that objective. Fonterra's constitution states that: "the Milk Price should be the maximum amount the Company, reflecting its status as a properly managed and efficiently run sustainable co-operative, could pay…". This creates an imperative for Fonterra's board approach maximisation of the farm gate milk price as the over-riding consideration in all circumstances. The economic evidence provided by Castalia demonstrates he influence of this imperative in practice, with Fonterra systematically raising the level of the base milk price over time. This imperative significantly reduces the utility of the farm gate milk price as a market signal, whether the intention is to control raw milk volumes or any other purp se (such as encouraging entry and expansion).

MPI question	Open Country response
12. Do you consider that the DIRA provisions governing Fonterra's base milk price calculation and Commerce Commission monitoring may be preventing or disincentivising Fonterra from deviating from the base milk price calculation for strategic or commercial reasons?	No. The underlying incentive and revealed behaviour is for Fonterra to increas the FGMP because the FGMP mechanism itself is flawed. Fonterra has deviated from the farm gate milk price in respect of only two seasons. While it is difficult to know for sure, the reason appears to be an inability to meet the costs associated w th the base milk price. This suggests another important avenue for inquiry by MPI, which is whether the setting of the base milk price itself is deviating from contestable market prices given the inability of Fonterra to deliver that price. It should also be noted that independent processors link thei prices to the base milk price, not Fonterra's final price. This means that Fonterra raises costs to its competitors but does not face the full extent of that cost increase itself. In most seasons, however, Fonterra can manipulate the farm gate milk price, and so it has little ongoing reason to depart from that price. The 'deviation' is one of mo ement away from an accurate, market-derived price for raw milk, and it occurs within the determination of the farmgate mi k price itself. Fonterra sees value in superficial endorsement of the farmgate milk price from the regulatory regime. This is itself part of Fonterra's strategic behav our in the market. It is able to influence the farmgate milk price so that it suits its own commercial and strategic interests which are misaligned with contestable market outcomes, and then publicly disavow it has done so because of the appearance of objective Commerce Commission scrutiny.[18] This is deliberately misleading conduct that interferes with the operation of dairy markets and is directly facilitated by the fundament l flaws in the current DIRA regime. It is imperative that these flaws are fixed.
13. If the DIRA is not driving Fonterra's business and investment strategy, what is?	Fonterra business and investment strategy is driven by a strategic policy of constraining the supply of raw milk to its independen processor competitors. This is clear from the economic evidence provided by Castalia. In this espect, DIRA itself may not be a causal factor in Fonterra's business and investment strategy. Its' business strategy may be driven by loyalty to farmers, the seasonality of production, the co-operative structure, or a number of other relevant factors. Fonterra is a complex business and there is unlikely to be a simple answer to the question of its precise motivations, especially over time. However, the key point is that Fonterra can and does use the DIRA provisions and lack of effective oversight under DIRA to its advantage. This is why it is essential that DIRA is amended in the ways we outline elsewhere in this submission.

18 See, for example, the comments of Bre t Goldsack reported here: see https://farmersweekly.co.nz/section/dairy/view/milk-price-guardian-fires-back.

MPI question	Open Country response
14. Do you agree with our preliminary analysis of the DIRA's impact on the industry's environmental performance? If not, please provide your reasons and supporting evidence.	DIRA is not directly responsible for poor environmental outcomes. A base milk price that is misaligned with contestable market outcomes may incentivise marginal dairy conversions, and this c n be addressed. However, environmental concerns are generally separate from the objectives of the DIRA regime, and need to be addressed in their own regulation.
15. Do you agree with our view that environmental issues are best dealt with through the Resource Management Act and not the DIRA regime?	Yes. Attempts to deal with environmental issues through the DIRA regime will lead to unintended consequences. Such issues are critical to the long-term sustainability of the sector, and hey must be addressed directly through fit-for-purpose regulation.
16. Are there other environmental issues that you consider should be addressed either through the DIRA review or some other means?	Environmental issues should not be addressed through the DIRA regime, as this is not its purpose. These issues are critically important, but need to be addressed directly hrough a separate review of environmental regulations.
17. Do you agree with our preliminary analysis of the impact the DIRA has on new processor entry? If not, please provide your reasons and information/evidence in support of your views.	Open Country agrees that the open entry and exit requirements, and the Raw Milk Regulations, have promoted new entry from independent dairy processor o an extent. Obviously, entry has occurred under these conditions. However, we do not consider that the base milk price calculation or the Commerce Commission's monitoring of that calculation supports efficient entry or expansion. Rather these features represent a significant constraint on new investment. We have set ou our detailed reasons for holding this view elsewhere. In summary, Fonterra retains considerable discretion over key aspects of the calculation which it determines in its own strategic interests. The Commission's monitoring is not sufficiently deta led or robust to prevent this occurring.
18. Do you consider that large dairy processors should continue to be eligible to purchase regulated milk from Fonterra under the Raw Milk Regulations or not? Please provide detailed comment in support of your views.	es. There is no empirical evidence of Fonterra facing a systematic disadvantage in export markets relative to its compet tors.

MPI question		Open Country response
19	Do you consider that greater confidence in the base milk price calculation outcomes could be achieved if additional legislative guidance on the term "practically feasible" were to be provided for in the DIRA? Please provide detailed comment in support of your views.	Additional legislative guidance is required for 'practical feasibility' to be used as a meaningful regulatory standard, but clarification and refinement is also required in respect of other aspects of the DIRA regime. We have outlined the ambiguity of the practical feasibility standard in our previous submission. In summary, it is unclear whether a notional or real-world standard of feasibility is required or which standard is actually being applied. In this regard, we note that practical feasibility is not an end in itself, but is used as a proxy measure for market contestability. This suggests that a focus on real-world, substantive market outcomes is key to achieving the legislative goals that the 'practical feasibility' standard currently represents. Improving the legislative guidance on these ma ters equires a return to the underlying principle of contestability itself. The question that ought to be addressed is: doe the ase milk price promote an optimal volume of milk for Fonterra to run its existing processing capacity while directing further investment to higher value use/product lines (including entry and expansion in relevant markets? This requires an assessment of the impacts of the level of the base milk price, as well as the way it is set (that is, the input and assumptions informing it, and the transparency of the calculation) in light of the prevailing market structure, and the conduct and performance of (potential) market participants. In our previous submission we also noted that the Commerce Commission has tended towards a superficial assessment of the statutory 'efficiency' standard with an almost exclusive focus on productive efficiency. This approach ignores that the level of the base milk pri e has important dynamic efficiency implications for Fonterra and the sector as a whole. Dynamic efficiency incentives, which directly influence value-added investment by processors and volume growth by farmer-supplier, result from the level of the milk price and need to be taken into account.

MPI question	Open Country response
20. Do you consider that the base milk price should be set by an independent body (e.g. the Commerce Commission)?	Yes. Open Country strongly believes that the base milk price should be set by an independent body, whether that is the Commerce Commission or a newly established dairy authority. This is essential o the credibility of the DIRA regulatory regime and the competitiveness of New Zealand dairy markets going forward. In our previous submission and above we have detailed specific examples of Fonterra leveraging its discretion over the milk price calculation in a way that distances the base milk price from ma ket dynamics. To reiterate: • As Castalia's evidence demonstrates, Fonte ra has systematically and consistently transferred value to the base milk price (and away from shareholder returns) for reasons other than producing an optimal volume of milk to run its existing capacity and directing fu ther inves ment to higher value uses/product lines. It is highly unlikely Fonterra has influenced the base milk pr ce for other purposes. • Fonterra deliberately obscures the commercial impact of its decision through increasingly opaque sales processes. • Fonterra repeatedly and blatantly gnores responsible criticism and detailed evidence of fundamentally errors in its base milk price calculat on. The most obvious and high-profile of these is the asset beta issue, which Fonterra has used in a calculated manner to inflate the final milk price. Ideally, the base milk price would be as mechanical as possible, limiting the amount of discretion required to determine it each season, as this increases transparency and predictability. We accept that eliminating all discretion may not be 100% possible in practice. In that case, it is essential that responsibility for any residual discretion sits with an independent and impartial decision-maker (including obligations of over-arching fidelity to the statutory regime and its objectives rather than the interests f any one market participant).
21. Do you agree with our preliminary analysis of the DIRA impact on the domestic consumer dairy markets? Please provide your reasons and information/evidence in support of your views.	Open Country i not a participant in domestic consumer dairy markets. That said, we consider that Goodman Fielder's presence in domestic consumer dairy markets is essential to maintaining workable competition under current market conditions. If Goodman Fielder's current supply arrangements were to end, it would need to invest in its own collection capacity if it was to secure supply at the DIRA price.
22. Are there any other factors that should be taken into account regarding the domestic consume dairy markets?	Open Country is not a participant in domestic consumer dairy markets. We note only that maintenance of the open entry and exit requirements and a more credible base milk price calculation are likely to be necessary pre-requisites for Goodman Fielder to enter the market as a collector of raw milk.

MPI question	Open Country response
23. Are there any other options for the DIRA open entry requirements that you think should be considered? Please provide sufficient detail when describing any alternative options as well as reasons for considering these.	The current open entry and exit requirements appear to be working well and there is no need to move away from the *status quo*. We know that Fonterra is incentivised to impose penalties on farmer-suppliers that seek to support competitors. Any proposed new exception to the current blanket requirements need to be considered in this light.
24. What costs and benefits would each of the options for the DIRA open entry requirements create for your business? Please provide quantitative information if possible.	The ability of farmer-suppliers to switch their supply to Fonterra's competitors and (if necessary) back again is essential to the contestability of the farmgate milk market. Any move away rom the status quo of blanket open entry and exit obligation on Fonterra risks compromising supply to Fonterra s competitors, including Open Country. Even for established competitors there is an ssociated risk for farmer-suppliers that they will have no buyer for their milk if they are required to return to Fonterra This would not be the case in a genuinely competitive market, where processors compete for the marginal supp er. However, in a market environment where Fonterra is still grossly dominant (and has clear incentives to constra n supply o its competitors), the risk can only be mitigated through a regulatory requirement to accept supply
25. How well do you think each of the options for the DIRA open entry requirements would perform against the principles of good regulatory practice of promoting certainty and predictability of regulatory outcomes, transparency, cost-effectiveness and timeliness of regulatory processes?	Open entry and exit is currently performing well against all of these criteria. Any new exception wou d be subject to interpretation and application by Fonterra itself, which would have the potential to directly undermine the certainty and predictability of regulatory outcomes. If past experience is taken as a reliable guide,[19] then Fonter a's propensity towards unsustainable interpretations of such requirements and a willingness to litigate will directly undermine the cost-effectiveness and timeliness of the regulatory processes.
26. What is your preferred option for the DIRA open entry requirements?	For the reasons set out in this paper and our previous submission, Open Country's preferred option for the DIRA open entry requirements is to maintain the *status quo*.

19 *McIntyre and Williamson Partnership Fonterra Co-operative Group Limited* [2015] NZHC 3012; [2016] NZCA 538; [2017] NZSC 197.

MPI question	Open Country response
27. Are there any other options for access to regulated milk for large dairy processors that you think should be considered? Please provide sufficient detail when describing any alternative options as well as reasons for considering these.	No comment.
28. Do you consider that the proposed 30 million litres threshold is too high or too low? If so, what would you consider the right threshold to be, and why?	No comment.
29. What costs and benefits would each of the options for access to regulated milk for large dairy processors create for your business? Please provide quantitative information if possible.	No comment.
30. How well do you think each of the options for access to regulated milk for large dairy processors would perform against the principles of good regulatory practice of promoting certainty and predictability of regulatory outcomes, transparency, cost-effectiveness and timeliness of regulatory processes?	No comment.
31. Do you have a preferred option for access to regulated milk for large dairy processors? Please provide your reasons and information/evidence in support of your views.	No comment.

MPI question	Open Country response
32. Are there any other options for the base milk price calculation that you think should be considered? Please provide sufficient detail when describing any alternative options as well as reasons for considering these.	Yes. Open Country strongly believes that the option of a newly establishe independent dairy authority should be considered. MPI should also consider the option of a statutory (or regulatory) methodology for the determination of the base milk price. We have detailed these additional options, and their benefits in th main body of this submission.
33. What costs and benefits would each of the options for the base milk price calculation create for your business? Please provide quantitative information if possible.	The key costs to Open Country's business stems directly from • the lack of reasonable predictability of the base milk price, which inhibits independent processers from managing their business operations in a forward look ng way; and • a base milk price that is out of step with contestable market levels, which artificially inflates costs for independent processors. Any reform option that fails to add ess the role of Fonterra's market dominance and excessive discretion within the DIRA regime will continue to impose these costs on independent processors. It is for this reason that we advocate strongly for: • the base milk price to be objectively determined by an impartial and independent regulatory authority; and • greater prescription t be built into the legislative scheme. A predictable, transpar nt milk price set by an objective, impartial regulator is the only way to effectively promote the efficiency and conte tability policy goals of the DIRA regime.

MPI question	Open Country response
34. How well do you think each of the options for the base milk price calculation would perform against the principles of good regulatory practice of promoting certainty and predictability of regulatory outcomes, transparency, cost-effectiveness and timeliness of regulatory processes?	Regulatory best practice suggests that the most effective way of promoting these principles is to ensure that the regulatory regime appropriately deals with discretion. This involves a number of s eps • Minimising the discretion within the regime by prescrib ng legislative standards (or, where necessary, making provision for the regulator to determine regulatory standards). This promotes certainty and predictability in particular by minimising the scope for arbitrary decision-making. It also 'front ends' much of the cost associated with the regime, as difficult questions of interpretati n and application are required to be resolved in the legislative scheme itself, rather than worked out over time. Ho ever, the costs associated with this 'front ending' will be modest in the context of building on the real-world learnings of an existing regime that has already worked through several iterations. • Conferring responsibility for residu l discretion on an independent and impartial decision-maker, including a special purpose regulator established for the task. Crucially, this step must include statutory obligations on the decision-maker to promote clearl defined statutory objectives. This gives the decision-maker confidence when resolving ambiguities and helps avoid regulatory capture, as well as setting a benchmark for formal regulatory accountability mechanisms. These are all pre-requisites for certainty, predictability, timeliness and cost-effectiveness of the regime. • We recognise that the structure of the regulatory regime inevitably requires Fonterra-sourced inputs to determine the revenue and cost components of the milk price calculation. These inputs must be transparently derived for the benefit of the regulator, market participants (independent processors) and other interested parties (shareholders and farmer-suppliers). The regulator should be afforded sufficient opportunity to test the veracity of these inputs, including through a standard 'notice and comment' consultation procedure. While this increases administrative costs these costs will be offset by savings in the effectiveness of, and confidence in, the resulting regulatory regime
35. Do have a preferred option for the base milk price calculation? Please provide your reasons and information/evidence in support of your views	or the reasons set out in the main body of this submission and elsewhere, Open Country's preference is for: the base milk price to be objectively determined by an impartial and independent regulatory authority; and • greater prescription to be built into the legislative scheme. Both of these steps are necessary for a sufficient level of confidence in the setting of the base milk price.

MPI question	Open Country response
36. Are there any other options for access to regulated milk for Goodman Fielder and smaller processors that you think should be considered? Please provide sufficient detail when describing any alternative options as well as reasons for considering these.	No comment.
37. What costs and benefits would each of the options for access to regulated milk for Goodman Fielder and smaller processors create for your business? Please provide quantitative information if possible.	No comment.
38. How well do you think each of the options for access to regulated milk for Goodman Fielder and smaller processors would perform against the principles of good regulatory practice of promoting certainty and predictability of regulatory outcomes, transparency, cost-effectiveness and timeliness of regulatory processes?	No comment.
39. Do you have a preferred option, or a combination of options, for access to regulated milk for Goodman Fielder and smaller processors? Please provide your reasons and information/evidence in support of your views.	No comment.

MPI question	Open Country response
40. How best do you consider "market dominance" could be measured? For example, are there certain criteria (other than a market share threshold) that could be provided for in legislation as a trigger for review and/or expiry of the DIRA?	Fonterra's market dominance manifests most significantly in its ability to set the *de facto* price for raw milk supply for the entire sector. As long as Fonterra is able to shape the base milk price for ommercial or strategic reasons, its market dominance is at levels that require concerted regulatory governance. Open Country sees no prospect of this occurring in the short to-medium term. As we have outlined at length elsewhere, the transitory assumption underlying the DIRA regulatory regime is fundamentally misplaced, and has negatively influenced the implementation of the regime. There is no substitute for detailed, empirical considera ion of the levels of actual competition in the relevant markets and the potential for entry and expansion by chall nger processors. Reliance on other criteria to trigger a review or expiry of the regime risks sending inappropriate signals to he market.
41. Are there any other options for the DIRA review and expiry provisions that you think should be considered? Please provide sufficient detail when describing any alternative options as well as reasons for considering these.	No. The Discussion Document summarises each of the main options available.
42. What costs and benefits would each of the options for the DIRA review and expiry provisions create for your business? Please provide quantitative information if possible.	The key issue with expiry provisions is that they promote a perception that the DIRA regime is transitory. This perception ignores that fact that F nterra's market dominance is intractable and likely to continue for the foreseeable future. Any approach to the exp ry of DIRA needs to consider the risk of a lack of protection from Fonterra's dominance.
43. How well do you think each of the options for the DIRA review and expiry provisions would perform against the principles of good regulatory practice of promoting certainty and predictability of regulatory outcomes, transparency, cost-effectiveness and timeliness of egulatory processes?	Periodic re iews of the actual levels of competition and contestability is the only responsible regulatory approach to the ssue of Fonterra's ongoing dominance in the relevant markets. Specifying triggers for review or expiry remove the ssessment from focusing on the substantive policy outcomes for the dairy sector that DIRA is intended to promote, as well as general market competition standards. The danger here is one of over-reliance on headline statistics comes with basic market competition assessments, when examination of actual market performance (including incentives and behaviours) is what is required. While Open Country recognises the appeal of simple standards and measures, any misalignment between those trigger points and the substantive outcomes experienced by market participants will materially reduce the predictability, transparency, and cost-effectiveness of the regime. It also risks directly undermining any improvements to the regime as these cannot be relied upon to last long enough to shape market dynamics and participant incentives in appropriate ways.

MPI question	Open Country response
44. Do you have a preferred option, or a combination of options, for the DIRA review and expiry provisions?	Open Country repeats that it sees no prospect of market dynamics changing in the short-to-medium term so that DIRA is no longer needed. Fonterra's dominance is simply overwhelming. It is possible to make a credible argument that the only responsible regulatory course of action in these circumstances is to retain the *status quo* so that there is no legislative provision for review or expiry of the DIRA regime. However, we are strongly of the view that decisions on these matters should be based on evidence of actual market structure, conduct and performance. On this basis, periodic reviews of the dairy sector is likely to be the preferred option, provided that any such review is focused on empirical measures of competi ion and contestability. This keeps market participants well informed of changing market dynamics and the regulator's view of the implications that arise from those dynamics, promoting predictability and transparency, and avoiding the cost shock of a sudden change to the regulatory regime.

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1 February 2019

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By email: dira@mpi.govt.nz

Dear Sir / Madam

<u>Organic Dairy Hub Co-operative Ltd – RESPONSE TO THE REVIEW OF THE DAIRY INDUSTRY RESTRUCTURING ACT 2001 AND ITS IMPACT ON THE DAIRY INDUSTRY</u>

This submission is based on the experiences of ODH with DIRA regulations, observations from being involved in the domestic liquid milk market, our farmers' views and our experiences of being a small~~er~~ co-op competing against much larger organisation for organic milk which is in high demand but low supply.

Who is ODH? Organic Dairy Hub Co-op NZ Ltd became a registered entity in March 2015 and is New Zealand's only 100% organic farmer owned co-op that specialises solely in organic liquid milk supply and milk powder production. ODH currently has 35 shareholders, all fully certified organic to a range of international markets and has some of New Zealand's most experienced organic dairy farmers. The co-op has seen rapid growth over the last two years establishing itself as a key partner in the supply of organic liquid milk for the domestic market and organic milk powder to both the domestic and international markets.

ODH is an extremely important player in the organic sector, providing choice of supply for organic farmers creating competition in a market where there was previously none but most importantly ODH provides the "whole package" a true co-operative family ethos for its shareholders with a remarkable story to tell.

Prior to becoming operational in June 2015, organic farmers met on a regular basis at various locations across the North Island to put the bones of the business together. The Co-operative was formed out of the need to provide a secure business and supply base for farmers' organic milk and provide security of supply for processors wanting organic milk. [redacted]. A constitution was established, and contracts for supply of organic liquid milk were offered to Northland farmers first.

Today ODH supplies organic liquid milk to leading brands in New Zealand [redacted], [redacted] Organic whole milk powder is manufactured and sold to customers [redacted].

In 2015 ODH utilised DIRA section 108 to source 20% milk supply from existing organic farms that were not currently supplying ODH. [redacted]

DIRA open entry Requirements: There are a range of factors to take into consideration around the open entry/exit requirements. Fonterra is still the dominant player in the New Zealand dairy sector and has the economies of scale and transport efficiencies to be able to maximise returns and fend off competition.

We believe the open entry exit should remain but that there could be an amendment to the existing rule, that would allow Fonterra to reject an application to supply where there is ***clear independent evidence*** showing there would be reputational risk to Fonterra and the greater ***dairy sector***. To reject an application there would need to be substantial proof from entities such as Regional Council that the applicant has had proven past non- conformances in any area of environmental, animal welfare or staff wellbeing breaches. Fonterra should not have to take on a supplier knowing this farmer is a high risk proven offender and then be required to manage that risk. The dairy sector as a whole, does not want farmers in the industry who are not complying with industry regulations and best practice standards.
An amendment to open entry that would allow Fonterra to reject an application would need be clearly defined in DIRA.

If the open entry were eliminated, this in our view would effectively give Fonterra the ability to hand pick supply, based on factors such as supply volume, geographical location, loyalty to the co-op while still holding a position of dominance. A farmer that leaves Fonterra and chooses to or has no choice but to return to Fonterra would find the path way back very difficult and in some areas with no alternative for supply. At the time of writing this report, Northland and Wairarapa are two regions that are not currently provided with an alternative to Fonterra. Until additional processors reach all regions and Fonterra is still dominant in the dairy industry the open entry exit rule needs to stay in force.

Option to access regulated milk for large dairy processors (except Goodman Fielder)

Option 4.2.2 – ODH agree that large scale dairy processors should have to source their own supply of milk if their supply is over 30 million litres for three consecutive years. This option still provides the opportunity for competition within existing processors and the opportunity for new processors. This provision would only be in force until Fonterra were not the dominant processor in NZ [redacted] If the large-scale processor does not want to source their own supply above 30 million litres the option to purchase milk from Fonterra or any other milk supply base under normal contractual terms could still give them access to milk. Fonterra is a NZ farmer owned co-op and must not be restricted to the point where it is no longer competitive. Large scale processors primarily source milk for export so should not be piggy backing off DIRA access milk but hold their won contracts to source milk supply.

4.3 Milk price calculation:
Fonterra is a privately-owned company that is experiencing more competition in the marketplace. Fonterra should be able to set a milk price that is conducive to its business. It is not the role of Government or the Commerce Commission to set any milk price. Fonterra is the only dairy business that is required to publicly demonstrate transparency behind its milk price. Other processors are not required to provide the degree of transparency of their milk price and most are using the Fonterra base milk price to set a minimum milk price for their own suppliers. Any farmer owned co-op milk price should always reflect what is best for their shareholders.

ODH does not set a milk price based on the Fonterra milk price.

4.4 Access to regulated milk for Goodman Fielder
Goodman Fielder is currently the only large- scale competitor to Fonterra in the NZ domestic liquid milk market. Competing in the domestic liquid milk market and traversing the complexities of the supermarket supply conditions can be challenging. Goodman Fielder has the size to be able to sustain these challenges. If the domestic liquid milk market were an area of opportunity and large profit, then there would be other processors taking advantage of the DIRA 50m litres per year and be putting milk on the supermarket shelf. New Zealand has a small population base and currently Goodman Fielder is purchasing milk from Fonterra under contract, they have not implemented the DIRA 250m litres per year take. It could be assumed the contractual terms in place between Fonterra and Goodman Fielder are beneficial to both parties. If the

access to regulated milk for Goodman Fielder remained and new contractual terms could not be agreed upon by 2021, Goodman Fielder would still have access to a consistent milk supply under DIRA. The challenge Goodman Fielder has is low volume supply of shoulder milk and the challenge Fonterra has is shoulder milk is more expensive to produce. The consumer has little to no appetite for price increases on seasonal milk. Goodman Fielder continuing to compete in the domestic market with Fonterra is good for the consumer as it provides variety and competitive pricing. Removing the DIRA access for Goodman Fielder of 250m litres could potentially remove the only competitor that has the size and scale to compete against Fonterra. There are no other big processors currently in this space. This is our view at the time of writing that Goodman Fielder should still have access to 250m per year for the benefit of the consumer. If this option is not desirable, then an alternative could be that government owned dairy farms supply the domestic market with milk.

4.5.2 Amend DIRA periodic reviews

The New Zealand dairy industry has changed considerably over the last 5 years. From Organic Dairy Hub Co-op's experience in the market there is a range of new processors looking to enter New Zealand, both New Zealand and foreign owned. Reviews of DIRA should ensure fairness to all parties and the market does not get to a point where Fonterra has become disadvantaged.
A balance must be found while also encouraging competition. Having regular reviews of DIRA will ensure that DIRA stays relevant, fit for purpose and provides options going forward.
It is documented that for every $1.00 a NZ dairy farmer earns $0.46c goes back into their local communities. New Zealand economy needs Fonterra and the vast majority of New Zealand dairy farmer needs Fonterra.

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8 February 2019

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GOODMAN FIELDER – REVIEW OF DAIRY INDUSTRY RESTRUCTURING ACT 2001 AND IMPACT ON DAIRY INDUSTRY

Goodman Fielder welcomes this opportunity o make a submission in relation to the Ministry of Primary Industries ("MPI") discussion paper issued in November 2018 ("Discussion Document") on the Dairy Industry Restructuring Act 2001 ("DIRA") and its impact on the dairy industry.

Goodman Fielder has commissioned independent financial and economic advisors, TDB Advisory ("TDB") to produce an independent repor on the Discussion Document which focuses on aspects relating to the domestic consum r m rket - where Goodman Fielder's primary business interests lie ("TDB Report"). In 2018, Goodman Fie der commissioned TDB, assisted by Pat Duignan, to provide an independent review of the regula ions su rounding New Zealand's domestic dairy products market ("2018 TDB Report"). Both reports a e referred to in this submission and are attached to this letter for your reference.

TDB has provided its views on each of the relevant options for regulatory change put forward in the Discussion Document. Goodman Fielder supports the views taken by TDB. However, importantly Goodman submits that, if DIRA is amended or repealed, some form of regulatory regime is necessary to ensure Goodman Fielder has access to, at a minimum, the volume of raw milk that it is currently entitled to under DIRA and at prices which allow Goodman Fielder to effectively compete in the domestic market.

Goodman Fielder requires access to additional milk at the same price as Fonterra Brands to ensure we can compete on equal terms with them. To achieve that outcome, Goodman Fielder submits that its preferred option for regulatory change is option 4.4.5 proposed by MPI in its Discussion Document (which ensures that the supply terms to independent processors mirror the terms on which Fonterra Brands is supplied by Fonterra) provided that this option is combined with option 4.4.2 to increase Goodman Fielder's regulated volume entitlement to 350 million litres per annum. As set out by MPI in Amendment 3 of option 4.4.2 f the Discussion Document, the proposed 350 million litres per season entitlement reflects 50% of the raw milk supply currently used for the domestic market (600 million litres) plus a small provision for market g owth

A key objective behind entitling Goodman Fielder to 250 million litres of raw milk unde DIRA was to ensure there was at least one large-scale national competitor to Fonterra Brands in the domest c wholesale milk market. This objective remains valid and important as removing the volume entitlement would be removing Goodman Fielder's only certain source of milk to meet the daily, year round, demand of its consumer products business. Of course, Goodman Fielder could contract directly with Fonterra for supply outside of DIRA, as it did in 2001 and 2004. However, as was the case in 2001 and 2004, Goodman Fielder requires the safeguard of DIRA (or another more effective form of regulation to underpin any potential contract. Otherwise, realistically Fonterra would not enter a contract with Goodman Fielder.

A factory gate market for raw milk, which might have provided Goodman Fielder an alternative source of raw milk, has failed to develop. It is doubtful a factory gate market of any material size and reliability will ever develop to meet the Goodman Fielder's demand for consistent, year round, milk supply (i.e. a flat supply curve) versus the peaky, seasonal natur of New Zealand's milk supply from farms. Export focussed processors in New Zealand have built their asset base around New Zealand's peaky milk curve. Except in the peak of the season when these processors' plants are running at full capacity, the processors have spare capacity to utilise and at these times, it makes little commercial sense for such processors to supply raw milk to third parties such as Goodman Fielder rather than utilise their assets and process the milk themselves.

The feasibility of a fact ry market developing was assessed in detail by TDB in the 2018 TDB Report and TDB concluded hat a factory gate market for raw milk is unlikely to develop on its own and TDB was unable to find clear examples of functioning factory-gate markets for raw milk in any other country.[1] Even if a factory gate market did develop, which we believe is unlikely, the Commerce Commission estimates that if Goodman Fielder had to purchase all of its milk requirements in an unregulated market, the price would be 25% higher than the DIRA milk price average. The Commission estimates this increase would likely translate into an average 6.25% increase in the retail price of fresh milk[2]. The resulting high welfare loss to consumers would represent a direct wealth transfer to Fonterra or independent processors (in the unlikely event of a factory gate market emerging). The Commerce Commission has conservatively estimated the consumer welfare loss through a factory gate price increase to be in the range of $51.9 million to $92.4

[1] 2018 TDB Report, section 8, pages 34-35
[2] Commerce Commission "Review of state of competition in the New Zealand Dairy Industry", March 2016 ("Commerce Commission (2016)") 6.55.1

million per annum.[3] This is in addition to substantial dead weight losses (i.e. the efficiency cost of removing DIRA) which the Commerce Commission estimated to be between $3.5 million and $13 million per year, alongside likely productive and dynamic efficiency losses.

Given the lack of any factory gate market from which to source milk, Goodman Fielder has considered developing its own milk supply. However, to do so is cost prohibitive.

To establish its own milk supply, Goodman Fielder would be required to recruit milk suppliers (who must have split herds enabling winter milk supply) and who would be currently supplying other processors. It would be required to develop milk collection and transport capability, and develop its own complimentary ingredients business for the purpose of managing excess milk it collects. Importantly, participants in the New Zealand dairy industry can have an ingredients business without a domestic consumer business but not a domestic consumer business without an ingredients business (or at least access to one).

Goodman Fielder's dairy assets have been specifically established to support a domestic consumer products business and neither of its two dairy sites are capable of being developed to support an ingredients business. Its South Island dairy site is based within Christchurch city (removed from a milk catchment area) and its Longburn site in the North Island has no spare land for development.

Putting aside the substantial capital expenditure (conservatively hundreds of millions of dollars) that would be initially required to establish an ingredients business with its own farm supply, Goodman Fielder could not match Fonterra's efficiency at sourcing, collecting, transporting and absorbing the variability in supply of raw milk. TDB have estimated the resultant milk cost for Goodman Fielder of securing its own supply (including via greenfield investments in both islands), in a best case scenario, to be Fonterra's Farmgate Milk Price plus [**redacted**] (additional costs of collection) plus [**redacted**] (capacity charge) plus winter milk premium.[4] This additional milk cost would put Goodman Fielder at a significant competitive disadvantage in the domestic consumer dairy products market.

Ultimately, the likely impact of Goodman Fielder being required to transform or relocate its business to remove its reliance on Fonterra's milk supply, would be a materially higher cost of goods for its milk and dairy consumer products (and in the case of relocation, significant adverse impacts on employment in the regions surrounding Goodman Fielder's existing assets). As a consequence, most of the cost increase will be passed through to Goodman Fielder's customers and consumers who will face higher product prices. This would limit Goodman Fielder's ability to compete against Fonterra Brands. Fonterra Brands will either increase its prices in response to Goodman Fielder's higher pricing (benefiting from increased margins), or maintain its pricing for the purpose of taking market share from Goodman Fielder. Increasing Fonterra Brands' market share in a market where it is already dominant will only serve to lessen competition in that market.

[3] Ibid para 6.53 Footnote 327
[4] 2018 TDB Report , sections 9.2, 9.4, 9.4 pages 36-37 and Annexure 4

We do not believe that Goodman Fielder should be expected to transform its domestic consumer business to effectively replicate its predecessor business (NZCDC) which had its own farm supply, ingredients business and domestic marketing and sales business (New Zealand Dairy Foods). We do not believe that regulators had, at the time of DIRA's establishment, or should have now, any expectation that Goodman Fielder materially transform its business as such. Instead, we believe that regulators assumed that the pathway to deregulation would be opened by the emergence of a viable factory gate market – which has not occurred and practically cannot occur on its own.

For the reasons set out above, Goodman Fielder considers that any removal or reduction of Goodman Fielder's volume entitlement will have significant negative consequences on the wider New Zealand dairy industry. More specifically:

a) There will be increased inefficiencies in the factory gate market, farm gate market and downstream domestic wholesale market.

b) Fonterra's dominant market position will be further enhanced

c) The New Zealand consumer will suffer a significant welf re loss and there will be no offsetting efficiency gains.

We agree with MPI's preliminary assessment that DIRA has enabled the presence of at least one viable large scale competitor to Fonterra in the supply of New Zealand consumer dairy products and we believe regulation must be maintained to ensure the domestic dairy market remains competitive. Goodman Fielder's volume entitlement under DIRA has been ffective in ensuring that Goodman Fielder can fairly compete against Fonterra Brands (although the 250 million litre per annum has placed a limit on Goodman Fielder's growth potential). If MPI consid rs that amendments to Goodman Fielder's entitlements under DIRA are necessary, we submit that any alternative regulatory regime must ensure Goodman Fielder's access to regulated milk is increased to 350 million litres per annum and supplied on pricing terms which mirror those provided to Fonterra B ands.

Yours faithfully,

Scott Weitemeyer	**Dave Anderson**
Chief Executive Officer and Managing Director	**Director – New Zealand**

Review of the Regulatory Environment for Domestic Dairy Products

A report prepared for Goodman Fielder New Zealand Limited

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db o nz

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List of abbreviations

B	billion
DIRA	Dairy Industry Restructuring Act, 2001 and Dairy Industry Restructuring Amendment Act, 2012
EBIT	earnings before interest and tax
FBNZ	Fonterra Brands (NZ) Limited
FGMP	farm-gate milk price
Fonterra	Fonterra Co-operative Group Limited
FSNI	Foodstuffs North Island
FSSI	Foodstuffs South Island
GDT	Global Dairy Trade™
GF	Goodman Fielder New Zealand Limited
IP	independent processor
kgMS	kilograms of milk solids. 1 litre of milk is comprised of approximately 8.5% milk solids. To convert one kgMS to the approximately equivalent litres of milk, divide it by 0.085.
Kiwi	Kiwi Co-operative Dairies Limited
M	million
Miraka	Miraka Limited
MPI	Ministry for Primary Industries
MT	metric tonnes
NZDG	New Zealand Co-operative Dairy Group Limited
OCD	Open Country Dairy Limited
Oceania	Oceania Dairy Limited
p.a.	per annum
Synlait	Synlait Milk Limited
Tatua	Tatua Co-operative Dairy Company Limited
UHT milk	ultra-heat treatment milk
Westland	Westland Co-operative Dairy Company Limited
WMP	whole-milk powder

Glossary

Allocative efficiency	the efficient allocation of resources among different uses
DIRA	Dairy Industry Restructuring Act, 2001
DIRA milk price	FGMP plus reasonable transport costs
Dynamic efficiency	the efficient allocation of resources over time, as affected in particular by incentives to invest and innovate
Factory-gate milk market	the market for raw milk where milk processors are the vendors
Farm-gate milk market	the market for raw milk where farmers are the vendors
Food service sales	sales to and by cafés, catering companies, hotels, restaurants, institutions and the like
Grocery sales	sales to and by supermarkets
Milk curve	the seasonal pattern of milk production
Monopsony	a single purchaser in a market. Akin to a monopoly which is a single supplier to a market
Normative analysis	a subjective, value-based assessment of “what should be”
Positive analysis	an objective, fact-based description or analysis of “what is”
Productive efficiency	the efficient choice of production and supply methods
Raw-Milk Regulations	Dairy Industry Restructuring (Raw Milk) Regulations, 2001 and Dairy Industry Restructuring (Raw Milk) Regulations, 2012
Route sales	sales to and by petrol stations, dairies and small convenience stores
2012 Regulation	Dairy Industry Restructuring (Raw Milk) Regulations, 2012

1. Summary

TDB Advisory Ltd (TDB), assisted by Pat Duignan, has been commissioned by Goodman Fielder New Zealand Limited (GF) to provide an independent review of the regulations surrounding New Zealand's domestic dairy products markets.

The domestic dairy markets we focus on in this report are:

- the consumer market for dairy products like fresh milk, cheese, butter and yoghurt. Supply of products to the consumer market is dominated by Fonterra Brands NZ (FBNZ) and GF; and

- the farm-gate market for raw milk, where around 11,600 dairy farmers supply milk to six main milk processors. The six processors are dominated by Fonterra, which collect 82% of the milk produced in New Zealand.

There are a number of characteristics of liquid milk that differentiate it, to varying degrees, from other commodities. In particular, milk is perishable and transport costs for milk are high relative to the value of the product. There are also some particular features of New Zealand's dairy market that should be taken into account when considering the appropriate regulatory regime for dairy products. In particular, New Zealand's domestic market is very small relative to the level of production, with domestic sales comprising only 4.5% of total output. In addition, New Zealand's production is pasture-based, meaning milk production is highly seasonal, with production in the peak month (October each year) being typically 20 times as large as production in the lowest producing month (June each year).

The way the regulatory regime and market structure has developed in New Zealand is important to understanding the industry. The merger that created Fonterra in 2001 was facilitated under special legislation (the Dairy Industry Restructuring Act or DIRA) that permitted the merger to bypass the normal protections provided to New Zealand consumers by the Commerce Act and the Commerce Commission. The case for the merger depended on the achievement of major efficiencies from New Zealand having a unified dairy exporter, Fonterra Co-operative Group Limited (Fonterra), competing in international markets. The merger resulted in Fonterra having, at least initially, a near monopsony (single buyer) position when purchasing milk from farmers and a dominant position in the domestic consumer market for dairy products.

Fonterra's dominant position in domestic markets was ameliorated somewhat by regulations that gave GF guaranteed access to 250M litres of raw milk p.a. from Fonterra at a regulated price while DIRA remains in place.

In 2015, the thresholds triggering a review of the state of competition in the domestic dairy markets were met in the South Island. In its March 2016 report[1], the Commerce Commission concluded that

[1]Commerce Commission, "Review of the state of competition in the New Zealand Dairy Industry", March 2016 ("Commerce Commission (2016)"). http://www.comcom.govt.nz/regulated-industries/dairy-industry/report-on-the-state-of-competition-in-the-new-zealand-dairy-industry/

competition was not sufficient to ensure the efficient and contestable operation of the relevant dairy markets if the DIRA Regulations were removed.

The Commission estimated that if the DIRA Regulations requiring Fonterra to supply milk at the regulated milk price were not in place, Fonterra would be able to use its dominant position to increase the factory-gate raw-milk price by around 25%. This would lead to an estimated transfer of wealth from New Zealand consumers of dairy products to suppliers of between $51M and $92M p.a. and an efficiency (deadweight) loss to the economy as a whole of around $6M p.a.[2] The Commission noted that these estimates were probably conservative.

As a consequence of the recommendations made by the Commerce Commission and a subsequent review led by the Ministry of Primary Industries (MPI)[3], the then Minister introduced into the House in March 2017 the Dairy Industry Restructuring Amendment Bill. The new Government subsequently altered the Bill. The major features in the new Bill, which was passed into law in early 2018, were to remove the DIRA expiry provisions and to remove periodic reviews of DIRA. Absent this law change the DIRA provisions would have terminated in respect of the South Island in May 2018.

With regard to the ongoing state of the regulatory regime, the Government has outlined its intention to undertake a comprehensive review of DIRA beginning in 2018. The purpose of this report is to inform that work by officials and the Government, with a particular focus on understanding the complexities surrounding the regulatory environment for domestic dairy markets.

Our analysis of the domestic dairy market indicates that the DIRA Regulations have worked well in many ways in ameliorating the monopsony power of Fonterra in regard to dairy farmers and its monopoly power in the domestic dairy product market. Competition in the farm-gate and consumer markets has increased since Fonterra was created. In the segment of the consumer market for which market share data are available[4], the market share of the two largest players, FBNZ and GF, has decreased from around 95% in 2002 to around 87% in 2016. In the farm-gate market, Fonterra's share of the milk produced in New Zealand has declined from 96% to 82% in the period to 2017.

While the degree of competition in the domestic dairy markets has increased, we consider that there are opportunities for the Government to improve the current situation and to achieve better-functioning markets. In particular, there are opportunities for the Government to: strengthen the degree of competition in domestic dairy markets; reduce regulatory uncertainty; improve incentives on market participants to innovate; and improve the market behaviour of Fonterra.

In our view, the potential for market-based solutions to improve the situation is limited. In particular, a well-functioning factory-gate market in liquid milk is unlikely to emerge because any milk processor that supplied the market would have to be compensated for the resulting under-utilisation of its own factory. We estimate that the compensation would have to be approximately [Redacted] above the farm-gate milk price (FGMP)[5], making factory-gate milk uncompetitive. Furthermore, independent milk

[2] Commerce Commission (2016), p.129, footnote 327.
[3] MPI, Discussion Document, "Proposed changes to the Dairy Industry Restructuring Act 2001 and Dairy Industry Restructuring (Raw Milk) Regulations 2012", Paper No: 2016/05 ("MPI (2016)").
[4] Market-share data for the consumer market is only available for the "grocery" (supermarket) part of the market. Supermarkets account for around 60% of dairy-product sales in New Zealand.
[5] Equivalent to a 17% premium on the average FMGP since Fonterra was established of $5.40. Refer Annex 7.

processors are highly unlikely to be able to match the cost efficiency of Fonterra's optimised arrangements for winter-milk supply.

There are a number of other market-based solutions to DIRA that might emerge over time. These options include: GF securing the supply of raw milk directly from farmers; GF extending its contract with Fonterra beyond 2021; the integration of GF with an NZ-based processing exporter; GF undertaking greenfield investments to reach a competitive scale; and the entry of other major independent processors (IPs) to the domestic dairy products market.

However, given New Zealand's current market structure and regulatory environment, all of these market-based possibilities face significant obstacles. The most likely market-based option to emerge is the entry of another major IP. Synlait has recently announced its intention to enter the South Island market in 2019 and in doing so will supply (under Foodstuffs South Island house brand) approximately 5% of domestic dairy consumption with its own independent milk supply.[6]

The entry of Synlait highlights the potential for competitive entry, which should benefit consumers (via downward price pressure in the wholesale and retail markets). However, it is not clear that Synlait's entry into the South Island domestic market is easily replicable. Further, none of the market-based options can be guaranteed to emerge to a significant degree and none are within the direct control of the Government. In our assessment, the only option that would unequivocally increase the efficiency of the industry is the extension of GF's contract with Fonterra and then only if the contract is extended on improved terms so that GF becomes a more effective competitor. There could be efficiency gains over time from the other options by increasing the degree of competition in the farm-gate and consumer-products markets. However, it is difficult to assess the magnitude of these gains and there would be some offsetting efficiency losses, as it would mean having more (overlapping) collectors of winter milk.

There is a range of regulatory options for improving the functioning of domestic dairy markets. The regulatory options considered in this report are:

- announcing that the DIRA Regulations requiring Fonterra to supply raw milk to processors that supply dairy products to the domestic market will be abolished from a fixed date;
- phasing down, over time, GF's current entitlement to access DIRA milk from Fonterra;
- extending the DIRA domestic market regulations to, say, 2030, on some combination of the following bases:
    i. the status quo;
    ii. catering for growth in the domestic dairy market;
    iii. requiring Fonterra to supply 100% of the raw milk required by any domestic dairy products market competitor for dairy products supplied to the domestic market;
    iv. requiring Fonterra to publish accounts for FBNZ as a separate entity; or
    v. requiring Fonterra to divest FBNZ;

6 It is not clear yet how Synlait will address the winter milk issue.

- extending the scope of the DIRA requirements to non-raw milk domestic dairy products (especially butter and cheese); and
- changing the dairy sector regulations so they operate on a basis similar to the Commerce Act Pt 4 as it applies to electricity line businesses and gas pipeline businesses or a basis similar to the proposed regulatory framework for fixed-line telecommunications networks.

Of these regulatory options, in TDB's view the greatest improvement in competition, and thereby allocative and dynamic efficiency, would be achieved by a combination of requiring Fonterra to supply 100% of the raw milk required by any domestic dairy products market competitor for dairy products supplied to the domestic market (with no special regulatory entitlement or limit for GF or any other participant) and requiring Fonterra to separately account for FBNZ.

Requiring Fonterra to supply 100% of the raw milk required by any domestic dairy products market competitor for dairy products supplied to the domestic market would reduce the restrictions on GF's ability to compete with FBNZ (by removing the 250M litre cap on GF) and create a more level playing field between FBNZ, GF and other current and potential domestic market participants. Requiring Fonterra to publish separate audited financial statements for FBNZ would reduce the potential for Fonterra to cross-subsidise FBNZ in a way that is detrimental to its competitors and the long-term interests of consumers.

We do not consider it desirable for the Government to simply remove or reduce GF's or other domestic market suppliers' entitlements to Fonterra milk without putting other offsetting measures in place. Our conclusions reflect our assessment that there would be a loss of allocative efficiency under any option where GF is required to develop its own farm-gate supply or to contract with an established IP. This assessment, in turn, reflects an analysis that Fonterra has achieved economies of scale and scope in milk collection, including, but not confined to winter-milk procurement that could not be matched by either GF or any other IP[7].

The overall implication is the provision of milk for the domestic dairy products market exhibits a high degree of market power and high barriers to entry. It might be the case that, if Fonterra had a competitor with a market share in the farm-gate market above, say, 25% in either island, then that competitor could access economies of scale of the same order as Fonterra. However, no competitor is likely to reach that scale in the foreseeable future. This conclusion applies to the supply of milk for the domestic dairy products market – it does not apply to production for export. However, the entry of Synlait to the domestic market should be followed closely to analyse its effect. Synlait's domestic market volumes will be approximately 5% of its total milk volumes (a similar ratio to Fonterra's), which reinforces that while it is possible for an IP with independent milk supply to have an export business without a domestic business it is difficult (if not impossible) to have a domestic business without an export business.

Overall, the best option is likely to be to amend and extend the DIRA regulations governing the domestic dairy products market in the manner suggested, that is, requiring Fonterra to supply 100% of the raw milk required by any domestic dairy products market competitor for dairy products supplied to the

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[7] We estimate that if GF had to source its milk directly from farmers, the additional collection costs would increase GF's milk costs by [redacted]. Refer Annex 5.

domestic market and requiring Fonterra to separately account for FBNZ, until sufficient competition has emerged.

2. Introduction

This report reviews the regulatory environment for domestic dairy products in New Zealand. Following the summary (Section 1) and this introduction (Section 2), we outline in the methodology section (Section 3) the framework followed for our analysis, the processes followed in preparing the report and the scope of the review.

The following three sections of the report provide a positive analysis of the domestic dairy products market. Section 4 provides the historical context for this review, including the establishment of Fonterra, the development of the DIRA and subsequent amendments to the legislation and regulations. The following section, Section 5, discusses the particular features of dairy products and the dairy sector in New Zealand that matter when considering the appropriate regulatory regime. Section 6 then outlines the current structure of the domestic dairy products market.

Sections 7 to 10 provide a normative analysis of the current regime and alternative regulatory and non-regulatory (market-based) institutional arrangements for the future. Section 7 discusses the problems with the current regulatory regime and the opportunities for achieving a better-functioning domestic dairy products market. Section 8 considers the potential for a factory gate raw-milk market to develop in New Zealand while Section 9 identifies and assesses a range of other potential market solutions. Section 10 then identifies and discusses a number of regulatory options, ranging from removing the current regulations to structural solutions that improve the efficiency and effectiveness of New Zealand's domestic dairy products market. Finally, Section 11 provides our conclusions.

Annexes to the report provide: a discussion of the relationship between the Commerce Act and the dairy sector in New Zealand (Annex 1); a description of the FGMP (Annex 2); details of the Commerce Commission's 2016 dairy competition review (Annex 3); an outline and analysis of the original Dairy Industry Restructuring Amendment Bill 2017 (Annex 4); an analysis of the natural monopoly characteristics of the domestic fresh-milk market (Annex 5); an analysis of the implications of seasonal milk supply for GF (Annex 6); a detailed estimation of a factory-gate milk price (Annex 7); and an analysis of the Synlait-FSSI agreement and the seasonal milk supply for Synlait (Annex 8).

3. Methodology

3.1 Framework for the analysis

The methodology adopted in this report is a conventional welfare-economics approach. We assume the Government's objective is to maximise the welfare of all New Zealanders (that is, a national-welfare perspective).

In the first instance, our focus is on assessing the net benefits of the different regulatory and non regulatory options to the New Zealand economy as a whole without regard to the distribution among different sectors (eg consumers vs. producers) of possible gains and losses. Our focus, therefore, is on economic efficiency and the impact of different market and regulatory options on the overall efficiency of the economy.

We then consider the impact on consumers and the possible wealth transfers from consumers to milk suppliers under the different options. As is discussed in more detail in Section 4, the merger that led to the establishment of Fonterra was permitted, under special legislation, to bypass the Commerce Act and thus bypass the protections afforded to consumers by the Commerce Act. As part of the deal made to gain the expected benefits for the dairy industry from the merger, protections were put in place to shield consumers from the detrimental effects of the domestic market becoming a near-monopoly[8]. These protections were:

- to require one of the two founding companies of Fonterra, the New Zealand Dairy Group (NZDG), to divest its domestic consumer business, New Zealand Dairy Foods (NZDF); and

- to give NZDF's (eventual) new owner, GF, guaranteed access to 250M litres of raw milk p.a. from Fonterra at a regulated price while DIRA remained in place.

We therefore consider carefully the impact of possible regulatory changes on consumers as well as the rest of the economy.

Our approach is consistent with the conceptual framework of the Commerce Act that focuses, in the first instance, on the state of competition in the domestic market. In that regard, the assessments in the Commerce Act (Part 2) are national-welfare assessments. If, however, there is little competition and little prospect of competition then Part 4 can be invoked. Part 4 explicitly includes the objective of limiting

[8] As then opposition MP Bill English said, in Parliament, at the time of the First Reading of the Dairy Industry Restructuring Bill:

> "… this bill (that established Fonterra) is the product of a political deal between the Government and the dairy industry, and part of that deal is that the industry accepts a degree of regulation to mitigate the effective monopoly with which it sets out.
>
> …..Parliament now has a public interest job to do, and that job is to ensure that a regulatory regime comes into place that protects consumers and protects suppliers."

Refer Hansard, 26 June 2001, p 10059.

the ability of suppliers to earn excess profits. In other words, there is a switch from a national welfare analysis to an analysis explicitly concerned with wealth transfers affecting consumers if there is little competition in a market.

In assessing the options considered in this report, if the option has a good prospect of achieving workable competition (which would limit wealth transfers from consumers to suppliers), our focus will be on conducting national-welfare analysis. However, where an option is likely to fail to achieve competition, it is appropriate that the assessment should fully consider, and give weight to, we lth transfers. Thus, for example, when considering the phased reduction in GF's milk entitlement, if there is doubt that the reduction will achieve a workably competitive factory-gate market, then the assessment of that option should give prominence to the wealth transfer. On the other hand, if the option is assessed to have good prospects of achieving a competitive outcome, the focus will be on the national-welfare assessment.

Our analysis follows the standard framework for public policy analysis and design, as outlined in the Treasury's "Regulatory Impact Analysis Handbook"[9]. These guidelines state that a Regulatory Impact Analysis (RIA) should:

- explain the current situation and the nature and size of the problem;
- set out the policy objectives;
- identify the range of feasible options (both market and non-market options);
- provide an analysis of the costs, benefits and r sks of these options; and
- provide an indication as to how the options would be implemented, monitored and reviewed.

The RIA seeks to ensure that private and non-regulatory arrangements are considered and that particular regulatory solutions have been demonstrated to enhance the public interest.

3.2 Process followed

In preparing this report, we reviewed numerous documents and consulted with a variety of market participants and regulators

We also consul ed with the following government agencies:

- the M nistry of Primary Industries (MPI); and
- the Ministry of Business, Innovation and Employment (MBIE).

Beyond this, our study was primarily desktop-based, relying on our extensive dairy and public-policy experience and the range of previous studies and reviews of the dairy industry.

[9] http://www.treasury.govt.nz/regulation/regulatoryproposal/ria/handbook/ria-handbk-jul13.pdf

3.3 Scope of the review

The focus of this review is on the regulatory regime for New Zealand's domestic dairy products market. As well as standard raw milk (as currently regulated by DIRA), we consider other important products in the domestic dairy products market such as organic milk, butter and cheese products. The relative size and structure of the markets for these different products are discussed in Section 6, below.

4. Background

4.1 Development of the DIRA

New Zealand's largest dairy processor, the co-operative company Fonterra, was established in 2001 from an amalgamation of the then two largest dairy co-operatives (New Zealand Co-operative Dairy Group Limited (NZDG) and Kiwi Co-operative Dairies Limited (Kiwi)) with the New Zealand Dairy Board. In forming Fonterra, participants sought to realise efficiencies of scale and scope in the collection and processing of farmers' milk so as to better compete in international dairy markets, to the overall benefit of New Zealand.

At the time, the value of the benefits to New Zealand farmers was estimated to be $310M[10] p.a. or almost $4 billion on a capitalised present value basis[11].

On creation, Fonterra collected approximately 96 percent of New Zealand's raw-milk production. Allowing the creation of such a dominant firm had competition policy implications. In particular, a dominant firm could have:

- the incentives and ability to create barriers to farmers switching to potential competitors;
- the incentives and ability to impede entry into the farm-gate market by new dairy processors;
- the incentives and ability to set wholesale prices in downstream domestic dairy markets; and
- fewer incentives to drive cost efficiencies and invest in innovation, as it could use its market position to retain farmer suppliers even if they were dissatisfied with the company's performance.

The Dairy Industry Restructuring Act, 2001 (DIRA) authorised the amalgamation after the Commerce Commission's draft determination that the merger would result in a strengthening of a dominant position in each of the relevant markets[12].

As the amalgamation resulted in an entity with a substantial degree of market power in several New Zealand dairy markets, DIRA was designed and implemented to mitigate the risks of Fonterra's market

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10 "The Quigley report on dairy megamerger", 24 January 2001. Section 4.1 of the Quigley report refers to the "Business Case for Global Dairy Co Ltd: Executive Summary" that outlines the sources of the $310M in benefits that were claimed to be associated with the merger.

11 Using Fonterra's FY16 pre-tax WACC of 7.9% to capitalise a benefit expressed in 2001 dollar values.

12 The Commerce Commission had reached the preliminary conclusion, in 1999, that the merger that formed Fonterra could not be authorised under the Commerce Act. The Commission's preliminary estimate was that the merger would result in a price rise in domestic dairy products markets (other than spreads) of between 10% and 20%. This translates to a wealth transfer from domestic consumers to the merged entity (Fonterra) of between $75M and $146M p.a., and a net deadweight welfare loss in the domestic dairy production and supply markets of up to $4M p.a. This deadweight loss included both allocative losses in the domestic dairy products-market and dynamic efficiency concerns.

power. In particular, DIRA allows for contestability in the New Zealand raw milk market and provides access to other dairy goods or services supplied by Fonterra to be regulated if necessary.

Regulations made under the Dairy Industry Restructuring (Raw Milk) Regulations, 2001 (and as amended and re-enacted in 2012) contain further provisions to facilitate the entrance of IPs to New Zealand dairy markets and enable them to obtain the raw milk necessary to compete in dairy markets.

The original regulations required Fonterra to supply, at a regulated price, up to 50M litres of raw milk p.a. to any IP and up to 250M litres p.a. to GF. The price of regulated raw milk was the farm-gate milk price (FGMP)[13] for that season plus reasonable transport costs.

An IP is defined in DIRA as:

- a processor of milk, milk solids or dairy products that is not associated with Fonterra; and
- includes NZDF (GF) and any associated person of that company other than Fonterra.

IPs, therefore, include the obvious companies such as Tatua and Westland, but also the less obvious companies like GF and Cadbury[14]. The latter IPs choose to outsource their raw milk supply to vertically integrated dairy processors rather than sourcing it directly from farmers.

The default price specified in the Regulations is a calculated price that is meant to ensure the following outcomes:

- Fonterra is constrained from offering farmers a higher price for their milk. This reduces the risk of Fonterra being able to offer a higher FGMP to limit the ability of competing processors to persuade farmers to switch to supplying them; and

- from a domestic consumer perspective, competition in the domestic market between wholesale companies is sufficient to ensure that Fonterra does not have the power to charge prices in excess of what is required to generate an adequate return on capital employed.

Thus, the DIRA pro-competition provisions were designed to ensure that milk flows to the highest-value user (whether the user is a producer of dairy commodities, ingredients or consumer products) and to avoid wealth transfers from domestic consumers to Fonterra. The provisions work in parallel with, and are supplementary to the general competition provisions of the Commerce Act, 1986 (refer to Annex 1).

The reference to a substantial degree of market power in many key domestic markets was a reference to the fact that both NZDG and Kiwi had sizeable domestic consumer businesses that would no longer be competing against each other (due to Fonterra's creation). Consequently, a condition of the amalgamation was that the domestic business of NZDG (being NZDF, which is now owned by GF, albeit with some material changes over the years) had to be divested.

[13] The FGMP is a notional calculation of the cost of milk supplied to Fonterra on the basis that Fonterra is an efficient processor. Annex 2 provides a detailed breakdown of the FGMP calculation and history.
[14] Supermarkets do not meet the definition of an IP under DIRA and do not have any direct access to DIRA market.

NZDF was a small part of the substantial dairy exporting co-operative business that was originally created to collect its supplier/shareholders' milk for processing and sale. As such, NZDF effectively had its own direct milk supply. The requirement for NZDG to divest NZDF excluded a requirement that NZDF retained its own milk supply. Instead, the requirement for NZDF to have access to milk was covered by the regulation that required Fonterra to supply 250M litres of raw milk p.a. to NZDF/GF.

That 250M litre annual supply requirement was enacted for at least two reasons:

- without the supply requirement, GF would probably have been forced to expand into and compete against Fonterra in export markets[15]; and
- if GF had to collect the raw milk directly from farmers it would have been at a competitive disadvantage to Fonterra from a collection-efficiency perspective that Fonterra could have exploited.

While GF has access to DIRA milk, the milk it obtains from Fonterra is supplied under contract. The terms and conditions of the contract are very similar to those in DIRA. The contract expires in 2021[16].

4.2 Changes to DIRA Regulations in 2012

The 2001 Regulations were revoked on 1 June 2013 and replaced by the Dairy Industry Restructuring (Raw Milk) Regulations, 2012 ("the 2012 Regulations").

Under subpart 1 of the 2012 Regulations:

- the total amount of raw milk to be supplied by Fonterra to IPs increased from 600M litres per season to 795M litres per season;
- the total amount of raw milk to be supplied by Fonterra to GF was unchanged, at 250M litres per season, but supply in the non-winter months was limited to 110% of the amount of raw milk supplied in the preceding October;
- the total amount of raw milk to be supplied by Fonterra to any one individual IP was unchanged, at 50M litres per season, but maximum monthly limits for non-winter milk were put in place; and
- the obligation on Fonterra to supply raw milk to an IP in a season beginning on or after 1 June 2016 was extinguished if that IP's own supply of raw milk in the three previous seasons was 30M litres or more.

Subpart 3 of the 2012 Regulations divided IPs into two categories:

[15] As explained in Section 5, it is possible in New Zealand to have a dairy export business without a domestic business but it is very difficult, if not impossible, to have a commercially viable domestic dairy products business without an export business.

[16] The overwhelming bulk of the raw milk supplied to GF goes into fresh white milk, flavoured milk, yogurt, and other cultured products markets in New Zealand. A small proportion of it goes into the manufacture of specialty cheeses at GF's Puhoi factory north of Auckland.

- those with no, or less than 30M litres of, own-supply raw milk; and
- all the others: being those with more than 30M litres of own-supply raw milk, those that do not require a fixed quarterly raw-milk price from Fonterra, and GF.

For the first group, the new regulations changed the price of raw milk supplied by Fonterra from the FGMP plus $0.10 per kilogram of milk solids (plus transport costs and winter-milk premiums) to a fixed quarterly price being Fonterra's most recent forecast FGMP (plus transport costs and winter-milk premiums).

For the second group, the new regulations changed the price of raw milk supplied by Fonterra from the FGMP plus $0.10 per kilogram of milk solids (plus transport costs and winter-milk premiums) to the FGMP (plus transport costs and winter-milk premiums).

4.3 The Dairy Industry Restructuring Amendment Bill (No 2) 2017

A review of the state of competition in the dairy industry was triggered in 2015 as a consequence of Fonterra collecting less than 80% of milk solids from dairy farms in the South Island in the 2014/15 season[17]. The review, undertaken by the Commerce Commission found that the current state of competition in the dairy industry is not yet sufficient to ensure the efficient and contestable operation of dairy markets in the absence of the DIRA regulatory regime[18]. The findings of the Commerce Commissions review are summarised in Annex 3.

The Commerce Commission recommended that any transition pathway to deregulation should take a staged approach. Initially, this would involve removing elements of the regulatory regime that contribute least to efficiency and contestability.

In March 2017 as a consequence of the recommendations made by the Commerce Commission and a subsequent MPI-led review, the then Minister introduced into the House the Dairy Industry Restructuring Amendment Bill. That Bill was subsequently substantially altered by the new Government before being passed into law on February 15, 2018. (The key features of the original Bill are outlined in Annex 4.)

The changes made to the DIRA by the amendment prevent the relevant DIRA provisions from expiring in the South Island and remove the market share thresholds that would trigger the Act's expiration in the future. The other provisions that were set out by the original Bill (under the previous Government) were removed[19].

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[17] Prior to the more recent amendments, DIRA provided for the default expiry of a number of its provisions in the event that IPs collected more than 20% of milk solids from dairy farms in either the North Island or the South Island in any season. However, meeting the 20% market share threshold was not conclusive evidence of sufficient competition and efficient dairy markets. DIRA therefore required that a detailed review of the state of competition in the New Zealand dairy industry be undertaken.

[18] Commerce Commission (2016).

[19] The original Bill (among other things):

- removed the default expiry provisions and the market share thresholds in the North and South Islands that trigger a review of the state of competition;
- required a review of the state of competition to commence during the 2020/21 dairy season;
- required a review at five-year intervals thereafter if competition has not yet been considered sufficient;
- allowed Fonterra the discretion to refuse supply from new dairy conversions;
- reduced the total volume of raw milk that Fonterra must supply to IPs from 795M litres to 600M litres per season; and

In removing the previous provisions which timetabled a further review for 2020/21 the new Government has announced its intention to "undertake a comprehensive review of the DIRA and consult fully with the dairy sector"[20], commencing in 2018. Cabinet is set to announce further details on the timing, delivery and scope of the review by the end of May 2018. It is likely that there will be additional changes to the DIRA after this comprehensive review is completed and its findings are considered.

– removed the requirement for Fonterra to supply DIRA milk to large export-focused processors from the beginning of the 2019/20 season. The definition of a large export-focused processor is one that has the capacity to process more than 100M litres of milk per season and exports more than 50% of its production by volume.

[20] https://www.beehive.govt.nz/release/dairy-industry-restructuring-amendment-bill-passed

5. Particular features of the domestic dairy market

5.1 Introduction

Liquid milk has certain important features that differentiate it to varying degrees from other commodities. In particular, milk is perishable, the volume and cost of supply vary on a seasonal basis, it has high transport costs because of its high water content and in New Zealand there is a very small domestic market relative to the total output of the industry. This section of the report discusses these particular features of liquid milk and dairy products and draws out some potential implications for the regulatory regime.

5.2 Context

Total global annual milk production is estimated to be around 500 billion (B) litres of milk as of 2016[21]. The size of the internationally traded dairy products market is estimated to be the equivalent of around 65B litres, which is less than 15% of total production. In other words, more than 85% of the milk produced globally is consumed within the country of production.

In contrast, New Zealand's annual milk production is estimated to be approximately 21B litres (or less than 5% of global production), of which approximately 5% is consumed domestically and 95% exported. New Zealand's share of the internationally traded dairy products market is approximately 30%, or 20B litres p.a.

The milk production statistics for selected countries or regions is illustrated in Table 1, below[22].

Table 1: Annual milk production for selected countries (2016)

Country / region	Production (billions litres)
European Union	150.0
United States of America	93.5
India	66.4
China	37.6
Russia	30.3
Brazil	34.6
New Zealand	21.3

Sources: USDA; UN FAO; TDB Advisory

Table 1 highlights the small size of New Zealand's milk production relative to the larger producing countries. The EU's production of milk is seven times as large as New Zealand's and the United States' is 4.5 times as large as New Zealand's.

[21] USDA, Dairy: World Markets and Trade, December 2016.

[22] The original source materials units of production were metric tonnes. We have converted those units to billion litres assuming that one litre of milk weighs one kg, which is approximately but not exactly correct.

The New Zealand dairy industry, however, is like no other in the world because it produces milk in huge volumes relative to the amount that is consumed domestically. While being able to produce milk at internationally competitive prices is positive, there are aspects of the New Zealand industry that are very challenging, including the proportion of production that needs to be exported, the consequent exposure to international prices, the distance from export markets and the shape of the seasonal milk curve.

Table 2 below provides the proportions of national dairy production that are consumed domestically and exported from the major milk-producing countries.

Table 2: National production consumed domestically and exported (2016)

Country	National production (billions litres)	Domestic consumption (%)	Exported (%)
New Zealand	21.3	5%	95%
Australia	9.5	55%	45%
United States of America	93.5	85%	15%
European Union	150	89%	11%
India	66.4	96%	4%
Russia	30.3	98%	2%
China	37.6	100%	0%
Brazil	34.6	100%	0%

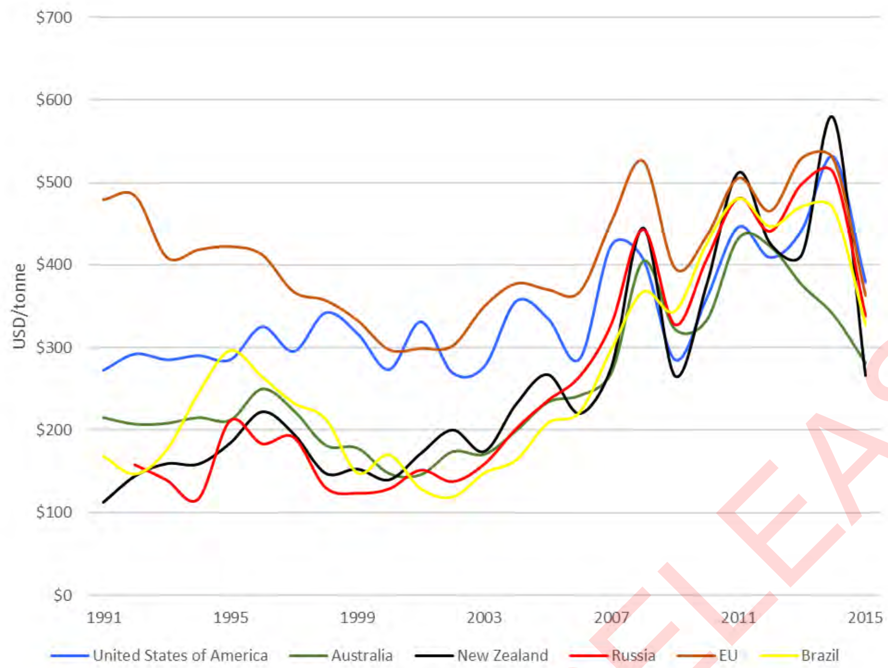
Source: USDA, 'Dairy: World Markets and Trade' Dec 2016; TDB Advisory

Table 2 illustrates two important issues:

- New Zealand's domestic market is almost insignificant compared with the volume of milk produced and exported; and
- New Zealand is more directly exposed to international dairy prices than any of the other countries/regions.

The consequences of being highly exposed to international dairy prices are significant as can be seen in Figure 1 below. The graph presents estimates of average dairy prices by country or region between 1991 and 2015.

Figure 1: Dairy-product prices per country / region



Source: UN FAO data; TDB analysis

As can be seen in Figure 1 above, New Zealand's dairy prices are more volatile than the other countries'. New Zealand's lowest price is lower than any other country's, its highest price is higher than any other country's, and the distance between the peaks and troughs moving through time is greater than any other country's. These price characteristics mean New Zealand processors (and therefore New Zealand dairy farmers) are exposed to more volat le prices than their international peers.

5.3 Size of the domestic market relative to domestic production

As noted above, New Zealand produces about twenty times more dairy products than the domestic market can consume. The fresh-milk market in New Zealand consumes approximately 600M litres of milk p.a. compared to annual production of 20.7B litres of milk. The relative size of the domestic market and the absolute requirement to be an efficient processor via scale forces new IPs to focus on export markets

As an example given today's technology, an efficient table-cheese plant is one that has the capacity to produce 25,000 metric tonnes (MT) of cheese p.a. at a cost of around $180M (including the ability to m nage by-product, effluent and storage). New Zealand's total domestic consumption of table cheese is 21,000 MT p.a. Therefore, in order to be able to produce cheese efficiently, an IP would have to build a plant with the capacity to service close to 120% of the domestic market.

For the New Zealand grocery-channel market for dairy products, Fonterra Brands New Zealand (FBNZ) has a branded marker share of around [Redacted] by volume and GF has around [Redacted]. The smaller players combined have about [Redacted]. The balance is made up of supermarket house-branded fresh white milk, cheese and butter – which together account for around 50% of the total dairy market.

Fonterra/FBNZ is the largest manufacturer of supermarket house-branded dairy products in New Zealand.

A new table-cheese manufacturer targeting the domestic market, therefore, would be fighting for a share of the [Redacted] of the market that the supermarkets do not own. If the new manufacturer was able to [redacted], it would, given the scale needed to be efficient, be producing 25,000 MT of cheese. Of this, 2,100 MT would be sold domestically (10% of the 21,000 MT domestic market) with the remaining 22,900 MT being exported.

The above helps to explain why there are only two non-specialty cheese manufacturers in New Zealand: Fonterra and Open Country Dairy (OCD). Fonterra's annual cheese production is approximately 310,000 MT and OCD's annual cheese production is approximately 30,000 MT. Practically 100% of OCD's cheese is exported.

As well as the efficient capacity requirement forcing producers into export markets, the capital required means that new capacity is limited to large corporates.

There are a number of specialty cheese manufacturers in New Zealand of which GF's Puhoi Valley Cheese Company Limited (Puhoi) is one of the largest. [Redacted] comparable to the annual production from approximately six average-sized dairy farms. Own-supply for specialty cheese manufacturers is therefore a difficult option because the risk of supplying a small specialty manufacturer is too much for a dairy farmer[23].

The butter situation in New Zealand is similar to the table-cheese situation. Butter is made from the fat component of milk. Therefore, a processor producing butter needs to also produce skim milk powder and have two separate manufacturing processes[24]. New Zealand exported 550,000 tonnes of butter in 2016 compared to a domestic market of around 22,000 MT[25]. If a processor is running a minimum-sized efficient plant in New Zealand and processing 200M litres of milk p.a. to produce butter and skim milk powder, that processor would be producing 7,800 tonnes of butter and 18,000 tonnes of skim milk powder[26,27]. Therefore, in order to be able to produce butter efficiently, an IP would have to build a plant with the capacity to service close to 35% of the domestic market.

5.4 Seasonality and the domestic fresh-milk market

The New Zealand dairy industry is internationally cost-competitive, in part because New Zealand's temperate climate and abundant water allows the farming system to be a pasture-based system where milk production matches grass growth. The pasture-based system, however, means milk production is highly seasonal. Milk production in the peak month (October each year) is typically 20 times larger than the lowest milk-producing month (June each year).

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[23] A specialty cheese manufacturer might integrate backwards and buy farms, but this would require a sizeable investment; the current value of a farm or farms producing 885,000 kgMS is around $50M.
[24] But not necessarily vice versa. If a processor is producing skim milk powder, it must also produce some sort of fat product such as butter, milk powder or anhydrous milk fat.
[25] https://www.indexmundi.com/agriculture/?country=nz&commodity=butter&graph=exports.
[26] 100 litres of milk produces approximately 3.9 kgs of butter and 9.0 kgs of skim milk powder.
[27] Skim milk powder is a basic commodity with the world's big manufacturers being the EU and the USA. New Zealand is not a globally significant producer of skim milk powder in the same way as it is a globally significant producer of whole milk powder.

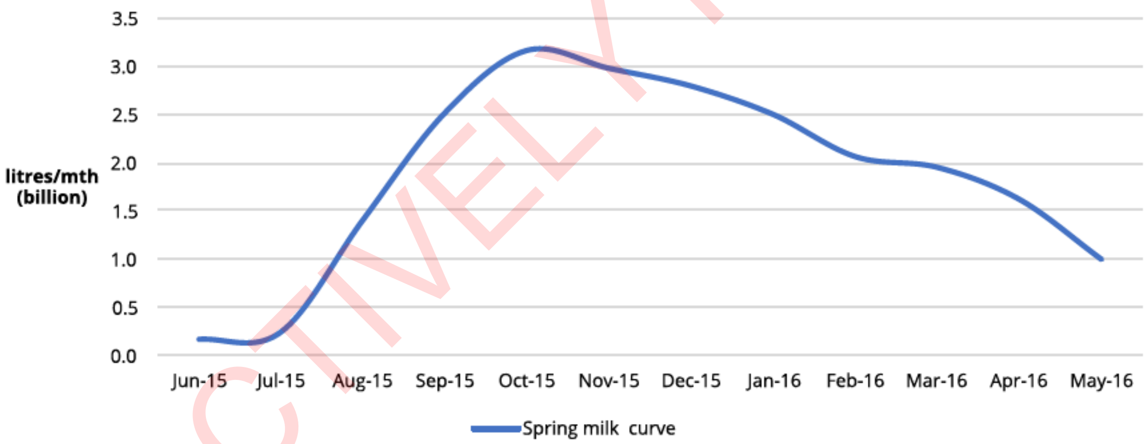
The demand for fresh milk in the domestic market does not match the seasonal milk supply curve of the industry. The domestic demand for milk is flat over a given year meaning that approximately the same amount of milk is demanded for domestic consumption in every month of the year.

The multiple between the highest and lowest milk-producing months would be more than twenty if Fonterra did not specifically incentivise farmers to produce winter milk for the domestic market by paying them a margin over the FGMP.

For the winter of 2017, the contracted winter-milk premium for the North Island was $3.17 and for the South Island it was $3.92. The contract premium reduced by 2.5 cents for every 10 kilometres (in travel distance) the supplying farm was from the designated factory. In the North Island, there are four designated factories: Kauri in Northland, Takanini in Auckland, Waitoa in Waikato, and Longburn in Manawatu. In the South Island, there is one designated factory located in Christchurch. The winter-milk premiums are designed to compensate farmers for the additional costs associated with feeding their herds when there isn't any grass growth and therefore are a good indicator of the costs of deviating from a pasture-based system. The contract design also means that farmers effectively pay the winter-milk transport costs.

Figure 2 below shows the seasonal milk supply curve[28].

Figure 2: New Zealand milk curve



Source: Dairy Companies Association of New Zealand (DCANZ), 2016 milk collections data.

The area under the curve presented in Figure 2 equals New Zealand's total milk production in the 12 months ended 31 May 2016 – approximately 21.3 billion litres of milk. The seasonal curve is based predominantly on a spring calving regime (to match grass growth). Seasonal milk curves vary throughout the country because of, amongst other things, different climatic conditions and different farming practices.

The seasonal pattern of milk production and the large excess supply of milk in the domestic market[29] is managed by creating extended shelf-life products where the date of manufacture is less important.

[28] Figure 2 includes Fonterra's winter-milk collections and it uses monthly data (rather than daily data). Therefore, it is a flatter curve than GF would expect to face if it sourced its milk directly from farmers.
[29] Annex 6 analyses more closely the seasonality effects on GF's business operations.

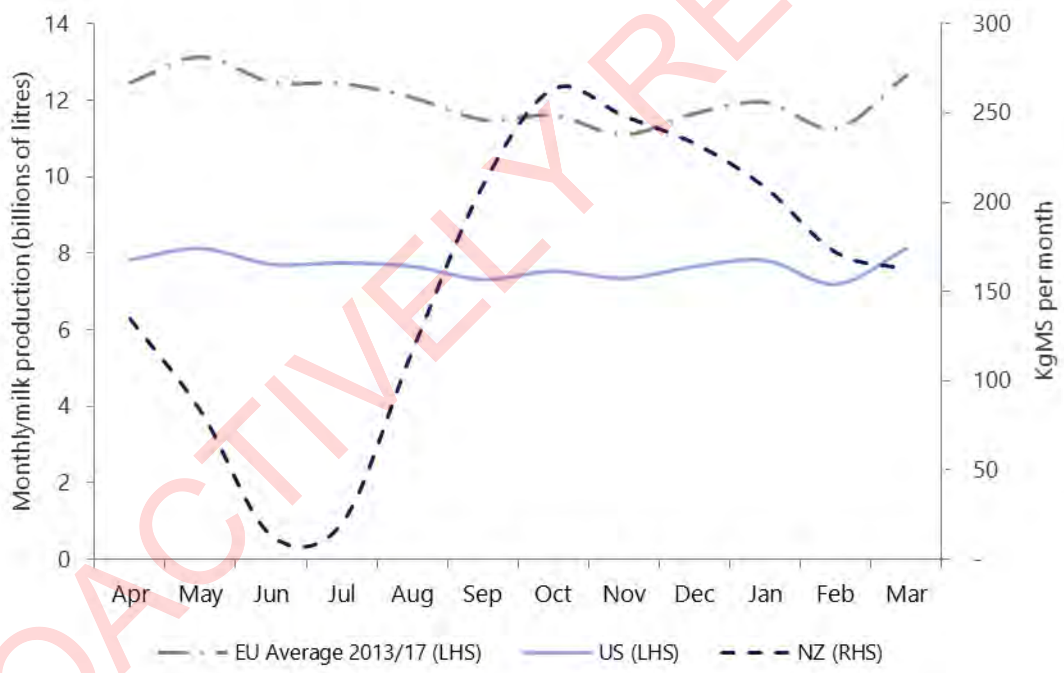
These products are then sold domestically or exported. Such products include bulk cheese, bulk butter, UHT milk, and a range of milk powders.

Given the seasonal milk curve and the non-seasonal nature of domestic demand, it is no surprise that the original two large pre-merger domestic businesses were subsidiaries of very large export businesses (NZDG and Kiwi). Both NZDG and Kiwi had large ingredient businesses to funnel their excess milk through to manufacture and export as long-life products (through the New Zealand Dairy Board at the time).

The important point is that participants in the New Zealand dairy industry that have their own milk supply from farmers can have an export ingredients business without a domestic business. However, these participants are unlikely to have a domestic business without an export ingredients business (or access to one).

As Figure 3, below, illustrates, the shape of the seasonal milk curve in New Zealand is much more extreme than in the US or EU.

Figure 3: Milk curves – international comparison



As noted above, New Zealand produces 20 times as much milk in October as it does in June each year. The EU's peak month is May and its trough month is November. The EU produces 1.2 times as much milk in May than it does in November each year. The United States' peak month is also May and its trough month is February. The US produces 1.1 times as much milk in May than it does in February each year[30].

[30] While not shown in the graph above, the approximate peak to trough measurements for Argentina (as a proxy for Brazil) and Australia are 1.6 and 1.8 times respectively.

These peak to trough variations graphically illustrate the difficulty the New Zealand milk curve causes New Zealand processors, especially those who are focused on the domestic market.

The combination of the size of the domestic fresh-milk market relative to the volume of output and the seasonal variation in milk production results in the New Zealand domestic fresh milk market having many of the characteristics of a natural monopoly. Capital costs and economies of scale are large relative to the size of the domestic market, making barriers to entry relatively high. Annex 5 explores in more detail the natural monopoly characteristics of the New Zealand fresh-milk market.

It has always been well known that the New Zealand dairy industry is more exposed to international dairy prices than other countries and that New Zealand's milk curve is "peakier" than others. This section adds context to the discussion and quantifies the magnitudes of these features. The magnitude of the differences needs to be taken into account when looking offshore for examples of how to manage the market dominance of an entity such as Fonterra or to encourage competition.

6. Current market structure: the farm-gate and consumer markets

6.1 Introduction

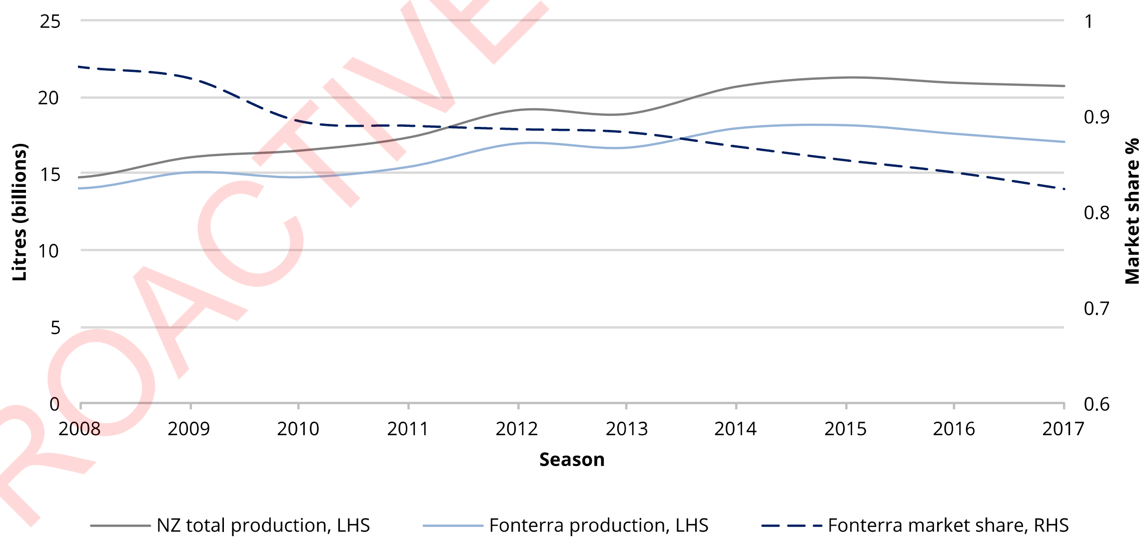
This section discusses the current structure of the dairy markets in New Zealand. The markets are segmented into the farm-gate market and the consumer market. The factory-gate market (where processors trade collected raw milk with other processors) is almost non-existent except for the regulated supply of milk by Fonterra to GF. The potential for an unregulated factory-gate market for milk to develop is discussed in Section 8.

6.2 The farm-gate market

The farm-gate market is the market for the collection and purchase of raw milk from farmers.

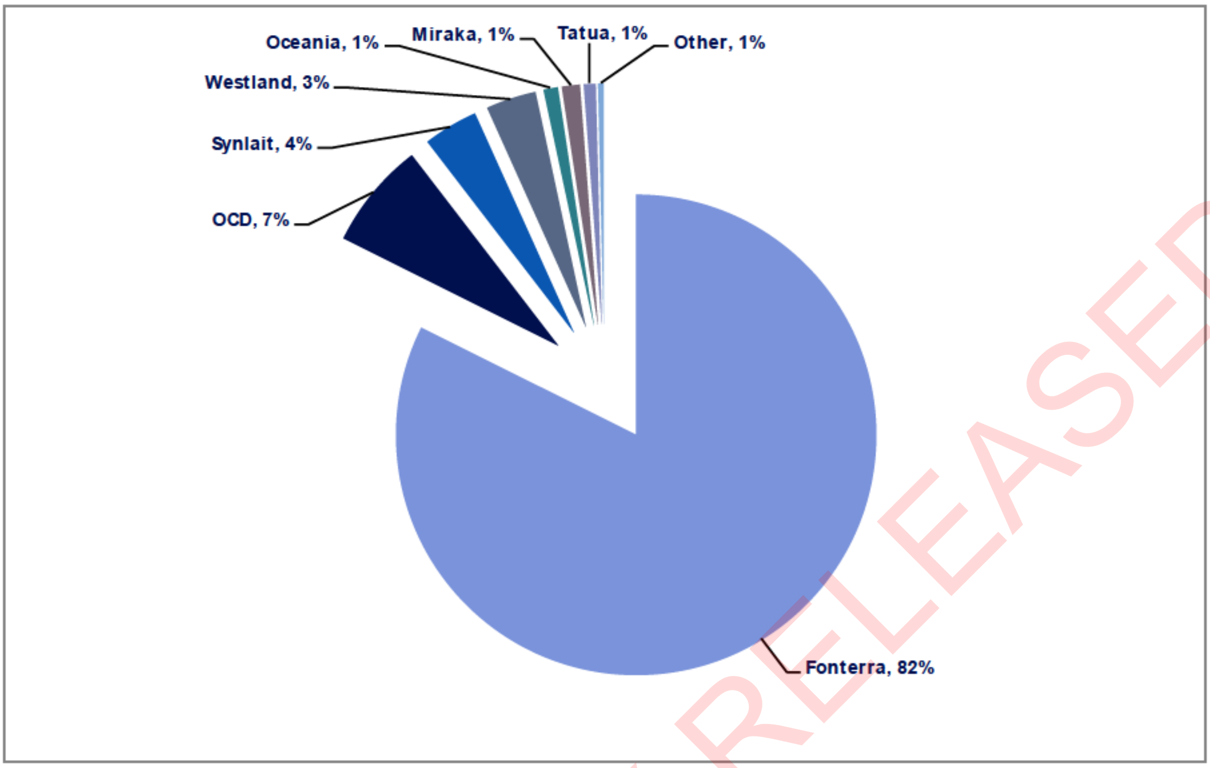
On the supply side, there are over 11,650 dairy farms supplying milk in New Zealand. Fonterra dominates the demand side of the market. On its formation, Fonterra collected around 96% of the milk produced in NZ. Since then, there have been six new entrants in the farm-gate market, with five of the new entrants continuing to operate and four effectively competing at the farm gate. Fonterra's share of the farm-gate market has declined steadily over the last fifteen years since Fonterra was established from 96% in 2002 to 82% in 2017. The trend in Fonterra's market share over the last ten years is shown in Figure 4 below.

Figure 4: Total NZ milk production and Fonterra's market share



The current market shares of the main NZ milk-processing companies are shown in Figure 5 below.

Figure 5: Market shares of milk collections in NZ (2017)



Each of the main dairy processors is described below.

Open Country Dairy Limited

Open Country Dairy (OCD) was originally established as Open Country Cheese Company Limited, which originally raised equity from a large number of small investors to build a cheese factory in Waharoa, in Waikato. OCD used DIRA milk to provide base volume for the cheese factory.

OCD's first expansion beyond Waharoa was the construction of a whole milk powder (WMP) plant in Southland. OCD used DIRA milk in conjunction with the milk supplied by a single very large dairy farmer, to mitigate its milk supply risk on its expansion into Southland. OCD subsequently used DIRA milk to mitigate its milk supply risk as it expanded into Whanganui. OCD is now the second largest dairy company in New Zealand with a processing capacity of approximately 1.3 billion litres of milk. 100% of its product is exported. It is focused on commodity or near-commodity markets.

OCD is no longer able to access DIRA milk.

Synlait Milk Limited

Synlait Ltd was founded in 2000 by three shareholders who established and managed various dairy farms and dairy farm conversions. Synlait Milk Ltd was incorporated in 2005 to process the milk provided by Synlait Ltd's farms and other third-party suppliers. The Synlait farms have now been sold and Synlait Milk is now jointly listed on the New Zealand Stock Exchange and Australian Securities Exchange. Its largest shareholder is Bright Dairy Holding Limited.

Synlait Milk (Synlait) has a current processing capacity of approximately 700M litres of milk. 100% of its production is exported. Its focus has traditionally been the business-to-business market for formulated powders although it has recently announced an intention to invest in a new $125M advanced liquid dairy packaging facility[31] on its site in Dunsandel, Canterbury. It has also recently announced the purchase of 28 ha of land in Pokeno, North Waikato, to establish a second $260M powder manufacturing site[32].

Synlait has its own milk supply contracts with farmers. It previously used DIRA milk to mitigate the risks of its growth strategy. It is also no longer able to access DIRA milk.

Miraka Limited

Similar to Synlait, Miraka Ltd (Miraka) started with a milk supply partially underwritten by its shareholders. It is located on a single site approximately 30 km north-west of Taupo. Miraka has a milk processing capacity of approximately 250M litres from which it produces WMP and UHT milk. 100% of its production is exported.

Miraka has its own milk supply and previously used DIRA milk as well. It is no longer able to access DIRA milk.

Oceania Dairy Limited

Oceania is owned by Inner Mongolia Yili Industrial Group Company Limited. It is located on a single site at Glenavy in North Otago. The plant is capable of producing a range of powders. Its output is exported to its parent company (China's largest dairy company)

Oceania has an estimated processing capacity of 420M litres of milk. The processing factory was opened in time for the 2014/15 season. It has its own supply but originally used DIRA milk as well. It lost its access to DIRA milk on 1 June 2017.

Gardians Limited

The Gardians plant was commissioned in 2012 with its single supplier being one of the joint venture owners. The plant produces infant formula. It is a 3 ½ tonnes/hour plant that has a processing capacity of approximately 80M litres of milk. This company is now owned by French dairy company Danone. While this company has its own milk supply, it gets all its milk from a single supplier and therefore is not competing in the farm gate market.

Gardians does not use DIRA milk.

New Zealand Dairies Limited (in receivership)

New Zealand Dairies was originally owned by New Zealanders that included local farmers. The Russian company Nutritek got involved with the company as a consequence of the original owners running into financial difficulties. New Zealand Dairies was eventually placed in receivership and Fonterra bought the assets. The plant (located in Studholme, Otago) has the capacity to process 200M litres of milk p.a.

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[31] Synlait's new facility will have a minimum capacity of 110M litres p.a. and be capable of producing high-specification pasteurised milk and cream (for domestic consumption); extended shelf life dairy products; long-life milk and cream (for the export market); ready-to-drink (RTD) liquid infant milk formula; and other blended dairy-based beverage products.
[32] https://www.nbr.co.nz/article/synlait-milk-buys-pokeno-site-new-factory-flags-260m-investment-b-213139

Yashili NZ Limited

Yashili is a Chinese company with a manufacturing site in Pokeno. It does not compete in the farm-gate market as it does not process raw milk.

Outlook for farm-gate market

Milk volumes have increased significantly since Fonterra was established. However, a number of industry commentators are now suggesting that New Zealand has reached or passed peak cows. If that is the case, any future milk volume growth will be dependent on increased productivity and it seems reasonable to argue therefore that any new processing facilities will have to compete harder for milk supply.

Fonterra's competitors now have profitable operations and well-established relationships with farmer-suppliers and offshore customers. Based on their current announced plans and assuming that a) New Zealand's total milk volumes are static at 20.7B litres (equating to actual production last season), b) Fonterra's competitors successfully recruit all the milk they need to fully utilise their additional capacity, and c) all of that extra milk is recruited from Fonterra suppliers, Fonterra's market share will fall from 82% to 78% by the end of the 2020 season.

6.3 The consumer market

Fresh white milk, cheese, yoghurt and butter account for approximately 80% of the volume in the New Zealand consumer dairy products market. The balance of the market is comprised of products such as flavoured milks, dairy desserts, cream cheese, sour cream and specialty cheeses.

The three key channels to market are grocery (supermarkets), route (petrol stations, dairies, small convenience stores) and food service (cafés, catering companies, hotels, restaurants, institutions and the like). Grocery is the largest of these channels with sales of approximately 60% of the total volume.

Figure 6 below provides a high-level depiction of the structure of the New Zealand consumer dairy products market.

Figure 6: [Redacted]

FBNZ is the dominant player in the New Zealand consumer dairy products market, supplying a full range of dairy products and having market leadership across all channels. GF is number two[33]. The rest of the consumer dairy market is supplied by smaller players such as Fresha Valley and Green Valley (milk), Dairyworks (cheese), Lion (yoghurt), The Collective (yoghurt), and Lewis Road (milk, butter, and ice-cream) along with a number of companies importing specialty dairy products.

Figure 7 below presents some of the leading brands of FBNZ and GF in the retail market.

Figure 7: Brands of FBNZ and GF

[33] GF has three milk-processing sites – in the North Island one at Longburn and one in Puhoi; in the South Island, one in Christchurch. As well as producing fresh milk for sale under its own brands, GF also produces private-label fresh milk for the supermarkets and Fonterra-branded fresh milk for Fonterra in Christchurch. The supermarkets do not meet the definition of an IP under DIRA and therefore do not have any access to DIRA milk.

It is important to note that while FBNZ, GF and others manufacture a wide range of dairy products using the base products of raw milk, block cheese and butter, the base products have been manufactured for the New Zealand domestic consumer market by Fonterra. Fonterra on-sells these base products to FBNZ, GF and others either in bulk form or ready packed into consumer formats.

FBNZ has around [Redacted] by volume of the branded-dairy market share in the grocery channel and GF has around [Redacted]. The smaller players combined have about [Redacted]. The balance is made up of supermarket house-branded fresh white milk, cheese and butter with Fonterra/FBNZ being the largest manufacturer of supermarket house-branded dairy products in New Zealand

FBNZ, GF and Fresha Valley are the largest manufacturers of supermarket house-branded fresh white milk. Fonterra/FBNZ and Dairyworks dominate the supply of supermarket house-branded cheese. Dairyworks buys cheddar cheese from Fonterra, which it then cuts/wraps/grates and markets under its own brands while FBNZ and GF purchase cheese from Fonterra that has already undergone secondary processing into consumer formats. Fonterra is practically the only manufacturer of supermarket house-branded butter in New Zealand.

FBNZ holds the branded and supermarket house-branded milk contract for Foodstuffs North Island (FSNI). GF currently holds the supermarket house-branded contract for Foodstuffs South Island (FSSI); however, Synlait has recently won that contract beginning in 2019 (see Annex 8 for a full description and analysis of the agreement). The Countdown/Progressive supermarket house-branded milk contract is held by GF and Fresha Valley (a smaller player in the market).

FBNZ holds an estimated [Redacted] share by volume of the route business with GF at [Redacted] and the balance being made up by Green Valley and others[34].

FBNZ holds an estimated [Redacted] share, by volume, of the food-service business, with GF sitting at about [Redacted] and the balance being held by other competitors[35].

The lack of comprehensive market-share data for any channel other than the grocery sector limits the ability to draw firm conclusions with respect to how the retail market for dairy products in New Zealand has developed since the establishment of Fonterra.

In the grocery sector, the market-share data indicates that the combined share of the private-label brands held by FBNZ and GF has decreased from [Redacted] over the last 16 years. The combined market share of all the other participants in the grocery sector has increased from [Redacted].

[34] Data from Aztec route retail database which samples around 200 stores.
[35] Internal GF market analysis.

FBNZ has been more successful than GF in the dairy products market in recent years. Since 2008, FBNZ has maintained a [Redacted] share by volume of the branded-dairy market through the grocery channel while GF has dropped from [Redacted] over the same period. This fall in market share for GF is due largely to a reduction in its share of consumer block cheese and butter, which are sourced from Fonterra at a non-regulated price.

Overall, if the grocery sector can be used as a proxy for the total consumer market, we would conclude that competition in the sector has increased since Fonterra was created and therefore that DIRA has been successful in preventing FBNZ from exercising its market dominance. The entry of Synlait to the domestic dairy products market is also a sign of increasing competition in the market.

Finally, it is worth highlighting a recent development in Fonterra's business strategy. In February 2018, Fonterra and the a2 Milk Company announced that they would be forming a partnership whereby Fonterra will begin to develop an A2 milk pool to help meet the growing global demand for A2 milk products. The partnership will also encompass[36]: a nutritional products manufacturing and supply agreement[37]; distribution and sales arrangements; an exclusive period for Fonterra to explore a2 Milk Company branded butter and cheese and China sourced liquid milk; the exploration of a jointly owned packaging facility; and an exclusive license for Fonterra to produce, distribute, sale and market a2 MilkTM fresh milk in New Zealand.

[36] https://www.fonterra.com/nz/en/our-stories/media/fonterra-and-the-a2-milk-company-form-comprehensive-strategic-relationship.html

[37] The nutritional products manufacturing and supply agreement involves Fonterra having exclusive supply of nutritional milk powder products intended for sale in South East Asia and the Middle East.

7. Opportunities to achieve better-functioning markets

7.1 Introduction

As noted in the Treasury's guidelines[38], the first step in public-policy analysis is to identify clearly the problem or problems that need to be addressed. Putting the task more positively, the challenge is to identify the opportunities for improving the current situation. In New Zealand's domestic dairy markets the main opportunities are likely to arise from improving the DIRA to offset Fonterra's dominan pos tion in the farm-gate, factory-gate and wholesale domestic markets. The opportunities include:

- strengthening competition in the domestic markets;
- reducing regulatory uncertainty;
- improving incentives to innovate; and
- improving the market behaviour of Fonterra.

This section presents and discusses each of the options above[39].

7.2 Strengthening competition in the domestic markets

As noted in Section 4.3, the Commerce Commission reviewed the state of competition in New Zealand's dairy markets and found the level of competition at th farm-gate and factory-gate markets is not yet sufficient to warrant deregulation at this time[40]. This lack of competition penalises farmers who have limited choice over whom they supply their milk o and domestic consumers of dairy products who face potentially higher prices.

In the domestic wholesale dairy products market there is competition between FBNZ, GF and a number of other smaller competitors. To the extent that the wholesalers have market power, this is offset by the countervailing power of the two major retailers, Progressive Enterprises and Foodstuffs.

DIRA itself, howeve , imposes constraints on the competition with GF's access to DIRA milk limited to 250M litres p.a and other potential entrants limited to 50M litres p.a. The cap on GF's DIRA milk supply means it is not able to compete for new high-volume contracts without switching product from an existing custome or sourcing milk directly.

GF c rrently accesses approximately 220M litres of the 250M litres it is contractually entitled to. Howeve , having a maximum entitlement under DIRA hampers GF's business in two ways:

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[38] Treasury, op cit.

[39] There are other challenges facing the sector, such as the dominance of the grocery trade in New Zealand by two companies, Progressive Enterprises and Foodstuffs, but the issues listed above are, in our view, the key ones that sit squarely within the scope of the current review.

[40] http://www.comcom.govt.nz/regulated-industries/dairy-industry/report-on-the-state-of-competition-in-the-new-zealand-dairy-industry/

1. it restricts the growth of the business to an additional 30M litres and therefore dilutes GF's ability to compete on large milk-supply tenders. GF was unable to submit a tender for the supply of milk to Foodstuffs (NI) Ltd because the required volume of 100M litres p.a. was more than GF could supply without moving milk from another customer; and

2. it provides a certain inevitability about a declining market share for GF. New Zealand's population grew in the year to 30 June 2015 by 1.9%. At this rate of population growth, if milk consumption per capita is reasonably static and GF maintains its current market share, GF will exhaust its entitlement to DIRA milk in seven years and, from that point on, start losing market share.

7.3 Reducing regulatory uncertainty

The previous situation was that participants and potential participants in the domestic dairy markets would have had little certainty about regulation of the industry until completion of the review timetabled for 2020/21. This uncertainty about the regulatory environment would have reduced incentives to invest and innovate in the industry in the period until completion of the 2020/21 review and potentially beyond that since further reviews were anticipated. The new Government has removed the provisions for regular reviews of DIRA and thereby indicated an objective of determining the long-term future regulatory regime in the 2018 review. Thus on the current timetable for the new review the uncertainty should be resolved relatively soon and for the long term provided the results of the comprehensive review are determined and implemented expeditiously.

7.4 Improving incentives to innovate

While there is some innovation in products, the limited state of competition in the market combined with the regulatory uncertainty is likely to reduce incentives for industry participants to invest in research and development and to innovate new products, processes and distribution channels.

Fonterra chooses to absorb the extra costs involved in supplying winter milk, however, better pricing signals could be delivered if Fonterra chose to pass-on this cost. If the extra cost of producing milk over the winter period were passed-on to consumers, the retail price of milk would rise by around 30c/litre (or approximately 15%) on average over the winter months. While such an increase may be politically unattractive, the higher prices would give consumers better signals about the true cost of supply and encourage them to economise on milk consumption over this high-cost period.

7.5 Improving the market behaviour of Fonterra

On several occasions in the past, Fonterra has used its dominant position in a way that has disadvantaged its competitors. Perhaps the most significant occasion was in 2011 when the global price of milk - and therefore also the FGMP - was at close to record high levels. With consumers facing high prices, there was considerable public angst that led to Fonterra putting a freeze on the wholesale price charged to the retailers by FBNZ but not the price at which it supplied milk to GF. GF's margins were squeezed as a result. Similar behaviour was experienced in 2013/14 when the FGMP rose by 48%, but FBNZ did not move its sales prices in line with commodity-price movements.

This concern Fonterra has with maintaining public goodwill in New Zealand can result in Fonterra applying margin squeezes to GF. Capping wholesale prices while allowing the increases in world prices to affect GF is detrimental to GF's operations. In such circumstances, Fonterra may inflict financial damage on GF even if that is not Fonterra's main objective.

The situation described above, whereby Fonterra has reason, due to its dependence on popular goodwill, to occasionally require FBNZ to set prices that will not yield a normal return given the FGMP, will also tend to inhibit any new processor from entering the domestic dairy products market.

GF has documented a number of other examples it has experienced of Fonterra using its dominant position to the detriment of other suppliers, in GF's submission to officials.

The potential cross-subsidisation of FBNZ by Fonterra is an ongoing issue. It is, however, difficult to assess the extent to which such cross-subsidisation is occurring because Fonterra does not publish separate financial statements for FBNZ. We discuss the potential for requiring grea er disclosure by Fonterra of its internal pricing, and in particular the option of requiring Fonter a to publish segmented accounts for FBNZ, in Section 10.5.

7.6 Conclusions

The regulatory regime provided by DIRA has been important n allowing competition to emerge and in dampening Fonterra's ability to use its dominant posit on in domestic dairy markets. However, there are various opportunities to improve the regulatory regime

The previous Government clearly signalled its desire to exit the special regulatory regime for the dairy industry. The problem is it did not find a credible exit pathway that would not risk imposing substantial costs on domestic consumers and so proposed to under a review in 2020/21. The new Government has removed the provisions for regular reviews of DIRA and thereby indicated an objective of determining the long-term future regulatory r gime in the 2018 review.

In its May 2016 Discussion Document, MPI stated that the Government's objectives for any amendments to the DIRA and Raw-Milk   egulations are to:

- promo e the efficient operation of dairy markets in New Zealand;
- ensure that New Zealand markets for dairy goods and services are contestable through a credib e threat of IP entry and expansion;
- enable IPs to obtain raw milk and other dairy goods and services, necessary for them to compete in New Zealand dairy markets; and
- enable deregulation of New Zealand dairy markets if, and when, competitive pressure on Fonterra is sufficient to drive the efficient operation of dairy markets in New Zealand[41].

[41] MPI, Discussion Document, "Proposed changes to the Dairy Industry Restructuring Act 2001 and Dairy Industry Restructuring (Raw Milk) Regulations 2012", Paper No: 2016/05, p.6.

In Sections 8, 9 and 10 of this report, we assess the options – both market-based and regulatory – for improving the current situation in domestic dairy markets against these objectives.

8. Feasibility of a factory-gate market

8.1 Introduction

The factory-gate market refers to the hypothetical market where processors could, instead of processing all the raw milk they collect from farmers, sell some or all of the raw milk to other processors.

If DIRA was repealed, a factory-gate market for raw milk could, in principle, be one way for dairy processors or food and beverage manufacturers to source unprocessed raw milk as an input for their manufacturing processes, either as a supplement to or instead of obtaining raw milk directly from farmers.

This section considers the feasibility of a sustainable and competitive factory-gate market for raw milk developing in New Zealand in the absence of specific government intervention.

8.2 The factory-gate market for raw milk

At present, there is no functioning unregulated factory-gate market for raw milk in New Zealand[42]. The Commerce Commission notes[43] that "the factory gate market is very small compared with the farm gate market". The Commission's data on the actual size of the market is redacted, but we agree with the Commission that the market, to the extent it exists at all, is very small.

The absence of a functioning farm-gate market in New Zealand may be in part because the DIRA regulations have reduced the incentive for a factory-gate market to develop. It may well also be because the factory-gate milk price would have to be materially higher than the FGMP.

A processor supplying the factory-gate market must contract with farmers for additional supply or divert milk that would otherwise be processed in its own plants. As noted in Section 5.4, above, milk processors must build enough capacity to process all of the milk supplied on the peak day (they cannot store it, and they cannot dump it). Their first objective is to have their factories operating as efficiently as possible and therefore as close as possible to capacity. To encourage them to take raw milk out of their factories to sell at the factory gate, they would need to earn at least as much from the sale of that raw milk as they would earn from the alternative. That is, they would need to earn a return on the capital employed in the under-utilised factory, and they would need to be compensated for having less volume to spread their fixed costs over.

Using the information provided in the 2016 Milk Price Statement and assuming a single efficient processing plant provides half of GF's domestic-milk requirements (assuming half in each island), we estimate the point of indifference for a processor would be achieved at a raw-milk cost to GF of the FGMP + [Redacted]. That is, GF would have to pay [Redacted] than FBNZ's cost of milk (which is the FGMP). To put the price of indifference in context, the average FGMP since the establishment of Fonterra

[42] The supply of up to 250M litres of raw milk by Fonterra to GF is a factory-gate level transaction but it is the result of the DIRA regulations requiring Fonterra to supply GF.
[43] Commerce Commission (2016), para 4.126.

has been $5.40, so the margin over the average FGMP would be around [Redacted]. Annex 7 provides the detailed calculations behind this estimate.

The conditions that would need to exist in order for the factory-gate milk price to be close to, or the same as, the FGMP (and therefore producing a sustainable market environment) are:

1. the processor would need to have excess milk – that is, not to have committed capital to processing all the milk being collected and therefore not having any capital return requirement; and

2. the customer at the factory-gate would have to guarantee to take all milk in excess of the volume the processor could process.

We consider it unlikely that these conditions will be met in the foreseeable future.

8.3 Other factory-gate markets

We are not aware of a functioning factory-gate market for raw milk in other OECD countries. Nor are factory-gate markets common in New Zealand for other (non-mi k) commodities.

The timber and meat industries are interesting in this regard. The factory-gate market equivalent for the timber industry would be a mill-gate market in which timber processors, having contracted with forest owners for a supply of logs and arranged transport, sell those logs to another timber mill with the logs being delivered to the other mill[44]. The factory-gate market equivalent in the meat industry would be a meatworks-gate market in which a meat processor such as Silver Fern or Affco, having bought livestock from a farmer and arranged transport, sells the livestock to another meat processor and arranges for the livestock to be delivered to the othe processor's works.

It is not at all obvious that a deep, i e. s zeable and reliable, mill-gate or meatworks-gate market exists or is likely to ever exist. A deep market would require that a timber or meat processor systematically contract to obtain a greater supply of its raw material than it needs in order to sell the excess to other timber mills or meat works. Temporary arrangements to sell excesses to competitors – eg, to adapt to equipment breakdowns or other reasons for plant closures - might be expected. However, a deep and on-going factory gate style market is not at all an obvious feature of the competitive landscape for these commodi ies.

8.4 Conclusions

There is a good theoretical basis to assume a factory-gate market for raw milk is unlikely to develop on its own. In addition, we are unable to find clear examples of functioning factory-gate markets for raw milk in other countries and factory-gate markets do not appear to be a common feature for other commodities in New Zealand. We therefore conclude that there is a low likelihood that a factory-gate market for raw milk will develop, or would be sustainable, without special legislative backing.

[44] The timber mill analysis relates to pinus radiata. There may be a small mill-gate trade of specialty timbers.

There are, however, several other potential market-based alternatives to DIRA. These options are considered in Section 9, below.

9. Other potential market solutions

9.1 Introduction

This section considers a range of market-based solutions (other than a factory-gate market) that could address the issues with and opportunities to improve the function of the dairy products market noted in Section 8 above. In particular, we consider whether any of the market-based options are feasible alternatives to DIRA in the short or medium term.

We consider five possible market-based options:

- GF securing a direct supply of raw milk from farmers;
- GF extending its contract with Fonterra beyond 2021;
- the integration of GF with an NZ-based processing exporter;
- GF undertaking greenfield investment to reach a competitive scale; and
- the entry of a major IP or multiple smaller IPs to the domestic dairy products market.

The options are considered in terms of their impact on overall economic efficiency. The efficiency analysis considers the impact of each option on productive, allocative and dynamic efficiency. Productive efficiency relates to the choice of production methods. Allocative efficiency relates to the allocation of resources among different uses and in particular whether prices reflect costs. Dynamic efficiency relates to the incentives for investment and innovation. The key issue regarding productive efficiency is whether the incentives for the supplier to achieve the lowest cost production method is lost or distorted. The key issue regarding allocative efficiency is that, where prices exceed marginal cost, the result will be a deadweight welfare loss to society. The key issue regarding dynamic efficiency is whether incentives provided by competitive rivalry, particularly for efficient investment, are lost or distorted. We also consider the likely impact of each option on domestic consumers, the suppliers of dairy products (GF, IPs, FBNZ and Fonterra) and the farm-gate and factory-gate markets.

9.2 GF secures own-supply

Given the seasonal nature of milk supply (as discussed in Section 5.4), if GF was to secure direct supply of milk from farmers, GF would need to invest in additional manufacturing capacity to process the excess milk needed to meet its minimum monthly requirement.

The investment in additional manufacturing capacity by GF would have to be of a scale that the processing of the excess milk was cost-competitive. All the new IPs in New Zealand have built plants with the capacity to process between 200M and 250M litres of milk p.a. We estimate that GF would need to recruit [Redacted] litres of milk in each island in order to be efficient and have sufficient fresh milk for that island.

Our estimate of the resultant milk cost for GF under this option is presented in Annex 5. We estimate the cost of milk would be the FGMP plus [Redacted] (additional costs of collection) plus [Redacted] (capacity charge) plus the winter-milk premium. That is a best-case scenario because it assumes that all supplying farmers have split their herd's 60:40 into spring and autumn calving. That assumption is overly optimistic because we know that the milk Fonterra currently collects for domestic supply equates to less than 4.5% of its total milk supply, meaning collection costs are going to be higher than estimated in Annex 5.

9.2.1 *Impact on economic efficiency*

The increased costs associated with the collection of milk and unutilised capacity indicates that this option would reduce the productive efficiency of the industry somewhat. To the extent that this option increased excess capacity in the industry, it would reduce allocative efficiency. On the other hand, the increased competition in the farm-gate milk market would be likely to increase dynamic efficiency.

9.2.2 *Impact on domestic consumers*

The implications for domestic consumers of this option are likely to be either neutral or negative in the short term and negative in the medium term. Whether they are neutral or negative in the short term depends on FBNZ's pricing response to GF's increased costs. FBNZ could choose to not change its prices, which would be neutral for domestic consumers in the short term but ultimately would deplete GF's market share, which could be negative for domestic consumers in the medium term. Alternatively, FBNZ could choose to increase its prices by almost as much as GF would have to. This would maintain GF's market share, but the higher prices would be negative for domestic consumers in the short and medium term. In the longer term, there could be benefits to consumers from having two or more fully independent processors competing in the dairy products market.

This option could also lead to seasonal pricing of fresh milk in the retail market. This would tend to be positive from an economic efficiency perspective and possibly negative for consumers (depending on whether prices in the non-winter period fell by a corresponding amount).

9.2.3 *Impact on suppliers*

The likely impacts on suppliers of GF securing direct-supply of milk are:

- for GF, there are opposing forces. On the one hand, its costs would increase. On the other hand, it would have independent supply;
- for IPs, the impact would likely be negative to the extent that this option increased excess capacity in the industry;
- for FBNZ, the impact would be positive as FBNZ would achieve a cost advantage that it could exploit; and
- for Fonterra, the impact would be marginally negative to the extent that Fonterra processes less milk. On the other hand, it would be marginally positive for Fonterra in the event that Fonterra no longer subsidised the winter-milk component of the milk it had supplied to GF.

9.2.4 *Impact on farm-gate and factory-gate markets*

GF competing for milk would add a participant (GF) to the farm-gate market and thus would be positive for that market but the increased competition would be limited to the two specific regions close to GF's milk plants.

Regarding the implications for the potential development of a factory-gate market, this option would take the one large potential factory-gate participant out of that market and on that basis would be negative for its development.

9.3 GF extends contract with Fonterra

GF's supply contract with Fonterra expires in 2021. Extending the contract[45] could be beneficial under three conditions:

- the length of the extension was such that GF was confident that it had sufficient time to generate an adequate return on new investment;
- the volume supplied was not limited to 250M litres p.a. but at least increased in line with the size of the domestic market; and
- the contract included some sort of "most-favoured-nation" clause whereby the price of product supplied by Fonterra to FBNZ was no less than the price of product supplied to GF.

9.3.1 Impact on economic efficiency

GF's contract has been suboptimal to date because the capped supply has limited GF's ability to compete in a number of areas. If the above three conditions are met, the contract extension will increase dynamic efficiency because it will allow GF to be a more effective competitor.

There would not be any productive efficiencies gained or lost as a consequence of the altered supply contract. The size of the domestic market would not change, and therefore there would be no overall change to the amount of milk being processed.

9.3.2 Impact on domestic consumers

To the extent that the contract extension increases efficiency, domestic consumers should benefit over time. However, the level of competition amongst retailers will influence the extent to which domestic consumers benefit.

9.3.3 Impact on suppliers

The likely impacts on suppliers of extending the GF contract are:

- GF would benefit under the three conditions noted above. An extension of the current contract without these criteria met may not be beneficial.
- for the IPs, this option will have minimal effect because the IPs either do not currently compete in the domestic market or their access to DIRA milk is unaffected;
- for FBNZ, it is negative to the extent that this option is positive for GF; and

[45] TDB understands that the parties have not been able to agree an extended contract to date, largely on the basis of differences in price.

- for Fonterra, there is no impact (other than through its ownership of FBNZ).

9.3.4 Impact on farm-gate and factory-gate markets

This option will have no impact on the farm-gate or potential factory-gate markets.

9.4 Integration of GF with an NZ-based processing exporter

Vertical integration would involve GF merging with a New Zealand-based exporting processor to attain the economies of scale necessary to be efficient and secure direct milk supply. Without a guaranteed milk supply, GF would be a risky acquisition for any company. It therefore seems more reasonable to envisage GF as the acquirer rather than the acquiree.

The implicit assumption attached to this option is that the new integrated company could recruit all the additional milk it requires to both run its plant efficiently and supply fresh milk to the domestic market.

This option is essentially the same as the "own-supply" option outlined in Section 9.2, above. The resultant milk cost for GF, under this option, would be the same as established in the "own-supply" discussion above: ie, the FGMP plus [Redacted] (additional costs of collection, where all additional suppliers must be winter-milk suppliers) plus [Redacted] (capacity charge) plus the winter-milk premium.

The resulting integrated company would require processing operations in both the North and South Islands because GF's fresh-milk business is nation-wide, and it is not economical to transport fresh milk between the two islands (as highlighted by the fact that Fonterra uses GF's fresh-milk processing plant in Christchurch for its South Island fresh-milk business).

At present, there is currently no single IP that could meet GF's capacity demand. Open Country Dairy (OCD) is the only IP that currently has operations in both the North and South Islands, but its South Island processing plant is located south of Invercargill whereas GF's fresh-milk processing plant is in Christchurch (where the largest population is). It would be costly to transport excess milk between Christchurch and Invercargill. However, both Synlait and Westland have existing milk supply in Canterbury. Therefore a GF-OCD combination would be possible (in theory at least) in the North Island, as would a GF-Synlait or GF-Westland combination in the South Island.

The same increased collection costs and capacity charges discussed in Section 9.2, above, apply to this option.

9.4.1 Impact on economic efficiency

The efficiency consequences of this option are the same as if GF secured its own supply (as discussed above). We would expect to see some decrease in productive efficiency from a collection-cost perspective to the extent that the processor would not have the scale to manage its winter-milk collections as efficiently as Fonterra. On the other hand, having another large-scale purchaser in the farm-gate market would tend to increase dynamic efficiency.

9.4.2 Impact on domestic consumers

In the short-term, this option would be neutral or negative for domestic consumers as discussed in 9.2.2, above. In the medium to longer term, this option could be negative for domestic consumers to the extent that FBNZ was able to continue to exploit its competitive advantage and win a dominant market share. There is also the possibility that this option would lead to seasonal pricing of milk, reflecting the increased cost of producing winter milk. Over time, though, there could be benefits to consumers from having two or more fully independent processors competing in the dairy products market.

9.4.3 Impact on suppliers

The likely impacts on suppliers are:

- for GF, some form of integration would be positive on the basis that it was no longer reliant on Fonterra for milk. However, the collection-cost inefficiency, described above, and FBNZ's ability to exploit its resulting competitive advantage would be negative;

- for other IPs, a GF-OCD combination in the North Island would have no impact as OCD does not compete for milk in Whanganui with anyone other than Fonterra. In the Waikato, OCD competes for milk with both Fonterra and Tatua but it is unlikely that Tatua suppliers would move their supply owing to the product positioning and success of Tatua The situation in Canterbury is different. Both Synlait and Westland compete against each other and against Fonterra for milk in that catchment. Therefore, a GF-Synlait combination or a GF-Westland combination would have an impact on the IPs to the extent that competition for milk supply in the catchment would increase and therefore push up the fa m-gate price;

- for FBNZ, this option would be positive to the exten that FBNZ gains a competitive advantage from the inefficiencies in winter-milk collection that it could exploit; and

- for Fonterra, this option would be negative to the extent there is increased competition in the farm-gate market.

9.4.4 Impact on farm-gate and factory-g te markets

This option is positive for the farm-gate market to the extent that there would be more competition for milk. Fonterra would be likely to try to retain its milk supply and therefore it is possible that GF would need to pay more than the FGMP in order to secure the milk.

This option is negative for the factory-gate market because it takes a potential buyer of factory-gate milk out of the market.

9.5 GF undertakes greenfield investment

Under t is option, GF is assumed to make an investment large enough to permit it to efficiently process and export all raw milk collected in excess of that required by GF for the fresh-milk market in New Zealand. This option is effectively the same as GF securing its own supply as discussed in Section 9.2, above. As per the discussion in Section 9.2, there would need to be separate greenfield investments in both the North and South Islands.

9.5.1 Impact on economic efficiency

The increased costs of collection indicate that this option would reduce the productive efficiency of the industry. On the other hand, as discussed above, it would tend to increase dynamic efficiency.

9.5.2 *Impact on domestic consumers*

As per 9.2.2, above, in the short-term, this option would be neutral or negative for domestic consumers. In the medium term, this option could be negative for domestic consumers to the extent that FBNZ was able to continue to exploit its competitive advantage and win a dominant market share. Over time there could be dynamic efficiency gains if the domestic dairy products market can sustain two or more competing suppliers. There is also the possibility that this option would lead to seasonal pricing of milk

9.5.3 *Impact on suppliers*

The likely impacts on suppliers are:

- for GF, the investment required by GF to obtain scale would increase the riskiness of its business in some regards but GF would no longer be reliant on Fonterra for milk. The collection-cost inefficiency described above and FBNZ's ability to exploit its resulting competitive advantage would be negative. GF would have to pay farmers a premium for winter milk;

- for IPs, the impact of this option depends on the location of the investment. In the North Island, the preference would be to invest as close to the largest market, Auckland, as possible. That would probably mean investing in the Waikato area, which would put GF in direct competition with OCD for raw-milk supply (and with Fonterra). In the South Island, GF has a fresh-milk processing plant in Christchurch, and therefore it would most likely prefer to invest in the wider Canterbury region. An investment in that region would put it in competition with Synlait and Westland for milk supply (and with Fonterra). Under both of these scenarios, an increase in competition for milk supply would lead to increased costs for IPs;

- for FBNZ, this option would be positive to the extent that FBNZ gains a competitive advantage from the inefficiencies in milk collection that it could exploit. It would also be positive for FBNZ on the basis that Fonterra decides to continue to absorb the winter-milk price premiums rather than pass them on to FBNZ; and

- for Fonterra, this option would be marginally negative as it would end up with marginally more underutilised capacity.

9.5.4 *Impact on farm-gate and factory-gate markets*

This option would be positive for the farm-gate market to the extent that there would be more competition for milk in the immediate collection areas. This option would be negative for the factory-gate market because it takes a potential buyer of factory-gate milk out of the market.

9.6 Entry of a major IP or multiple smaller IPs

The main barrier to a new entrant entering the domestic dairy products market is the need to recruit enough additional milk to supply fresh milk to the domestic market year-round. Entry by another IP could come in the form of a major IP or multiple smaller IPs.

Synlait recently entered a contract to supply the house-branded fresh milk and cream for FSSI beginning in 2019 for a period of ten years[46]. The agreement is for approximately 30M litres p.a. of fresh milk and

[46] Refer to Annex 8 for a fuller description and analysis of the Synlait-FSSI agreement

cream and is equivalent to approximately 5% of domestic dairy product consumption. The entry of Synlait to the domestic dairy market is surprising because of the assumed marginal profitability of the domestic product given the economies of scale that Fonterra (and therefore GF) has in collecting winter milk. However, Synlait's entry is relatively small (only 5% of the domestic market) and therefore its effects should be considered carefully and not be overplayed.

TDB's analysis suggests the marginal profitability of Synlait's domestic entry is likely to be low (given the likely relative collection inefficiencies) and less profitable than efficiently produced dairy commodity exports. If this is the case it may be that Synlait sees a benefit from having a domestic presence in the New Zealand market through positive reputational effects in export markets (its core business). Export markets, particularly in Asia, may view Synlait's domestic presence as a signal of quality. This reputational effect should still hold despite Synlait primarily operating at the wholesale level. If this is the rationale for Synlait's domestic entry it may be commercially rational for Synlait to enter the domestic New Zealand market even if, on a stand-alone basis, it is not profit maximising. If this is the case, Synlait's entry into the New Zealand market is akin to a loss-leader strategy.

In addition, it may be that Synlait is entering the domestic dairy products market to provide some certainty of supply to underlie the development of its new $125m Dunsandel facility. FSSI will be a cornerstone customer for approximately 30 percent of the new facility's output. Having a cornerstone customer reduces Synlait's risk profile while still leaving sufficient production capacity to target higher value export markets.

The key question is whether other IP's are likely to follow Synlait and enter the domestic dairy products market, particularly in the North Island. OCD and/or Miraka may see domestic entry as worthwhile if they, like Synlait, perceive positive reputational effects. Synlait itself is currently in pursuit of a site in the North Island and it may use this export focused site as a lever for entering the North Island domestic market. On the other hand, Synlait's entry into the South Island domestic market may be a one-off due to Synlait's unique position of having excess milk due to its focus on infant formula (infant formula uses much less milk to manufacture than whole-milk powder). No other IP in New Zealand currently has excess milk so they are therefore less likely to be in pursuit of new product markets.

TDB understands that there are two private-label contracts in the North Island and both are more than twice the size of the FSSI contract with Synlait. Therefore the likelihood of entry by one of the existing IPs appears low in the current state of the market without investing in an own brand. However, market behaviour is unpredictable and it cannot be said with certainty that further domestic entry will not occur in the future.

9.6.1 Impact on economic efficiency

As discussed in Section 9.4.3, we would expect to see a decrease in productive efficiency from a collection-cost perspective to the extent that the new entrant would not have the scale of Fonterra to manage its winter-milk collections as efficiently[47].

[47] For example, we estimate that Synlait will have to procure approximately 56.3M litres p.a. of milk to meet the daily volume requirements of the FSSI agreement and taking into account a 25% buffer for daily demand variation. This includes approximately 33.8M litres of spring milk and 22.5M litres of autumn milk (see Annex 8 for the full calculation).

On the other hand, the dynamic efficiency of the consumer market may increase over time from the entry of a new competitor.

9.6.2 Impact on domestic consumers

If the entry of an IP to the domestic dairy products market occurred while GF had continuing access to milk at the FGMP then the impact would in general be expected to be positive. The exception would be if the following two conditions hold. Firstly, the wholesalers have considerable degrees of market power and don't pass on the benefits of lower wholesale prices to consumers. And secondly, if the incumbent chose to no longer supply the displaced milk to the domestic market. However, if the incumb nt chose to supply (at least some of) its displaced milk to the domestic market then overall supply wi l have increased and there will be downward price pressure. If the displaced incumbent redirected its m lk from the supermarket to the route trade then there will likely be downward price pressure in the route trade. There may also be indirect downward price pressure in the supermarket trade as there is some competition between supermarkets and the route trade (ie, petrol stations)

However, if the entry of a major IP into the domestic market meant that GF lost its access to milk then the impact on domestic consumers could be negative in the short to medium term as FBNZ would be able to exploit its cost advantage and increase wholesale prices. Over time though, consumers would be expected to benefit from having more competing suppliers i the dairy products market.

9.6.3 Impact on suppliers

The likely impacts on suppliers are:

- for GF, this option is negative. The additional competition at the wholesale level would lead to a lower market share and lowe sale volumes;
- for IPs, the impact depends on the way the option is achieved. In the case of Synlait, the investment is in the Canterbu y egion. It is possible that further future entry could be made by different entities. The most likely North Island investor will be OCD. Like Synlait, an investment by OCD would rep esent a major change in its strategy – OCD is currently focused on commodity exports and Synlait is focused primarily on high-value ingredient products on a business-to busine s basis;
- in the Synlai case, the impact on Westland could be significant. It has a Canterbury supply base that cou d potentially be competed away. We think it is unlikely that Westland would be a new entran into the fresh-milk wholesale market in the medium term, given its relatively recent investment in a UHT milk plant in Canterbury and its limited access to capital, given its co-operative structure. If OCD entered then the impact on other IPs would be negligible in the North Island as OCD is the only IP operating in the Waikato region (other than Tatua as discussed above);
- for FBNZ, the extra competition would be negative; and
- for Fonterra, this option would be marginally positive because it would no longer be absorbing the cost of winter-milk premiums paid on behalf of GF. It would be negative for Fonterra on the basis that it is more likely to lose its milk supply than any other milk processor because of its limited ability to compete on price at the farm-gate. The net result for Fonterra is negative.

9.6.4 *Impact on farm-gate and factory-gate markets*

Regardless of the way that this option is achieved, there would be more competition at the farm-gate for raw milk. That is good for farmers who supply the milk. This option is negative for the factory-gate market because it reduces the chances of such a market developing.

9.7 Summary of the market analysis

Our assessment of the likely implications of the five different potential market solutions is summarised in Table 3, below.

Table 3: Summary assessment of market solutions

	Effects on / responses of							
Potential solutions	Efficiency	Domestic consumer	GF	IPs	FBNZ	Fonterra	Farm-gate	Factory-gate
GF own-supply	o	–	o	–	+	–	+	–
Contract extension	+	+	+	o	–	o	o	o
Integration	o	–	o	–	+	–	+	–
GF greenfield investment	o	–	o	–		–	+	–
New IP	o	+	–	–	–	–	+	–
Legend	–	negative impact	+	positive impact		o	neutral impact	

The only option that is likely to unequivocally increase the efficiency of the market is the contract-extension option and only if the contract is extended on improved terms to allow GF to become a more effective competitor. There could be efficiency gains over time from the other four options, but it is difficult to assess the magnitude of the gain and there would be some-offsetting efficiency losses from having multiple collectors of winter milk

The domestic consumer is likely to benefit from a new entrant into the wholesale market as there is likely to be downward price pressure from increased competition and from the incumbents having excess capacity. However, if the incumbent reduces its domestic milk supply and the wholesaler captures the entirety of the benefit of a better supply contract, then the consumer will at the very least be no worse off

GF benefits if there is a contract extension, but the benefit is only derived with amended contract terms. GF may benefit in the longer term from the other options (other than a new IP) but there are risks inherent with each option.

Other than in the case of an expansion by an existing IP, none of the existing IPs are likely to benefit from any of the options. The best-case scenario for the existing IPs is a contract extension. The lack of benefit is the consequence of increased competition for their milk supply.

FBNZ would benefit from the majority of the options as a result of it being able to exploit the additional costs attached to them. FBNZ would be unlikely to benefit from the contract-extension option or a new IP entering the market.

All of the options (except contract extension) are marginally negative for Fonterra because of the increased competition it would face at the farm gate.

The farm-gate market benefits in most instances because of increased competition. We note however that Fonterra’s ability to compete on price at the farm-gate is limited by regulation.

The factory-gate market does not benefit in any instance because none of the options provide any opportunity for a factory-gate market to develop.

Overall, an extension of GF’s contract with Fonterra appears to be the most attractive option. It is also the only option that we find unequivocally increases the efficiency of the industry. The other four options considered may yield dynamic efficiency benefits over time (by increasing the competition in the farm-gate and consumer products market) but these dynamic efficiency gains need to be assessed against the losses in productive efficiency (from having competing collectors of raw milk).

10. Potential regulatory solutions

10.1 Introduction

This section analyses options for the future regulation of domestic dairy-product markets that ministers or officials may decide to examine. We seek to canvass a broad range of options and to assess their costs and benefits from the point of view of their impact on New Zealand's overall economic welfare including the impact on milk suppliers and domestic consumers of dairy products.

As background to the consideration of regulatory options, it is relevant to recognise th t, i 2011, the Commerce Commission undertook a consideration of whether to initiate a Commer e Act Part 4 Inquiry into milk prices, in response to a range of complaints regarding the state of competition in dairy markets.

The Commerce Act provides that the Commission may undertake such an examination of the case for considering regulation on its own initiative. The Act sets out three tests, all o which the Commission must be satisfied are met, before it can recommend that the Minister regulate goods or services:

- first, the goods or services are supplied in a market where there is little or no competition and little or no likelihood of a substantia increase in competition (the Competition Test);

- second, there must be scope for the exercise of substantial market power in relation to the goods or services, taking into account existing regulations and arrangements (the Other Constraint Test); and

- third, the benefits of regulating the goods or services in meeting the purpose of Part 4 materially exceed the costs of regulation (the Net-Benefit Test).

If these threshold tests are met, the Commission must then consider whether regulation should be imposed and, if so, in what form

The Commission concluded that the Competition Test was met in regard to the factory-gate market and came to the same onclusion in the 2016 review. In 2011, the Commission nevertheless concluded initiating a Part Inquiry was not warranted given the Raw-Milk Regulations were and are addressing the iss e: ie, the Other Constraint Test was not met.

If th Raw-Milk Regulations were terminated then, on receipt of complaints, the Commission would, given its previous position, likely agree to reconsider whether to initiate a Part 4 Inquiry, with a high likelihood of concluding that such an Inquiry was warranted if no form of regulation was in force.

10.2 The regulatory options

The regulatory options we consider are the Government:

- announcing that the DIRA (Raw Milk) Regulations that require Fonterra to supply raw milk to processors that supply dairy products to the domestic market will be abolished from a fixed date;

- phasing down, over time, GF's current entitlement to access DIRA milk from Fonterra;

- extending the DIRA domestic market regulations to, say, 2030, on one or more of the following bases:
    i. status quo entitlements;
    ii. catering for growth in the domestic dairy market;
    iii. requiring Fonterra to supply 100% of the raw milk required by any domestic dairy products market competitor for dairy products supplied to the domestic market;
    iv. requiring Fonterra to divest FBNZ;
    v. requiring Fonterra to account for FBNZ as an entirely separate entity;

- extending the scope of the DIRA requirements to non-milk domestic-dairy products (especially butter and cheese); and

- moving the dairy-sector regulation to operate on a basis similar to the Commerce Act Pt 4 as it applies to electricity line businesses and gas pipeline businesses or a basis similar to the proposed regulatory framework for fixed line telecommunications networks.

The options are assessed in terms of their effect on economic efficiency and on equity. The efficiency analysis includes allocative, dynamic and productive efficiency (as discussed in Section 9.1).

The key equity consideration in the analysis is the effect of the options in transferring wealth from domestic consumers to milk suppliers. This potential wealth transfer warrants specific consideration, given, as noted in Section 4.1, the key feature of the domestic dairy market is that Fonterra exists as a result of the 2001 overriding by legislation (ie, DIRA) of the Commerce Act 1986. More specifically, the potential for substantial wealth transfers relates to options where it is uncertain that the result will be a workably competitive market. In those cases, equity considerations are appropriately given great weight in the assessment of the options.

10.3 Abolishing the DIRA Regulations from a fixed date

The 2016 report by the Commerce Commission (summarised in Annex 3) provides an assessment of the efficiency and equity effects of abolishing the regulations that require Fonterra to supply raw milk to processors that produce dairy products to the domestic market - the first option listed above. As noted in Annex 3, the Commission estimates the abolition of the DIRA regulation would result in an allocative efficiency loss of between $3.5M p.a. to over $13M p.a. and a transfer of wealth from New Zealand consumers of dairy products to milk suppliers of between $51M and $92M p.a.

The wealth transfer of $51M to $92M p.a. would be a cost that consumers would pay attributable to the override of the Commerce Act in 2001, with the efficiency benefit assessed by Parliament as justifying that override continuing to be enjoyed by milk suppliers. Thus, milk suppliers, having already been provided the efficiency benefits of the merger, would, on the Commission's analysis, receive an additional benefit of an annual $51M to $92M wealth transfer at the expense of consumers if the regulations were removed.

This quantification, by the Commission, of the effects of abolishing the DIRA (Raw Milk) Regulations as they relate to the domestic market provides a baseline that is helpful in assessing the effects of the other options listed earlier. Each option is considered separately below.

10.4 Phasing down GF's current entitlement to Fonterra milk

As described in Annex 3, in the Commerce Commission's 2016 dairy industry competition review, it concluded that GF would need to pay a price 25% above the DIRA price to obtain milk from IPs.

It is uncertain whether a reduction in GF's DIRA milk supply would result in IPs supplying the shortfall in GF's requirement. It is possible that Fonterra would aim to be the supplier of this milk and offer milk to GF at a price just below the level at which IPs would be interested in supplying milk. One reason for Fonterra to adopt a strategy focused on retaining its role as GF's milk supplier is that its collection-system costs have economies of scale. Another long-run consideration is that Fonterra has an interest in discouraging export-orientated IPs from developing an interest in the domestic retail market. Fonterra will recognise that, at present, involvement in the domestic liquid milk market is probably viewed by IPs as a distraction. It would be in Fonterra's interest to reinforce this attitude by offering pricing to GF that undercuts, by a small margin, the price that would be break-even for IPs.

The Commission's proposal of a phased reduction in GF's entitlement to DIRA milk appears to be based on a view that the availability of DIRA milk has suppressed development of the factory-gate market. A closer analysis, however, reveals that since the contract Fonterra entered into (which GF inherited) slightly undercuts the DIRA price, there was no prospect of development of a deep factory-gate market. It is not valid to attribute the lack of development of such a market to the existence of GF's DIRA entitlement since GF is obtaining its milk independently of its DIRA entitlement[48].

For the above reasons, it is not certain that reducing GF's DIRA milk entitlement would, in practice, result in a substantial increase in competition in the factory-gate market. Arguably, Fonterra would be concerned to avoid the appearance of pricing that excluded IPs, so some increase in IP participation could be expected. Further, GF has an interest in diversifying its milk sources, and a reduction in its entitlement to DIRA milk would substantially increase this incentive. Nevertheless, competition from FBNZ limits GF's ability to take a strategic approach to diversifying its milk supply. Fonterra can pressure GF by intensifying FBNZ pricing competition with GF. So long as GF gets all its milk from Fonterra, any loss of FBNZ's market share to GF is only a loss of processing margin and is not disruptive to Fonterra's milk collection. If GF was obtaining milk from IPs, however, a loss of market share by FBNZ would be more fundamentally disruptive, and Fonterra would be expected to protect its market share more vigorously in that situation.

The most secure form of supply for GF would be contracted supply from farmers. To achieve economies of scale in regard to transport and farm contracting, however, the amount of milk contracted for would need to be substantially greater than 250M litres (as discussed in Section 9.2). Thus, developing direct

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[48] Thus, the valid analysis is that Fonterra's decision to offer such a contract ruled out the development of a deep factory-gate market. While the decision to offer such a contract may have reflected a number of considerations, the fact that the contract has served to ensure that GF's milk is supplied by Fonterra illustrates the point made above that Fonterra could continue to suppress the development of a factory-gate market to protect its position.

supply would require GF to become an exporter or, for the domestic dairy supply business, be sold to an exporter.

As described in the 2016 TDB report, a phase down in GF's entitlement to DIRA milk on the analysis set out earlier would be expected to result in a price increase proportionate to the reduction in DIRA milk. Specifically, it is reasonable, at least as a first approximation, to assume the price GF pays for milk in the unregulated market would be the same as under the Commission's scenario, namely 25% higher than the DIRA price, on average.

On this assumption, the cost for GF to acquire its milk requirements would be the weighted average of the DIRA price for 100M litres and the DIRA price plus 25% for the rest. Thus, if GF needed to purchase 150M litres in the unregulated market, the weighted average price would be slightly less than the DIRA price plus 15%[49].

An average raw-milk price of DIRA plus 15% would, under the Commission's assumptions, translate to an increase in retail prices of 3.75% compared to a situation in which GF acquires all of its milk at the prices specified in the DIRA regulations (including the price premium formula specified for winter milk).

Given GF currently acquires virtually all of its milk under its commercial contract which prices all milk below the DIRA price without any price premium for winter milk, the increase in average retail milk prices and fresh-milk product prices on expiry of the commercial contract in 2021 would be at least 5% when the winter-milk premium is added in.

The effect of a phase down of GF's DIRA milk entitlement on allocative efficiency would be a loss in allocative efficiency proportionate to the increase in price and, therefore, proportionate to the reduction in GF's DIRA milk entitlement, as discussed above. The effect on productive efficiency would be none or minimal since, as explained earlier, the need for Fonterra to maintain excess capacity that the Commission identified is not caused by the Raw-Milk Regulations as the regulations relate to the supply to domestic market processors. Therefore, there would be no or minimal reduction in the need for Fonterra to maintain the excess capacity which the Commerce Commission identified as the major efficiency cost of the DIRA regulations. The effect on dynamic efficiency depends on whether GF's need to acquire milk in the market to offset the reduction in its DIRA milk entitlement would result in development of a deeper factory-gate market on an ongoing basis and, in particular, a reduction in the premium over the DIRA price in that market. As discussed in the 2016 TDB report and explained above, only long-term contracts regarding the taking and processing of milk can reduce the need for an IP to have processing capacity to accommodate peak milk supply from its contracted farmers.

In summary, it is uncertain whether there would be a dynamic efficiency benefit if GF's entitlement to DIRA milk were phased down.

A variant of the proposal to phase down GF's DIRA entitlement would be to allow GF to utilise its remaining entitlement to fully secure its winter-milk supply. While this would, to some extent, recognise that Fonterra is best placed to optimise winter-milk collection, the result would not offer material benefits in terms of efficiency compared to the situation under full-entitlement continuation. The development of a factory-gate market for milk in peak months while dependence on DIRA continues in

[49] GF currently purchases somewhat less than 250M litres in total. However, given the growth in population (currently over 2% p.a.), GF's requirement would climb above the 250M litres in due course.

regard to winter milk may give the appearance of progress towards deregulation, but it does not actually represent a path to deregulation. Only a solution that resolves the issue of winter milk would represent real progress towards deregulation.

10.5 Extending the DIRA domestic market regulations in different ways

10.5.1 Status quo: ie, DIRA Regulations as they relate to milk for processors to supply the domestic market extended over time

Continuing beyond 2021, the DIRA Regulations providing GF with a guaranteed 250M litres at the DIRA FGMP would involve a moderate increase in prices if, as seems likely, Fonterra did not renew the current contract with GF. That contract provides a very small discount on the DIRA price and does not equire GF to pay the winter-premium cost. It is not clear whether the termination of the discount and the passing on of the cost of the winter premium would be detrimental or beneficial to a ocative efficiency, given that the reasons why Fonterra agreed to these terms in the contract a e no certain.

As population, and thus dairy, demand increases, GF's fixed (250M litre) entitlement to DIRA milk would represent a reducing proportion of domestic demand. GF would thus provide a gradually diminishing constraint on Fonterra's pricing under these circumstances because either GF's market share would reduce or GF would have to source milk on the open market, which would cost more for the reasons discussed earlier. Unless new entrants with entitlements to DIRA milk met the gap, FBNZ would be able to increase its prices. This would result in a loss of allocative efficiency as the increases to retail prices would include monopoly rents.

Continuation of the status quo, without any provision for growth in demand, would not seem to have any short-term effects on competition and dynamic efficiency. In the long term, at some point, the rising prices could attract IPs to consider enteri g the domestic market. That would be beneficial for dynamic efficiency if it occurred, but Fonterra would have an interest in limiting the price increases to a level below that at which IPs would be likely to enter the domestic market.

10.5.2 Catering for growth in the domestic-dairy market

In terms of prices and allocative efficiency, catering for growth in domestic demand by progressively increasing GF s entitlement to Fonterra milk in line with the growth in the domestic dairy products market would avoid the detrimental effects described above whereby GF's market share would decline, or GF would have to source milk on the open market which would cost more for the reasons discussed earlier. Thus, catering for growth would avoid the reduction in the constraint on Fonterra's exercise of market power that GF currently provides.

Catering for growth would preserve the current situation regarding competition and dynamic efficiency whereas, otherwise, GF's ability to provide competition to Fonterra would decline as domestic demand grew.

10.5.3 Requiring Fonterra to supply 100% of the raw milk required by any domestic dairy products market competitor (for dairy products supplied to the domestic market) with no special regulatory entitlement or limit for GF or any other participant

Under this option, the current caps on the amount of DIRA milk GF and other IPs can acquire, of 250M litres and 50M litres p.a. respectively, would be removed subject to the amount acquired being supplied to the domestic market. GF and other acquirers would be subject to audits to confirm how they used the DIRA milk supplied. A penalty, for example a higher price or some other mechanism, would be applied if the milk acquired was used to produce exports rather than to supply the domestic market.

This option has the potential to lead, over time, to a more innovative and competitive dai y produc s market:

- it would allow successful niche participants to grow to scale without the associat d costs of an ingredient business to balance milk supply;
- it provides competitive neutrality amongst current and potential buyers of raw milk at the factory-gate; and
- it allows Fonterra to capture the economies of scale in collecting and processing milk for the international market while not penalising domestic consumers of dairy products.

This option would avoid the detrimental effects of competition and allocative, dynamic and productive efficiency being harmed by the current caps.

There is a risk that this option could disincentive IPs from having an independent supply when entering the domestic dairy products market This option could therefore partially reinforce Fonterra's dominance and discourage competition at the farm-gate. Nevertheless, because it is unlikely that a large IP would establish a presence in the domestic market without an exporting arm, this is less of an issue. As New Zealand currently exports 95% of total milk production, it is unlikely that this option (which is limited to the domestic market) will have a significant impact on the incentives of an IP considering sourcing independent milk supply. In summary, the benefits should outweigh any potential costs.

10.5.4 Requiring F nterra o divest FBNZ

Requiring Fonterra to divest FBNZ would achieve a level competitive playing field between FBNZ and GF plu other independent suppliers to the domestic market (but with no change in Fonterra's dominance of actory-gate supply).

As disc ssed in section 7.5, Fonterra has in the past engaged in market behaviour that prima facie involves use of Fonterra's dominance in a way that has detrimental effects on GF's ability to compete with FBNZ. These episodes indicate that full achievement of a level playing field would involve requiring that Fonterra divest FBNZ in the same way that electricity lines companies were required to be separated from generation and retail companies in the electricity market. More recently, Telecom was required to divest Chorus in order to achieve a level playing field in the retail market for fibre broadband telecommunications services. Both of these structural ownership separations were introduced to separate out entities that had dominant near monopoly roles in the relevant markets from components of those markets where competitive provision was readily achievable.

Allocative efficiency would be improved if Fonterra were required to divest FBNZ as regards the contribution of processing costs to the overall cost of milk in the domestic market. Specifically, the divestment of FBNZ would encourage more vigorous competition (including providing better incentives for entry by new IPs) by eliminating the risk of Fonterra assisting FBNZ to retain or increase its market share by actions that apply a margin squeeze on IPs including GF.

The issue of allocative inefficiency if Fonterra was not required to supply milk at regulated prices would remain, although in the long run the entry of new IPs into the domestic market, encouraged by removal of FBNZ's privileged position, could introduce a constraint on Fonterra.

Dynamic efficiency would also be improved, probably substantially, since GF and other IPs considering entry to the domestic market would have an assurance of competitive neutrality in regard to competition. As noted, in the long run the entry of IPs into the domestic market could reduce and eventually eliminate the effect of Fonterra's dominance in the factory-gate market. Synlait's entry to the South Island market is a positive step in this regard. Time will tell whether further entry by other IPs will (or will not) take place.

One obstacle to this approach, in the case of Fonterra, is the argument that, in export markets, confidence in Fonterra's product safety and quality relies on Fonterra being able to assure overseas customers that they are receiving the same product as is sold on the New Zealand market.

Overall, in order to achieve the optimal position for Fonterra and its supplier shareholders in export markets, the "first-best" approach of requiring Fonterra to divest FBNZ may have to be foregone. The second-best alternative in that case would be to require accounting or legal separation of Fonterra and FBNZ, while leaving FBNZ as part of the Fonterra group.

10.5.5 Requiring accounting or legal separation of Fonterra and FBNZ

Requiring accounting or legal separation of Fonterra and FBNZ, while leaving FBNZ as part of the Fonterra group, would go some way towards providing a level competitive playing field between GF and FBNZ but with no change in Fonterra's dominance of factory-gate supply. Fonterra could be required to account for FBNZ as a separate entity or to legally separate FBNZ by creating a holding company where one subsidiary was FBNZ and the other was the remainder of Fonterra's business operations[50].

Allocative efficiency would be likely to be somewhat improved under this option. If monitored appropriately by non-supplier shareholders and the Commerce Commission, this approach would reduce the risk of Fonterra assisting FBNZ to retain or increase its market share by cross-subsidising FBNZ. The issue of allocative inefficiency if Fonterra was not required to supply milk at regulated prices would remain, although in the long run the entry of IPs into the domestic market, encouraged by removal of FBNZ privileged position, could introduce a constraint on Fonterra.

Dynamic efficiency would also be improved, possibly substantially, since GF and IPs considering entry into the domestic market would have a degree of protection against competitive non-neutrality by

[50] As was initially done in the case of Telecom with the 2008 operational separation of Telecom into a Wholesale Unit and a Telecom Business Unit. This operational separation preceded the 2011 required structural ownership separation of Telecom into two separately owned companies, Spark and Chorus.

Fonterra. As noted above, in the long run the entry of IPs into the domestic market could reduce and eventually eliminate the effect of Fonterra's dominance in the factory-gate market.

10.6 Extending the DIRA requirements to other domestic dairy products

Another option that could be considered to enhance the competitive nature of domestic dairy markets would be to extend the DIRA requirements on Fonterra to supply raw milk to GF and other competitors to other domestic dairy products like organic milk, butter and cheese.

10.6.1 Organic milk

The DIRA Regulations limit Fonterra's requirement to supply organic milk to each IP to a maximum of the quantity of organic milk supplied to that IP by The New Zealand Co-operative Dairy Company Ltd and Kiwi Co-operative Dairies in the 2000/01 season.

The consumption of organic milk has grown significantly since 2000/01, from virtually zero to approximately 7.5M to 10M litres p.a. (being approximately 3.0% of liquid fresh milk sales).

Finding accurate information about the volume of organic milk supply in th 2000/01 season is difficult, but in any case Fonterra has alleged that GF was not supplied any organic milk during that season and therefore has zero access to organic milk from Fonterra now. This is at a time when the premium over the FGMP Fonterra pays its organic suppliers has increased from $1.75 per kgMS in the 2015/16 season to a forecast $3.20 per kgMS in the 2016/17 season on the back of increasing market demand for organic milk.

10.6.2 Butter

There are two butter manufacturers in New Zealand: Fonterra and Westland. Westland's butter is predominantly exported but it relaunched its Westgold brand into New Zealand supermarkets in 2015. All the other New Zealand-made butters that are available in New Zealand have Fonterra butter as a base product.

The DIRA Regulations do not require that Fonterra supply any butter to GF at any price. However, butter is one of the commodity p oducts sold on the Global Dairy Trade (GDT) platform. Therefore, there is a clear factory-gate market reference price. The butter that is auctioned is butter that is frozen in 20 kg blocks.

10.6 3 Chees

There are two scale cheese manufacturers in New Zealand: Fonterra and OCD. Without needing to produce exclusively table cheese, Fonterra produces more than enough to satisfy the domestic market. OCD has in the last couple of years upgraded its cheese production facility such that it is now producing table cheese. However, it is probably reasonable to say that OCD is still in the process of establishing its reputation for table cheese with companies such as GF in New Zealand.

Cheese is also one of the commodities auctioned on the GDT platform. However, the quality of that cheese is such that it is referred to as "kettle" cheese. That means that its quality is inconsistent and it is used as a base ingredient in the manufacture of "processed" cheeses such as the quick melt cheeses used in fast foods like cheese burgers and toasted sandwiches.

The standard Fonterra and GF-branded cheeses that consumers typically purchase at the supermarket (such as cheddar, colby and edam) are referred to as "table" cheeses. The GDT auction price is an important reference for the price of table cheese as the price premium for table cheese over the auction price is relatively stable.

10.6.4 Implications of extending DIRA

Extending the DIRA Regulations to require Fonterra to supply bulk butter and cheese to GF and other processors supplying the domestic market with these products would increase competition in the relevant wholesale and retail markets (but not change Fonterra's dominance of the factory-gate market).

However, the value of these products compared to their transport costs is (albeit barely) sufficient for imports to provide some competition for Fonterra, particularly in regard to higher value variants.

The analysis of Fonterra's behaviour in Section 10.5, above, is however highly relevant and modifies the conclusions that might otherwise be reached. Specifically, the concern of Fonterra to maintain the goodwill of domestic consumers in regard to environmental issues can result in Fonterra applying margin squeezes to GF and other suppliers to domestic markets, by capping retail prices while inflicting increases in world prices on GF and other suppliers, as described in Section 10.5. In these circumstances, consideration of at least backstop regulatory arrangements to ensure competition in the supply of these additional products (butter, cheese and organic milk) is preserved is warranted.

10.7 Moving the dairy-sector regulations to the Commerce Act, Part 4

As described at the beginning of this section, the Commerce Act provides that the Commission can initiate a Part 4 Inquiry and, if the specified tests are met, can recommend that the Government impose regulation under Part 4 of the Commerce Act.

Such regulations would be likely to be similar in general terms to the current DIRA regulations, but with the Commission playing a more direct role in determining the FGMP.

At present the Commerce Commission reviews the Milk Price Manual and its application to Fonterra in determining the FGMP. In its review the Commission is able to report concerns it has regarding the Manual or Fonterra's application but the expression of concerns does not necessarily result in revisions to the FGMP.

As an example, in its review of the 2015/16 FGMP the Commission expressed concerns regarding the asset beta estimate used by Fonterra. Specifically, it noted:

- Our revised view is that Fonterra and its expert have not provided information to allow us to conclude that New Zealand milk processors, including the notional producer, have sufficiently different risk exposures to those in the international sample to justify a downward beta adjustment of 0.13 from the mid-point estimate of beta from the comparator set (ie, from the 0.51 mid-point estimate to the 0.38 estimate adopted by Fonterra).

The Commission noted however:

- 4.38 We note that it is not our role to determine the estimates of the asset beta and specific risk premium. Rather, our role is to review the assumptions adopted, the inputs and processes used by Fonterra in calculating the milk price for consistency with the s150A purpose.

If the DIRA Regulations were changed to a basis similar to the Commerce Act Part 4, it would be the Commission's role to determine specific estimates of the asset beta and specific risk premium. This would result in a more definitive and independent assessment of the DIRA price.

It is not feasible to assess the scale of the change in outcome that would result from a change to a Part 4 approach, however. Thus, it is uncertain whether the benefit of the change in terms of a more definitive and independent price estimation would justify the cost of the change. There would be a benefit in terms of improved confidence of potential entrants to the market.

10.8 Summary of the regulatory analysis

In summary, in terms of the options considered above, the fullest improvement in competition and thereby allocative and dynamic efficiency would be achieved by a combination of:

- requiring Fonterra to supply 100% of the raw milk required by any domestic dairy products market competitor (for dairy products supplied to the domestic market) with no special regulatory entitlement or limit for GF or any other participant; and
- requiring Fonterra to divest FBNZ.

This conclusion reflects our assessment that economies of scale and scope would result in a substantial loss of allocative efficiency under any option whereby GF is required to develop its own farm-gate supply itself or by contracting with an established IP. This assessment in turn reflects an analysis that Fonterra has achieved economies of scale and scope in milk collection, including but not confined to winter-milk procurement, which could not be matched by either GF or any existing IP. While Synlait has entered the domestic market, it has yet to secure supply of winter milk and is likely using the domestic market as a 'loss-leader' to enhance its reputation on its core exports business. This does not therefore indicate that Synlait, or any other IP, can currently compete with Fonterra's productive efficiencies.

The overall implication is that Fonterra's optimisation of raw-milk collection in each Island and the provision of milk for the domestic fresh and chilled market exhibits a high degree of market power and high barrier to entry. It might be the case that if Fonterra had a competitor for the domestic market with a market share in the farm-gate market above (say) 25% in either Island then that competitor could access economies of scale of the same order as Fonterra. However, no competitor is likely to reach that scale in the foreseeable future. This conclusion relates to the supply of milk for the domestic fresh and chilled market – it does not apply to production for export.

While the combination of the two options noted above is likely to achieve the fullest improvement in allocative and dynamic efficiency under the options considered, continued regulation would be required since those options do not remove Fonterra's market power in the factory-gate market.

As described at the beginning of this section, a complete withdrawal of the DIRA Regulations would probably result in the Commerce Commission undertaking a consideration of whether to recommend application of Part 4 regulation to the factory-gate milk market.

11. Conclusions

The current structure and degree of competition in New Zealand's domestic dairy markets is a result of past government interventions. DIRA established Fonterra with a highly dominant position in the collection of raw milk from farmers and divided the supply of milk for the domestic dairy products market between two participants, FBNZ and GF, both of whom get their milk from Fonterra. These regulations governing the market are not easily removed without leaving Fonterra (and its 100% owned subsidiary FBNZ) in a position where it has considerable market power over New Zealand consumers.

There are a number of market solutions that have the potential to increase the competitiveness of the domestic dairy markets over the longer term. But these options almost all involve trade-offs between gains in dynamic efficiency (from having more competitors in the farm-gate and factory-gate raw-milk markets or the wholesale domestic dairy products markets) and losses in productive efficiency in the arrangement and collection of winter milk (where Fonterra has established highly efficient operations). The option that is likely to offer unequivocal gains in efficiency would be an extension of GF's contract with Fonterra on enhanced terms. However, the entry of another IP (Synlait) into the domestic dairy products market in 2019 could put some downward price pressure on the domestic market, to the benefit of consumers, as well as increase demand at the farm-gate. Any loss in productive efficiency will be borne by Synlait shareholders and not consumers, as Synlait must have had to offer better terms to FSSI than GF, which has access to DIRA milk. However, Synlait's entry represents only 5% of the domestic market so the likely effects are limited. Further entry by another IP may occur in the future however the Synlait entry does not appear to be easily replicable and therefore any future regulatory change should consider the implications of current and future competitive market entry.

It is possible that market-based solutions may evolve over time. In particular, the entry of another major IP into the domestic dairy products market in addition to Synlait's entry in 2019 could lead to benefits to consumers and farmers. In this respect, it may be prudent to wait and see whether further competition will develop on its own accord. However, in the absence of any certainty that such market-based solution will develop, there is a range of improvements to the regulatory environment for domestic dairy products that the Government should consider to improve the functioning of New Zealand's domestic dairy markets. In our assessment two options are likely to provide the greatest gains. The first would be to require Fonterra to supply 100% of the raw milk required by any domestic dairy products market competitor, not just GF, for dairy products supplied to the domestic market. Thus placing all competitors on an equal footing. This approach would reduce the restrictions on GF's ability to compete with FBNZ (by removing the 250M litre cap on GF) and create a more level "playing field" between FBNZ, GF and other current and potential domestic market participants. The second measure would be to require Fonterra to publish separate audited financial statements for FBNZ. This greater financial transparency, by reducing the potential for Fonterra to cross-subsidise FBNZ, would enhance the competitiveness of the domestic dairy products market to the long-term benefit of consumers.

Annex 1: The Commerce Act and the dairy sector

Fonterra is subject to Part 2 of the Commerce Act, 1986 (the Act) which, as well as prohibiting collusive practices that substantially lessen competition, more relevantly prohibits the taking advantage of market power by a supplier or purchaser that has market power. In particular, Section 36(2) provides that:

> "A person that has a substantial degree of power in a market must not take advantage of that power for— (a) restricting the entry of a person into that or any other market; or (b) preventing or deterring a person from engaging in competitive conduct in that or any other market; or (c) eliminating a person from that or any other market."

Section 36 was one of the subjects being considered in a Targeted Review of the Commerce Act. The Commerce Commission expressed its view regarding the efficacy of Section 36 in a letter to the Minister of Commerce on 2 June 2016:

> "As we outlined in our original submission, we believe reform is necessary because s36 is not currently effective in promoting competition in New Zealand domestic markets for the long-term interests of consumers. An effective unilateral conduct provision is especially important for a small economy with concentrated markets. Section 36 is not effective primarily because of the way the courts have interpreted the "taking advantage" part of s 36."

Nevertheless the Government decided not to, at present, change section 36 of the Commerce Act.

In the case of the domestic dairy markets, the difficulties explained by the Commerce Commission result in the Commerce Act likely being ineffectual if Fonterra exercises its market power through the pricing or other behaviour of FBNZ.

As noted in Section 7.5 of this report, Fonterra has engaged in market behaviour which prime facie involves use of Fonterra's dominance in a way that has detrimental effects on GFs ability to compete with FBNZ. For example, we detail how Fonterra decided and announced in 2012 that, despite the export price of milk powder increasing markedly, FBNZ would not let the retail price of milk go higher than $3.99 per litre. Fonterra continued however to price milk supplied to GF at the contract price which reflected the FGMP and thus the export price of milk powder. In effect, Fonterra required FBNZ to price below the level corresponding to a normal return thus creating a margin squeeze on GF.

The Commerce Commission would, however, face difficulties in winning a case regarding this example of "predatory pricing" under the current wording of s36 of the Commerce Act.

In addition to the provisions of Part 2, the Commerce Act Part 4 empowers the Commerce Commission to undertake an inquiry to determine whether to recommend to the Minister that markets with little or no competition should be regulated to mimic outcomes in competitive markets.

The Commerce Commission in 2011 considered whether to initiate an inquiry under Part 4 of the Act into milk markets given complaints it had received[51]. The report noted that the Act sets out three tests

[51] "Consideration of whether to initiate a Commerce Act Part 4 inquiry into milk prices", Commerce Commission, August 2011.

which the Commission must be satisfied are met before it can recommend that the Minister regulate goods or services:

1. the goods or services are supplied in a market where there is little or no competition; and little or no likelihood of a substantial increase in competition (the Competition Test);

2. there must be scope for the exercise of substantial market power in relation to the goods or services, considering the effectiveness of existing regulation or arrangements, including ownership arrangements (the Market Power Test); and

3. the benefits of regulation must materially exceed the costs of regulation (the Net Benefit Test).

The threshold for undertaking a Part 4 inquiry is high. Part 4 regulation is only imposed on fi ms with a high degree of market power, usually because of the natural monopoly characterist cs of the industry in question (such as electricity or gas distribution).

The Commerce Commission concluded that a full pricing inquiry into any of the milk markets considered was not warranted at the time. This decision was based on its analysis of the s ate of competition in the relevant markets and whether Part 4 could effectively solve any po ential problems identified given the cost incurred to undertake the exercise. The conclusions we e strongly influenced by the parallel ongoing interdepartmental reviews at the time of the Raw-Milk Regulations and Fonterra's FGMP.

The Commission did conclude that the Competition est was likely to be met in the markets for the factory-gate supply of raw milk. The Commission stated:

> "There appears to be little or no competition, and little or no likelihood of a substantial increase in competition, in what is called factory-gate supply. Little raw milk is traded voluntarily. Nearly all raw milk su plied to the factory-gate is milk Fonterra must sell at a regulated price und r DIRA and the Regulations. We consider it unlikely that alternative suppliers of sizeable, consistent quantities of milk throughout the year to the factory-gate will develop in the medium-term.
>
> However, given the Regulations, it is questionable whether Fonterra has scope to exercise subs antial market power in relation to the supply of raw milk to other processors. The Regula ions provide an access regime for raw milk and are designed to counter Fonterra's market power. It is premature for us to consider this matter further, given the uncertainty surrounding the outcome of the current interdepartmental review."

It i notable that the Commission concluded it was unlikely that competition would develop in the factory-gate market in the medium term. The Commission's 2016 report confirms that competition has not developed in the factory-gate market.

Annex 2: Farm-gate milk price

As noted in Section 4.1 of this report, the farm-gate milk price (FGMP) is a notional calculation of the cost of milk supplied to Fonterra on the basis that Fonterra is an efficient processor. This annex provides background to the calculation and history of the FGMP.

The FGMP calculation assumes that 100% of the milk supplied goes into the production of what are known as the reference commodity products – whole milk powder (WMP), skim milk powder (SMP), anhydrous milk fat (AMF), butter and butter milk powder (BMP). The calculation assumes that approximately two thirds of all milk collected goes into the production of WMP. Fonterra produces other products such as cheese and casein. The values of these other products are not taken into consideration when calculating the FGMP. Given the heavy weighting to WMP in the calculation of the FGMP – and given the values of different dairy products are not perfectly positively correlated and that IPs must be able to pay their suppliers a similar amount as Fonterra pays its suppliers each year or risk losing their supply, from a risk-management basis, IPs are effectively forced to focus their production on WMP.

OCD, Synlait and Miraka all have WMP-centric production. Table 4 below illustrates the FGMP for each processor in the market. Note the similarities between the different processors' milk prices and Fonterra's FGMP.

Table 4: FGMP

Year	2010	2011	2012	2013	2014	2015	2016	Average ($)
Fonterra	6.10	7.60	6.08	5.84	8.40	4.40	3.90	6.05
OCD	6.07	7.46	6.19	5.78	8.40	4.61	3.94	6.06
Synlait	6.21	7.66	6.14	5.81	8.31	4.48	3.91	6.07
Miraka	-	-	6.18	5.94	8.50	4.50	4.00	5.82*
Westland**	6.15	7.70	6.04	6.04	7.27	4.85	3.88***	5.99

* More recently established company. Only five years of data. Fonterra's average FGMP over the same five years was $5.72

** Westland's numbers are not directly comparable to other data in the table as its numbers include an implied dividend paid to shareholder suppliers.

*** Westland's 2016 payout included a $0.26 top-up paid out of reserves

Annex 3: The Commerce Commission's 2016 review

DIRA requires that once thresholds regarding collection of milk (independent of Fonterra) are reached the Minister must request a report on the state of competition in the New Zealand dairy industry. Upon receipt of that report the Minister must decide whether to promote legislation to reset the thresholds and/or promote the adoption of measures that provide a transition pathway to deregulation.

Following the South Island threshold being met in the 2014/15 season the Minister requested the required report from the Commerce Commission. In the resulting March 2016 review of the state of competition in the New Zealand dairy industry[52], the Commerce Commission concluded that there is insufficient competition at both the farm-gate and factory-gate markets.

The Commerce Commission estimated that if the DIRA regulations requiring Fonterra to supply milk at the regulated milk price were not in place, Fonterra would be able to use its dominant position to increase the factory-gate raw-milk price by around 25%. The Commerce Commission noted that:

> "If other large IPs did not prove a constraint on the ultimate factory-gate price [25%] could underestimate the price effect whereas if they are a more effective constraint the price rise may be overestimated".

The Commerce Commission concluded this increase in the factory-gate price would result in a retail price increase of up to 6.25%, when other costs contributing to the retail price are taken into account. Assuming a price elasticity of -0.5 to -1.0, the retail price increase is estimated to result in an allocative efficiency loss of between $3.5M p.a. to over $13M p.a. and a transfer of wealth from New Zealand consumers of dairy products to milk suppliers of between $51M and $92M p.a.

The Commission provides an indication of the sensitivity of its estimates. Firstly, it notes that the estimated price increase has a non-linear effect on the deadweight loss. A doubling of the price increase estimate would increase the deadweight (efficiency) loss range to $14M to $50M. Secondly the Commission advises that the estimates:

> "are based on static efficiency losses by which we mean these do not capture the full efficiencies and benefits that competitive rivalry can bring over time. Typically, we give more weight to these dynamic efficiencies as they bring important benefits such as more efficient investment, which can easily outweigh static measures of efficiency."

As indicated, the estimate of efficiency loss is sensitive to the margin (above the DIRA price) required to persuade IPs to sell milk into the factory-gate market. The DIRA price is the international price of a basket of traded commodities less processing costs including return on capital. The IPs which contract with farmers must install capacity to accept milk from their contracted farmers at peak production. Thus, IPs have spare capacity at most times of year. Therefore, for an IP considering selling liquid milk to GF versus processing that milk itself, the break-even price is the international price of a basket of traded commodities less operating costs since capital costs are sunk and will be incurred regardless of whether

[52] http://www.comcom.govt.nz/regulated-industries/dairy-industry/report-on-the-state-of-competition-in-the-new-zealand-dairy-industry/

the IP processes milk in question or sells it to GF. The IPs save capital costs only if their agreement with GF is for a period long enough that they can reduce the need to have processing capacity for that amount of milk. Thus, IPs can price at close to the DIRA price if and only if they have an agreement with GF that it will take milk at all times including at the peak[53].

The 2016 TDB report also assessed the validity of the Commerce Commission's expectation of a 25% price increase by analysing the economics of GF managing its milk supply itself. As there is no surplus milk in the industry currently (other than DIRA milk) that is available to be traded at the factory-gate, the 2016 TDB report concluded that all of GF's options require the recruitment of new milk. The only difference is who does it: another IP on behalf of GF (the factory-gate); or GF itself (own supply). Because of the established relationships that the IPs have with suppliers, the report assumed that it would be easier for an IP to recruit new milk than GF but it assumed the cost of the milk at the farm gate would be the same.

The analysis in the 2016 TDB report demonstrated that it is possible to have an ingredients business without a domestic consumer business, but it is not possible to have a domestic consumer business without an ingredients business. This is because of the requirement to recruit excess milk and because of the requirement to manage the daily variations in demand and supply.

The analysis in the 2016 TDB report concluded that it is more cost effective for GF to rent milk-processing capacity than it is to build its own, with the build option being estimated to result in over twice the cost per kgMS of the rental option. The report noted however that the comparison ignored the relative negotiating power of the potential parties to the contract. Taking into consideration that processing plants must be shut down for maintenance once a year while GF requires milk to be processed 365 days of the year means that only those processors with at least two plants have sufficient capacity available for rent. In the North Island, the only candidate is Open Country Dairy. In the South Island, the only candidate is Synlait Milk. Those two companies will know that they are the only processing capacity alternative that GF has in each island and they will know what the cost for GF will be of building its own plant in each island and will use that knowledge to negotiate a rental outcome close to FGMP plus [Redacted].

This analysis described above supports the Commerce Commission's estimate that the non-regulated price GF would have to pay is DIRA plus 25% is reasonable in the absence of long-term agreements that require GF to take milk. Fonterra can better bear the volume risk because of the processing agreements with GF and because any fall in GF market share will be accompanied by an increase in FBNZ's market share.

The Commerce Commission also assessed whether there was an efficiency cost attributable to the DIRA regulations. The Commerce Commission assessed the economic efficiency cost of Fonterra maintaining excess capacity as a result of all aspects of the DIRA regulations, including the open-access requirements and the DIRA (Raw Milk) Regulations in respect to export and domestic market orientated producers, was up to $6M p.a. The Commission notes "The direct costs to Fonterra are not the same as the cost to economic efficiency from maintaining this capacity. It is not necessarily the case that such capacity would not exist, or that the costs would not be incurred by another industry participant in some other

[53] Annex 3 sets outs a fuller analysis of the economics faced by an IP that is considering entering the factory-gate market: i.e., contracting to supply milk to GF or another domestic market supplier.

form. There would, however, be likely to be better incentives to manage this risk and price it accordingly. As such we consider $6M as an upper bound on the costs."

The need for Fonterra to maintain excess capacity is not attributable to the requirement of supplying domestic processors with Raw Milk. The variation in GF's milk requirements of around 200,000 litres on a daily basis (as noted in Section 7.2 of the 2016 TDB report), while substantial relative to GF's average requirement of 685,000 litres per day, is very small relative to Fonterra-installed capacity which is capable of processing 100,000,000 litres per day. Thus, GF's access to DIRA milk is not responsible for the excess capacity requirement for Fonterra that the Commerce Commission identifies as the only material efficiency cost. That capacity buffer is determined by longer term uncertainties in the quantity of raw milk IPs will take under the DIRA regulations and the uncertainties created by the open access provisions.

The Commerce Commission review of competition in dairy markets in 2016 also concluded

> "5.150 Fonterra remains the most significant player in domestic downstream markets, particularly for fresh milk and cream (typically supplied indirectly through private label toll manufacturing). However, smaller IPs (IPs) have made significa t in- oads in certain product categories. There appears to have been some consequent price pressure on Fonterra (although this may be limited since most of the smaller IPs products are premium products), as well as a quality pressure.
>
> 5.151 We consider that Fonterra would have an incentive to foreclose smaller IPs in event of no regulations. Whether this incentive extends to Goodman Fielder is less clear given its observed ability to negotiate a discount off the DIRA price for its milk supply."

This qualification regarding GF is incor ect since the discount, and indeed all the terms of the current contract, reflect the unique circumstances of 2001. The contract was designed to allow a higher price to be paid for the processing and brand assets which Fonterra was required to divest. Fonterra wanted the assets being divested to command a higher price and provided a favourable contract as part of the package to obtain such a higher price. Thus, the discount is not at all an indicator that GF has countervailing powe against Fonterra.

The more accurate observation would be that Fonterra is concerned with achieving and retaining the goodwill of domesti consumers because it and its suppliers depend on that goodwill in a variety of ways, including fending off advocates of tighter environmental regulation of dairy farming.

Annex 4: The (original) Dairy Industry Restructuring Amendment Bill 2017

The original Dairy Industry Restructuring Amendment Bill had the following key features:

The Bill (amongst other things):

- removed the default expiry provisions and the market share thresholds in the North and South Islands that trigger a review of the state of competition;
- required a review of the state of competition to commence during the 2020/21 dairy season;
- required a review at five-year intervals thereafter if competition has not yet been considered sufficient;
- allowed Fonterra the discretion to refuse supply from new dairy conversions;
- reduced the total volume of raw milk that Fonterra must supply to IPs from 795M litres to 600M litres per season; and
- removed the requirement for Fonterra to supply DIRA milk to large export-focused processors from the beginning of the 2019/20 season. The definition of a large export-focused processor is one that has the capacity to process more than 100M litres of milk per season and exports more than 50% of its production by volume

The five-yearly reviews and the amendment with respect to large export-focused processors seemed to be the most significant changes in the original Bill from a potential competitor investment perspective. The five-yearly review intervals would have created a short investment horizon and may, therefore, established sufficient uncertainty that at least some potential investors adopted a wait-and-see approach.

The espoused key benefits of removing the requirement for Fonterra to supply DIRA milk to large export-focused processors were that:

- it would have clearly signalled to existing and future processors that the current regulatory regime is not permanent and would have encouraged them to find ways of operating without it; and
- it would have incentivised different entry points into New Zealand's factory-gate market and created a focus on higher-value products, rather than incentivising primary processing of raw milk at a time when the industry is perceived to have spare capacity.

The then Minister considered that there was little risk of the amendment preventing the entry of new competitors even though the Minister acknowledged that efficient processing requires a plant with the capacity to process at least 200M litres of milk p.a.[54]

The amendment appeared to restrict the size of small domestic-focused processors by effectively limiting them to 50M litres of milk p.a. unless the factory-gate market develops sufficiently. The risk that the factory-gate market does not develop, together with the risk that the continuing provision of DIRA milk was to be reviewed again during the 2020/21 dairy season, providing a disincentive for new competition, which would have reduced the probability of the factory-gate market developing.

Annex 5: Winter milk – is it a natural monopoly?

Section 5.3 of this report noted possible parallels between the New Zealand winter-milk market and markets that are natural monopolies. This annex explores this issue further.

A natural monopoly exists in a particular market if a single firm can serve that market at lower cost than two or more firms. In essence, natural monopolies exist because of economies of scale and economies of scope that are significant relative to market demand. Because monopolies have the ability to exert market power at the expense of consumers, natural monopolies are typically subject to government regulation. Regulations may include price, quality, and entry conditions[55].

Economies of scale in the winter-milk market come in two areas: collection costs and the ability to manage daily variations in fresh-milk demand (represented as capacity costs)

Winter milk

The milk curve in New Zealand is similar to the grass-growth curve. Such a pasture-based curve results in milk production in New Zealand varying from 100M litres per day at the peak in spring to virtually zero in June and July. In these latter 2 months, grass production is very low on most farms in New Zealand.

Such a milk production system requires some modification to produce milk for domestic consumption in June and July. To ensure the most efficient milk production occurs, Fonterra offers a winter-milk premium for farmers to supply at the factory gate in June and July, rather than at farm gate (as is the case for the other 10 months of the year). Farmers intending to supply winter milk apply for a contract to supply. Fonterra contracts only as much winter milk as it requires. Each contracted farmer in the North Island is offered the same premium and each contracted farmer in the South Island is offered the same premium (ie, the North and South Island premiums are different). The transport costs associated with transporting the milk from the farm to the nearest receiving factory are deducted from the winter-milk premium.

To supply milk in June and July, a farmer must have a food source for feeding the lactating cows during this period. Farmers have different options for food sources for this period, depending on their individual circumstances. Some may enjoy a little grass growth but typically this will not be sufficient in itself. More typically, farmers will use silage made from grass or maize that has been grown, cut and stored. There are other alternative supplements such as kale and fodder beet. In all cases though, the feed costs are greater than a cow walking to the paddock to eat grass.

In the North Island, some farmers may choose to change the time when cows are mated and when they hit their peak production period. This will entail having some or all of the dairy herd having calves in early April rather than August, so that peak production occurs in June and July rather than in September and October.

[55] https://stats.oecd.org/glossary/detail.asp?ID=3267

Some farmers will convert their entire herd to this autumn calving pattern, but more typically a farmer will operate a split herd with about 60% on a normal spring calving pattern and 40% of the herd on the autumn calving.

In the South Island, farmers supplying winter milk typically continue to milk cows that have calved in the previous spring (but have not got back in-calf for the following spring) through the winter.

North Island farmers particularly normally seek some security of offtake for a period of time to mitigate the risk of having created a high cost of supply. Winter-milk contracts are typically three years. To split the herd and to change a calving pattern, a farmer requires a lead time of typically for 18 months.

The New Zealand monthly milk production numbers produced by the Dairy Companies Association of New Zealand indicate that New Zealand produced 147M litres of milk in June 2016, the lowest producing month of last season. The New Zealand domestic fresh-milk market requires approximately 50M litres of milk per month. In other words, farmers produce more winter milk than is required for purely domestic purposes, which reconciles with Fonterra using more winter milk for processing into other value-add products. (The implication of Fonterra recruiting more winter milk than it needs for the domestic market is that it would be harder and therefore more expensive for GF to try and recruit its own winter milk.)

Assuming all farmers supplying winter milk have a 60/40 spring/autumn split and based on the average annual production of New Zealand dairy farms of 160 000 kgMS[56], we estimate that approximately one in eight farmers (or approximately 1,350 of Fonterra's 10,500 dairy farmers) choose to supply winter milk.

Fonterra has to date been the only processor that collects winter milk. We understand that Miraka, Synlait and Westland may now be trying to also recruit some winter milk to support their value-add products.

In contrast with Fonterra's ratio of one-in-eight farmers supplying winter milk, GF would require all its suppliers to be winter suppliers. The implications of a one-in-one requirement on collection costs are significant, as discussed below

Collection costs

An annual domestic fresh-milk requirement of 600M litres equates to less than 3.5% of Fonterra's total annual milk collections.[57] The scale of Fonterra's total operation creates collection economies of scale for Fonterra that an IP is unlikely to be able to replicate. For ten months of the year Fonterra can go to the farms closest to its fresh-milk processing plants and pick up milk for use in the domestic fresh-milk market regardless of whether these closest farms are winter-milk suppliers or not. It is only for the remaining two months of the year that it needs to go to its winter-milk suppliers to pick up milk specifically for the domestic market and transport the milk back to a single fresh-milk plant in the South Island or to one of four plants in the North Island.

[56] DairyNZ Economic Survey 2015-16, p.30.
[57] 1.566 billion kgMS in 2015/16 equates to approximately 18.25 billion litres of milk.

Contrast that situation with GF establishing its own milk supply (or contracting an IP for raw-milk supply) for the domestic fresh-milk market. GF needs 125M litres of milk p.a. in each island and it would need to recruit around [Redacted] litres of milk in each island (60% from spring calvers and 40% from autumn calvers) to have as much milk as it needs for every single month of the year. [Redacted] litres of milk means that 100% of GF's suppliers would need to be split calving, meaning GF would have no ability to flex its collections during the year. GF would also need to do something with the [Redacted] litres of excess milk that it would have collected across the year.

According to Fonterra, its milk-tanker fleet travels 85M km per year from 16 tanker depots to collect milk from approximately 10,500 farms to deliver milk to 70 delivery locations.[58] Depending on what assumptions are made, this information suggests an average round trip of something like 78 km per farm per day, indicating that on average, farms and delivery locations are within a radius of approximately 55 km from a tanker depot. We know from Fonterra's Milk Price Statement that its collection costs average 22 cents per kgMS. Any extension of this collection radius will lead to increased collection costs per kgMS.

It is probably reasonable to assume that the IPs' collection costs per kgMS are similar to Fonterra's because they will try and locate their plants in those areas where they judge they will be able to recruit milk easiest.

A single efficient plant (assuming a 8.5 MT per hour dryer) can process 200M litres of milk p.a. (17M kgMS) assuming a standard New Zealand milk curve. Note – the standard milk curve assumption implies that the IP would not be processing any winter milk and therefore none of its suppliers would be winter-milk suppliers. The IP's collection costs would be $3.8M.[59]

In order to operate as close to capacity as possible and provide enough milk for GF every month of the year (in a single island), that IP would need to collect [Redacted] litres of milk – 125M litres (10.625M kgMS) for GF and [Redacted] for the IP.

All other things being equal, an increase of [Redacted] litres would mean that an IP would need to increase its collection area by [Redacted]. However, the conclusion drawn above that only one in eight suppliers chooses to supply winter milk and the requirement for every single supplier in this case to be supplying winter milk suggests that the collection area would need to further increase by a multiple of [Redacted].

An area increase of that amount would increase the average distanced travelled from 78 km to [Redacted] km. If we assume that there is some sort of optimal transport networking solution such that the effective increase in the milk supply area is [Redacted] times rather than [Redacted] times, the average distance travelled is [Redacted] km. The IP's collection costs would increase to [Redacted] meaning that the incremental cost of collecting GF's milk would be [Redacted]. The IP would pass that incremental cost onto GF, which would increase GF's cost of milk by approximately [Redacted] per kgMS.

The detailed calculation of the above starts with Table 5 below.

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[58] http://files.ecan.govt.nz/public/consent-projects/consent-project-hearing/Evidence_of_Alan_Maitland.pdf
[59] 17M kgMS multiplied by $0.22 per kgMS.

Table 5: [Redacted]

In Table 5, above, we establish that the single efficient IP needs to recruit [Redacted] litres of milk across both the spring and autumn milk curves in order for GF to get as much milk as it requires for the domestic market in a single island and for the IP to stay within the bounds of its daily processing capacity constraint.

If we assume that the IP collects 200M litres of milk (17M kgMS) from an area that is within 55 km of its plant we can calculate the average round trip distance travelled to collect milk from each of its suppliers as follows:

Table 6: [Redacted]

If the IP now needs to collect [Redacted] litres of milk [Redacted] (kgMS), that is a [Redacted]% increase in the amount of milk required and it is therefore reasonable to assume that the a ea that the IP collects that milk from will be [Redacted]% larger than it was.

Even if we assume that the amount of milk being collected is the same per square kilometre, this increase in area increases the average round trip distance from [Redacted] km to [Redacted] km and therefore increases collection costs from $0.22 to $[Redacted] per kgMS.

The IP requires every supplier to be a winter supplier. Howe er we assume that only one in eight suppliers will choose to be a winter supplier. That implies that the IP needs to extend its milk recruitment coverage by a multiple of [Redacted]. If we assume that there is some sort of optimal transport networking solution such that the effective increase in the milk supply area is [Redacted] times rather than [Redacted] times, the average distance tr velled is 169 km. Using that information, we can calculate the increase in collection costs per kgMS as follows

Table 7: [Redacted]

Capacity costs

As noted above GF requires 250M litres of milk p.a. for the domestic fresh-milk market, which equates to an average milk equirement of approximately 685,000 litres per day. However, that average milk requirement can vary by + - 200,000 litres per day. If we assume the milk split is half to each of the North and Sou h Islands, that variation is +/- 100,000 litres per day.

If GF contract d an IP to recruit its milk and manage its daily milk variations, the IP's peak day milk capacity would have to reduce by 100,000 litres from 1.0M litres to 0.9M litres for its own milk. The cost of that reduction in efficiency is around [Redacted] cents per kgMS.

To a rive at this conclusion we start at Table 5 above. Table 5 tells us that the IP is limited to [Redacted] litres of its own milk ([Redacted] kgMS) versus 200M litres (17M kgMS) if it didn't have to manage GF's milk requirements. That means that its plant is only operating at [Redacted]% capacity. Table 8, below, tells us that the cost of that inefficiency is [redacted] cents per kgMS.

Table 8: [Redacted]

In Table 8 above:

- column 2 is Fonterra's FGMP calculation as per the 2016 Milk Price Statement. It sets the FGMP at a level at which Fonterra is able to generate an adequate return on its capital employed;
- column 3 applies the numbers in column 2 to an efficient IP processing 17M kgMS;
- column 4 establishes the cost to the IP of being only [Redacted]% full, which means that the IP's fixed costs (including return on capital employed) are spread over fewer kgMS; and
- column 5 establishes the incremental cost passed on to GF by the IP in order to re-coup the inefficiency costs. The incremental cost is [Redacted] cents per kgMS.

Annex 6: The implications of seasonal milk supply for Goodman Fielder

This annex presents the analysis drawn on in Section 5.4 of this report and analyses the implications of the seasonality in milk supply on Goodman Fielder's business operations.

Figure 8, below, presents a variation on the information presented in Figure 2 in Section 5.4 (the NZ milk curve) of the main report to create a GF milk curve.

Figure 8: [Redacted]

In Figure 8 the dark blue curve is proportionally exactly the same as the DCANZ curve in Figure 2 except that it has been sized to fit GF's annual fresh-milk requirements. The light blue curv is the dark blue curve moved forward by eight months to create a June peak for winter milk, being an illustration of a seasonal curve based on autumn calving. The two curves together illustrate the milk production pattern of a "split calver", that is a farmer who splits the herd in two with 40% cal ing in autumn and 60% calving in spring[60].

The dotted line is the minimum amount of milk required by GF in any month throughout the year, being approximately 21M litres per month (depending on the number of days in the month). The orange curve is the sum of the spring and autumn curves. At its minimum, it equals the minimum required in any month throughout the year. All the milk below the orange curve and above the dotted line is milk in excess of GF's requirements.

Figure 8 demonstrates that in order for GF to be able to supply a minimum of 21M litres per month (or 250M litres p.a.), it would need to recruit [Redacted] litres, [Redacted]% more than is actually required[61]. GF does not have an export ingredien s bu iness and therefore does not have the capacity to manage this excess milk.

Within the annual milk-production pattern, there is a need to match supply and demand on a daily basis. In round numbers, GF needs on average approximately 685,000 litres of milk per day. The daily variation is plus or minus 200,000 litres per day (almost 30%) across its three delivery sites. This daily variation is currently absorbed by Fonterra, which has a processing capacity of almost 100M litres per day.

If Font rra was unable to absorb the variation in GF's daily milk requirements, GF would either have to build its own long-life manufacturing plant or rent capacity from another IP or (equivalently) negotiate

[60] To illustrate the seasonality point, one participant in the fresh-milk market in New Zealand is Fresha Valley Processors (Waipu) Limited. Fresha Valley is a Northland-based company selling milk under the Fresha Valley brand that was established by a few farmers to sell their own milk. Its annual production is estimated to be 15M litres p.a. Fresha Valley and GF produce house-brand fresh milk for Countdown/Progressive Enterprises. Fresha Valley's suppliers are split calvers and therefore Fresha Valley's milk supply has two peaks. During the peaks when Fresha Valley is producing more milk than the house-brand contract requires, it discounts the price of its milk significantly and markets the milk directly to smaller retailers in order to clear its daily stock. It then exits this "swing" market as milk production tails off.

[61] Figure 2 represents an average production curve. There will be variations in the detail with some farmers splitting their herds 60/40 spring/autumn and other farmers calving 100% in autumn.

a supply agreement with an IP in which the IP absorbed the variation, with that cost being reflected in the price under the agreement.

Annex 7: Factory-gate milk price

There is no functioning factory-gate market in New Zealand; the reason being the factory-gate milk price would have to be materially higher than the FGMP. This annex presents a theoretical estimation of what a factory-gate milk price would be if there was a functioning factory-gate market for competitors like GF to access.

Milk processors have to build enough capacity to process all of the milk supplied on the peak day: they cannot store it and they cannot dump it. Their first objective is to have their factories operating as efficiently as possible and therefore as close as possible to capacity. To encourage the processors to take raw milk out of their factories and sell at the factory-gate would require the processors to be earning at least as much from the sale of that raw milk as they would be earning from the alternative. That is, they would need to be earning a return on the capital employed in the under-utilised factory and they would need to be compensated for having less volume to spread their fixed costs over.

Using the information provided in the 2016 Milk Price Statement and assuming a single efficient plant providing half of GF's domestic-milk requirements (with half in each island), we estimate the point of indifference for a milk processor to supply into the factory-gate market would be at a raw-milk cost to GF of FGMP + [Redacted]. This cost of milk to GF compares to FBNZ's cost of milk of FGMP + 0 cents.

Our workings to derive this estimate of the premium between the FGMP and the factory-gate milk price are provided below.

The following constraints were used in the modelling to determine the point of indifference:

- the maximum amount of milk that can be processed in any one day is 1M litres of milk (being the approximate processing capacity of a 8.5 MT per hour dryer);
- the IP recruits just enough winter milk to meet GF's requirements;
- GF requires a constant amount of milk each day in each island being 342,465 litres (being 125M litres of milk p.a.);
- the IP would be operating at capacity if it didn't supply any milk to GF. That is, it does not recruit any additional milk other than winter milk; and
- the FGMP is assumed in this case to include the winter-milk premiums required to recruit sufficient winter milk.

Table 9, below, shows the maximum amount of milk that can be processed as a consequence of these constraints:

- the assumption is that the split calving regime is 60% spring and 40% autumn. That is, the winter milk collected equals 40% of the total amount of milk collected (ie. the sum of column 2 is 1.5 times the sum of column 3);
- column 1 is the month of the milk season – 1 June through to 31 May each year;

- column 2 converts the milk curve shown in Figure 2 of the report into thousands of litres of milk. The volumes shown are the maximum amount of summer milk that can be recruited, which, when combined with the winter milk recruited, would have the processing plant operating at maximum capacity on the peak milk supply day in the event that GF didn't take any milk;
- column 3 is column 2 divided by 1.5 to get a 60:40 summer:winter milk split. As per Figure 2, the winter-milk curve is the summer milk curve moved forward eight months so that the winter-milk curve has a peak in June;
- column 4 is the sum of columns 2 and 3 and shows the total amount of milk collec ed each month;
- column 5 is GF's monthly fresh-milk requirements for the domestic market;
- column 6 is a check column that ensures that GF has enough milk;
- column 7 is the peak-day processing that would be required in the event that GF didn't take any milk and the milk therefore needed to be processed by the IP; and
- column 8 is a check column to ensure that the peak processing constraint has not been breached.

Table 9: [Redacted]

Figure 9, below, illustrates the summer milk, winter mi k and total milk curves corresponding to Table 9, above.

The dashed line is GF's monthly fresh-milk equirement for either the South or the North Islands (assuming it sells half of it fresh milk in each island) The dark blue line is the milk curve associated with a spring-calving program. The light b ue l ne is he milk curve associated with an autumn-calving cycle. The orange line is the sum of the two blue lines.

Figure 9: [Redacted]

Table 10 calculates the cost of milk at the factory-gate:

- column 2 de ails the notional efficient processor's revenue and costs per kgMS as per Fonterra's Milk Price Statement 2016. Note that the notional efficient processor's earnings after tax are just suff ient to generate an adequate return on capital employed;
- column 3 converts the per kgMS numbers in column 2 into thousands of dollars assuming the efficient processor is one with a 8.5 MT per hour dryer. The efficient processor would be able to process 253M litres of milk per season with a peak milk-processing capacity of 1.0M litres of milk per day. The important numbers in column 3 are the fixed costs and the required return on capital employed;
- column 4 establishes the consequences of under-utilising the processing plant. In Table 9, above, we established that the total amount of milk required p.a. was 253M litres. GF requires 125M litres of that total, which leaves 128M litres of milk for the efficient processor to process and sell. Note that the fixed costs and required return on capital employed in column 4 are the same as they are in column 3. Depreciation is not the same however as the rate of depreciation

is determined by hours of use and is therefore variable. The consequence of under-utilising the plant is a loss of $[Redacted]; and

- column 5 estimates the premium over and above the FGMP required by the efficient processor in order to offset the loss established in column 4. The premium required is [Redacted].

Table 10: [Redacted]

The premium calculated in Table 10 is a best-case outcome. It assumes that GF requires exactly the same amount of milk every single day. To the extent that there are random variations in its daily requirements, which there are, the efficient processor would need to hold processing capacity in reserve, which in turn would mean that the amount processed in column would 4 would be less and the bottom line loss would be higher.

For the sake of this exercise, our working also assumes that collection costs would be the same as Fonterra's at 22 cents/kgMS (with GF paying collection costs for 10 months of the ear and farmers paying the winter-milk collection costs for the other two months). However, this is highly unlikely as Fonterra has multiple processing sites, which means that it should be able to more efficiently configure its collection network.

Annex 8: Analysis of Synlait's entry into the domestic dairy products market

The Synlait-FSSI agreement

Synlait has recently announced that it will produce FSSI's private-label liquid milk under contract fo 10 years beginning in 2019. The volume of milk to be supplied is 30M litres p.a. and Synlait's announcement confirmed that its current supply base is sufficient to supply the required milk. The FSSI contract announcement was part of a broader announcement about Synlait's intention to spend $125M to build a liquid dairy packaging plant with capacity to process 110M litres of milk. The stated intention is that new products will be developed by Synlait for sale in domestic and export markets as part of a business-to-consumer (B2C) strategy.

GF currently produces FSSI's house-brand milk. Up until the Synlait announcement the FSSI private-label contract was tendered every two years and was contested by both GF and FBNZ.

Therefore, there were three aspects of the Synlait announcement hat were generally surprising:

1. that Synlait had decided to compete in the domestic mark t;
2. that the parties had agreed a 10-year contrac ; and
3. that Synlait was contemplating a B2C strategy to sit alongside its well-established and successful B2B strategy.

On the first point, the domestic liquid milk market is generally regarded as being a marginal proposition from a profitability perspective owing to the negotiating power of the two dominant retailers and to the commodity-like characteristics of l quid milk where price is the major area of competition. TDB's analysis of the domestic liquid market suggests that it is only marginally profitable and also significantly less profitable than efficien ly produced dairy commodity exports. We might speculate therefore that the FSSI announceme t had more to do with Synlait's export intentions than its domestic intentions. That is, in order to be a credible B2C exporter Synlait needs to have an established domestic presence.

Other details that may be relevant to the FSSI announcement are that Synlait has excess milk (and has been selling excess milk at the factory gate) and that the required FSSI volume represents approximately 5% of Synlait's total milk supply. The excess supply situation might be relevant because it can only be solved by Synlait reducing its supply base or by building additional capacity. For a company in expansion mode, xiting supply agreements could be detrimental to its expansion plans. Continuing to sell excess milk at the factory gate is likely to be unprofitable given the excess only occurs at the peak of the season being the time that all the other processors are at or near full capacity and therefore demand for the excess will be low. The 5% of total milk supply might be relevant from a winter milk supply perspective because it is approximately equal to the size of the domestic market versus total production, which suggests that winter milk supply might be economic.

The Synlait announcement raises the question of whether Synlait or another IP may supply liquid milk in the North Island. TDB understands that there are two private-label contracts in the North Island and both are more than twice the size of the FSSI contract.

The existing North Island IPs are Miraka, Open Country Dairy, Tatua, and Fresha Valley. We think it unlikely that any one of them would contract for liquid milk supply to one of the private-label contracts in the North Island for the following reasons:

1. if our analysis is correct that private-label contract fresh milk supply is less profitable than efficiently produced commodity exports then there is no incentive for either Miraka or OCD to try to compete in that market;
2. Tatua has a value-add strategy and it doesn't have any excess milk so it seems incongruous that it would contemplate shifting production from more profitable to less profitable products;
3. Fresha Valley doesn't collect enough milk to contemplate one of these contracts a d, even if t did, we think it would find the winter milk requirements too difficult to meet.

The implications of seasonal milk supply for Synlait

The remainder of this annex analyses Synlait's winter milk needs to meet the volume requirements of the FSSI agreement. For Synlait to meet the FSSI volume requirements (approx. 30M litres p.a.) it must procure approximately 82,190 litres of milk per day taking into accou t for a 25% buffer for daily demand variation[62].

In Figure 10 below, the light blue curve is proportionally the same as the DCANZ curve in Figure 2 except that it has been sized to fit Synlait's annual fresh-milk requir ments to meet the FSSI agreement. The dark blue curve is the light blue curve moved forward by eight months to create a June peak for winter milk, being an illustration of a seasonal curve based on autumn calving. The two curves together illustrate the milk production pattern of a "split calver", that is a farmer who splits the herd in two with 40% calving in autumn and 60% calving in spring

However, there is regional variation n m lk supply so the New Zealand milk supply curve may not perfectly correlate with the milk supp y curve in Canterbury (where Synlait collects its milk). If the Canterbury milk supply curve is steeper then the modelled milk supply curve then our estimates will understate the volume of m lk Synlait must procure year-round to meet its daily requirements (or vice versa).

Figure 10: [Redacted]

The dotted line s the minimum amount of milk required by Synlait in any month throughout the year, being approxima ely 3.125M litres per month[63] (depending on the number of days in the month). The red curve is the sum of the spring and autumn curves. At its minimum, it equals the minimum required in any month throughout the year. All the milk below the red curve and above the dotted line is milk in excess of Synlait's requirements.

Figure 10 demonstrates that in order for Synlait to be able to supply a minimum of 3.125M litres per month (or 37.5m litres p.a.), it would need to recruit [Redacted] litres. This equates to [Redacted]% more

[62] Assuming demand is linear across the year.
[63] Based on annual requirement of 30M litres plus 25% buffer for daily demand variation.

than is actually required[64]. This includes [Redacted] litres of spring milk and [Redacted] litres of autumn milk.

[64] Figure 10 represents an average production curve. There will be variations in the detail with some farmers splitting their herds 60/40 spring/autumn and other farmers calving 100% in autumn.

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Healthy Soil, Healthy Food, Healthy People

08 February 2019

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Submission on Dairy Industry Restructuring Act 2001 review

Introduction

1. The Soil & Health Association of New Zealand Inc. ("Soil & Health") thanks the Ministry for Primary Industries for the opportunity to comment on the Dairy Industry Restructuring Act 2001 ("DIRA") review and specifically the 'Review of the Dairy Industry Restructuring Act 2001 and its impact on the dairy industry' Discuss on Document ("Discussion Document").

2. Soil & Health is an incorporated society, with charitable status, supporting organic food produc ion established in 1941. It is the largest membership organization supporting organic food and farming practices in New Zealand and is one of the eldest present-day organic organisations in the world. Soil & Health's objectives are to promote sustainable organic agricultural practices and the principles of good health. Its membership is chiefly composed of home gardeners and consumers, organic farmers and growers, secondary producers, retailers and restaurateurs. Soil & Health publishes the bi-monthly 'Organic NZ' magazine – New Zealand's leading organics magazine.

3. Soil & Health has concerns about a lack of government support for dairy farmers to transition to higher premium organic milk production. We consider that the Government should recognize the economic and environmental benefits of organic milk production for New Zealand; these include higher returns for farmers and less environmental degradation. The changes we therefore seek from the DIRA review are that:

a) Fonterra must be obligated to collect all certified organic milk and in transition to certified organic milk; and

b) Fonterra must be obligated to pay any Fonterra organic milk supplier a minimum of 25% premium above the annual farm gate price, irrespective of location or availability of processing capacity.

Submission

4. Soil & Health understand that the DIRA was enacted in 2001 to facilitate the formation of Fonterra to drive the New Zealand dairy industry's economic performance in global dairy markets, and to regulate its dominance domestically, for the long-term interests of New Zealand dairy farmers, consumers and the wider economy. However, we consider that this strong focus on economic growth has come at the expense of the environment.

5. We strongly agree with the Discussion Document that along with economic benefits of the growth of the dairy industry, there have been negative effects on our environment. Such effects include increased greenhouse gas emissions, nitrate leaching, and the expansion of dairy into increasingly marginal land areas. We are pleased to see this acknowledged in the Discussion Document.

6. We share concerns highlighted in the Discussion Document that the DIRA has been encouraging uneconomi and environmentally unsustainable milk production inevitably preventing Fonterra from transitioning to higher value-add processing activities such as organic dairy.

7. It is well known that New Zealand's freshwater is in a dire state, with a stagger ng 62% of monitored waterways being unsafe for swimming, and a big factor in this is nitrogen pollution from the increasing intensification of agriculture. The Ministry for the Environment says New Zealand has recently experienced one of the world's highest rates of agricultural intensification.

8. There is also growing concern about the public health impacts of high-density livestock production - especially for dairy farming. There are health concerns as nitrate levels in drinking water increase.

9. Nitrogen pollution comes from cow urine and synthetic nitrogen fertilizer diffusing through soils and pasture root zones, so simply planting stream banks and fencing off streams cannot solve this issue.

10. Our concerns are that Fonterra's focus on economic value growth, primarily from greater volume of commodity production, have made it more difficult for dairy farmers to transition to organic dairy production, and therefore to more environmentally friendly methods of dairy farming.

11. Going organic is part of the solution to fixing polluted fresh waterways in New Zealand. Organic dairy farming involves no synthetic nitrogen fertilizers, lower stock numbers, more biodiversity, and grass-fed cows with no GE feed or palm kernel supplements. Organic farming methods impro e the soil biology and soil structure, which means better water retention and less nutrient leaching. Organic and biological farmers make use of natural fertilizers including legumes, instead of soluble artificial nitrogen fertilizers that are more prone to leaching.

12. Organic dairying also has higher animal health outcom s and lower intensity. Some of the profit making of organic dairying and their ability to remain profitable with less volume is because of the reduced veterinary costs because of the reduced animal health issues

13. Studies have found that a low-input system with fewer cows per hectare and no synthetic nitrogen fertilizer produces the most milk per cow per year. This research also confirms that the low input system is the best environmental performer, the least financially risky, and is most profitable when milk-price payouts are low.[1]

14. We support the DIRA in that it is legislation enabling a cooperative and protective approach to market access for many farmers, controlling farmgate milk price to some degree, and because it exists it allows for what could be a legislat ve environmental gamechanger for dairy in New Zealand.

15. The DIRA however has allowed Fonterra to treat organic farmers poorly over time including reducing the organic pickup area for paying the organic premium, meaning no premium, even for some of the organic pioneers that helped get the organic dairying underway, because they were beyond the 'organic hub'. Only when it has suited Fonterra did they reinstate some parts of Taranaki and Manawatu, but overall there has been limited encouragement for new organic transitions beyond its organic hub.

[1] Basset-mens C, Ledgard S and Boyes M (2009). Eco-efficiency of intensification scenarios for milk

16. Fonterra have made it more difficult to have certified organic dairy farmers in parts of New Zealand away from their prescribed hubs. We understand this has been done for efficiencies however at the same time has resulted in organic dairy growing better outside of Fonterra in New Zealand.

17. Fonterra established its organic programme in 2002 following three years of research and the sector grew strongly. At its peak in 2011, there were 127 dairy farms supplying Fonterra with organic milk. Fonterra had a review and changed its organic policy in the same year. This opened the door to commercial opportunities for new players to fill the supply vacuum. The Organic Dairy Hub Cooperative which is now the third largest supplier of organic milk in New Zealand was incorporated in 2015. Fonterra, Open Country Dairy, Organic Dairy Hub and Marphona Farms which operates Green Valley Dairies, are now the four main suppliers of organic milk in New Zealand.[2]

18. Consumers worldwide are demanding safe, healthy and more environmentally friendly food, and are prepared to pay for high quality, GE-free, organic dairy products. New Zealand is well placed to provide discerning consumers with an expanding range of organic dairy products to meet their demands, particularly in Asia. The 2018 Organic Market report found that global organic dairy market is currently estimated to be worth about US$17b with a compound annual growth rate of 8% during 2009 to 2016. By 2022 the sector is projected to be worth US$25b the value of organic milk powder being an important contributor.[3]

19. If Fonterra are obligated to pay farmers the premium for organic milk everywhere, then the co-op will be motivated to process more of the milk into organic products and do better at marketing the same. DIRA needs to be amended to make it obligatory for Fonterra to be picking up certified organic milk and in transition to certified organic and be paying the premium for it.

Soil & Health's recommendations

20. Soil & Health considers that government intervention is required to incentivize more sustainable and organic methods of farming. We consider

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[2] OANZ 2016 Organic Market Report
[3] OANZ 2018 Organic Market Report

that a shift towards organic farming practices is needed to protect and enhance our environment and our economy.

21. Soil & Health therefore seek that the legislation require that Fonterra must collect all certified organic milk and in transition to certified organic Fonterra milk and pay a 25% premium above the annual farm gate price for it, irrespective of location or availability of processing capacity.

22. Other changes Soil & Health seek are that the DIRA open entry requirements are repealed. As one of the key mechanisms that has facilitated the growth of this industry Soil & Health strongly recommends that the open entry provision be completely removed. For completeness we recommend that open exit be retained so that Fonterra cannot impose any restrictions on farmers who wish to leave Fonterra.

23. Further, with regards to Terms of Supply, Soil & Health recommends that the DIRA be clarified to ensure that Fonterra can provide financial incentives and disincentives to farmers who are performing above or below any element of Fonterra's Terms of Supply or standards. Being able to use financial incentives and disincentives should include, but not be limited to, issues associated with environment, emissions and animal welfare standards.

Yours sincerely

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Submission by the Royal New Zealand Society for the Prevention of Cruelty to Animals Inc.

on the

Review of the Dairy Industry Restructuring Act 2001 and its impact on the dairy industry

8th February 2019

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Introduction

The following submission is made on behalf of the Royal New Zealand Society for the Prevention of Cruelty to Animals (SPCA NZ).

SPCA is the preeminent animal welfare and advocacy organisation in New Zealand. We have been in existence for over 140 years with a supporter base representing many tens of thousands of New Zealanders across the nation.

The organisation includes 40 Animal Welfare Centres across New Zealand, 600 staff and 6000 volunteers, and 80 inspectors appointed under the Animal Welfare Act 1999.

SPCA appreciates that opportunity to make a submission as part of the consultation process regarding the Review of the Dairy Industry Restructuring Act 2001 and its impact on the dairy industry.

SPCA Position

SPCA is broadly supportive of the changes proposed in the Review of the Dairy Industry Restructuring Act (DIRA; the Act) 2001. However, the Society would like to see a much greater consideration of animal health and welfare in the Act, and believes that animal welfare must be factored into the DIRA regime in a similar capacity to sustainability and environmental concerns.

Specific feedback on the discussion document

Below we have assessed and responded to the points stated in the Dairy Industry Restructuring Act 2001 discussion document relevant to animal welfare (the points from the application are *italicised*):

- ***Section 2.1***
    - SPCA broadly agrees with the description of the DIRA regulatory regime and its original policy rationale.

- ***Section 2.2***
    - The Society would like to see a much greater consideration of animal health and welfare, in the Dairy Industry Restructuring Act, and believes that animal welfare must be factored into the DIRA regime in a similar capacity to sustainability and environmental concerns.

- ***Section 3.1***
    - SPCA believes that DIRA has been effective at achieving its core regulatory objective of preventing Fonterra from using its dominance to create barriers to farmers' milk and land flowing to their highest value uses.
    - SPCA believes that Fonterra is still dominant in the market for farmers' milk, at regional and national levels. It is also noted that Fonterra also has a significant international dominance as well.
    - SPCA does not believe that DIRA imposes unreasonable costs on Fonterra.

- ***Section 3.5***
    - SPCA agrees that DIRA's open entry and exit requirements are unlikely to incentivise large dairy processors to invest in the substantial and long-term outlay of establishing a large processing plant in the absence of a solid business case.

- ***Section 3.6***
    - SPCA believes that the base milk price should be set by an independent body to provide greater confidence.

- ***Section 4.1***
  - SPCA would like to see option 4.1.3: "amend the DIRA open ent y requirements to allow Fonterra to decline to accept applications from new and existing farmers if Fonterra considers their supply is unl k ly to omply with Fonterra's terms of supply", to be implemented with he ability to decline applications from farms where animal welfare standards are not met. It is noted that Fonterra have in the past declined milk from farms where there have been animal welfare offences and s rongly encourage this to be made public to assist with increasing publi confi ence the dairy system.

- ***Section 4.3***
  - SPCA believes that option 4.3.3., amending the DIRA to give the Commerce Commission statuto y pow r to set the base milk price for the dairy industry, is necessary to ensu e a fair farm gate milk price. SPCA would prefer to see the establishment of an independent regulated panel (including processors and specialis s in academia) by the Commerce Commission.

Justification

An mal welfare in New Zealand agriculture is a vital part of our "brand" as an exporting c untry. Both nationally and globally, consumers are increasingly demanding proactive steps are taken to safeguard animal welfare and calling for more transparency throughout the food supply chain.

With access to information at an all-time high, animal agriculture is under greater public scrutiny in relation to both impacts on the environment and animal welfare (Cembalo et al., 2016). New Zealand's commitment to animal welfare is reflected by the New Zealand

Government's decision to formally recognise animals as "sentient" by amending our animal welfare legislation (Animal Welfare Amendment Act, 2015).

There is a steady trend for increasing dairy herd size in New Zealand (LIC et al., 2018). This may attract greater scrutiny in terms of animal welfare as people tend to think that larger farms are worse for animal welfare despite little empirical evidence that animals a e worse on these farms (Robbins et al., 2016).

In some cases, the public's introduction to the modern dairy farm comes in the form of videos documenting abuse and other contentious practices. Th se types of images can have a profound impact. For example, in February 2014, an underc ver i eo taken on a New Zealand owned dairy farm operating in Chile reported that over 6 00 calves had been killed using blunt force trauma (Gulliver, 2014). This video, alongside a realisation of the widespread practice in New Zealand, resulted in public outcry and our G vernment responding with a change in 'accepted' methods in killing calves in New Zealand. The Code of Welfare for Dairy Cattle 2018 now states calves must not be ki led by blunt force to the head, except in emergency circumstances.

Another undercover video, also released in 2014, showed footage of unacceptable animal handling on one of Canada's largest dairy farms and attracted worldwide news coverage (Clark, 2014). Under Canada's supply management system, the milk marketing board has an obligation o buy the milk produced. As a result, the largest Canadian milk processor, Saputo Inc , was n a position where it was not permitted to refuse to buy milk on animal welfare grounds Heavy public pressure resulted in Saputo being forced into refusing to collect milk from the farm but the company still had a legal requirement to pay the farm for the milk. Consequently, Saputo, a company that had remained largely silent on the issue of farm animal welfare, revised its animal welfare policy in response to the consequent public outcry and a precedent was set to allow the company to refuse milk on animal welfare grounds (Saputo, 2017).

These examples highlight the dangers of a reactive approach to dairy cattle welfare to the New Zealand dairy industry. Mandating Fonterra to collect milk from all farms without explicit exemptions for farms not achieving animal welfare standards, DIRA may cause pronounced inefficiencies and prevent Fonterra from effectively managing its farms' animal welfare performance, thus exposing Fonterra, its farmers, and the wider dairy industry to reputational risk. SPCA welcomes a proactive approach to dairy cattle welfare and believ s DIRA must include proactive measures that explicitly incentivise the dairy industry to improve animal welfare.

As an animal welfare organisation, SPCA encourages all measu es that would support processors' ability to offer increased incentives for farmer meeting high animal welfare standards. Currently, there are concerns that Fonterra is able to manipulate its competitive position through over valuing milk price and unde valuing share price (Begg et al., 2016). This does not create a fair playing field for smaller processors, hampering their ability to offer farmers incentives for higher animal welfare tandards. Improving transparency of base milk price as outlined in the discussion document or, ideally, amending the DIRA to give the Commerce Commission s atutory power to set the base milk price for the dairy industry through the establishment of an independent regulated panel (including processors and specialists from academia), is necessary to ensure a fair farm gate milk price and thus a fair playing field for smalle processors.

SPCA believes the resulting higher levels of confidence in the base milk price calculation ou weigh otential costs that may be encountered. We suggest that once the milk price is set at an appropriate level, processors should be required to invest the additional capital to improving on-farm animal welfare through offering a premium to farms meeting higher welfare standards.

We appreciate the opportunity to give feedback on this topic and would welcome further engagement on this issue. We would like to speak at a hearing in support of our submission, if one is held.

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Synlait

8 February 2019

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REVIEW OF THE DAIRY INDUSTRY RESTRUCTURING ACT 2001 (DIRA) AND ITS IMPACT ON THE DAIRY INDUSTRY: DISCUSSION DOCUMENT (NOVEMBER 2018) – SUBMISSION

The dairy industry makes a substantial contribution to New Zealand, and plays a key role in influencing the economy, the environment, and the well-being and prosperity of New Zealanders. Due to the structure of the dairy industry in New Zealand, DIRA plays an integral part in ensuring the industry remains competitive.

In Synlait's view, now is an important time to review DIRA and the implications that DIRA has had, both good and unintended. We set out Synlait's corporate submission below.

We would like to thank the Government for proceeding with a full review of DIRA now to help ensure that the dairy industry remains competitive and performance is optimised for the benefit of all New Zealanders, while also ensuring negative environmental effects are being managed effectively.

Background: Competition in the dairy industry is good for all

The key focus of our submission is around the promotion of competition in the dairy industry. Synlait is a good example of a company in the industry that started from small beginnings and has grown into a successful independent processor with a focus on value-added products for global markets. This success has allowed Synlait to positively influence changes in the industry around sustainability and the environment.

We believe that healthy industries are underpinned by the combined dynamic of high-quality public policy, well performing enterprise, and buy-in by the general population. A considered review of DIRA, along with other relevant regulation, could provide the foundation for a more sustainable, profitable industry that brings benefits to all New Zealanders.

We have outlined Synlait's approach to creating sustainable outcomes across environmental, community and business aspects below by way of example of what could be achieved in the dairy industry if there is more competition and greater transparency.

Synlait's corporate purpose is "*doing milk differently for a healthier world*". We have adopted a number of proactive practices at Synlait to promote sustainability both in our own business and through our farm suppliers. Changes in on-farm activities are supported by Synlait through premiums paid to our farm suppliers in addition to what we pay as the base milk price. Synlait made the decision to pay these premiums to encourage positive change from its farm suppliers.

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, provides an incentive for farmers to focus on

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the four pillars of the environment, animal health and welfare, milk quality, and social responsibility. Farmers who supply Synlait and meet the LWP requirement, which is independently audited annually by AsureQuality, receive a premium on their base milk price.

Under our LWP programme a total of up to 0.24 cents by way of different premiums are paid (this includes $0.08 per kg of milk solids to be palm kernel expeller free). We have also built cultural principles of importance to local iwi into LWP such as provision for Mahinga Kai. We continue to work with our farm suppliers to ensure that we have both the highest standards of animal welfare and that farm workers are safe and healthy in their jobs.

In using this programme, over the last five years, Synlait has succeeded in directly driving change across 31% of its supply base as they have become certified. We anticipate that 85% of our supply base will be LWP certified by 2024, thus demonstrating best practice in addressing on-farm environmental impact. The direct cost of paying these premiums to promote on farm sustainability has been carried by Synlait. It is hoped that Synlait is able to benefit by increasing the quality of milk it receives and by attracting customers that value (and are willing to pay for) our approach.

Perhaps of greatest importance is that the LWP programme has created pressure for the rest of the industry to follow.

We believe Synlait's approach provides an example of the greater levels of innovation, value creation and improved sustainability that can be achieved across the industry by encouraging more competition and greater transparency.

Executive Summary: Improve transparency in setting FGMP, remove out of date DIRA practices, and continue to review DIRA based on outcomes

DIRA plays a critical role in ensuring the dairy industry remains competitive. Parts of DIRA, such as open entry and exit, must continue to be retained while Fonterra remains in a market dominant position. Other parts of DIRA require urgent amendment (17 years on) to ensure DIRA remains effective in encouraging competition and keeps pace with the changing industry.

A key part of DIRA requiring urgent amendment is in setting the Farm Gate Milk Price (**FGMP**). To ensure there is no manipulation, or perception of manipulation, around the setting of the FGMP greater transparency is imperative, as is the certainty of enforcement of the agreed price setting formula (when considered absolutely necessary). This is important to the industry and has been an area of concern for some time. Creating greater clarity and certainty in setting the milk price will benefit all New Zealanders.

Our submission is focused on the following key areas:

- Ensuring a realistic FGMP is set through transparency and enforcement (Part A); and
- Change to some out of date DIRA practices that impact competitiveness (Part B).

We also submit on a question raised in the Discussion Document on retention and review of DIRA (Part C).

Part A. The FGMP setting process needs to be more transparent to be effective

There are shortcomings with the current method for calculation of the FGMP that we believe should be corrected to ensure greater credibility in the process. These shortcomings come in a large part from the lack of transparency, effective oversight and accountability in the way Fonterra sets the milk price, as explained below. This has resulted in outcomes that are inconsistent with the statutory purpose of DIRA (which is to promote the efficient operation of dairy markets in New Zealand by regulating the activities of Fonterra to

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ensure New Zealand markets for dairy goods and services are contestable) and therefore must be corrected as part of 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 considered in New Zealand by default to be the FGMP, calculated by Fonterra applying the milk price model.

While DIRA sets out broadly how the milk price model is intended to be applied, Fonterra has consistently demonstrated that they are able to make unilateral changes, without effective oversight, to the assumptions used within the milk price model to effectively increase the milk price, at the expense of their value-added business performance, therefore artificially reducing their capital value.

The continued lack of transparency regarding the components of the milk price calculation heightens the uncertainty around the milk price each year, making it difficult for independent processors to accurately forecast where the market price for milk will land, and thereby potentially discouraging new entrants. This has led to a continual concern, widely held, that Fonterra is able to manipulate its competitive position through overvaluing the milk price and undervaluing the Fonterra share price. Fonterra has openly confirmed this cross-subsidy of the FGMP in recent times. In May 2018 Duncan Coull, Fonterra Shareholders' Council Chairman, openly stated in a RadioNZ interview that:

> *"... the question we're being asked 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..."*

This was recently reinforced by the previous Chairman of Fonterra, the late 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."*

In the case of independent processors these "tweaks" effectively increase the cost of milk in an unpredictable way. 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 FGMP must have been "tweaked" to support this lift.

As Fonterra is not required to provide 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.

In the Northington Partners' report on Fonterra's financial performance since inception (November 2018), commissioned by the Fonterra's Shareholders' Council, Northington Partners concluded that *"...the cumulative impact of these changes [in the FGMP] since FY09 is 51.8 cents/kgMS..."*.

What is being described is a system which enables Fonterra to make unilateral and arbitrary choices about the allocation of earnings between milk price and capital. While $0.50/kg MS is a seemly small amount, when applied across the industry, it is misallocating circa $750M/annum to on farm milk production at the expense of returns on value adding investments outside the farm gate. In this context, $750M is enough to distort land values, cause greater conversion of marginal land to dairy farming than would otherwise be the case,

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increase on-farm use of marginal inputs such as nitrogen fertiliser and PKE, and create significant disincentives from value added investment across all manufacturing companies.

We consider the opaqueness, and ability of Fonterra to make tweaks, in the setting of the FGMP as a major weakness in the current regime (given the significance of changes in the FGMP for all independent processors) that needs to be addressed. This is due to the lack of transparency and the lack of 'light touch' enforceability where required by the Commerce Commission. A continuation of the status quo on FGMP will stymie the further competition in the dairy industry, cause ongoing misallocation of capital across the industry, and maintain environmental pressure at a farm level by continuing to incentivise land use change to dairy, and greater use of marginal inputs than would otherwise be the case (intensification).

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

- **Application of the milk price model:** Under DIRA Fonterra is required to promote the setting of the FGMP so that it provides an incentive to Fonterra to operate efficiently while providing for contestability in the market for the purchase of milk from farmers (section 150A of DIRA). In setting the FGMP Fonterra is required to do a number of things including maintain a milk price manual publicly that sets out how FGMP is calculated; establish and maintain the Milk Price Panel which is responsible for supervising the calculation of the FGMP; and certifying to the Commerce Commission the manner in which it has calculated the FGMP. The Commerce Commission then reports on whether the FGMP calculated is consistent with DIRA but has no power under DIRA to enforce any of its recommendations by requiring Fonterra to amend the milk price model. We see little value and purpose of the Commerce Commission undertaking this review process only to have no ability at all to ensure that its recommendations are taken up by Fonterra.

- **Notional Producer:** The conceptual model under DIRA anticipates that the FGMP will reflect the price that would be achieved by a notional producer in a contestable market. The notional producer modelled by Fonterra under DIRA enjoys a "super-competitor" mix of characteristics which are simply not practically feasible. These characteristics are not displayed or practically feasible for Fonterra, nor could any new entrant build this business model. Independent processors such as ourselves get a retrospective insight into how the annual FGMP was set when Fonterra release their milk price statement in September each year. However, we have very little to no insight as to how the FGMP has been determined from the start of and through the course of each year. Fonterra provide no insight into the key variables applied when they announce their updated forecast milk price. We expect that they will have made further changes or "tweaks" to the notional producer model, but do not know what these are and will only find out when the final milk price for that year is announced in mid-September, following the end of the season.

- **Asset Beta:** The asset beta used in setting the FGMP is not practically feasible for any manufacturing company in the industry, leading to an estimate of risk for the cost of financing milk processing operations that is too low. The asset beta measures the extent to which changes in the value of a company are related to changes in the stock market as a whole. A lower beta will (all else being equal) result in a higher FGMP. The effect of a 0.1 change in asset beta would have approximately a 3-4 cents effect on FGMP.

  The Commerce Commission in 2018 determined, after extensive independent analysis, that the asset beta being used by Fonterra to calculate the 2017/18 FGMP was too low. Other independent processors agreed with the Commerce Commission position. However, as stated above the Commerce Commission does not have the power to enforce its decision, in this case by ensuring that Fonterra adopts the correct asset beta. Independent processors, who need to consider what the FGMP will be to run their businesses effectively, still do not know whether Fonterra has adjusted its asset beta for the FY19 season to comply with the Commerce Commission decision. It is totally unreasonable that Fonterra has not updated the market on whether or not it has implemented the Commercial Commissions recommendation on the asset beta and therefore the independent processors have to make an assumption, which could ultimately turn out to be incorrect.

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Why is this important to all New Zealanders?

The flow on effect is that the shortcomings (effectively over inflating) in the calculation of the FGMP has distorted investment incentives, created barriers to entry to the milk processing market by other independent processors, and is inconsistent with the spirit of DIRA in terms of driving contestability.

A FGMP not set in an appropriate way encourages farmers to invest in dairy farming in marginal areas (over other land uses) potentially putting themselves under financial stress by taking on higher debt. Further this promotes the misallocation of resources, both economic and environmental. The International Monetary Fund has identified the level of debt in the dairy industry as a key vulnerability for New Zealand.

Initiatives to introduce greater transparency will assist with competitiveness in the dairy industry

In our view improving transparency in setting the FGMP will improve behaviours in the industry. This is evidenced by what we are seeing across the global financial industry including recently in Australia with the publication of the Final Report by the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (February 2019, KM Hayne). The Reserve Bank of New Zealand is responding to these challenges by implementing a three pillar programme of self, market and regulatory discipline, as explained below.

We submit that to improve transparency in setting the FGMP the following initiatives are introduced based on a similar three pillar approach:

- **Self-discipline (aimed at supporting internal risk management and governance systems):**
  - **Attestation:** We submit that both the Milk Price Panel and the Fonterra Board be required to formally attest that the milk price model and resulting FGMP meets the objectives of DIRA each time the price is adjusted.
  - **Two independent members are appointed to the Milk Price Panel:** The Fonterra Milk Price Panel members are currently appointed by Fonterra. We submit that two (2) independent persons are appointed to the panel by an independent body such as the Ministry of Primary Industries or by the majority of independent processors via DCANZ.
  - **Minutes of the Milk Price Panel Meetings:** We submit that the minutes of the Milk Price Panel meetings be made publicly available to all interested parties with the published FGMP dashboard, discussed below.

- **Market Discipline** (aimed at reducing the information asymmetry between market participants in the dairy industry):
  - We submit that Fonterra be required to publish the attached FGMP dashboard or a similar dashboard each time that they report on the FGMP with detailed explanations provided as to the reasons for any changes in the key components and assumptions as listed on the dashboard (Appendix).

- **Regulatory Discipline** (involves setting rules including enforcement and requirements):
  - We submit that the Commerce Commission needs to be given statutory power under DIRA to enforce its decisions (only where considered absolutely necessary) where the Commerce Commission's decisions are clearly supported by their own research and by the majority of the independent processors. As stated above this was clearly the case with the Commerce Commission's position on the asset beta supported by the independent processors and yet there is no certainty that Fonterra will adopt the appropriate asset beta. This creates considerable uncertainty in the industry and

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deters competition. For the avoidance of doubt, we do not support amending DIRA to give the Commerce Commission statutory power to set the FGMP.

Part B. Some change is required to out-of-date DIRA practices that are creating inefficiency in the dairy industry

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 amended or transitioned out as explained below.

- **Retain open entry and exit criteria which are critical to ensuring competitiveness in the dairy industry**

  In Synlait's view open entry and exit are critical to maintaining and building competition in the dairy industry. If farm suppliers are not free to leave Fonterra, and return later (if they choose to), it will be difficult for independent processors to encourage farm suppliers to leave Fonterra, the current market dominant player, and supply them.

  We believe that the preferred option is for the DIRA open entry requirements to be amended to allow Fonterra to decline to accept applications from new dairy farms/suppliers (i.e., supply from dairy farms which have not at any time in the past supplied to Fonterra) if Fonterra considers the supply would not comply with Fonterra's terms of supply. Fonterra should have discretion as to whether to accept milk from suppliers who have never in the past supplied Fonterra.

  Our concern, if Fonterra was able to apply its terms of supply to all farm suppliers (including farmers who have in the past supplied to Fonterra,) is that Fonterra's terms of supply could be used to prevent open entry by allowing Fonterra to not accept a returning farmer under the guise of not meeting its terms of supply when the actual reason was that they had left Fonterra. This would create further uncertainty in the industry and inhibit competition.

  We submit that the Fonterra's terms of supply would need to be clear and made publicly available. Ideally, the decision not to accept new milk suppliers would be based on a quantitative model using a series of factors including high standards of compliance in animal welfare; environmental standards such as ecological sensitivity of the land and the track record of the farmer (if any).

  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 are required for farmers to make the rapid change in sustainability practices that our communities are now expecting. It is currently falling upon processors to help incentivise farmers toward more sustainable practice.

  As set out above Synlait isn't relying upon legislative change to improve the sustainability performance of our suppliers. We believe that effective regulation should create the conditions in which market players work towards better outcomes, rather than the regulation itself enforcing these outcomes. An effective review of DIRA could help achieve this.

  To conclude, we do not support repealing DIRA's open entry requirements, particularly given the lack of transparency around the setting of the FGMP, which was intended, but has failed to act as a regulatory discipline.

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- **Removal of the requirement for Fonterra to collect all milk is important in ensuring that further marginal land in New Zealand is not converted to dairy farming**

  More land in New Zealand has been, and continues to be, 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.

  Some 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. We submit that it would be more effective if Fonterra was only required to collect from new dairy farms that meet Fonterra's terms of supply (see above).

- **Remove requirement for Fonterra to supply milk to Goodman Fielder (up to 250 million litres)**

  There was good reason to ensure that Goodman Fielder, as the main domestic competitor, had an adequate supply of milk when Fonterra was established in 2001. Goodman Fielder has had ample time to build its own milk supply over the past 17 years.

  Under DIRA, Goodman Fielder is guaranteed up to 250 million litres of milk from Fonterra at discounted prices not obtainable by other independent processors (**DIRA milk**) making entry into this market against two large incumbents difficult.

  In our view, continuing to allow Goodman Fielder to rely on DIRA milk is hindering the establishment of a wholesale milk market. A wholesale milk market would create more competition around milk prices by enabling suppliers to balance surpluses and shortfalls in supply that may arise for a number of reasons including climatic conditions through that market. A corollary benefit of a wholesale milk market is that it will provide a robust (market) reference point for Fonterra's FGMP.

  At the moment, Goodman Fielder is not required to purchase DIRA milk (but is guaranteed DIRA milk) enabling it to arbitrage its milk input costs by acquiring milk from other players at cheaper prices than DIRA milk, during the peak season when milk is in high supply. During the shoulder season, when milk is less available and more expensive, Goodman Fielder can rely on the DIRA milk from Fonterra.

  There is no justification for this concession to remain and we submit that it should now be transitioned out by the end of 2021. Thereby allowing Goodman Fielder sufficient additional time to acquire its own milk supply. This will have the effect of creating more competition in the dairy industry by promoting a wholesale milk market.

  An alternative approach, as a temporary measure, would be to ensure that the rights to access DIRA milk are taken up in full or not at all by Goodman Fielder.

Part C. Additional Submission: Continue to monitor and review DIRA review based on outcomes

As we have stated above DIRA is critical to ensure continued competition in the dairy industry. We submit that DIRA be retained while Fonterra remains a dominant player.

We support periodic reviews based on the behavior of market players and industry outcomes to determine whether the DIRA regulatory regime should be retained, repealed or amended as changes in the dairy industry occur.

In summary, Synlait continues to grow its business while at the same time maintaining an ambition to have a net positive impact upon the planet through restorative and regenerative agricultural practices.

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Our LWP programme has been embraced by our farm suppliers. They have a strong appetite to improve their farming systems and by means of our targets, systems and incentives, they are on a very encouraging path to ensuring future prosperity for their business, their land and people. We have also established a strong value-add dairy business underpinned by global partnerships with our customers. This has been possible through the competitive framework provided by DIRA, and we would encourage the government to continue to complete this review with the goal of increasing transparency and competitiveness in the dairy industry for the benefit of all New Zealanders and our environment.

We are happy to provide further information or provide any additional assistance.

If you wish to discuss, please contact Deborah Marris or Leon Clement.

Yours sincerely

Leon Clement
CEO

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Synlait Submission: Review of the DIRA Discussion Document (November 2018): Pro-forma Dashboard for Reporting FGMP

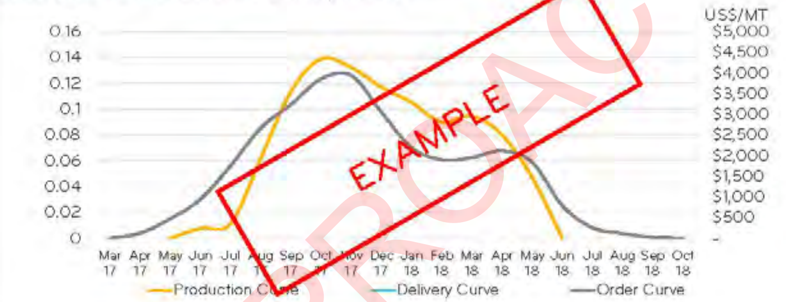
Fonterra Farmgate Milk Price Dashboard

Farmgate Milk Price Summary

Million kgMS		1,505		1,525	(20)	(1.3)%
Farmgate Milk Price Revenue	13,005	8.64	12,290	8.06	0.58	7.2%
Off GDT Sales Revenue	158	0.11	109	0.07	0.03	47.0%
Lactose	(441)	(0.29)	(415)	(0.27)	(0.02)	7.5%
Net Revenue	12,723	8.45	11,984	7.86	0.59	7.6%
Farmgate Milk Price Cash Costs	(1,753)	(1.16)	(1,763)	(1.16)	(0.01)	0.8%
Farmgate Milk Price Capital Costs	(817)	(0.54)	(873)	(0.57)	0.03	(5.2)%
Supply Adjustments[1]	(11)	(0.01)	(13)	(0.01)	0.00	(14.3)%
Total Costs	(2,581)	(1.72)	(2,649)	(1.74)	0.02	(1.3)%
Farmgate Milk Price	10,142	6.74	9,335	6.12	0.62	10.1%

GDT Reference Commodity Price Forecast

Sales Order to Production to Delivery Profile



Volume and Product Mix

WMP	1,856	1,826	29	1.6%
SMP	577	619	(42)	(6.8)%
Butter	258	256	2	0.8%
AMF	136	154	(18)	(11.8)%
BMP	59	63	(3)	(5.5)%
Total	2,886	2,918	(32)	(1.1)%
kgMS	1,505	1,525	(20)	(1.3)%
Yield	191.7%	191.4%	0.4%	0.2%

WMP	64.3%	62.6%	1.7%	2.7%
SMP	20.0%	21.2%	(1.2)%	(5.7)%
Butter	9.0%	8.8%	0.2%	1.9%
AMF	4.7%	5.3%	(0.6)%	(10.8)%
BMP	2.0%	2.1%	(0.1)%	(4.5)%
Total	100.0%	100.0%	-	-

Lactose

Lactose (000MT)	342	351	(9)	(2.6)%
Average FAS Price (USD/MT)	910	738	172	23.3%
Average CIF Cost (USD/MT)	-	80	(80)	(100.0)%
Total Purchase (USD $'m)	312	288	24.03	8.4%
FX Rate	0.7074	0.6924	0	2.2%
Total Purchase (NZD $'m)	441	415	25.17	6.1%
Production (000MT)	2,886	2,918	(32)	(1.1)%
% Dry Lactose Usage	11.87%	12.04%	(0.18)%	(1.5)%

Weighted Average Cost of Capital

Risk Free Rate	3.13%	3.40%	(0.27)%	(7.8)%
Specific Risk Premium	0.15%	0.15%	-	-
Debt Premium	1.37%	1.39%	(0.03)%	(1.9)%
Leverage	40.00%	40.00%	-	-
Post Tax Market Risk Premium	7.00%	7.00%	-	-
Asset Beta	0.38	0.38	-	-
Equity Beta	0.63	0.63	-	-
Cost of Equity	6.84%	7.03%	(0.19)%	(2.7)%
Cost of Debt	4.50%	4.79%	(0.29)%	(6.1)%
Gross WACC	5.40%	5.60%	(0.20)%	(3.6)%
WACC Adjustment	-	-	-	-
Net WACC	5.40%	5.60%	(0.20)%	(3.6)%

USD Pricing and OFF GDT Sales Premiums

Average USD Prices (GDT - Only)				
WMP	3,056	2,837	219	7.7%
SMP	1,951	2,188	(237)	(10.8)%
Butter	5,464	4,184	1,280	30.6%
AMF	6,422	4,977	1,445	29.0%
BMP	2,038	2,172	(134)	(6.2)%
Average USD/MT	3,188	2,916	272	9.3%
Average Off-GDT Sales Premium				
WMP	35	17	18	107.1%
SMP	17	28	(11)	(39.8)%
Butter	111	37	74	200.3%
AMF	52	99	(47)	(47.3)%
BMP	19	39	(20)	(50.5)%
Average USD/MT	39	26	13	49.9%
Average USD Prices (GDT + Premium)				
WMP	3,091	2,854	237	8.3%
SMP	1,968	2,216	(248)	(11.2)%
Butter	5,575	4,221	1,354	32.1%
AMF	6,474	5,076	1,398	27.5%
BMP	2,057	2,211	(154)	(7.0)%
Average USD/MT	3,227	2,942	285	9.7%
Off GDT Sales Premium Summary				
Average USD Prices (GDT - Only)	3,188	2,916	272	9.3%
Average Off-GDT Sales Premium	3,227	2,942	285	9.7%
Variance in USD/MT	39	26	12.92	49.9%
FX Rate	0.7074	0.6924	0	2.2%
Variance in NZD/MT	55	37	17.48	46.8%
Sales Volume (000MT)	2,886	2,918	(32)	(1.1)%
Total NZD Variance	**158,313**	**109,079**	**49,234**	**45.1%**
Production (m kgMS)	1,505	1,525	(20)	(1.3)%
Off-GDT Sales Premium ($ kgMS)	0.11	0.07	0.03	47.0%
GDT Sales Premium (WMP/SMP/AMF)	*0.08*	*0.06*	*0.02*	*28.1%*

Cash and Capital Costs

Sales Costs	106	106	(0)	(0.3)%
Variable Manufacturing & Supply Chain Cost	652	673	(22)	(3.2)%
Fixed Manufacturing & Supply Chain Costs	405	406	(1)	(0.2)%
Collection Costs	339	339	(0)	(0.1)%
Other Costs	252	239	13	5.6%
Total Cash Costs	1,753	1,763	(10)	(0.5)%

WACC Rate %	5.40%	5.60%	(0.20)%	(3.6)%
Total Fixed Assets (Book Value)	7,021	7,021	-	-
Depreciation	262	265	(3)	(1.0)%
WACC Charge - Fixed Assets	374	398	(24)	(5.9)%
WACC Charge - Net Working Capital	36	55	(19)	(34.6)%
Tax	144	155	(11)	(6.9)%
Total Capital Costs	817	873	(56)	(6.4)%
Additional Milk Payments & Supplier Adj	11	13	(2)	(15.4)%
Total Cash and Capital Costs	2,581	2,649	(68)	(2.6)%

The Tatua Co-operative Dairy Company Limited

Submission on the

Review of the Dairy Industry Restructuring Act 2001 and its impact on the dairy industry

February 2019

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SUBMITTER

Formed in 1914, The Tatua Co-operative Dairy Company Ltd (Tatua) is one of the few dairy companies in New Zealand that has remained unchanged by merger or take-over. The Company operates as a co-operative, with 107 supplying shareholders and concentrates its business activities in the added value and higher technology sectors. The Tatua business model can be considered as being part dairy processor and part food producer.

Having had a long history of trading dairy materials, including raw milk, with other New Zealand dairy companies as part of its normal business activities, Tatua continues to take a keen interest in all milk related matters. We are grateful for the opportunity to provide our unique view of the dairy industry and markets.

The contact for this response is:

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1. EXECUTIVE SUMMARY

1.1 Tatua welcomes the opportunity to contribute to this review. We agree that the dairy industry is of significant national interest, and plays a key role in New Zealand's economic, environmental and social wellbeing, and ongoing prosperity. The DIRA regulatory regime is an important part of the industry and it is sensible to review how it can best achieve its objectives.

1.2 DIRA regulation and its effects must be viewed in context. The New Zealand dairy industry has continued to evolve and is now in a new phase that will give rise to new behaviours and different outcomes than those previously seen. Dairy farming is under increasing pressure to be more sustainable and responsible, and industry growth has slowed. New entrants have successfully established, and excess processing capacity in some regions is now likely to drive increased farm gate competition.

1.3 One of the main lessons learned from the past, and one that holds true today, is that competition is essential to driving efficiency. Independent processors will therefore continue to play an important role in ensuring Fonterra remains focussed on growing value and returns to its stakeholders. In this sense, DIRA has had a positive effect on the sector because it enabled new entrants to become established and create competitive tension in the market.

1.4 With increased competition in many dairying areas, the ability to retain (or grow) milk supply will be a key success factor for individual dairy processors. Against this background, and in the absence of the DIRA open entry and exit safeguards, Fonterra would have a strong incentive to use its market dominance to supress farm-gate competition. For example, the use of long-term supply contracts (in absence of the open-entry-and-exit regime) could effectively shut down the farm-gate milk market, ultimately to the detriment of the sector.

1.5 Tatua supports the New Zealand dairy industry acting responsibly in all its activities and their effects, including management of environmental, animal welfare and workplace outcomes. We would be concerned if legislative controls provided protection for the continuation of poor on-farm practices. Tatua is therefore open to Fonterra having the ability to decline entry into the co-operative where it believes that doing so would have a material negative impact on its reputational risk profile.

1.6 Fonterra's market dominance in New Zealand means that it sets the benchmark for farm gate milk pricing. While there will always be competing objectives and divergent views regarding the forecast milk price, Tatua is satisfied that the current milk price calculation methodology is sufficient for its intended purpose of providing an indication of its future milk pricing.

1.7 The combination of access to regulated milk and open-entry-and-exit provisions of DIRA has enabled new entrants to become established, exactly as planned. As a result, the willingness of dairy farmers to transfer their milk supply between dairy processors has increased, lowering the milk supply hurdle for future start-ups. Our view is that the industry has now evolved to a point that the supply of regulated milk to large export focussed processors is no longer required.

1.8 Tatua's preference is for all dairy processors, irrespective of size or market served, to secure their milk requirements via an open and competitive market. We acknowledge, however, the small size of the New Zealand consumer dairy market and the absence of an active factory gate market make this outcome challenging. Tatua is therefore comfortable that Goodman Fielder continues to have access to the milk it requires to satisfy its domestic dairy market supply.

1.9 In the absence of a dominant Fonterra Co-operative, and Fonterra's reference milk price, there is a real risk that long term farm returns would diminish, resulting in erosion of farm resilience, and at the extreme, failure of the farm-gate milk market in some regions. This supports our assessment that the DIRA provisions have incorrectly been viewed as being transitory and should more correctly be seen as enduring alongside Fonterra.

1.10 To help ensure that the DIRA provisions continue to remain relevant and effective, Tatua considers that a time based review cycle of five years is appropriate. We are uncomfortable with the market share approach due to it being a blunt measure of market dominance, and the expectations that setting of a specific market share trigger may create.

2. DAIRY INDUSTRY EVOLUTION

2.1 The decision to allow the formation of Fonterra was mad on condition that the Dairy Industry Restructuring Act 2001 (DIRA) contained provisions to restrain the resulting company from acting anti-competitively. Tatua was art of that process but chose to remain independent with confidence that the DIRA leg slation would provide ongoing protections, particularly in the farm-gate and factory-gate milk markets. The 2015 Commerce Commission Review concluded that these protections remained necessary.

2.2 The New Zealand dairy industry has evol ed significantly since 2001, through several distinct phases. The first phase f om 2002-2007 involved robust industry growth at 3.2% per annum but very little actual competition. Open Country was the only new entrant and accounted for just 1% of national milk collections by 2007. In contrast, the second phase from 2007 to 2015 saw highe annual milk growth of 5.5% but with significantly more competition. Fonterra continued to grow its milk collections at 3.7% per annum, while independents su ged to 12% of total milk (growing at 36% per annum). The industry has now entered its third phase with very low milk growth, and more intense competition for supply. In the period 2015 to 2017, total milk production dropped 1% per annum while Fonterra s milk collections dropped 2.7% per annum and independents still grew their milk coll ctions at 9% per annum. Fonterra's share of total milk in 2017 ended at 82%, wh ch is still dominant[1] but less than previously. These figures are summarised below.

K y Measures on per annum basis	2002-2007	2007-2015	2015-2017
NZ Milk Growth	3.2% High Growth	5.5% High Growth	-1.0% Falling Production
Fonterra Milk Growth	2.4% High Growth	3.7% High Growth	-2.7% Shrinking
Independent Milk Growth	22% Very High Growth	36% Very High Growth	9% High Growth
Change in Fonterra Share of Milk	-0.29%	-1.16%	-1.46%

[1] See Tatua's 2015 submission to Commerce Commission, with calculation of relevant indices.

2.3 The reduction in milk growth in recent years is the result of a combination of factors. One of the most significant of these was the sharp drop in milk prices paid during the 2014/15 and 2015/16 dairy seasons, which led to many farmers reducing supplementary feed inputs and refocussing on profitability rather than production. It is uncertain how imbedded this change is and whether farmers will revert to higher production over time, and particularly in response to any future increase in milk pricing.

2.4 Another constraint on milk growth has been the increased expectations on environmental performance, with limits on land use and nutrient loss already imposed in some regions and signalled in others. The impact of these changes is yet to be fully realised, but it appears likely that, subject to the development of breakthrough technologies, they will have a dampening effect on milk supply for the foreseeable future.

2.5 More recently, climate change response and the possible future requirement to reduce methane and nitrous oxide emissions relating to dairying, has the po ential to moderate milk production intensity and see marginal dairying land move to other uses. Associated with this is the global trend toward substitution of dietary animal protein with a plant and cultured proteins. It remains to be seen whether this will flow th ough to extensive land use change in New Zealand or lead to a transformation of international dairy market dynamics and pricing.

2.6 These changes to New Zealand's dairy farming landscape mean that the behaviours and observations made in the earlier phases of DIRA a e not necessarily a reflection of what can be expected in the future. Our view is that we can expect to see a sustained period of zero or negative milk growth, with s gnificantly increased competition at the farm gate.

3. DIRA OPEN ENTRY

3.1 Tatua supports retaining the open entry and exit provisions contained in the DIRA as a general principal. As per our previous submissions, we consider these provisions to be essential for th continued development and protection of an effective farm gate milk market. We acknowledge, however, that strict adherence to this principle may require Fonterra to accept milk from farms that pose a significant risk to Fonterra's reputation relating to food safety and/or environmental non-compliance. As this outcome would be detrimental to Fonterra and the New Zealand dairy industry as a whole, we support the ability for Fonterra to decline entry in specific circumstances.

3.2 Tatua sees significant benefits in DIRA legislation facilitating ongoing competition at the farm gate. In our view, the only justified means for dairy processors to secure long term milk supply is by paying a competitive milk price. In some cases this may mean entering into commercial arrangements with other processors, but more commonly it will involve entering the farm gate milk market. Either way, New Zealand farmers will receive a fair price for their milk, and value will be returned to the New Zealand regional economy through that payment.

3.3 Maintenance of a competitive farm gate market, combined with the establishment of new processors has also incentivised all milk processors to operate as efficiently as possible. This stimulus for efficiency has occurred as a consequence of DIRA.

3.4 In the absence of the current open-entry-and-exit rules, the ability of Fonterra to impose some form of restraint on farmer suppliers wishing to leave the co-operative would be possible. This could involve long-term contractual commitments that farmers would be required to sign in the absence of any immediate alternative. The effect being to inhibit competition, with any prospective new processor unable to secure sufficient milk to become viable.

3.5 It has been suggested that DIRA's requirement for Fonterra to accept all milk offered, in conjunction with high milk growth, somehow forced it to focus on developing large-scale commodity ingredients processing capacity rather than a sustainable value-added business. In our view, the decision to build a large powder-processing capacity across New Zealand has been economically rational based on relative stream returns and market demand. Independent processors have focussed on milk powder driers for the same reason. Whatever the case, the current industry phase of low/zero/declining milk growth renders this argument obsolete. It will be competition rather than regulation that drives innovation in value-added milk products.

3.6 Tatua does accept that the open entry rules <u>may</u> have required Fonterra to accept "marginal milk" from new suppliers in some instances – i.e. where the additional costs of collection and return to a processing site are high. Also, that it <u>may</u> have been required to build capacity that could have been stranded if/when farmers left to supply another party. However, we make the following points in relation to this:

(a) The net effect of "marginal milk" collection is likely negligible;
(b) With near zero milk growth, any future impact will be negligible; and
(c) It is doubtful that Fonterra would have otherwise scaled back capacity development, and in doing so, allow competitors to become established in key milk growth regions.

3.7 Tatua supports the New Zealand dairy industry acting responsibly in all its activities and their effects. This includes managing environmental, animal welfare and workplace outcomes, for example. We view this as an imperative for both dairy farmers and dairy processors who value a positive reputation.

3.8 It has been suggested that an unintended consequence of DIRA has been a detrimental impact on the environment, both in terms of water quality and landscape change. This includes collection of milk from farms established in environmentally sensitive areas, and from farms with substandard on-farm practices (due to the requirement for Fonterra to accept milk supply, even where there is a track record of poor performance).

3.9 Tatua rejects the notion that DIRA should be re-constructed to achieve outcomes other than the efficient functioning of the industry itself. Issues such as land-use change are properly the business of other Government regulation and policy (i.e. Resource Management Act, National Environmental Standards, and National Policy Statements) and of the affected Regional Councils (i.e. Regional Policy Statements, Regional Plans). If there is a failure in regard to permitting dairy conversions in any area, it resides with those parties. It would be inappropriate to attempt to utilise DIRA's open-entry-and-exit rules for this purpose.

3.10 We are nonetheless mindful of the need to avoid the situation where legislative controls in any way provide protection for the continuation of poor on-farm practices. We are therefore open to Fonterra having the ability to decline entry into the co-operative where it believes that doing so would have a material negative impact on its reputational risk profile. This discretion would require oversight, including the ability for farms that are denied entry to seek review from the Milk Ombudsman or Commerce Commission.

4. ACCESS TO REGULATED MILK

4.1 Tatua understands the aspiration for the development of an efficient and competitive unregulated factory gate milk market in New Zealand. However, we also desire to see Fonterra succeed and maintain its dominant position. It is the natural tension between these two outcomes that has historically been managed through the application of DIRA legislation, including access to regulated milk in some circumstances. Notwithstanding the continued absence of an effective factory gate milk market, our view is that the industry has now evolved to a point that the supply of regulated milk to large export focussed processors is no longer required.

4.2 DIRA regulation currently requires the supply of raw milk to various qualifying processors at fair prices as a substitute for the ability to purchase milk via a competitive factory gate market (rather than actually facilitating the market). Furthermore, it is impo tant to consider whether expectations of such a market emerging are even rea is ic while the market remains concentrated with one dominant participant.

4.3 The combination of access to regulated milk and open-entry-and-exit provisions of DIRA has enabled new entrants to become established, exactly as planned, with successful establishment of several new milk processors since the DIRA was first implemented. As a result, the level of confidence for dairy farmers to transfer their milk supply away from Fonterra (and others) has increased, lowering the m lk supply hurdle for future start-ups.

4.4 Tatua's primary interest in the factory-gate milk market is access to (or sale of) milk components in addition to its own milk supply. One of the key principles for dairy processing companies is that the product mix must be balanced to fully utilise all the components in the milk supply such as casein, whey and milk fat. This is a particular challenge for most smaller processing operations where the incremental nature of processing capacity imposes elatively greater constraints. Trading with other dairy processing companies achieves a better result for all parties, and is why Tatua actively trades milk products and components with other independent dairy processors.

4.5 The same is not true in dealing with Fonterra, which has a large and sufficiently diverse operation that it has little need to exchange raw materials with smaller parties. It is also likely th t agency and delegation issues within Fonterra provide little incentive for trading. This is a commercial reality which regulation should not attempt to resolve, beyond ma nt nance of the current protections provided by the DIRA.

4.6 As no ed above, the dairy industry has evolved considerably and this has, in some cases, created an increased opportunity for trading of milk and milk components between processors. Notwithstanding this, Tatua's experience is that the market remains thin and while there are opportunities for bilateral arrangements for raw milk supply between existing companies, there are no incentives for this to constitute an efficient market, especially for new entrants.

5. MILK PRICE

5.1 The Fonterra calculated base milk price is utilised by many organisations and for a range of purposes. As such, there is value in it providing a reasonable estimate of the average milk price likely to be achieved in a dairy season. It is Tatua's view that the cost of producing the base milk price forecast must be balanced with the reality that it is only

one indicator of future performance and that it is susceptible to a range of uncontrollable factors. As such, we are satisfied that the current base milk price methodology is sufficient for its intended purpose.

5.2 Milk pricing is an important part of efficient milk market operation as it impacts on interactions and transactions at both farm and factory gate level. Co-operatives are focused on maximising the milk price to their supplying shareholders. Conversely, private companies are incentivised to minimise the milk price (consistent with securing the milk) in order to maximise profit and share price.

5.3 Fonterra, due to its unique capital structure arrangements, is attempting to do both, but can be expected to give priority to maximising the milk price due to the governance arrangements (all farmer or related interests) of the milk price panel. In order to resolve these competing interests, in a way which maximises market efficiency, it is essential for Fonterra to maintain a milk price discovery mechanism that is credible, accurate, independent, transparent and timely.

5.4 One of the foundations of the 2001 Industry Restructure was that Fonter a would be a co-operative. A central co-operative principle is that the profits of the enterprise are returned to the supplying members. We at Tatua maintai this prin ple across the whole of our business. The Fonterra milk price mechanism achieves this or Fonterra's core dairy ingredients business. Also, while the requirement fo Fonterra farmers to hold co-operative shares to match milk supply continues, this also remains largely true for Fonterra as a whole.

5.5 Fonterra's market dominance in New Zea and means that it sets the benchmark for farm gate milk pricing. This means that Font r a's dominance, combined with its co-operative structure and farm-gate milk price, helps ensure global market returns are reflected in the milk price received by all dairy farm operators, including those supplying independently owned processors.

5.6 We are aware that there is a high level of frustration amongst many independent processors regarding milk p icing, with the general view being that current application of the model has resulted in the Fonterra milk price being overstated. This is not unexpected, given that, as noted above, private companies are incentivised to minimise the milk price. It is also worth noting that there is no requirement for independent process rs to reference their milk price to the Fonterra calculated price.

5.7 It is like y that the majority of Fonterra shareholders are primarily concerned with their total milk payout (milk price plus dividend), and that ultimately, Fonterra must balance its mil payment with the need to reinvest in the business and maintain share value.

5 8 Tatua is satisfied that, while not perfect, the current milk price calculation methodology is sufficient for its intended purpose of providing an indication of its future milk pricing. While greater transparency of inputs could provide improved confidence, we see little justification for significant changes to the methodology given the volatility and other vagaries associated with international dairy markets (i.e. even if the milk pricing system were completely transparent or undertaken by an independent body, the wide range of uncontrollable factors involved mean that it would not necessarily reflect the final price achieved). In any case, the current regulation relates almost entirely to transparency, with no real powers of enforcement, and the model has already been disregarded at times.

5.9 Tatua's primary concern with regard to milk pricing has always been the ability for Fonterra to use its relative size advantage to maintain or grow its share of milk supply through targeted tactical milk pricing. In the current environment with static or declining milk volumes, and the very real likelihood of excess processing capacity, milk processors may pay more than they can afford in the long term to secure milk in the short term, i.e. a procurement war similar to what has been seen in the meat industry at various times.

5.10 In the above situation Fonterra would have the ability and economic incentive to utilise its size and wide geographic coverage to pay a localised elevated milk price in order to maintain or grow its milk supply in that area. This could ultimately result in the failure of one or more competitor processors who do not have sufficient size to sustain uneconomic milk pricing.

5.11 We are aware that there are no controls in DIRA to manage the tactical pricing risk and that, to date, it has been internal Fonterra shareholder pressure that has prevented its use. We note, however, that in a low milk growth environment, this internal pressure may be insufficient to control this risk in future.

6. REGULATED MILK FOR GOODMAN FIELDER

6.1 Ideally, Tatua would prefer to see all dairy producers (large small, domestic and export) having the choice of satisfying their raw milk requirements either directly from farmer suppliers (farm gate market) or through supply arran ements with others (factory gate market). We acknowledge, however, that Goodman Fielder is in the unique position of having something akin to existing use rights in relation to milk supply, and that the factory gate market remains very thin. There is n real ind cation that this situation will change in the foreseeable future.

6.2 Given the small size of the N w Zealand consumer dairy market, we consider it appropriate that a balance is struck etween milk supply competition and consumer dairy market competition. Tatua is therefore comfortable with Goodman Fielder continuing to have access to the milk it requ res to satisfy its domestic dairy market supply. This concession should not, however, be extended to other large processors who may wish to enter the New Zealand domestic milk market.

7. DIRA REVIEW TIMING

7.1 Tatua supports the adoption of a legislative process that would trigger a review each five years, with the purpose of the review being to determine whether or not the DIRA remains fit-for-purpose, and if not, what provisions should be added, amended or repealed.

7.2 Economic indices demonstrate that the New Zealand milk market remains highly concentrated, and that Fonterra is the dominant participant. While we consider this to be a positive outcome for New Zealand, it does create a set of milk market challenges that require regulatory control. Given that this situation is unlikely to change in the foreseeable future, it is appropriate that it be tested through periodic review.

7.3 It has been suggested that the DIRA is a temporary measure designed to achieve sufficient competition. While we agree that this is one of its purposes, we also consider that it has an important role in limiting Fonterra's ability use its dominant position to exert undue competitive pressure on other industry participants. Should Fonterra perform well and maintain or grow its market share over the long term, then we see strong justification for maintaining the protections afforded by the DIRA in parallel.

7.4 The two primary options proposed for triggering a review are based on either time interval or market share. We are uncomfortable with the market share approach for two reasons. Firstly, market share is a blunt measure of market dominance, and secondly, that setting a specific market share trigger may create an expectation that DIRA provisions are unlikely to continue to be required at that point.

7.5 In our view, a time based review cycle of five years provides an appropriate balance between DIRA provisions continuing longer than necessary, and the cost to the indus ry and government of undertaking a review. A periodic review cycle also has the advantages of providing (medium term) certainty, and allowing participants to plan their involvement in advance.

Tatua is grateful for the opportunity to comment on the above issues and is happy to further discuss any aspect of our response.

S.B. Allen.

Stephen B Allen
Chairman of Directors

Brendhan A Greaney
Chief Exe utive Officer

Review of the Dairy Industry Restructuring Act 2001 and its impact on the dairy industry: Discussion Document

Submission of a Group of Young Waikato Fonterra farmers

We are a group of young Waikato Fonterra Farmers who met on 4 February at Fonterra Farmsouce, Cambridge to discuss the MPI led review of the DIRA. Following that discussion, we set out our submissions addressing the key issues below.

Issue 1: Open Entry

The open entry provisions of the DIRA were necessary in 2001 to safeguard the farming community against the potential abuse by Fonterra of its dominant position in the dairy processing market. That market has significantly different characteristics in 2019. The arrival of new processors has Increased competition for milk and reduced Fonterra's dominance in most regions. The market share thresholds specified in both the original legislation and subsequent amendments as the triggers for the expiration of the open entry requirement have been exceeded. The market now has one big pr cessor in Fonterra and enough smaller processors to keep the big processor honest We believe this is the optimal market shape and do not wish to see further fragmentation in the dairy industry. Furthermore, the open entry provision necessitates Fonterra maintaining excess processing capacity. This burden is becoming more obvious in an era of no milk growth. The red meat processing sector has been suffering the consequences of excess capacity for decades. Neither the dairy industry, or New Zealand as a whole, will benefit from a similar situation arising in the dairy sector. We submit that the open entry requirement is no longer a necessary or reasonable restriction on the fr edom of Fonterra to conduct its business. The requirement should be removed ompletely, or at least removed from those regions where competition exists in the dairy processing market. If the open entry requirement is to remain in any regions it must be amended to allow Fonterra to reject applications for supply which could give rise to eputational risks for Fonterra. We support the agreement reached between Federated Farmers and Fonterra that no existing suppliers would be terminated in the event that the open entry requirement is discontinued.

Issue 2: Regulated Milk for Large Dairy Processors

The regulated milk provisions have served their purpose in promoting a significant level of competition in the milk processing market. Their continuation does not promote the interests of New Zealand. The restrictions imposed upon Fonterra by the DIRA are intended to protect two groups of people: the farming community and domestic consumers. Allowing large export focused dairy processors access to regulated milk does not protect the interests of either group. We submit that the Raw Milk Regulations be amended to exclude large processors from access to regulated milk.

Issue 3: Milk Price

We submit that Commerce Commission oversight of Fonterra's milk price calculation is desirable.

Issue 4: Goodman Fielder

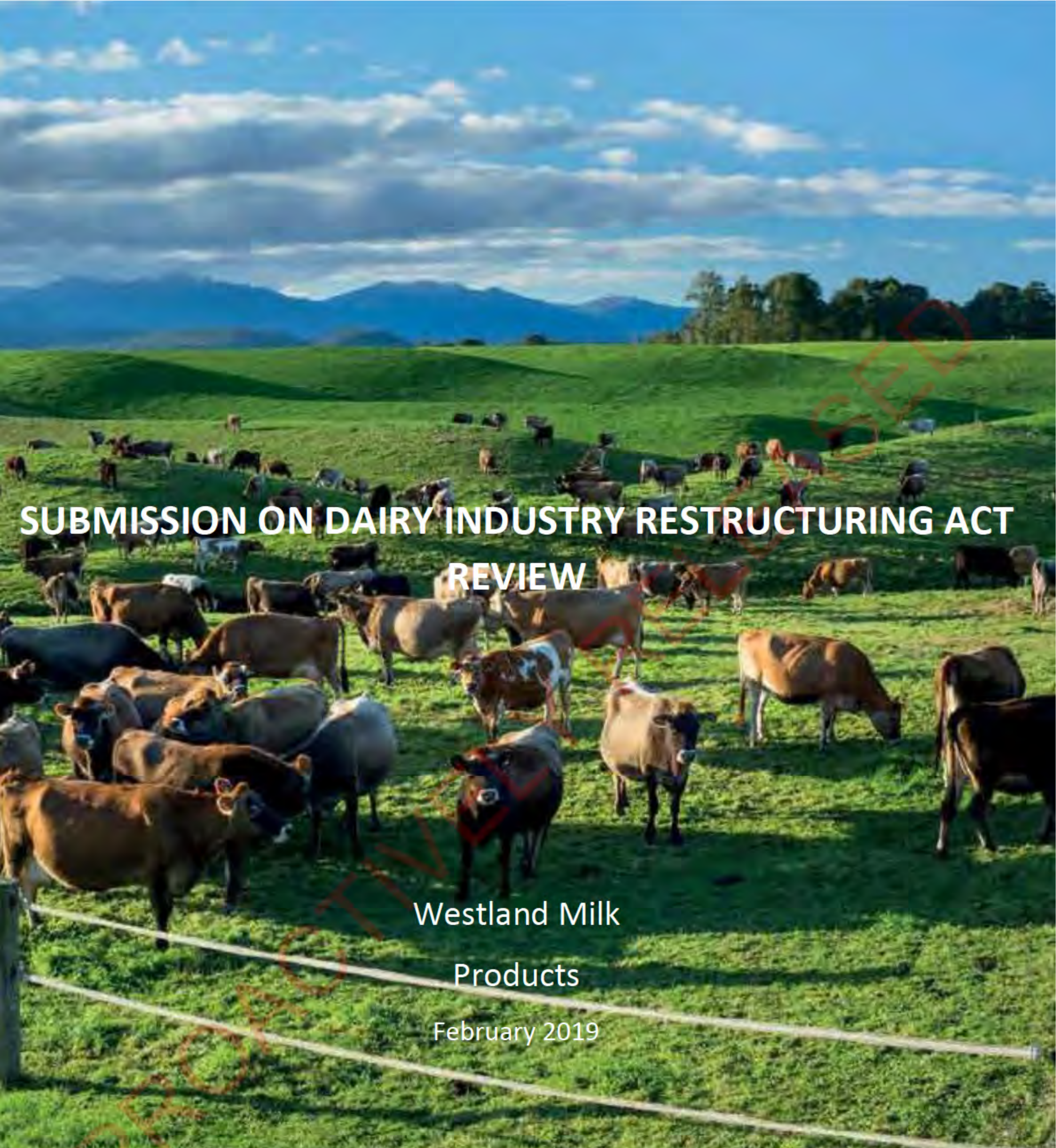
We submit that the Raw Milk Regulations be amended to gradually reduce Goodman Fielders' eligibility for regulated milk over time.

Issue 5: DIRA Review and Expiry Provisions

The core purpose of the DIRA was to enable the creation of a dairy cooperative with the scale to compete globally for the benefit of New Zealand as a whole. This core purpose will be frustrated if the restrictions placed upon Fonterra, and the corresponding benefits conferred upon competitors, promote a continuing decline in Fonterra's share of the milk processing market. The amendments to the thresholds for the DIRA expiry provisions that have already occurred have been an undesirable moving of the goalposts We submit that the DIRA should be amended to provide for automatic expiry at a nominated date or a set market threshold.

Sumitted by Mike Montgomerie (Fonterra Shareholder's Councillor, Waipa Ward) who acted as meeting secretary) on behalf of the following young Waikato Fonterra farmers who were present at the meeting and have approved this submission:

Mike Montgomerie s 9(2)(a)
Steven Gillies s 9(2)(a)
Amy Johnson s 9(2)(a)
Melissa Slattery s 9(2)(a)
Ben Moore s 9(2)(a)
Scott Freeman s 9(2)(a)
Bas Nelis s 9(2)(a)



SUBMISSION ON DAIRY INDUSTRY RESTRUCTURING ACT REVIEW

Westland Milk Products

February 2019

Westland Milk Products
Hokitika · New Zealand

Disclaimer

The economic modelling and expert comments in this report have been prepared by TDB Advisory Ltd (TDB) for Westland Milk Products with care and diligence. The statements and opinions in this report are given in good faith and in the belief on reasonable grounds that such statements and opinions are correct and not misleading. However, no responsibility is accepted by Westland Milk Products, TDB or any of its officers, employees, subcontractors or agents for errors or omissions arising out of the preparation of this report, or for any consequence of reliance on its content or discussions arising out of or associated with its preparation.

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Introduction

Westland Milk Products (Westland) is a key economic driver of the West Coast economy and New Zealand's second biggest dairy cooperative. Dairy is also the biggest single contributor to GDP on the West Coast and consistently contributes almost a quarter of a billion dollars annually ($234.4 million in 2016 alone).

Westland has 342 shareholding farmers and over 420 supplying farms. It directly employs 555 staff, in addition to indirect supplier jobs, and contributes to considerable economic 'spill overs' to the region.

During the deliberations, which became the Dairy Industry Restructuring Act 2001 (DIRA), Westland chose to remain an independent processor in order to maintain processing on the West Coast.

The company believes that New Zealand needs strong independent processors that work as part of *NZ Inc* and that it is important to counter against any global perception of New Zealand having a state-supported monopoly.

Westland agrees with our economic experts, TDB, in that the DIRA enabled Fonterra to be set up as a near monopoly/monopsony in New Zealand's dairy markets. DIRA was designed to be the counter-balance. It included a number of provisions designed to foster competition at the farm gate and to protect New Zealand dairy product consumers.

The key "contestability" provisions that apply to Fonterra are:

- open entry;
- open exit;
- no discrimination between suppliers;
- the right for Fonterra suppliers to supply up to 20 percent of their weekly production to an independent processor; and
- the setting of the base milk price.

In addition, the Dairy Industry Restructuring (Raw Milk) Regulations 2012 (DIRA regulations) require Fonterra to supply raw milk to Goodman Fielder and independent processors (IPs) subject to certain conditions.

DIRA was originally envisaged as temporary legislation with automatic expiry provisions once certain milk supply thresholds were met. Those automatic expiry provisions have now been removed.

Executive Summary

Westland considers there remains a need for the DIRA. The DIRA contestability provisions have helped protect the long-term interests of New Zealand dairy farmers, consumers and the nation's overall economic wellbeing.

It is recognised that the dairy industry's environmental impact has got worse as intensification has increased and as land has been converted to dairy. We consider that, at the margin, DIRA's open entry provisions may have contributed to this outcome and could be phased out without imposing significant costs.

We would not want to see unfettered open entry available for new dairy conversions.

The environmental situation has been acknowledged by farmers and efforts are in place to mitigate adverse effects of dairying. However, any further environmental protections required should be imposed by environmental legislation, such as the Resource Management Act (RMA), rather than through the DIRA.

Although fit for purpose, **we recommend these changes to the DIRA**, including to the milk price methodology which would increase the transparency of the calculation and appear less manipulated.

- We contend that **open entry (and open re-entry) could be phased out.** To be clear, by open entry and re-entry we mean milk from new dairy conversions. We do not mean that Fonterra could choose not to collect milk from an existing dairy farm. Westland does not wish to see a situation whereby any farmer could have their milk not collected.
- the base milk price provisions remain crucial but these are changes we recommend:
  - **Fonterra's average currency conversion rate should be excluded** from the calculation**;**
  - **non-Global Dairy Trade (non-GDT) sales should be excluded** from the calculation;
  - **the asset beta used should not be that of the hypothetical efficient processor but that of the industry**; and
  - **full accounting separation and reporting of Fonterra and Fonterra Brands New Zealand (FBNZ).**

Full accounting **separation and reporting of Fonterra and FBNZ is required** to ensure that FBNZ's ability to compete in the domestic market is not being subsidised by another part of the business.

Westland believes that there are some **unintended outcomes from the DIRA such as dominant behaviour displayed by Fonterra.** To prevent this type of behaviour, we consider the legislation could be strengthened in a way that **prevents the ability to abuse market power, and maintains and encourages true contestability.**

Table 1: Summary of responses to MPI's questions

Question	Summary response
Does the DIRA promote sufficient confidence in the base milk price calculation?	We do not think that DIRA promotes sufficient confidence in the base milk price calculation. A report recently commissioned by the Fonterra Shareholders' Council[1] implies that Fonterra's actual return on capital has been less than its required return on capital because it has been able to increase the farmgate milk pri e (FGMP) by 28.3 cents. In other words, it implies that Fonterra has transferred value out of earnings and into th FGMP.
Q1 - Do you agree with our description of the DIRA regulatory regime?	We agree with the original policy rationale and consider the rationale is still valid. However, we disagree with aspects in the description of the impacts of the DIRA regulatory regime. For example, we disagree that the DIRA incentivises Fonterra to use price signals as a means of managing the volume of its milk supply
Q2 - Are there any other dairy industry developments or industry performance indicators that are not captured in Chapter 2, Appendix 1?	We do not think it an be said that most of the large-scale dairy processors established in New Zealand since 2004 have focused on higher value products. The dominant product remains whole milk powder in specifications that match or nearly match the reference commodity product.
Q3 - Do you consider the DIRA has been effective at achieving its core regulatory objective of preventing Fonterra from using its dominance?	We agree the DIRA has been effective in preventing Fonterra from creating barriers. But the DIRA appears not to have c eated enough of an incentive for Fonterra not to pay a "too high" milk price to its suppliers.
Q4 - Do you think Fonterra is still dominant in the market for farmers milk, at the national and regional levels?	Yes – at the national level its share of total milk supply is 82 percent.
Q5 - Do you think the DIRA imposes unreasonable cos s on Fonterra?	No – the anticipated benefits of the establishment of Fonterra (to its shareholders) were $310 million per annum. We estimate the costs imposed to Fonterra are approximately $25-30 million.
Q6 - Are there ways for the costs imposed on Fonterra to be mitigated without impacting on the effectiveness of the DIRA regulatory regime?	We do not think that the costs imposed on Fonterra need to be mitigated. The anticipated net benefit to Fonterra's shareholders was significant.
Q7 - Are there any other regulatory tools that, in your opinion, would be more effective than the current DIRA provisions at managing Fonterra's dominance?	No – in our opinion the DIRA has been, and continues to be, reasonably effective. The only part of the market that has not developed is the factory gate market.
Q8- Are there other factors you consider need to be taken into account when considering the effectiveness of the DIRA regime and whether it is still needed?	We think the open entry could be phased out for new dairy conversions. All other parts of the DIRA need to be retained.

[1] Fonterra Shareholders' Council Values Review 2018, Northington Partners, Nov 2018 at page 11.

Q9 - Do you agree with our preliminary assessment of the extent to which the DIRA encourages industry growth?	We agree – the DIRA allowed industry volume growth rather than drove it.
Q10 -Do you agree with our preliminary assessment of the extent to which Fonterra can influence milk supply volumes through price, notwithstanding the DIRA open entry requirements?	Yes – to a degree. Fonterra could have decided to pay farmers less or more for their milk in order to manage its milk supply. The problem with paying less is the extent to which it would have been "too low" and therefore would have encouraged inefficient investment in new processing capacity by the independent processors.
Q11 - Are there other factors that you consider should be taken into account?	We question the suggested relationship between dividend policy and milk supply. For farmers, given the link between supply volumes and shareholding, we suggest that the important ratio is the ratio of dividends pa d versus share price.
Q12 - Do you consider that the DIRA provisions governing Fonterra's base milk price calculation and Commerce Commission monitoring may be preventing or disincentivising Fonterra from deviating from the base milk price calculation for strategic or commercial reasons?	No - for example, a report r cently commissioned by the Fonterra Shareholders' Council[2] implies that Fonterra has made the strategic decision to pay more rather than less for milk.
Q13 - If the DIRA is not driving Fonterra's business and investment strategy, what is?	We believe Fonterra's business, like most other commercial en ities, is driven by total shareholder value, social responsibility, and environmental sustainability.
Q14 - Do you agree with our preliminary analysis of the DIRA's impact on the industry's environmental performance?	Yes – we agree with MPI's preliminary analysis: the dairy industry and its rate of growth have had a negative environmental impact. However, that growth has not been driven by the DIRA.
Q15 - Do you agr e with our view that environmental issues are best dealt with through th Resource Management Act and not the DIRA regime?	Yes – we agree that environmental issues are best dealt with through the RMA and not the DIRA regime. It would be poor public policy practice to have more than one piece of legislation governing the same resource-use issues.
Q16 - Are there other environmental issues that you consider should be addressed either through the DIRA review or some other means?	No – we think that environmental issues should be addressed via specific legislation.
Q17 - Do you agree with our preliminary analysis of the impact the DIRA has on new processor entry?	Yes – the preliminary analysis is that there are significant disciplines and constraints on new investment.

[2] Fonterra Shareholders' Council Values Review 2018, Northington Partners, Nov 2018 at page 6.

Q18- Do you consider that large dairy processors should continue to be eligible to purchase regulated milk from Fonterra under the Raw Milk Regulations or not?	No – in our opinion there are already a sufficient number of large processors established in New Zealand for there to be sufficient farm gate competition. However, it does not necessarily follow that there is sufficient farm gate competition yet in all parts of the country.
Q19 - Do you consider that greater confidence in the base milk price calculation outcomes could be achieved if additional legislative guidance on the term "practically feasible" were to be provided for in the DIRA?	Yes – from our perspective, "practically feasible" means: • the basket of reference commodity products produced consumes all the milk supplied; • only the milk supplied during the season is used to manufacture the products sold during the season; • it is possible to manufacture the amount of product sold during a season from the milk supplied during that season • the notional processor has the available capacity to manufacture the basket of reference commodity products proportionally; • the costs of all the products that are manufactured and sold are included in the base milk price calculation including those that are very similar to but not exactly the same as the reference commodity products – in other words, that the accounting principle of matching revenue and costs is strictly adhered to; and • capital costs include any additional investment in fixed assets (if any) that provides surplus processing capacity and thereby product mix flexibility or optionality in order to maximise earnings.
Q20 - Do you consider that the base milk price should be set by an independent body (e.g. the Commerce Commission)?	No - Having an independent body, such as the Commerce Commission, set the price is not necessary if the level of transparency around the calculation of the base milk price is increased, so that the numbers can be verified by the market.
Q21 - Do you agree with our preliminary analysis of the DIRA impact on the domestic consumer dairy markets?	The preliminary analysis highlighted an on-going risk being that Fonterra and Goodman Fielder remain the only two large-scale dairy processors supplying the domestic consumer market and that Goodman Fielder remains almost entirely dependent on Fonterra for its milk supply. Without a large-scale competitor, Fonterra could exert market power over the wholesale supply of domestic consumer products.

Q22 - Are there any other factors that should be taken into account regarding the domestic consumer dairy markets?	A key factor inhibiting effective competition in the domestic consumer products market, and the ability of domestic consumer market suppliers to compete against FBNZ, is the lack of transparency about the terms between Fonterra and FBNZ.
Q23 - Are there any other options for the DIRA open entry requirements that you think should be considered?	We think that open entry for new milk supply to Fonterra could be phased out.
Q24 - What costs and benefits would each of the options for the DIRA open entry requirements create for your business?	Status quo – no impact. Repeal – significant for Westland. Amendment – no impact
Q25 - How well do you think each of the options for the DIRA open entry requirements would perform against the principles of good regulatory practice of promoting certainty and predictability of regulatory outcomes, transparency, cost-effectiveness and timeliness of regulatory processes?	We agree with MPI's analysis. The repeal option at this stage risks significantly weakening the effectiveness of the DIRA.
Q26 - What is your preferred option for the DIRA open entry requirements?	We think that open entry for new milk supply to Fonterra from new dairy conversions should be phased out. We believe that the tools and remedies that Fonterra has at its disposal to manage non-compliant farmers are sufficient for Fonterra to manage its reputational risk.
Q27 - Are there any other options for access to regulated milk for large dairy processors that you think should be considered?	This is not the main concern for Westland; however, we think there are two other options: 1. the eligibility provisions could be amended to exclude large dairy processors; and 2. the amount of regulated milk made available could be, say, the sum of 50 million litres minus the processor's own supply.
Q28 - Do you consider that the proposed 30 million litres threshold is too high or too low?	From the perspective of large processors who would need at least 200 million litres to make one plant economical, the 30 million threshold is too low.
Q 29 - What costs and benefits would each of the options for access to regulated milk for large dairy processors create for your business?	Status quo – no impact. Amendment – no impact. We think that the proposed amendment would effectively discourage any new investment.

Q30 - How well do you think each of the options for access to regulated milk for large dairy processors would perform against the principles of good regulatory practice of promoting certainty and predictability of regulatory outcomes, transparency, cost-effectiveness and timeliness of regulatory processes?	We think that the proposed amendment would effectively discourage any new investment from any entity other than those that already have a presence in New Zealand and no longer have any access to regulated milk in any case.
Q31 - Do you have a preferred option for access to regulated milk for large dairy processors?	We think that there are probably enough dairy processors in New Zealand for there to be sufficient farm gate competition even if there is not sufficient farm gate competition in some parts of the country yet. Of the two options, our preference is the status quo.
Q32 - Are there any other options for the base milk price calculation that you think should be considered?	MPI's description of the current situation highligh s the issue – that Fonterra is not required to change its approach, even if the Commission finds that the assumptions are not appropriate. In our opinion, Fonterra sh uld be required to change its approach if the Commission finds that the assumptions are not appropriate
Q33 - What costs and benefits would each of the options for the base milk price calculation create for your business?	The cost and b nefi s to Westland's business depend on the extent to which any of the options allow Fonterra to deviate from the right" base milk price. Of the thre suggested options, we think that the option to amend the DIRA to provide additional statutory guidance on th meaning of the term "practically feasible" is the one that is most likely to lead to the "right" milk price.
Q34 - How well do you think each f the options for the base milk price calculation would perform against the principles of good regulatory practice of promoting certainty and predictability of regulatory outcomes, transp rency, cost-effectiveness and t meliness of regulatory processes?	We think that the option to amend the DIRA to provide additional statutory guidance on the meaning of the term "practically feasible" is the one that is most likely to lead to the "right" milk price and therefore would perform best against the principles of good regulatory practice. Giving an independent body such as the Commerce Commission the statutory power to set the base milk price represents a high level of regulatory intervention, could increase uncertainty, and could lead to unintended consequences.
Q35 - Do have a preferred option for the base milk price calculation?	We consider Fonterra should be required to change its approach if the Commission finds that the assumptions being used are not appropriate and that non-GDT sales be excluded from the base milk calculation.
Q40 - How best do you consider "market dominance" could be measured?	A factory gate market does not yet exist and is highly unlikely to develop on its own accord. Therefore, regulation necessarily provides a factory gate proxy and will continue to need to until there are multiple (probably at least three)

	significant processors with their own milk supplies competing in the domestic consumer market.
Q41 - Are there any other options for the DIRA review and expiry provisions that you think should be considered?	No – we think that the options suggested by MPI cover the full spectrum of possibilities.
Q42 - What costs and benefits would each of the options for the DIRA review and expiry provisions create for your business?	Under the status quo option, the benefit of certainty is larger than the cost of the risk of the regulations remaining in plac for longer than they should.
Q43 - How well do you think each of the options for the DIRA review and expiry provisions would perform against the principles of good regulatory practice of promoting certainty and predictability of regulatory outcomes, transparency, cost-effectiveness and timeliness of regulatory processes?	We think the status quo performs the best aga nst the principles of good regulatory practice. We think that the probability of the regulations remaining in place for too long is very low.
Q44 - Do you have a preferred option, or a combination of options, for the DIRA review and expiry provisions?	We favour the status uo We regard the benefit of the certainty that this b ings to the industry as being larger than the cost associated with the regulations staying in place for too long.

Introduction

This report focuses on the regulatory aspects[3] pertaining to the dairy markets that are of particular interest to Westland.

TDB Advisory Ltd (TDB) assisted Westland Co-operative Dairy Company Ltd (Westland) to provide a report on the Discussion Document, released by the Ministry of Primary Industries (MPI) in November 2018, reviewing the Dairy Industry Restructuring Act, 2001.

This report covers the costs and benefits of the various options presented in the Discussion Document. It is important to note that in assessing the options, costs and benefits from a national economic welfare perspective are considered rather than the costs and benefits specifically to Westland or any other individual company.

Westland's primary areas of interest with respect to this DIRA review are in the area of the open entry, open exit, and base milk price regulations. The company's position with respect to open entry and exit remain consistent with those detailed in its initial submission on the DIRA review dated June 2018[4]. That submission is appended to this report and we refer back to that submission in answer to a number of the questions posed by the MPI in its DIRA Discus ion Document dated November 2018.

Accordingly, while Westland offers brief answers to most of the questions posed, its detailed focus is on the questions concerning the base milk price.

Section 3.6 of MPI's Discussion Document asks the question: does the DIRA promote sufficient confidence in the base milk price calculation? We answer that question in the next section before answering MPI's specific questions (as numbered) in the following section with specific attention paid to MPI's questions about the base milk price being questions 19 and 20. We have not answered questions 36-39 that relate to Goodman Fielder and smaller processors.

[3] As is the practice in the MPI Discussion Document, we use the term 'regulations': to cover both the Dairy Industry Restructuring Act 2001 and the associated regulations.

[4] See Appendix A - Westland Milk Products initial submission on the DIRA review.

Does the DIRA promote sufficient confidence in the base milk price calculation?

We do not think that DIRA promotes sufficient confidence in the base milk price calculation.

For example, the report recently commissioned by the Fonterra Shareholders' Council and completed by Northington Partners[5] (Shareholders' Council report) reports that the farmgate milk price (FGMP) is now 28.3 cents higher than it would otherwise be because of items (for example, efficiency gains) attributable to Fonterra. However, these asserted efficiency gains are not obvious. If the 2012 FGMP Statement is compared to the 2018 FGMP Statement, cash costs per kilogram of milk solids are highe now than they were in 2012 ($1.16 versus $1.10). If that is the case, efficiency gains must mean that the notional processor is using less milk to produce each tonne of reference commodity product sold. If we examine Fonterra's FGMP Statement disclosures that appears to be the cas , but the numbers are hard to reconcile.

The 2012 FGMP Statement discloses that the notional processor was able to produce 2.819 million tonnes of reference commodity products from 1.493 billion kgMS I other words, 530 kgMS were used in the production of each tonne of reference commodity prod ct That compares with a theoretical requirement of 531 kgMS per tonne of reference commodity product based on what the notional processor would have produced that year and accordi g to he fat and protein specifications of each of the reference commodity products (and assuming an unrealistic 100% processing yield).

In the 2018 FGMP Statement, it is disclosed that the notional processor was able to produce 2.886 million tonnes of reference commodity products from 1.505 billion kgMS. In other words, 521 kgMS were used in the production of each tonne of reference commodity product. That again compares with a theoretical requirement of 531 kgMS per tonne of reference commodity product based on what the notional processor would have produced that year and according to the fat and protein specifications of each of the reference commodity products (and assuming an unrealistic 100% processing yield).

If we use the theoretical 531 kgMS per tonne of reference commodity product and assume a more realistic 98% yield, the 2017/18 FGMP would have been 25 cents less than its calculated $6.74.

Given the weighted average cost of capital charge on fixed assets in the 2017/18 season was 25 cents, this efficiency question is obviously material from a contestability perspective.

We have not tri d to reconcile the difference between the actual and the theoretical as any attempt to do so would be speculation.

The price Fonterra pays dairy farmers for milk is a key industry metric that drives both Fonterra's and independent processors' profitability. Fonterra's market dominance means that its milk price effectively sets the default price that all dairy processors must match or better to attract and maintain supply from farmers.

The DIRA does not regulate the price Fonterra pays farmers for milk. However, it does require "the setting of a base milk price that provides Fonterra with an incentive to operate efficiently while providing for contestability in the market for the purchase of milk from farmers".

[5] Fonterra Shareholders' Council Values Review 2018, Northington Partners, Nov 2018.

According to the legislation, “the setting of a base milk price provides for contestability in the market for the purchase of milk from farmers if any notional costs, revenues, or other assumptions taken into account in calculating the base milk price are practically feasible for an efficient processor”.

In other words, an efficient processor should be able to manufacture and sell the reference commodity products in the same proportions as the notional processor and earn an adequate return on capital employed.

We consider “practically feasible” to mean:

- the basket of reference commodity products produced consumes all the milk supplied;
- only the milk supplied during the season is used to manufacture the products sold during the season;
- it is possible to manufacture the amount of product sold during a season from the milk supplied during that season;
- the notional processor has the available capacity to manufactur the basket of reference commodity products proportionally;
- the costs of all the products that are manufactured and sold are included in the base milk price calculation including those that are very similar o but not exactly the same as the reference commodity products – in other words, the accounting principle of matching revenue and costs is strictly adhered to; and
- capital costs include any additional investment in fixed assets (if any) that provides surplus processing capacity and thereby product mix flexibility or optionality in order to maximise earnings.

The DIRA also:

- sets out the pu pose and principles to underpin Fonterra’s base milk price calculation;
- requires Fonterra to maintain certain milk price governance arrangements;
- impos s certain milk price information disclosure obligations on Fonterra; and
- p ovides for the Commerce Commission to monitor Fonterra’s methodology and calculation of the base milk price.

The purpose of these provisions is to promote transparency and confidence in the base price that guides Fonterra’s and other dairy processors’ prices they pay farmers for milk. We think that the efficiency example above shows a lack of transparency.

It is also possible that the total shareholder return metric for an investment in Fonterra shows a lack of confidence by dry investors because of a lack of transparency.

The Shareholders’ Council report referred to above reports that $1.00 invested in Fonterra when it was established in 2001 is now worth $2.84 as a consequence of share price appreciation and pre-tax dividends, representing an annual pre-tax return to farmers of 6.3% compared to a pre-tax return of 9.6% on $1.00 invested in the NZX 50 over the same period of time. [6]

While Fonterra's risk profile relative to the NZX 50 risk might justify a lower return by Fonterra over time, we think returns on investments in Fonterra have probably been negative since the introduction of Trading Amongst Farmers in November 2012.[7] It is apparent returns have been negative, i.e. the share price has decreased by more than the sum of the dividends received, throughout the last five years. This negative return compares to a return on Synlait Milk Limited shares of 18.4% during the last five years.

While Fonterra has had some extraordinary and non-recurring losses particularly during the last year, in two of the last five years, the FGMP has been extraordinarily low and therefore Fonterra should have been extraordinarily profitable. This makes it difficult to explain negative total shareholder returns over the same period.

One reasonable explanation is that the share price has under-performed because dry shareholders have not been able to reconcile the company's earnings performance relative to commodity prices and therefore the FGMP.

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[6] Fonterra Shareholders' Council Values Review 2018, Northington Partners, Nov 2018 at page 2.

[7] Fonterra Shareholders' Council Values Review 2018, Northington Partners, Nov 2018 at page 4. The numbers required to support this statement are not actually specified in the Northington Report. A graph in the report shows total shareholder returns since the establishment of Fonterra. That graph shows the date on which Trading Amongst Farmers was introduced and indicates negative overall returns since that date.

Questions posed in the MPI Discussion Document (as numbered)

Question 1 - Do you agree with our description of the DIRA regulatory regime and its original policy rationale? Do you consider the original policy rationale is still valid?

We agree with the **original policy rationale and consider that the rationale is still valid.** That is:

- maximise the economic performance of the dairy industry by allowing the structure of the industry to evolve in response to changes in the domestic and global dairy industry;
- remove constraints on dairy industry performance created by the structure that was imposed by existing legislation (including the export monopoly of the New Zealand Dairy Board);
- facilitate the emergence of new competition and new strategies in the dairy industry;
- limit the potential for dairy farmers, New Zealand consumers and other firms or co-operatives in the dairy industry to be adversely affected by the use of monopoly power by the merged entity; and
- ensure lowest regulatory and compliance costs while achieving the above objectives.

However, we **disagree with aspects of the description of the impacts of the DIRA regulatory regime.** For example, we disagree that the DIRA incentivises Fonterra to use price signals as a means of managing the volume of its milk supply.

The Discussion Document notes that “higher prices for farmers’ milk and a lower cost of shareholding tend to incentivise increased milk production. If Fonterra sets a milk price that is “too high” and the cost of shareholding in Fonterra that is “too low” it risks incentivising farmers to produce excessive volumes of milk. Of necessity**, excessive milk production will require additional investment in additional processing capacity that is capable of managing large volumes”[8].**

From the shareholders’ or the overall economy’s perspective, **that additional investment will be inefficient.**

As a consequence of a “too high” milk price, it could be argued that **growth in milk production has been more than it might otherwise have been, which has led to rapidly appreciating land values, “too low” earnings leading to a low-cost shareholding in Fonterra, and investment in commodity processing rather than value-add.**

It is also possible that the low-cost shareholding in Fonterra has incentivised farmers to switch supply to independent processors, because farmers do not need to supply Fonterra to get the benefit of a too high milk price and rapidly appreciating land values. **The rational response from farmers would be to switch their investment out of under-performing Fonterra shares into over-performing land.**

[8] Review of the Dairy Industry Restructuring Act 2001 and its impact on the Dairy Industry Discussion Document. *Ministry of Primary Industries* at page 13.

Question 2 - Are there any other dairy industry developments or industry performance indicators that are not captured in Chapter 2, Appendix 1, or the reports by Frontier Economics? Please provide details and supporting evidence.

We do not believe that large-scale dairy processors established in New Zealand since 2004 have focused on higher value products.[9] **The dominant product** being manufactured by Open Country Dairy, Synlait Milk, and Miraka is whole milk powder in specifications that **match or nearly match the reference commodity product.** Cheddar cheese, while not a reference commodity product, is a near-commodity.

Question 3 - Do you consider the DIRA has been effective at achieving its core regulatory objective of preventing Fonterra from using its dominance to create barriers to farmers' milk and land allowing to their highest value uses? If not, please provide reasons and supporting information/evidence.

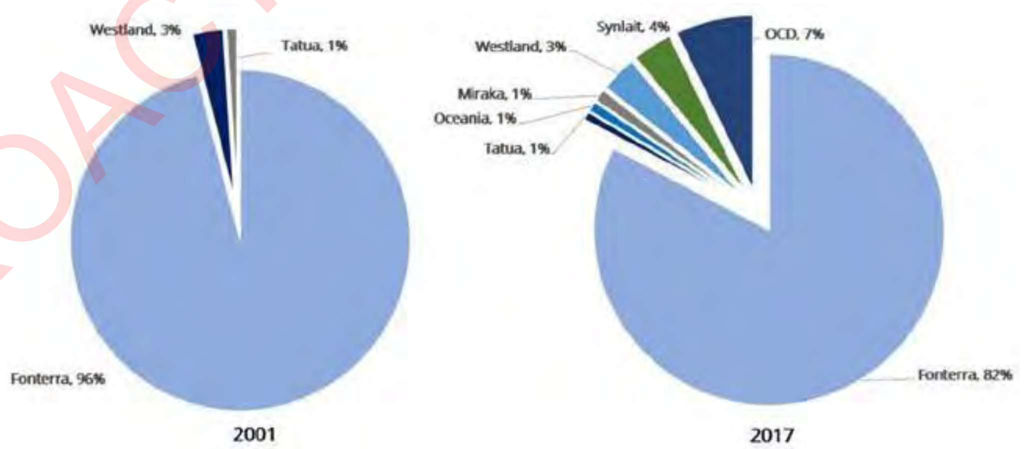
We agree that the **DIRA has been effective in preventing Fonterra from creating barriers, which means that farmers have been able to switch their supply away from Fonterra.**

However, following on from question 1 above, the DIRA appears **not to have created enough incentive for Fonterra not to pay a "too high" milk price to its suppliers** (and therefore all farmers), which, all other things being equal, means that **potential investment in value-added products has not been as attractive as it otherwise would have been.**

Question 4 - Do you think Fonterra is still dominant in the market for farmers' milk, at the national and regional levels?

Yes – at a national level its share of total milk supply is 82% with the remaining 18% divided between the other six processors.

Figure 1: Farm gate competition in 2001 and 2017



[9] Review of the Dairy Industry Restructuring Act 2001 and its impact on the Dairy Industry Discussion Document. *Ministry of Primary Industries*. Page 16.

At a regional level, of the 11 regional groupings, **Fonterra has no competition in five and more than one competitor in only two.**[10]

Figure 2: Map of farm gate competition

Question 5 - Do you think the DIRA imposes unreasonable costs on Fonterra? If so, please provide supporting information/evidence.

No – the anticipated benefits of the establishment of Fonterra (to its shareholders) were $310 million per annum. We estimate that the costs imposed on Fonterra are near $25-$30 million.[11]

Question 6 - Are there ways for the costs imposed on Fonterra to be mitigated without impacting on the effectiveness of the DIRA regulatory regime? If so, please provide supporting information.

We do not think that the costs imposed on Fonterra need to be mitigated. The anticipated net benefit to Fonterra's shareholders was significant. The question of whether or not those anticipated benefits have been realised is a moot point. **Those not being realised is not a reason for their mitigation to be considered.**

[10] For more discussion on this point please see section 3.6.2 of the Westland Milk Products Initial Submission on the DIRA review.

[11] For more discussion on this point see page 15 and Appendix 1 of the Westland Milk Products Initial Submission on the DIRA review.

Question 7 - Are there any other regulatory tools that, in your opinion, would be more effective than the current DIRA provisions at managing Fonterra's dominance? If so, please provide examples and supporting information/evidence.

No – in our opinion the **DIRA has been and continues to be reasonably effective. The only part of the market that has not developed is the factory gate market.** That has meant that domestic consumer market competitors largely remain dependent on Fonterra for their milk supply. We think that it is highly unlikely that a factory gate market will develop.[12]

Question 8 - Are there other factors you consider need to be taken into account when considering the effectiveness of the DIRA regime and whether it is still needed?

We think that open entry for new dairy conversions could be phased out. We think all other parts of the DIRA need to be retained.[13]

Question 9 - Do you agree with our preliminary assessment of the extent to which the DIRA encourages industry growth? If not, please provide reasons and supporting information/evidence.

We agree – the **DIRA enabled industry volume growth rather than drove it.** Most specifically, it enabled it by allowing new capital to be invested in additional processing capacity via new independent processors.

Question 10 - Do you agree with our preliminary assessment of the extent to which Fonterra can influence milk supply volumes through price, notwithstanding the DIRA open entry requirements?

Yes – to a degree. Fonterra could have decided to pay farmers less or more for their milk to manage its milk supply. The problem with paying less is the extent to which it would have been "too low" and therefore would have encouraged inefficient investment in new processing capacity by independent processors. **Paying less for milk implies that the processor earns more. If those earnings are artificially or temporarily inflated so potential new independent processors could initially earn more than their cost of capital, any resulting investment would have ultimately been inefficient.**

Question 11 - Are there other factors that you consider should be taken into account? Please provide detailed comment in support of your views.

The **suggested relationship between dividend policy and milk supply is questionable – we suggest any relationship would be weak.** For farmers, given the link between supply volumes and shareholding, we suggest that **the important ratio is the ratio of dividends paid versus share price.**

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[12] For more discussion on this point see section 3.7.7 of the Westland Milk Products Initial Submission on the DIRA review.

[13] For more discussion of this point see section 1.2 of the Westland Milk Products Initial Submission on the DIRA review.

Contrary to what is written in the discussion document[14], **investment in higher value-add products is riskier than investment in commodities** (reflected in there being a higher required rate of return by investors in value-add products). **Farmers' earnings only become less volatile if their milk pay-out includes both a commodity milk price component and a contribution from the value-added activities of the processor** such that low commodity prices are offset by high value-add earnings and vice versa.

Also, Fonterra **does not have the ability to increase or decrease the cost of supplying it by varying the number of shares farmers must own to supply Fonterra.** The market determines the value of Fonterra's equity. The value of that equity divided by the number of shares on issue determines the share price. **If the number of shares on issue changes via a bonus issue, so too does the share price proportionally.**

The cost to farmers of the mentioned bonus share issue was the decrease in the value of the shares they already owned and the increase in financial risk associated with the extra debt required to build the processing capacity to process the additional milk.

Question 12 - Do you consider that the DIRA provisions governing Fonterra's base milk price calculation and Commerce Commission monitoring may be preventing or disincentivising Fonterra from deviating from the base milk price calculation for strategic or commercial reasons?

No - for example, the report recently commissioned by the Fonterra Shareholders' Council[15] implies that Fonterra's actual return on capital has been less than its required return on capital because it has been able to increase the farmgate milk price (FGMP) by 28.3 cents. In other words, it suggests that Fonterra has transferred value out of earnings and into the FGMP.

Fonterra may have made a strategic decision to pay more rather than less for milk, in order to retain farmers and/or discourage new processors. If so, we think that this strategic decision has led to a number of **unintended consequences**, **including incentivising Fonterra suppliers to switch to an independent processor, where they can obtain the same or similar "high" milk price, and without the required investment in consequently underperforming Fonterra shares.** [16]

Question 13- If the DIRA is not driving Fonterra's business and investment strategy, what is? Please provide detailed comment in support of your views.

Like most other commercial entities, this strategy is driven by total shareholder value, social responsibility, and environmental sustainability. Investors are suggesting that **Fonterra has not created enough shareholder value** – particularly in the last five years – but that has **little to do with the DIRA; as shown by most of the other dairy processing businesses operating successfully in the same DIRA environment.**

[14] Review of the Dairy Industry Restructuring Act 2001 and its impact on the Dairy Industry Discussion Document. *Ministry of Primary Industries*. Page 25.

[15] Fonterra Shareholders' Council Values Review 2018, Northington Partners, Nov 2018 at page 25.

[16] See the discussion under the heading '*Does the DIRA promote sufficient confidence in the base milk price calculation.'* at pages 17-19.

Question 14 - Do you agree with our preliminary analysis of the DIRA's impact on the industry's environmental performance? If not, please provide your reasons and supporting evidence.

Yes – we agree with MPI's preliminary analysis: **the dairy industry and its growth have had a negative environmental impact**. **However, that growth has not been driven by the DIRA**. The Resource Management Act empowers local communities to make decisions on how their environment is managed.

Reputational risk is an industry-wide issue rather than just a Fonterra one. Fonterra (or any other processor), via the tools available to it, can drive a poor farmer out of the industry. That would be a reasonable action given the damage that a few farmers can cause to the industry's reputation.

Question 15 - Do you agree with our view that environmental issues are best dealt with through the Resource Management Act and not the DIRA regime?

Yes – we agree that **environmental issues are best dealt with through the Resource Management Act (RMA) and not the DIRA regime.** It would be poor public policy practice to have more than one piece of legislation governing the same resource-use issue. Any argument that suggests that environmental issues should be dealt with via the DIRA **implies that the RMA has been ineffective in which case the RMA should be made more effective**.

Question 16 - Are there other environmental issues that you consider should be addressed either through the DIRA review or some other means?

No – we think that **environmental issues should be addressed via specific legislation.**

Question 17 - Do you agree with our preliminary analysis of the impact the DIRA has on new processor entry? If not, please provide your reasons and information/evidence in support of your views.

Yes – the preliminary analysis is that **there are significant disciplines and constraints on new investment.** The establishment of a large processing plant involves significant amounts of capital, long term investment, and the need to generate sufficient returns to recoup and sustain that investment. Large dairy processors also have to pay a highly competitive milk price to secure sufficient milk supply volumes, including for regulated milk. It seems unlikely that just because farmers are able to switch their supply, large dairy processors would be making such substantial and long-term investments in the absence of a solid business case for such investments.

Furthermore, the **ability of farmers to switch back to Fonterra, in practice, may not be that easy**. It is possible that farmers who have switched from Fonterra to an independent processor have leveraged the capital from the sale of their Fonterra shares to invest in additional land or they have used it to repay debt. Under neither scenario will they necessarily have access to the capital required to switch back to Fonterra.

Question 18 - Do you consider that large dairy processors should continue to be eligible to purchase regulated milk from Fonterra under the Raw Milk Regulations or not? Please provide detailed comment in support of your views.

No – in our opinion, **there are already a sufficient number of large processors established in New Zealand for there to be sufficient farm gate competition.**

Table 1– Farm gate competition

Dairy Region	Total production (millions kgMS)	Percentage of national market (kgMS)	No. of IPs	Market share of the IPs	Strength of balance sheet
Northland	104	6%	0	0%	
Waikato	503	27%	2	15%	OCD – strong Tatua- strong Miraka - strong
Bay of Plenty	124	7%	0	0%	
Taranaki	180	10%	0	0%	
Hawkes Bay	16	1%	0	0%	
Whanganui / Manawatu	81	4%	1	49%	OCD – strong
Wellington / Wairarapa	59	3%	0	0%	
Westland / Tasman / Nelson / Tasman	85	5%	1	59%	Westland – moderate
Canterbury	385	21%	3	30%	Westland - moderate Synlait - strong Oceania - moderate
Otago	101	5%	1	6%	Danone - strong
Southland	223	12%	1	18%	OCD - strong
Total	1861	100%	9	100%	

However, it does not follow that there is sufficient farm gate competition yet in all parts of the country. Given the industry is likely to see only marginal milk production growth in the future, **we do not think that any future investment by new processors needs the same level of support from the DIRA.**

Question 19 - Do you consider that greater confidence in the base milk price calculation outcomes could be achieved if additional legislative guidance on the term "practically feasible" were to be provided for in the DIRA? Please provide detailed comment in support of your views.

Yes, we consider additional guidance on the term "practically feasible" could achieve greater confidence in the base milk price calculation. However, we also consider greater confidence could be achieved through more transparency in the way the FGMP is calculated.

As discussed in the first section of this submission[17], it does not seem practically feasible to produce 2.886 million tonnes of reference commodity products using 1.505 billion kgMS (being 521 kgMS per tonne of reference commodity product). The product specifications of the various reference commodity products together with the notional processor's product mix indicate that the production

[17] See the discussion under the heading '*Does the DIRA promote sufficient confidence in the base milk price calculation.*' at pages 17-19.

of 2.886 million tonnes of reference commodity products should have required 1.532 billion kgMS (being 531 kgMS per tonne of reference commodity product).

From our perspective, “practically feasible” means:

- the basket of reference commodity products produced **consumes all the milk supplied**;
- only the **milk supplied during the season is used to manufacture the products** sold during the season;
- it is possible to **manufacture the amount of product sold during a season** from the milk supplied during that season;
- the **notional processor has the available capacity** to manufacture the basket of refer nce commodity products proportionally;
- the costs of all the products that are manufactured and sold are **included in the base milk price calculation including those that are very similar to but not exactly the same as the reference commodity products** – in other words, that the accounting principle of matching revenue and costs is strictly adhered to; and
- **capital costs include any additional investment in fixed assets** (if any) **that provides surplus processing capacity** and thereby product mix flexibility or optionality in order to maximise earnings.

In our opinion, greater confidence could be further achieved by more transparency in the way the FGMP is calculated. In recent years, there have be n two significant changes to the FGMP calculation methodology that have reduced transparency:

- the inclusion of non-GDT sales; and
- the inclusion of non-reference commodity products.

An example from the Shareholders Council’s Report illustrates the point.

Page 6 of the Shareholders’ Council’s Report states that the difference between Fonterra’s actual return on capital and the weighted average cost of capital amounts to more than $2 billion during a 17-year period.

On the same page, it states *“the opportunity cost of around $2 billion is reflective of the Co-op’s inability to generate Shareholder value over and above the cost of capital for its owners. The 28.3 cents increase in the Milk Price since FY09 arising from Milk Price calculation method changes has been a key driver of this over the past five years…”.* In other words, the Council appears to be saying that Fonterra’s earnings were lower than they should have been because Fonterra was able to transfer earnings into the FGMP.

Essentially the value attributable to shareholders and measured via the share price is transferred to suppliers. This is apparent in increasing investment in farms and increasing farm prices and results in an inefficient allocation of capital from the overall economy’s perspective.

Further, the higher the FGMP is relative to revenue earned, the less profitable Fonterra will be. That being the case, the less attractive investment in value-added processing will appear to be and the less capital retained to fund additional value-add investment.

Question 20 - Do you consider that the base milk price should be set by an independent body (e.g. the Commerce Commission)? If so, please provide supporting information.

No – having an independent body such as the Commerce Commission set the base milk price is not necessary if the level of transparency around the calculation of the base milk price is increased such that the numbers can be verified by the market. We think that **sufficient transparency would be achieved if only GDT sales were included in the calculation.** That would necessarily mean that only the sales of the reference commodity products were also included in the calculation.

The impact of non-GDT sales on the FGMP seems to be increasing over time. Fonterra's original estimate was that non-GDT sales would add 5 cents to the FGMP. Last season it was 8 cents. This is material when it is considered against the notional processor's required rate of return on its investments in fixed assets of 25 cents.

It is not immediately obvious why the non-GDT sales premium would be increasing, other than if it were the consequence of an increasing premium being earned from sales of non-reference commodity products. It could be expected that **the premium would increase as the product specification difference between reference commodity products and non-reference commodity increased.** This is where the argument about what is a commodity (and therefore what should be included in the FGMP) begins.

Question 21 - Do you agree with our preliminary analysis of the DIRA impact on the domestic consumer dairy markets? Please provide your reasons and information/evidence in support of your views.

The preliminary analysis highlighted an on-going risk that Fonterra and Goodman Fielder remain the only two large-scale dairy processors supplying the domestic consumer market, and that Goodman Fielder remains almost entirely dependent on Fonterra for its milk supply. **Without a large-scale competitor, Fonterra could exert market power over the wholesale supply of domestic consumer products.**

On the one hand, the DIRA has enabled competition in the domestic consumer market by ensuring that domestic consumer market suppliers without their own milk supply have access to regulated milk.

On the other hand, the **DIRA has limited competition by limiting the amount of regulated milk these domestic consumer market suppliers can access.** In effect, **the restrictions in DIRA protect Fonterra's domestic market share.** It is also limiting the number of potential buyers of any domestic consumer market focused assets such as Tip Top that Fonterra might want to sell.

Question 22 - Are there any other factors that should be taken into account regarding the domestic consumer dairy markets? Please provide your reasons and information/evidence in support of your views.

A key factor inhibiting effective competition in the domestic consumer products market and the ability of domestic consumer market suppliers to compete against Fonterra Brands New Zealand (FBNZ) is the lack of transparency between Fonterra and FBNZ on their transaction terms.

Small processors without their own milk supply competing in the domestic consumer market need a flat milk curve. The provision of a flat milk curve, according to Fonterra, would inflict additional costs on it. **We note that small processors may agree to pay for a flat curve if the terms on which they were being supplied were the same as the terms on which Fonterra was supplying its own New Zealand domestic consumer business, FBNZ.**

Question 23 - Are there any other options for the DIRA open entry requirements that you think should be considered? Please provide sufficient detail when describing any alternative options as well as reasons for considering these.

As outlined in the Westland's initial submission[18], we think that **open entry for new milk supply to Fonterra from new dairy conversions could be phased out.** We believe that the **tools and remedies that Fonterra has at its disposal to manage non-compliant farmers are sufficient for Fonterra to manage its reputational risk.**

Question 24 - What costs and benefits would each of the options for the DIRA open entry requirements create for your business? Please provide quantitative information if possible.

Status quo – no impact. The tools and remedies that are available to Fonterra to manage its reputational risk are essentially the same as those available to Westland. **Those tools and remedies together with the RMA should be sufficient.**

Repeal – **significant impact in terms of Westland being able to attract new supply from Fonterra** if the identified chilling effect of the uncertainty regarding farmers being able to switch back to Fonterra if they wanted to is as significant as suggested in the discussion document.

Amendment – no impact. **The amendment would not lead to any improvement in Fonterra's or the industry's reputation.** In addition, we think that the tools and remedies that are available to Fonterra to **manage its reputational risk, together with the RMA, are sufficient.**

[18] For more discussion on this point see section 3.7.2 of the Westland Milk Products Initial submission on the DIRA.

Question 25 - How well do you think each of the options for the DIRA open entry requirements would perform against the principles of good regulatory practice of promoting certainty and predictability of regulatory outcomes, transparency, cost-effectiveness and timeliness of regulatory processes?

We agree with MPI's analysis. At this stage, **the repeal option risks significantly weakening the effectiveness of the Act's core regulatory purpose** - **to manage Fonterra's market dominance.**

On that basis, it would **represent poor regulatory practice.**

Question 26 - What is your preferred option for the DIRA open entry requirements? Please provide your reasons and information/evidence in support of your views.

As per Westland's initial submission[19], we think that **open entry for new milk supply to Fonterra from new dairy conversions could be phased out.**

If amended, there is a real need for clear objective criteria to determine when an applicant farmer can be rejected. The benefit of an amendment needs to outweigh the costs. **The proposed amendment increases legislative complexity and uncertainty for farmers as well as giving Fonterra 'discretion' to choose its shareholders.**

We believe that the tools and remedies that Fonterra has at its disposal to manage non-compliant farmers are sufficient for Fonterra to manage its reputational risk. Westland's experience is that robust environmental standards, along with regular monitoring and support by the company and, if necessary, the ability to impose financial penalties or to suspend milk collection are sufficient to manage the very small number of non-compliant farmers.

Question 27 - Are there any other options for access to regulated milk for large dairy processors that you think should be considered? Please provide sufficient detail when describing any alternative options as well as reasons for considering these.

This is not the main concern for Westland; however, we think there are two other options:

3. the eligibility provisions could be amended to exclude large dairy processors; and
4. the amount of regulated milk made available could be, say, the sum of 50 million litres minus the processor's own supply.

The eligibility provisions exist to encourage competition at the farm gate. If there is now sufficient competition at the farm gate, the eligibility provisions are no longer required. When the Commerce Commission last checked the state of competition at the farm gate in 2016, it found that there was insufficient competition. Since then, one new independent processor has entered the market (Mataura Valley) and three existing independent processors have or are in the process of building additional capacity (Open Country Dairy, Synlait Milk, and Oceania Dairies).

[19] For more discussion on this point see section 3.7.2 of the Westland Milk Products Initial submission on the DIRA.

Even if there still is not sufficient competition at the farm gate, we think that there are enough competitors such that there could be and that encouraging new large processors into the market by giving them access to regulated milk is no longer required.

Question 28 - Do you consider that the proposed 30 million litres threshold is too high or too low? If so, what would you consider the right threshold to be, and why?

From the perspective of large processors who would need at least 200 million litres to make one plant economical, the 30 million-litre threshold is too low.

It would likely limit for any processor wanting to compete in the domestic consumer market to approximately 5% of the domestic consumer market.

Question 29 - What costs and benefits would each of the options for access to regulated milk for large dairy processors create for your business? Please provide quantitative information if possible.

While Westland is not affected by these provisions we consider:

Status quo – no impact.

Amendment – no impact. We think that **the proposed amendment would likely discourage any new investment from any entity other than those that already have a presence in New Zealand** and no longer have any access to regulated milk in any case

Question 30 - How well do you think each of the options for access to regulated milk for large dairy processors would perform against the principles of good regulatory practice of promoting certainty and predictability of regulatory outcomes, transparency, cost-effectiveness and timeliness of regulatory processes?

We think that the proposed amendment would likely discourage any new investment from any entity other than those that already have a presence in New Zealand and no longer have any access to regulated milk in any case.

If the intention of the amendment is to try and direct more of the regulated milk to domestic consumer market competitors, **then if the amendment effectively limits the size of these competitors to a very small proportion of the market, this would be poor regulatory practice.**

Question 31 - Do you have a preferred option for access to regulated milk for large dairy processors? Please provide your reasons and information/evidence in support of your views.

The industry in New Zealand has changed significantly since Fonterra was established. The most significant change in this context being that the industry has probably reached peak-cow and therefore the growth in milk supply will slow significantly and likely to come mostly from genetic advances (cow or pasture). There is probably already excess processing capacity in New Zealand.

We think that there are probably enough dairy processors in New Zealand for there to be sufficient farm gate competition, even if there isn't enough farm gate competition in some parts of the

country yet. In other words, we think that the existing processors could gain sufficient share of the milk supply market for it to be determined that there is sufficient competition at the farm gate.

Of the two options, our preference is the status quo. We agree with MPI's analysis: there are significant disciplines and constraints on new investment and, more often than not, large dairy processors would not necessarily be Fonterra's closest competitors in export markets. We think that access to regulated milk is probably a necessary, but not sufficient condition, for new large processors to consider investing in New Zealand.

Question 32 - Are there any other options for the base milk price calculation that you think should be considered? Please provide sufficient detail when describing any alternative options as well as reasons for considering these.

MPI's description of the current situation highlights the issue: that **Fonterra is not required to change its approach, even if the Commission finds that the assumptions are not appropriate.** For example, last year the Commission determined that the asset beta being used to calculate the FGMP is too low to be practically feasible. Fonterra chose not to change the asset beta it uses. We estimate the impact of the asset beta being too low is the FGMP being too high by approximately 3-4 cents.

In our answer to question 19, we highlighted the decrease in transparency introduced by non-GDT sales being included in the base milk price calculation, which subsequently allowed sales of non-reference commodity products to be also included in the base milk price calculation. We think that **only GDT sales should be used to calculate the base milk price and that would also mean that only sales of reference commodity products are used.**

These proposed changes would not mean that farmers earn less. They just mean that the components of their total earnings change.

Question 33 - What costs and benefits would each of the options for the base milk price calculation create for your business? Please provide quantitative information if possible.

The cost and benefits to Westland's business depend on the extent to which any of the options allow Fonterra to deviate from the "right" base milk price. The cost of a **"too high" milk price** for Westland's business is that it leads to **under-investment in Westland's value-added strategy** because its value-added earnings are understated. The **cost of a "too low" milk price** is that it could lead to **inefficient over-investment in Westland's value-added strategy.**

Of the three suggested options, we think that the option to amend the DIRA to provide **additional statutory guidance on the meaning of the term "practically feasible" is the one that is most likely to lead to the "right" milk price.**

The status quo is likely to mean that **the milk price will continue to tend to be high.**

Giving an independent body, like the **Commerce Commission, the statutory power to set the base milk price for the dairy industry is not a practical solution**. In particular, this would require the product mix to be fixed, whereas currently Fonterra can flex its production to maximise earnings from sales of reference commodity products according to current fat and protein prices.

We believe that any introduced **rigidity could lead to unintended consequences such as inefficient investment.**

Question 34 - How well do you think each of the options for the base milk price calculation would perform against the principles of good regulatory practice of promoting certainty and predictability of regulatory outcomes, transparency, cost-effectiveness and timeliness of regulatory processes?

History has shown that the status quo has led to uncertainty, a lack of predictability of regulatory outcomes, and a lack of transparency.

We think that the option to **amend the DIRA to provide additional statutory guidance on the meaning of the term "practically feasible" is the one that is most likely to lead to the "right" milk price** and therefore would perform best against the principles of good regulatory practice.

We think that giving an independent body such as the Commerce Commission the statutory power to set the base milk price represents a high level of regulatory intervention, could increase uncertainty, could lead to unintended consequences such as inefficient investment, and represents poor regulatory practice.

Question 35 - Do have a preferred option for the base milk price calculation? Please provide your reasons and information/evidence in support of your views.

Our preference is that **Fonterra should be required to change its approach if the Commission finds that the assumptions being used are not appropriate and that non-GDT sales be excluded from the base milk calculation.**

Question 36 - Are there any other options for access to regulated milk for Goodman Fielder and smaller processors that you think should be considered? Please provide sufficient detail when describing any alternative options as well as reasons for considering these.

N/A

Question 37 - What costs and benefits would each of the options for access to regulated milk for Goodman Fielder and smaller processors create for your business? Please provide quantitative information if possible.

N/A

Question 38 - How well do you think each of the options for access to regulated milk for Goodman Fielder and smaller processors would perform against the principles of good regulatory practice of promoting certainty and predictability of regulatory outcomes, transparency, cost-effectiveness and timeliness of regulatory processes?

N/A

Question 39 - Do you have a preferred option, or a combination of options, for access to regulated milk for Goodman Fielder and smaller processors? Please provide your reasons and information/evidence in support of your views.

N/A

Question 40 - How best do you consider "market dominance" could be measured? For example, are there certain criteria (other than a market share threshold) that could be provided for in legislation as a trigger for review and/or expiry of the DIRA?

There are, in fact, two markets: the farm gate market and the factory gate market. The factory gate market is the more important of the two – certainly from a domestic consumer market perspective.

A **factory gate market does not yet exist** and is highly unlikely to develop on its own accord. Therefore, **regulation necessarily provides a factory gate proxy**. Regulation will continue to be needed until there are multiple (probably at least three) significant processors with their own milk supplies competing in the domestic consumer market.

Question 41 - Are there any other options for the DIRA review and expiry provisions that you think should be considered? Please provide sufficient detail when describing any alternative options as well as reasons for considering these.

No – we think that the options suggested by MPI cover the full spectrum of possibilities.

Question 42 - What costs and benefits would each of the options for the DIRA review and expiry provisions create for your business? Please provide quantitative information if possible.

Under the **status quo option, the benefit of certainty is larger than the cost of the risk of the regulations remaining in place for longer than they should**. Also, we think that there is little risk of Fonterra being regulated for too long as it will continue to advocate for the removal of the regulations.

The cost of the **periodic review option is that it discourages investment in the domestic consumer market** because of the uncertain investment time horizon. We consider **that cost to be greater than the benefit** of not being regulated for too long.

The cost versus benefit of the market threshold review option is similar to the periodic review option in that it will **discourage investment as the market threshold is approached because of the uncertainty created by the upcoming review**.

The **cost of removing regulations too early is much more significant** than the benefit of not being regulated for too long, and we believe the **risk of the regulations being removed too early as a consequence of having an automatic expiry is too high.**

Question 43 - How well do you think each of the options for the DIRA review and expiry provisions would perform against the principles of good regulatory practice of promoting certainty and predictability of regulatory outcomes, transparency, cost-effectiveness and timeliness of regulatory processes?

We think the status quo performs the best against the principles of good regulatory practice.

Question 44 - Do you have a preferred option, or a combination of options, for the DIRA review and expiry provisions? Please provide your reasons and information/evidence in support of your views.

We favour the status quo. We regard the benefit of the **certainty that this brings to the industry as being larger than the cost associated with the regulations staying in place for too long.** In addition, we think that there is little risk of Fonterra being regulated for too long as it will continue to advocate for the removal of the regulations.

Appendix A – Westland Milk Products initial submission on Dairy Industry Restructuring Act Review

Westland Milk Products
Hokitika · New Zealand

DAIRY INDUSTRY RESTRUCTURING ACT REVIEW

Initial Submission from Westland Milk Products

June 2018

Disclaimer

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1. Introduction and summary

1.1 Introduction

Westland Milk Products (Westland) is a key economic driver of the West Coast economy and New Zealand's second biggest dairy cooperative. Dairy is also the biggest single contributor to GDP on the West Coast and consistently contributes almost a quarter of a billion dollars annually ($234.4 million in 2016 alone.)

Westland has 342 shareholding farmers and over 420 supplying farms. It employs 555 staff in total as well as indirect supplier jobs and contributes to considerable economic 'spill overs' to the region. During the deliberations which became the Dairy Industry Restructuring Act 2001 (DIRA), Westland chose to remain an independent processor in order to maintain processing on the West Coast. The company believes that New Zealand needs strong independent processors that work as part of NZInc and that it is very important to counter against any global perception of New Zealand having a state-supported monopoly.

Westland agrees with our economic experts, TDB, in that the DIRA enabled Fonterra to be set up as a near monopoly / monopsony in New Zealand's dairy markets. DIRA was designed to be the counter-balance. It included a number of provisions designed to foster competition at the farm gate and to protect New Zealand dairy product consumers. The key "contestability" provisions that apply to Fonterra are:

- open entry;
- open exit;
- no discrimination between suppliers;
- the right for Fonterra suppliers to supply up to 20 percent of their weekly production to an independent processor; and
- the setting of the base milk price.

In addition, the Dairy Industry Restructuring (Raw Milk) Regulations 2012 (DIRA regulations) require Fonterra to supply raw milk to Goodman Fielder and independent processors (IPs) subject to certain conditions.

DIRA was originally envisaged as temporary legislation with automatic expiry provisions once certain milk-supply thresholds were met. Those automatic expiry provisions have now been removed.

The objectives of the current review by the Government are to ask:

- is the DIRA regulatory regime operating in a way that protects the long-term interests of New Zealand dairy farmers, consumers and the nation's overall economic, environmental and social wellbeing?
- does the DIRA regulatory regime give rise to any unintended consequences manifesting themselves in other parts of the wider regulatory system and, if so, to what extent? and

- does the purpose and form of the DIRA regulatory regime remain fit-for-purpose, given the dairy industry's current structure, conduct and performance, as well as the global and domestic challenges and opportunities facing the industry, the wider regulatory system within which it operates, and the Government's broader policy objectives?

1.2 Executive summary

The DIRA contestability provisions have helped protect the long-term interests of New Zealand dairy farmers, consumers and the nation's overall economic wellbeing. This is demonstrated by:

- farmers have an increasing level of farm gate competition;
- New Zealand consumers have been at least partially protected from the adverse impact of the formation of Fonterra to the extent that there is more competition in the domestic market now than there was, although in our opinion, regulatory changes are required o remove the competitive limits unintentionally imposed; and
- the dairy industry continues to be an important contributor to New Ze land s economic health.

It is recognised that the dairy industry's environmental impact has worsened as intensification has increased and as land has been converted to dairy. We consider hat at the margin, DIRA's open-entry provisions have contributed to this outcome and could be phased out without imposing significant costs.

The poor environmental situation (and, probably more importantly, the industry's slow and hesitant response to it) means that there is a lot of discussion ow about dairy farmers having lost their social license to operate. From that perspective, we would argue that DIRA has not protected the nation's wellbeing. However, we would argue that any environmental protections required should be imposed by generic environmental legislation rather than through DIRA.

The purpose of the DIRA regulatory regime remains fit-for-purpose, although we would recommend the following changes:

- we contend that open-entry (and open re-entry) <u>could be</u> phased out. To be clear, by open entry and open re entry we mean milk from new dairy conversions. We do not mean that Fonterra co ld not choose to collect milk from an existing dairy farm. Open entry has contributed to the development of marginal farming land so we would be happy to have that area clo ed to entry. We do not want to see a situation whereby any farmer would not have their milk collected;
- the base milk price provisions remain crucial, but we would recommend a number of changes to the milk price methodology as follows:
  - Fonterra's average currency conversion rate should be excluded from the calculation,
  - non-Global Dairy Trade sales should be excluded from the calculation, and
  - the asset beta used should not be that of the hypothetical efficient processor, but that of the industry. (Note – this is a different discussion to the one that the Commerce Commission is currently consulting on.);

- the special provisions relating to Goodman Fielder should be removed and Fonterra should be required to supply 100 percent of the raw milk required by any domestic dairy products market competitor; and
- full accounting separation and reporting of Fonterra and FBNZ should be required.

The recommended changes to the milk price methodology are intended to increase the transparency of the calculation. Currently, Westland believes Fonterra's prices appear to be unacceptably manipulated.

With regard to the domestic market, the highly seasonal nature of the milk production in New Zealand relative to the pattern of domestic demand, and the absence of a factory gate market mean that domestic competitors are largely reliant on Fonterra for their milk supply. The raw-milk supply provisions, therefore, essentially limit the size of domestic competitors by limiting their access to 50M litres of milk (or 250M litres in the case of Goodman Fielder (GF)). We consider that the individual company limits should be removed and all potential suppliers to the domestic market be treated equally in terms of their access to Fonterra milk. Full accounting separation and reporting of Fonterra and FBNZ is required to ensure that FBNZ's ability to compete in the domestic market is not being subsidised by another part of the business.

Westland believes that there are some unintended outcomes from the DIRA such as the dominant player mentality displayed by Fonterra. We want measures in place that prevent discriminatory behaviour. For this we see a need for the legislation to potentially be strengthened in a way that prevents abuse of market power and the maintenance and encouragement of true contestability.

Table 1: Summary responses to MPI's questions

Question	Summary response
1. Benefits of 2001 industry restructure realised?	• There is little evidence that Fonterra has delivered the anticipated benefits to farmer/shareholders • The anticipated benefits for farmer/shareholders were $310 million per annum • We estimate that those benefits should translate into a theoretical share price now of $8.43 versus the current actual price of $5.15 • We estimate that, in the absence of those benefits, the theoretical share price now should be $6.07
2. Is the DIRA contestability regime contributing to and/or impeding the sector's performance?	• Leaving aside the original mega-merger, performance and competition within the dairy sector has not been impeded by DIRA • Fonterra's farm gate market share has decreased by 14 percent in 16 years – from 96 percent to 82 percent • Five new IPs have started up since Fonterra was established, with one of those failing. An additional two new IPs have announced their intention to build new processing plants. Along with Westland and Tatua, the addition of the two new companies would bring the total number of IPs competing with Fonterra at the farm gate to eight • The organisational structures of IPs range from co-operative companies to private companies to publicly listed companies

	• The strategies employed by the IPs range from commodity to business-to-business to consumer products • We estimate that capital of approximately $19 billion has been invested by the processors since 2001
3. Who is benefiting?	• Farmers – the amount of on-farm investment since 2001 indicates that farmers have been earning an adequate return on their investment • Processing company shareholders – the return on asset performance of the IPs vis-à-vis their capital cost is variable • NZ Inc – the contribution of the sector to the NZ economy continues to be significant • However, it is generally accepted that the environment has suffered as a consequence of dairying. It could be argued that DIRA has contributed to that outcome
4. What incentives exist for the dairy industry to transition to higher value products?	• There isn't any incentive but neither is there any disincentive • Moving up the value chain brings potential for higher investment returns • Moving up the value chain also increases risk • The challenge for companies is to create value rather than to necessarily move up the value chain • The Government's role is to create an environment that allows the processors and their shareholders to make their own decisions about their business strategy and how much risk they want to take
5. Are the current contestability provisions still fit-for-purpose?	• The incentives and ability for Fonterra to operate to the detriment of the long-term dynamic efficiency of the broader dairy industry remain and, with stalled milk growth, might be stronger now than they were in 2001 • There is more competition at the farm gate now than there was in 2001 and there have been a number of announcements since the last Commerce Commission review regarding increasing competition at the farm gate • There is more domestic consumer market competition now than there was in 2001, although there are a number of unintended consequences with respect to the raw-milk supply provisions • No factory gate market has developed
6. What changes are required? 7. Are changes to the industry and/or the DIRA regulatory regime required?	• The open-entry provision is no longer required • The base milk price provision is still required but changes are needed to make the calculation of the FGMP more transparent • Fonterra's obligation to supply raw milk destined for the domestic market to competitors should not be capped
8. Is the domestically-focused dairy sector operating in the long-term interests of New Zealand consumers?	• The domestic market is still dominated by the same two companies (although one has a different owner – GF) • In the grocery channel, we estimate that Fonterra and GF's combined market share has decreased by 8 percent (from approximately 95 percent to 87 percent) since 2001

	• The milk-supply volume limits do not restrict the number of domestic competitors that could emerge but do unnecessarily limit the absolute and relative size of any of those competitors in an environment of domestic market growth
9. Are there significant economies of scale in the collection, processing, and wholesale distribution of into domestic consumer markets?	• Yes – in two areas – collection costs and capacity costs • The domestic market requires a flat milk curve supplying constant monthly milk volumes • The NZ milk-production curve is not flat. There is twenty times more milk produced in the peak month than there is in the low month • We estimate that 10 to 15 percent of Fonte ra supplie s supply winter milk • A larger proportion would require the processor to either pay higher winter-milk premiums than Fonterra or to travel further to collect milk • A larger proportion would require the processor to hold more capacity in reserve to manage daily demand fluctuations
10. What would the domestically-focused dairy sector look like in the absence of the DIRA regulations?	• The absence of DIRA regulations would lead to fewer competitors and high r pri es fo domestic consumers as per the Commerce Commission's 2016 report
11. Does the DIRA regulatory objective of ensuring "competition in the wholesale supply of domestic consumer dairy products" remain fit-for-purpose?	• Yes – the regulatory objective remains fit-for-purpose, although chang s to the regulations are required to remove the d sincentive that potential domestic competitors have to invest, and to remove the regulatory limits on the size of individual competitors
12. What changes would be required to ensure that the DIRA regulatory regime supports a we l-func ioning domest cally focused dairy sector that operates in the long-te m nterests of New Zealand consumers?	• Fonterra's obligation to supply raw milk destined for the domestic market to competitors should be unlimited • That obligation needs to be on-going and needs to survive any future phasing out of the other contestability provisions • Fonterra should be obliged to separately account for and report on its domestic consumer brands business 'Fonterra Brands New Zealand', to demonstrate that its financial performance is not being subsidised by some other part of the business

2. Background

2.1 Context

Total global annual milk production is estimated to be around 500 billion (B) litres of milk[1]. The size of the internationally traded dairy-products market is estimated to be the equivalent of around 65B litres, or around 15 percent of total production.

New Zealand's annual milk production is estimated to be approximately 21B litres (or less than 5 percent of global production), of which, approximately 5 percent is consumed domestically and 95 percent is exported. New Zealand's share of the internationally traded dairy-products market is approximately 30 percent, or 20B litres p.a.

While being able to produce huge volumes at internationally competitive prices is positive, there are aspects of the New Zealand industry that are very challenging, including the proportion of production that needs to be exported, the consequent exposure to international p ices, the distance from export markets and the shape of the seasonal milk curve.

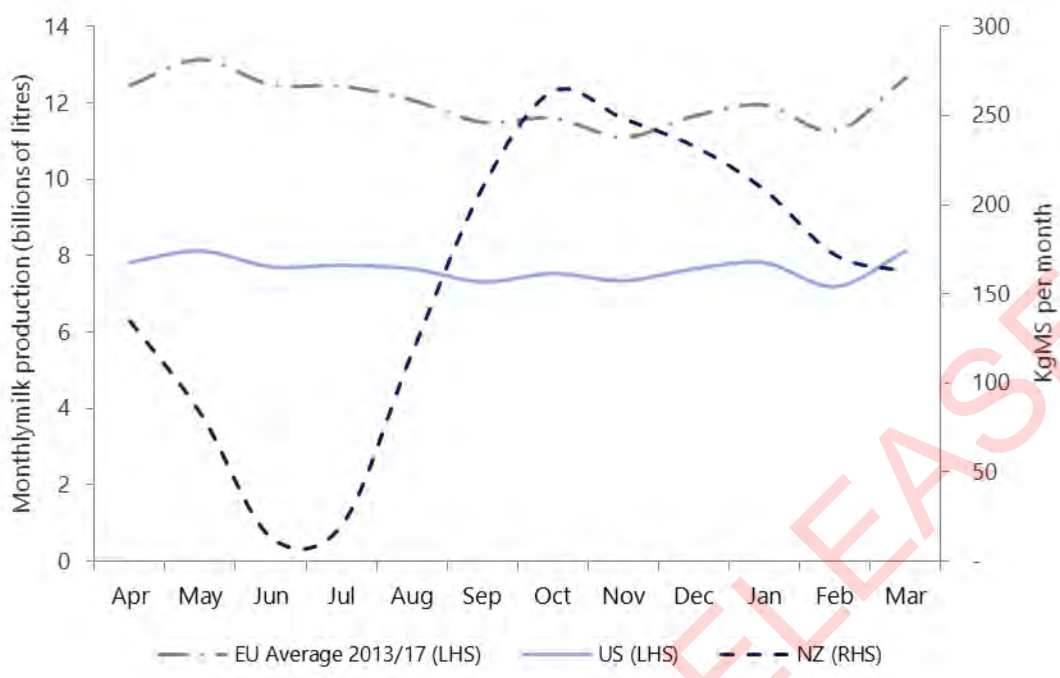
The New Zealand dairy industry is internationally cost-competitive, n part because New Zealand's temperate climate and abundant water allows the farming system to be a pasture-based system where milk production matches grass growth. The pasture-based system, however, means milk production is highly seasonal, with milk production in the peak mo th (October each year) being typically 20 times as large as milk production in the slowest month (June each year).

Given the seasonal milk curve and the non-seasonal nature of domestic demand, it is no surprise that the original two large pre-Fonterra domesti businesses were subsidiaries of very large export businesses (NZ Co-operative Dairy Group Ltd (NZDG) and Kiwi Co-operative Dairies Ltd (Kiwi)). Both NZDG and Kiwi had large ingredient bus nesses to funnel their excess milk through to manufacture and export as long-life products (through the New Zealand Dairy Board at the time).

As Figure 1, below illustrates, the shape of the seasonal milk curve in New Zealand is much more extreme than in the US or EU.

[1] USDA, Dairy: World Markets and Trade, December 2016.

Figure 1: Milk curves – international comparison



These peak to trough variations graphically illustrate the difficulty the New Zealand milk curve causes New Zealand processors, especially those who are focused on the domestic market.

2.2 Historical development of DIRA

New Zealand's largest dairy processor the co-operative company Fonterra, was established in 2001 from an amalgamation of the then two la gest dairy co-operatives: NZDG and the New Zealand Dairy Board. In forming Fonterra, participants sought to realise efficiencies of scale and scope in the collection and processing of farmers' milk so as to better compete in international dairy markets, for the overall benefit of New Zealand.

At the time, the value of the benefits of the mega-merger (ie, Fonterra) to New Zealand farmers was estimated to be \$3 0M[2] p.a., or almost \$2.5 billion (B) on a capitalised present value basis[3].

On creation, Fonterra collected approximately 96 percent of New Zealand's raw-milk production. Allowing the creation of such a dominant firm had competition policy implications. In particular, a dominant firm could have:

- the incentives and ability to create barriers to farmers switching to potential competitors;
- the incentives and ability to impede entry into the farm gate market by new dairy processors;

[2] "The Quigley report on dairy megamerger", 24 January 2001. Section 4.1 of the Quigley report refers to the "Business Case for Global Dairy Co Ltd: Executive Summary" that outlines the sources of the \$310M in benefits that were claimed to be associated with the merger.
[3] Using Fonterra's FY16 pre-tax WACC of 7.9% to capitalise a benefit expressed in 2001 dollar values.

- the incentives and ability to set wholesale prices in downstream domestic dairy markets; and
- fewer incentives to drive cost efficiencies and invest in innovation, as it could use its market position to retain farmer suppliers even if they were dissatisfied with the company's performance.

The Dairy Industry Restructuring Act, 2001 (DIRA) authorised the amalgamation and allowed it to bypass the Commerce Commission. The Commerce Commission's earlier draft determination found that the merger would result in a strengthening of a dominant position in each of the relevant markets[4].

As the amalgamation resulted in an entity with a substantial degree of market power in several New Zealand dairy markets, DIRA was designed and implemented to mitigate the risks of Fonterra's market power. In particular, DIRA seeks to promote contestability in the New Zealand raw-milk market and provides for access for other dairy goods or services supplied by Fonterra to be regulated, if necessary.

Regulations made under the Dairy Industry Restructuring (Raw Milk) Regulations, 2001 (and as amended and re-enacted in 2012) contain further provisions to facilitate the entrance of independent processors (IPs) to New Zealand dairy markets and enable them to obtain the raw milk necessary to compete in dairy markets.

The original regulations required Fonterra to supply, at a DIRA price, up to 50M litres of raw milk p.a. to any IP and up to 250M litres p.a. to Goodman Fielder (GF). The price of this regulated raw milk was the farm-gate base milk price (FGMP)[5] for that season, plus reasonable transport costs.

An IP, in DIRA:

- is defined as a processor of milk, milk solids or dairy products that is not associated with Fonterra; and
- includes GF and any associated person of that company, other than Fonterra.

IPs, therefore, include the obvious companies such as Tatua and Westland, but also the less obvious companies like GF and Cadbury[6]. The latter IPs outsource their raw-milk supply to vertically integrated dairy processors, rather than sourcing it directly from farmers.

The default price specified in the regulations is a calculated price that is meant to ensure the following outcomes:

- Fonterra is constrained from offering farmers a higher price for their milk. This reduces the risk of Fonterra being able to offer a higher FGMP to limit the ability of competing processors to persuade farmers to switch to supplying them; and

[4] The Commerce Commission had reached the preliminary conclusion, in 1999, that the merger that formed Fonterra could not be authorised under the Commerce Act. The Commission's preliminary estimate was that the merger would result in a price rise in domestic dairy-products markets (other than spreads) of between 10% and 20%. This translates to a wealth transfer from domestic consumers to the merged entity (Fonterra) of between $75M and $146M p.a., and a net deadweight welfare loss in the domestic dairy production and supply markets of up to $4M p.a. This deadweight loss included both allocative losses in the domestic dairy products-market and dynamic efficiency concerns.

[5] The FGMP is a notional calculation of the cost of milk supplied to Fonterra on the basis that Fonterra is an efficient processor.

[6] Supermarkets do not meet the definition of an IP under DIRA and do not have any direct access to DIRA milk.

- from a domestic consumer perspective, competition in the domestic market between wholesale companies is sufficient to ensure that Fonterra does not have the power to charge prices in excess of what is required to generate an adequate return on capital employed.

Thus, the DIRA contestability provisions were designed to ensure that milk flows to the highest-value user (whether the user is a producer of dairy commodities, ingredients or fresh consumer products) and to avoid wealth transfers from domestic consumers to Fonterra. The provisions work in parallel with, and are supplementary to, the general competition provisions of the Commerce Act, 1986.

2.3 Changes to DIRA Regulations in 2012

The 2001 Regulations were revoked on 1 June 2013 and replaced by the Dairy Industry Restructuring (Raw Milk) Regulations, 2012 ("the 2012 Regulations").

Under subpart 1 of the 2012 Regulations:

- the total amount of raw milk to be supplied by Fonterra to IPs increased from 600M litres per season to 795M litres per season;
- the total amount of raw milk to be supplied by Fonterra to GF was unchanged, at 250M litres per season, but supply in the non-winter months was limited to 110 percent of the amount of raw milk supplied in the preceding October;
- the total amount of raw milk to be supplied by Fonterra to any one individual IP was unchanged, at 50M litres per season, but maximum monthly limits for non-winter milk were put in place; and
- the obligation on Fonterra to supply raw milk to an IP in a season beginning on or after 1 June 2016 was extinguished if that IP's own supply of raw milk in the three previous seasons was 30M litres or more.

Subpart 3 of the 2012 Regulations divided IPs into two categories:

- those with no, or less than 30M litres of own-supply raw milk; and
- those with more than 30M litres of own-supply raw milk and those that do not require a fixed quarterly raw-milk price from Fonterra and GF.

For the first group, the new regulations changed the price of raw milk supplied by Fonterra from the FGMP plus $0.10 per kilogram of milk solids (plus transport costs and winter-milk premiums) to a fixed quarterly price being Fonterra's most recent forecast FGMP (plus transport costs and winter-milk premiums).

For the second group, the new regulations changed the price of raw milk supplied by Fonterra from the FGMP plus $0.10 per kilogram of milk solids (plus transport costs and winter-milk premiums) to the FGMP (plus transport costs and winter-milk premiums).

2.4 The Dairy Industry Restructuring Amendment Bill, 2017

In March 2017, as a consequence of the recommendations made by the Commerce Commission and a subsequent MPI-led review, the then-Minister introduced into the House the Dairy Industry Restructuring Amendment Bill. That Bill was subsequently substantially altered by the new Government before being passed into law on February 15, 2018.

The changes made to the DIRA by the amendment prevent the relevant DIRA provisions from expiring in the South Island and remove the market share thresholds that would trigger the Act's expiratio in the future. The other provisions that were set out by the original Bill (under the previous Government) were removed[7].

In removing the previous provisions which timetabled a further review for 2020/21, the new Gove nment announced its intention to "undertake a comprehensive review of the DIRA and consult fully with the dairy sector"[8], commencing in 2018.

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[7] The original Bill (among other things):

- removed the default expiry provisions and the market share thresholds in the North and South Islands that trigger a review of the state of competition;
- required a review of the state of competition to commence during the 2020/21 dairy season;
- required a review at five-year intervals thereafter if competition has not yet been considered sufficient;
- allowed Fonterra the discretion to refuse supply from new dairy conversions;
- reduced the total volume of raw milk that Fonterra must supply to IPs from 795M litres to 600M litres per season; and
- removed the requirement for Fonterra to supply DIRA milk to large export-focused processors from the beginning of the 2019/20 season. The definition of a large export-focused processor was one that has the capacity to process more than 100M litres of milk per season and exports more than 50% of its production by volume.

[8] https://www.beehive.govt.nz/release/dairy-industry-restructuring-amendment-bill-passed

3. Is DIRA achieving its objectives

3.1 Introduction

There are two components to the question 'is DIRA achieving its objectives?':

- have the originally anticipated benefits been realised?; and
- has DIRA enabled competition to emerge?

These two questions are answered in turn below.

3.2 To what extent have the anticipated benefits of the 2001 industry restructure been realised?

As noted in section 2.2, above, the anticipated benefits of the establishment of Fonterra were $310 million per annum[9]. The sources of the benefits were anticipated to be as follows:

- annual cost savings in the order of $120 million as a consequence of the elimination of duplicated facilities and activities;
- annual revenue enhancements and productivity improvements in the order of $70 million as a consequence of enhanced economies of scale and scope if manufacturing activities are integrated with marketing and distribution functions; and
- additional increased earnings of $120 million per year as a consequence of being able to harness the synergies between different parts of the industry, provide fresh strategic impetus and broaden options to exploit new market, technology and biotech opportunities.

We would expect to be able to measure the realisation of the benefits with reference to Fonterra's share price as follows (details of the calculations are provided in Appendix 1):

- the expected benefit in 2001 was $310m per year to farmer-shareholders. If we assume that the expected benefit was expressed in pre-tax terms, it would equate to $223m after tax;
- if we assume an average cost of equity for Fonterra of 9 percent, an average dividend ratio of 70 percent, and add all the new equity associated with increased production, we estimate that the current share price should be $8.43;
- Fonterra's current share price is $5.15;
- if we exclude the anticipated benefit from the theoretical share price calculation, the current share price should be $6.07; and
- we note that since Fonterra's change in capital structure in 2012, its share price has averaged $6.10 with a range of $4.60 to $8.08. We also note that over the same period of time, Fonterra's normalised EBITDA has increased by 0.6 percent, year-on-year[10].

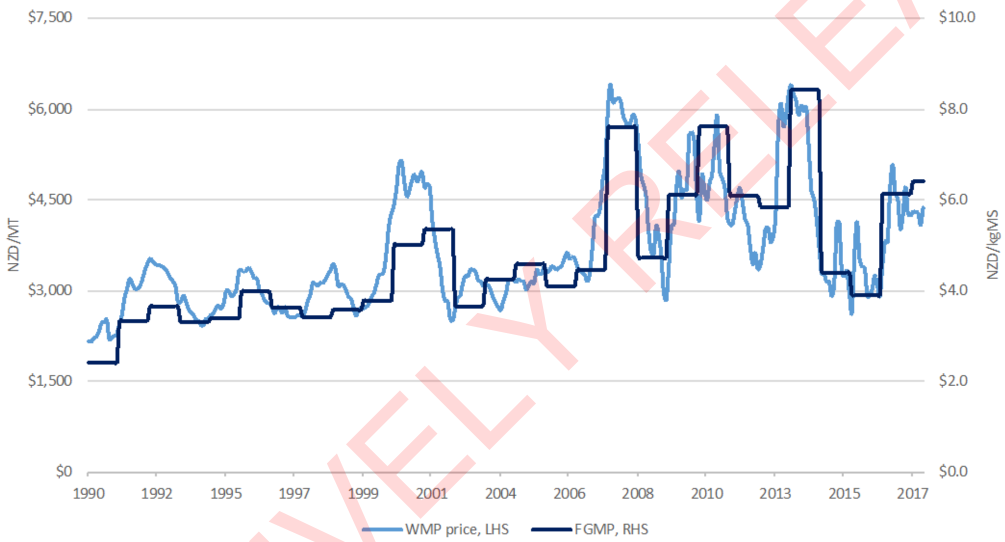
[9] Refer to footnote 2 above.
[10] ANZ Research, Agri Focus – we have lift off, June 2018, p.24.

The logic employed above would lead us to conclude that there is little evidence that Fonterra has delivered the anticipated benefits to farmer / shareholders.

However, it should be noted that Fonterra, like most companies, has been subject to some adverse shocks over the period (like the GFC and WPC80 crisis) that will have affected its financial performance.

We do not think that it could be argued that the benefit has been passed through to shareholders via the FGMP. In the first instance, the anticipated benefits can only be achievable as a consequence of the merger and not otherwise. We can observe that most of the IPs are paying slightly more than the FGMP to their suppliers for their milk on average and are earning more than their required rate of return which implies that the merger was not required for any benefits to be received via the FGMP. In addition, Figure 2, below, indicates that the FGMP has generally been consistent with international commodity prices.

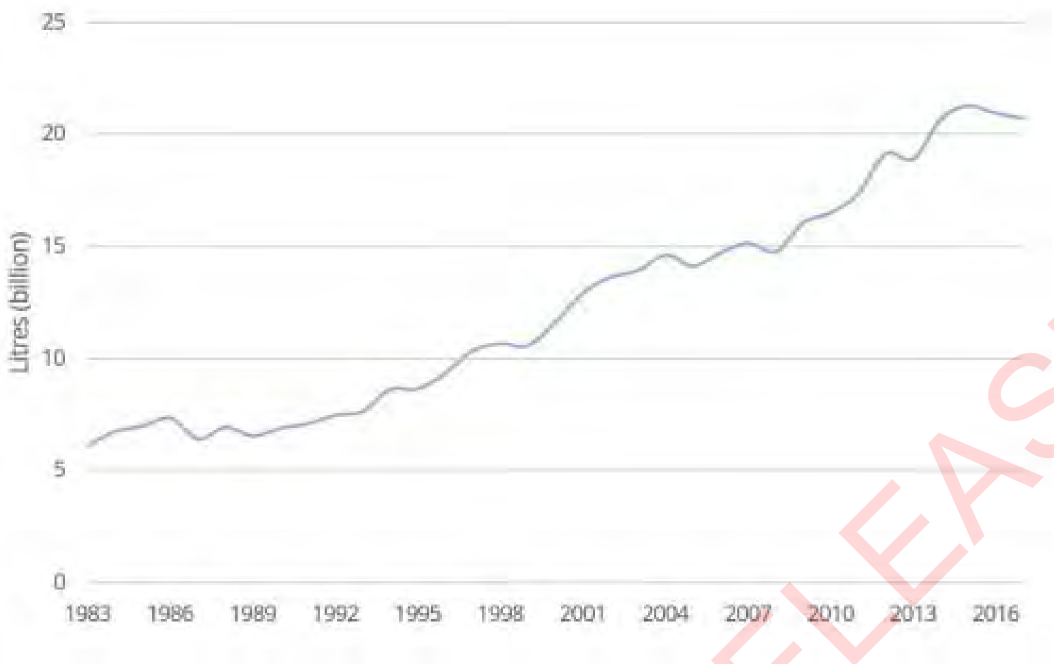
Figure 2: Timeline of FGMP and commodity prices



Similarly Westland does not think it can be argued that the costs imposed on Fonterra by DIRA have therefore been excessive. The contestability provision that has received the most attention by Fonterra (and has subsequently been changed most significantly as a consequence) is the raw-milk supply provision. We estimate that the opportunity cost to Fonterra of having to sell raw milk to IPs at the FGMP has been approximately $25-$30 million per annum.

DIRA, by allowing the mega-merger to be formed without going through the normal Commerce Commissi n process, was a major step. DIRA itself was an attempt to offset the adverse competition effects of the merger. DIRA has been reasonably successful in this regard. Figure 3, below, presents a time series of dairy processing volumes in New Zealand since 1983.

Figure 3: Dairy processing volume in NZ



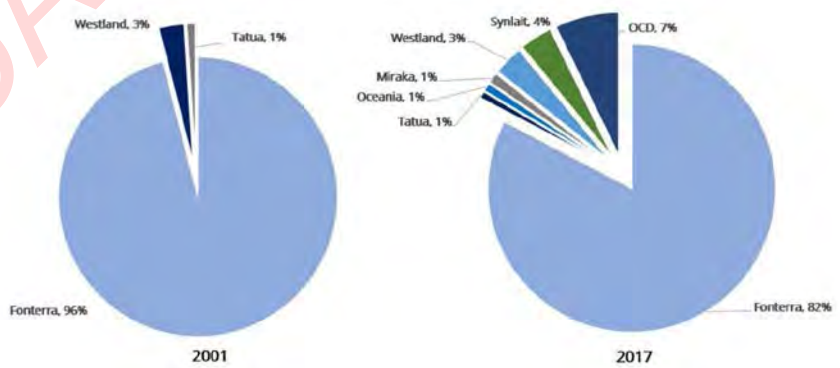
3.3 To what extent and in what way is the DIRA contestability regime contributing to or impeding the sector's performance?

Figure 3 shows no notable change in the trend in New Zealand's milk production following Fonterra's creation (although New Zealand has likely n w reached (or passed) peak cow numbers, which will see continuing growth in milk production stall or at lea t slow considerably from now on). In our opinion, this overall trend indicates that DIRA ha not impeded industry growth.

3.3.1 Farm gate competition

As presented in Figure 4 in addition to volume growth in the industry, the market share of competition at the farm gate has increased f om 4 percent to 18 percent over the last 16 years.

Figure 4: Farm gate competition in 2001 and 2017



In 2001, directly following the formation of Fonterra, there were three processors competing at the farm gate in the New Zealand dairy industry with Fonterra being almost completely dominant, processing 96 percent of all volume collected. Since then, although Fonterra's collection volumes have continued to grow, its market share (in terms of New Zealand milk collected) has fallen to 82 percent.

The market share that has been captured from Fonterra has been distributed across multiple competitors in the farm gate market that have varying corporate structures and strategic objectives. Apart from Fonterra there are now six IPs competing at the farm gate and collecting 18 percent of New Zealand's raw milk. An additional two IPs have announced their intentions to build new processing plants in the near future (subject to milk supply).

3.3.2 Industry composition

Table 2 presents an overview of the major competitors at the farm gate (based on publicly available information). The table notes when each company was established, their total revenues in the 2017 financial year, their revenues per kgMS (which indicates where in the value chain they compete), their product positioning and their ownership structure.

Table 2: Major farm gate competitors

Company and year established	Volume growth rates 2012-2017	2017 Revenue	2017 Revenue per kgMS	Product positioning	Sales channels	Ownership
Fonterra 2002	0.12%	$19.2b	$12.60	Branded consumer goods, dairy ingredients, and processed commodity powders	Largest global exporter of dairy products. 95% of local production is exported to over 100 countries.	Co-operative ownership for farmer shareholder / suppliers who purchase an ownership stake consistent with their supply volume. Fonterra Shareholders Fund (FSF) is publicly traded on the NZX and ASX and gives non-voting right ownership to retail and institutional owners.
Open Country Dairy 2002	12%	$1.1b	$8.73	Commodity powders and cheese, with some movement recently into higher value ingredients (mozzarella curd, mature cheddar, whey protein concentrate).	100% exports to over 64 countries Sells direct to trade customers 20% of sales though OLAM (a 15% shareholder)	NZ public unlisted company, Talley's 76%, OLAM 15%, sixty others 9%.
Synlait 2007	8%	$759m	$11.69	Ingredient powders, infant formulas, cream, UHT and specialty ingredients.	Sells direct to business partners and trade buyers. 2% of sales to Bright Dairy (a 39% shareholder)	Publicly owned and listed on NZX and ASX. Major shareholders are Bright Dairy 39%, A2 Milk 8.2% and Mitsui 8.4%.
Westland 1938	4%	$630m	$10.60	Base commodities through to branded consumer products, powders, UHT milk, butter, and yoghurt.	Export to 60+ countries.	Co-op owned by 429 farmer suppliers.
Tatua 1914	3%	$332m	$22.16	High value speciality ingredients, caseinate, whey protein and anhydrous milk.	Progressively established offshore offices once separated from NZDB/Fonterra	Co-op owned by 113 farmer suppliers.
Oceania 2013	0	$228m	n/a	Whole milk powder, infant powders, UHT milk.	Exported through Yili (100% owner) sales channels	100% Yili Industrial Group.

In 2001, the three competitors in the processing sector (Fonterra, Westland and Tatua), were all co-operative companies. Since 2001, new processing firms have emerged with differing corporate structures. OCD is a public unlisted company. Synlait is publicly listed on the NZX and the ASX. Oceania is a wholly owned subsidiary of a major foreign company.

The nature of each processing business has also varied, with some processors like OCD continuing to be focused on commodity processing for the export market, other new entrants focusing on the ingredients and consumer business segments and incumbent competitors diversifying away from commodity processing into ingredients and consumer segments.

Our conclusion is that DIRA has contributed to increasing competition at the farm gate without placing significant structural constraints around the way in which that competition has emerged.

Figure 5 presents the 2017 firm revenue per kgMS.

Figure 5: Revenue per kgMS per processing company

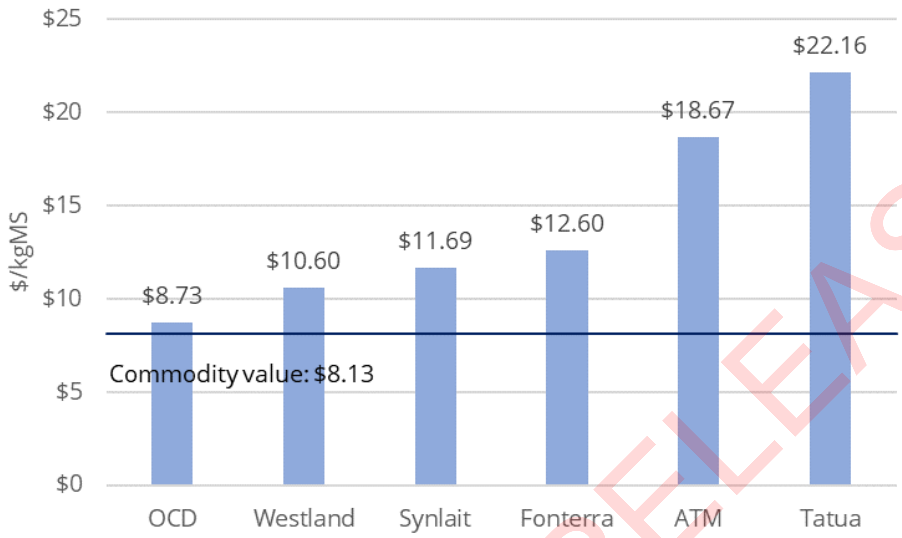


Figure 5 highlights the variation in strategy and market positioning in the industry. Revenue per kgMS gives insight into the product mix, as it gives both an indication of sale price of products per unit of milk processed and the cost of production. The pure commodity value calculated for the hypothetical efficient processor (HEP) used for the calculation of the FGMP was $8.13 for the 2017 season. OCD (as noted above) is close to a commodity processor and only competes in the export market. Its revenue per kgMS of $8.73 is close to that of the notional processor. Revenue per kgMS increases with Fonterra, Synlait and Westland as, in addition to commodity products, they also compete in the ingredients and the consumer markets, both domestically and internationally. A2 Milk is a consumer company and outsources its processing. Tatua is a processor of speciality ingredients and has the highest level of revenue per kgMS processed (and the highest cost of production).

Figure 5 shows that the sector in general is now made up of a diverse array of corporate strategies and that DIRA has contributed to increasing competition at the farm gate, without placing structural constraints around the way in which that competition has emerged.

3.4 Where and by whom are the benefits of the sector's performance being captured and the costs / risks incurred?

We would expect to see the benefits and the costs of the sector's performance being captured by farmers, by the processing companies' shareholders and the broader economy generally. We think that leaving aside how the market may have evolved in the absence of DIRA, the cost to the broader economy has been largely environmental.

3.4.1 *Farmers*

Total milk production in New Zealand has increased by 60 percent since Fonterra was established in 2001. Part of that increase in production has been the result of improving genetics (animals and pasture) and farmers investing in more intensive, higher cost farming systems leading to higher production per hectare. The other part of the increase has been the result of farmers converting more land to dairy.

Table 3: Attributes of milk production changes since 2001

	2001	2017	change
Total production (millions of litres)	12,925	20,702	60%
Total production (millions of kgMS)	1,096	1,851	69%
Land area (000 ha)	1,329	1,729	30%
Cows (000s)	3,486	4,861	39%
Production per cow	314	381	21%
Cows per ha	2.6	2.8	7%

Source: New Zealand Dairy Statistics 2016-17, LIC - DairyNZ

Table 3, above, records the breakdown of the changes in milk production on-farm since 2001. We conclude that the continuing investment by farmers in both productivity improvements and land suggests that farmers have been earning an adequate return on their capital for the risks being taken.

3.4.2 *Processing company shareholders*

While on-farm investment by farmers seems to indicate that farmers believe that they are being adequately rewarded for the risks they are facing, it is not at all clear that the same can be said for the milk-processing companies' shareholders. We have measured the investment performance of Westland, Fonterra, Synlait, OCD and Tatua by subtracting their weighted average cost of capital from their return on assets to see which companies have generated an adequate return and which haven't. We have used the FGMP to adjust each company's reported earnings to make their relative performances comparable.

Figure 6: 7-year average adjusted ROA-WACC 2011-2017

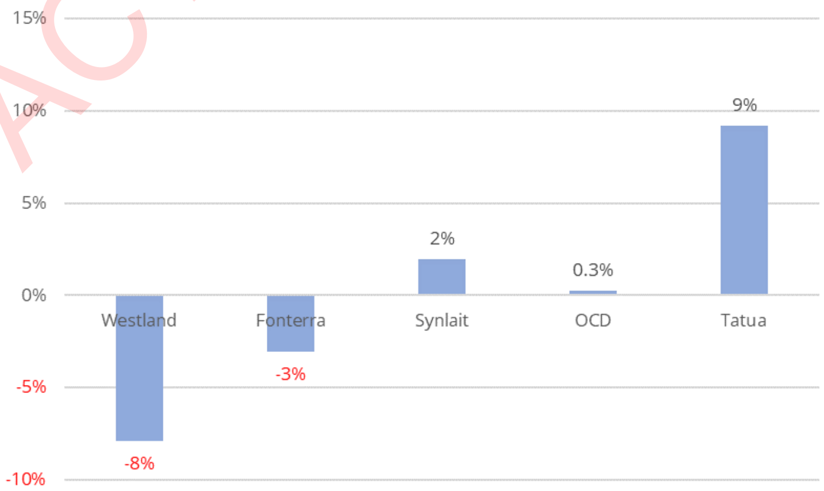


Figure 6 indicates that both Westland's and Fonterra's capital providers (and therefore shareholders) have not received an adequate return on capital employed, while Synlait's, OCD's, and Tatua's have[11]. We have not analysed the causes of any under or over-performance, although it is unlikely that DIRA was a major factor in the differing returns.

3.4.3 Macro economy

According to the New Zealand Institute of Economic Research, from a macro-economic perspective, it is estimated that the dairy sector[12]:

- contributes $7.8 billion (3.5 percent) to New Zealand's total GDP, comprising dairy farming ($5.96 billion) and dairy processing ($1.88 billion);
- supports rural New Zealand, with the sector accounting for 14.8 percent of Southland's economy, 11.5 percent of the West Coast, 10.9 percent of the Waikato, 8.0 percent of Taranaki and 6.0 percent of Northland;
- remains New Zealand's largest goods export sector, at $13.6 billion in the year to March 2016. Export growth has averaged 7.2 percent per year, over the past 26 years, faster than any primary industry apart from the wine and 'wood and wood products' industries;
- exports twice as much as the meat sector, almost four times as much as the 'wood and wood products' sector and nine times as much as the wine sector;
- accounts for more than one in four goods export dollars coming into New Zealand;
- employs over 40,000 workers, with dairy employment growing more than twice as fast as total jobs, at an average of 3.7 percent per year since 2000;
- creates jobs at a faster rate than the rest of the economy in all but 5 territorial authorities across New Zealand;
- provides over 1 in 5 jobs in three territorial authority economies (Waimate, Otorohanga, Southland); and over 1 in 10 in a further eight (Matamata-Piako, South Taranaki, Hauraki, Waipa, South Waikato, Clutha and Kaipara);
- delivered $2.4 billion in wages to farmers and processing workers in 2016;
- supports a range of supplying industries; in 2016, farmers spent $711 million on fertilisers and agro chemicals, $393 million on forage crops and bought over $190 million of agricultural equipment. Farmers also spent $914 million on agricultural services, $432 million on financial services and $197 million on accounting and tax services; and
- as well as taking farmers' raw milk, the dairy processing sector also spends significant amounts on packaging ($288 million in 2016), hired equipment ($199 million) and plastics ($174 million).

[11] This measure is a proxy shareholder measure because the companies' assets are funded via both debt and equity but it is a reasonable measure.
[12] "Dairy trade's economic contribution to New Zealand", NZIER report to DCANZ, February 2017.

3.4.4 Environment

It is generally accepted that the environment has suffered as a consequence of the performance of the dairy industry. From the dairy industry's perspective, and leaving aside the behaviour of individual participants, it has been operating to applicable laws and regulations and they have been tightened as their inadequacies have been revealed.

It might be reasonably argued that DIRA has contributed to poor environmental outcomes by incentivising the conversion of land to dairy that probably should not have been and otherwise probably would not have been converted. An obvious example would be the Mackenzie Country land. The open entry provisions require Fonterra to accept all the milk that farmers want to supply. This means that farmers could have converted cheap (and therefore, by definition, marginal) land into dairy if it was economical to do so, knowing that Fonterra would have to collect the milk. This point is expanded upon in section 5.

3.5 What and how strong are the existing incentives and disincen ives for the dairy industry to transition to a higher-value based dairy production and processing industry, that global consumers seek out for a premium?

In our opinion, the challenge for dairy companies (like oth r companies in the economy) is not necessarily to move up the value chain, but to create valu Cr ating value is not necessarily the same as moving up the value chain. Economic value is created if the return earned on the capital employed is greater than the cost of the capital employed. From that perspective, if we refer back to Figure 6, above, we can observe that Synlait, OCD, and Tatua have created value, on average, over the last seven years and Fonterra and Westland have not.

The cost of the capital employed is lowest when companies operate at the low-risk end of the risk spectrum, which means that the requi ed retu n on the capital employed to compensate for this cost is also lowest at that point. For milk p oce sing companies, the low-risk end is the commodity-production end because the margin ea ned by the processors is relatively constant, as the processors are able to pass the majority of the commodity=price risk back to the farmer suppliers.

Risk increases as a company moves up the value chain because:

- produ tion is more capital intensive;
- production is more difficult;
- the margin earned becomes more variable, as increases in milk prices take time to be passed through to the consumer, while the consumer expects immediate relief when milk prices decrease;
- stock becomes obsolete as tastes change; and
- there is a constant need to invest in research and development.

OCD is the closest example there is in New Zealand to a commodity product manufacturer (ie, a company at the low end of the value chain) and it has successfully created value. Tatua is probably the company that has positioned itself furthest away from the commodity end and therefore is probably the riskiest of the processors and it similarly has successfully created value. Synlait is somewhere between the two in terms of risk and it has created value. Fonterra and Westland are probably similar to Synlait in terms of overall average position on the value chain, but they have lost value, on average, over the last seven years. In other words, moving up the value chain involves taking more risk and there is no guarantee that it will add value for shareholders, or the economy.

Rather than seeking to promote so-called "high value" or "low value" products, the government's role is to create an environment that allows dairy companies to adopt the strategies that best meets their objectives, manages their risks and makes the best risk-adjusted return possible for their suppliers/shareholders.

The current regulations, appropriately, do not appear to provide any strong incentive or disincentive for companies to move up or down the value chain.

3.6 Does the DIRA regulatory objective of ensuring "contestability for the supply of milk from farmers" remain fit-for-purpose?

3.6.1 Incentives

The key competition concern with a company such as Fonterra ha ing su h a dominant position in the market for farmers' raw milk is that it could have the incentive and ability to operate to the detriment of the long-term dynamic efficiency of the broader dairy industry. By declining applications for new supply, paying inefficiently high milk prices to existing suppliers and retaining the value of the exiting supplier's capital contributions for as long as possible after they ceased to supply milk, it could "lock in" its suppliers. Such actions would create significant barriers to entry for those seeking to compete for farmers' raw milk and allow Fonterra to operate ineff ciently, but nevertheless remain in business.

To address this concern, the DIRA requires Fonterra to operate an open entry and exit regime. This means that Fonterra must accep all milk-supply offers from dairy farmers in New Zealand and allow relatively costless exit from the co-operative, upon the request of farmer-shareholders. These requirements ensure that Fonterra cannot "lock in" its farmer-suppliers, and, as a consequence, Fonterra faces strong commercial incentives to pay efficient prices for farmers' raw milk and the capital invested in Fonterra.

The Commerce Commission reviewed the state of competition in New Zealand dairy markets and released its final eport in March 2016. The Commission concluded at that time there was not sufficient compe ition at either the farm gate or the factory gate to consider full deregulation.

Since the last Commerce Commission review, there have been a number of additional processing capacity investment or announcements by the competing processors:

- OCD has built a new processing plant in Horotiu (Waikato) with milk processing due to commence for the 2018/19 season;
- Mataura Valley Milk has built a new plant in McNab (Gore, Southland) with milk processing due to commence for the 2018/19 season;
- Oceania (Glenavy, South Canterbury) intends to increase its capacity by 50 percent, although the timing of this expansion is not clear;

- Synlait has announced the purchase of land to build a second processing plant – to be located in Pokeno (north Waikato). The plan is for this plant to be processing milk for the 2019/20 season; and
- Happy Valley Milk has announced the construction of a new plant to be built in Otorohanga. The company has received land use consent and the plant could be ready for the 2020/21 milk season.

It is not clear exactly how much additional capacity is implied by these announcements, but we estimate that it could be around 1 billion litres of milk, which equates to approximately 4.5 percent of New Zealand's total milk production.

We are not suggesting that this additional capacity necessarily represents sufficient additional competition such that the Commerce Commission might conclude differently to what it did in March 2016. However, on the assumption that there isn't any increase in milk production in the next three years and, in order for these plants to be full, Fonterra is most at risk of losing milk supply. To the absence of (particularly) the base milk price contestability provisions, Fonterra would have a strong incentive to transfer profits into the FGMP in order to retain milk. The Fonterra shareholders who would be most affected by such a transfer would be the 12 percent of shareholders who are not also suppliers. Shareholder-suppliers are not affected at all by this transfer because, in total, they would still receive the same amount of cash from Fonterra with the increase in milk price, offsetting a decrease in the dividend.

We note that the milk-price principles in Annexure 1 of Fonterra's constitution require the milk price to be the maximum it can be.

3.6.2 Farm gate competition

Table 4, below, is our estimate of where there is farm gate competition in New Zealand. The points to note are:

- there are two regions where there are more than one IP competing with Fonterra at the farm gate – the two biggest producing regions in New Zealand: Waikato and Canterbury;
- 5 of the 11 regions have no direct competition at the farm gate (including West Coast, where Westland is currently the only processor); and
- while there is direct farm gate competition in the regions where 74 percent of New Zealand's milk is produced, the current capacity of the IPs limits their immediate competition to approximately one quarter[13] of that milk.

[13] 18% / 74% = 24%.

Table 4: Farm gate competition

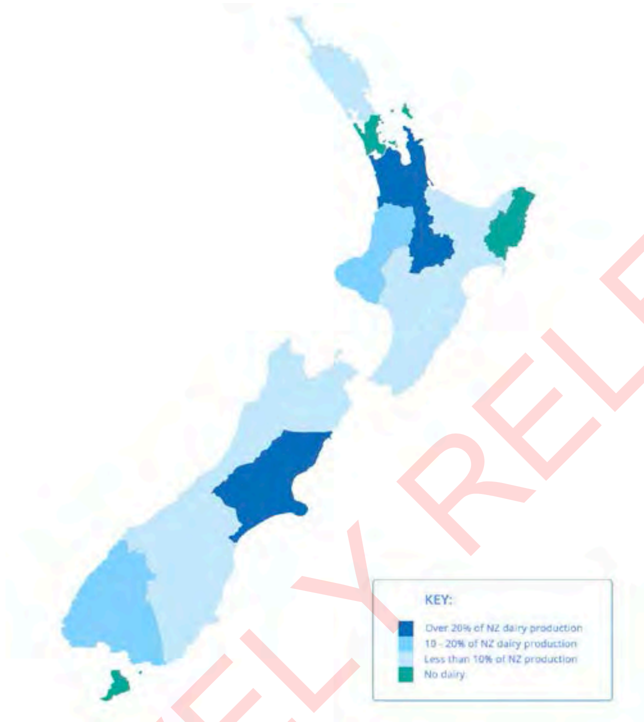
Dairy Region	Total production (millions kgMS)	Percentage of national market (kgMS)	No. of IPs	Market share of the IPs	Strength of balance sheet
Northland	104	6%	0	0%	
Waikato	503	27%	2	15%	OCD – strong Tatua- strong Miraka - strong
Bay of Plenty	124	7%	0	0%	
Taranaki	180	10%	0	0%	
Hawkes Bay	16	1%	0	0%	
Whanganui / Manawatu	81	4%	1	49%	OCD – strong
Wellington / Wairarapa	59	3%	0	0%	
Westland / Tasman / Nelson / Tasman	85	5%	1	59%	Westland – moderate
Canterbury	385	21%	3	30%	Westland - moderate Synlait - strong Oceania - moderate
Otago	101	5%	1	6%	Danone - strong
Southland	223	12%	1	18%	OCD - strong
Total	1861	100%	9	100%	

Figure 7, below, shows the location of the existing IPs, the intended locations of their new processing plants (Synlait in Pokeno, OCD in Horotiu, and Oceania in Glenavy) and the yet-to-be built IPs (Happy Valley Milk (Otorohanga) and Mataura Valley Milk (Gore)). As can be seen, the most intensive competition is in Waikato. This is set to escalate, with Waikato being the location of three of the five new processing plants.

Figure 7: Farm gate competition

Figure 8, below, illustrates regional milk production, with Waikato and Canterbury both producing in excess of 20 percent of New Zealand's milk and together accounting for almost half of New Zealand's milk. Taranaki and Southland each produce more than 10 percent of New Zealand's milk and together account for almost a quarter of New Zealand's milk. The other seven milk producing regions each produce less than 10 percent of New Zealand's milk and there are three regions that produce no milk at all (Auckland, Poverty Bay, and Stewart Island).

Figure 8: Milk production by region



An emerging issue for the industry is excess capacity, partly as a result of Fonterra deciding to increase capacity in order to give itself "production optionality" at the peak of the season. We estimate that excess capacity is currently probably at least 10 percent and will rise to at least 15 percent if all the announced additional capacity comes online. Excess capacity will become more of a problem if total milk production de reases

3.7 If so, what changes, if any, are required to ensure that the individual provisions of the DIRA contestability regime remain fit-for purpose and are consistent with the Government's wider policy objectives?

3.7.1 Contestability provisions

As per the Act, the key contestability provisions are:

- open entry / exit and, as part of that, Fonterra being limited to offering one-year supply contracts except under certain conditions;
- the right for Fonterra suppliers to supply up to 20 percent of their weekly production to an independent processor;

- the setting of the base milk price; and
- no discrimination between suppliers.

As per the Regulations and subject to certain constraints, Fonterra must supply raw milk to independent processors.

All of these provisions (other than arguably the 20 percent rule) appear to have been crucial to the competitive development of the industry.

The contestability provisions that remain crucial until there is effective competition are:

- open exit and, as part of that, Fonterra being limited to offering one-year supply contracts except under certain conditions;
- the setting of the base milk price;
- no discrimination between suppliers; and
- raw milk supply.

The 20 percent rule (anecdotally) appears to have been used very sparingly by farmers and because the benefit attached to the 20 percent rule has been very small, its cost has also been very small for Fonterra. There is a reasonable argument that the 20 percent rule could be used more in the future, as farmers seek to cash in on the premiums being offered for A2 and grass fed milk e.g., by those IPs that have the ability to segregate milk for processing. On the basis of the potential benefit and the small cost of the 20 percent rule, our recommendation is that it be retained.

3.7.2 Open entry (and re-entry)

We contend that open entry (and open re-entry) should be phased out. To be clear, by open entry and re-entry we mean milk from new dairy conversions. We do not mean that Fonterra could choose not to collect milk from an existing supplying dairy farm. Open entry has contributed to the development of marginal farming land so we would be happy to have that area closed to entry. We do not want to see a situation whereby any famer doesn't have his/her milk picked up.

It might reasonably be argued that the open-entry provisions of DIRA have contributed to worse environmental outcomes, with land being converted to dairy that probably should not have been and otherwise probably would not have been. For example, land in the Mackenzie Country. The open entry provisions require Fonterra to accept all the milk that farmers want to supply it, which means that farmers could have converted cheap (and therefore, by definition, marginal) land into dairy if it was economical to do so, knowing that Fonterra would have to collect it.

Fonterra would reasonably argue that the open-entry provisions have increased its costs to the extent that it has extended its milk catchment area and therefore Fonterra's collection costs.

Fonterra might also argue that the open-entry provisions have frustrated its value-add strategy by obliging it to invest its limited capital in stainless steel instead. We contend that this argument is unreasonable for the following reasons:

- while total milk production in New Zealand has increased by 60 percent since Fonterra was established, Fonterra's milk collections have only increased by 37 percent. In the absence of

DIRA and assuming the same increase in milk production, Fonterra's milk collections would have increased by almost 60 percent;

- half of the milk production increase was the result of genetic improvements and intensification, with only half coming from land being converted to dairy (with most of that land being in Canterbury and Southland); and

- Fonterra set its own rules about the capital contribution required from supplier / shareholders to match increased milk production.

We are not aware of any significant cost that would be incurred by the rest of the industry as a consequence of the phasing out of the open-entry provisions as described.

There is an emerging debate regarding open entry versus open re-entry, with concern being voiced that Fonterra could frustrate the open exit provisions by threatening to restrict re-entry. That is, there is a concern that existing Fonterra supplier / shareholders would be more reluctant to exit Fonterra in the future if they think that their ability to re-enter might be in danger, should they choose to. That is a legitimate concern.

The counter-argument is that there seems to be a reasonable consensus in the industry that peak-cow numbers have not just been reached, but surpassed (though, not necessarily peak-milk production), which means that milk production in the future will increase at a much lower rate than it has for the last 16 years. The consequences of that are that every litre of milk supplied to a processor becomes more valuable, to the extent that it becomes harder to replace and the cost of excess capacity is not insignificant in an industry where efficient processing is an absolute requirement.

3.7.3 Open exit

The open exit provisions deliberately put Fonterra at a competitive disadvantage relative to the rest of the industry, to the extent that all of the IPs' supply contracts are for terms of more than one year. It is a basic risk management strategy for the IPs to limit their exposure to lost supply in any one year. Fonterra's supply risk is lower than the IPs owing to the number of Fonterra suppliers and the limited capacity of the IPs to recruit a significant proportion of Fonterra suppliers in any one year. The open exit provisions need to be retained while it is determined that there is insufficient competition at the farm gate.

3.7.4 Base milk price

In our opinion the base milk price provisions are emerging as the most critical issue, on the basis that they are essential in order to differentiate between the Fonterra supplier / shareholders' return on their on farm investment (via the FGMP) and the return on their off-farm investment. This differentiation is critical to containing Fonterra's power. That is, Fonterra has an incentive to pay more for milk by transferring profit into the FGMP in order to attract and retain milk supply and without this clear differentiation, Fonterra would have the ability to do just that – its non-supplier shareholders notwithstanding.

Commodity-price risk is the IPs' biggest risk. That is, in order to be able to pay their suppliers a milk price that is at least the same as the notional hypothetical efficient processor (HEP), the IPs need to know how much of which reference products are being sold by the HEP and when. On the basis that more transparency around the calculation of the FGMP is better than less transparency, we would recommend a number of changes to the milk price methodology as follows:

- Fonterra's average currency conversion rate should be excluded from the calculation. Fonterra's average conversion rate has nothing to do with the value of the milk produced and the reference commodities sold. Including Fonterra's average conversion rate forces the IPs to try and match it in an environment of non-disclosure by Fonterra and just adds a level of opaque complexity that doesn't need to exist. In addition, hedging the sales of USD-priced commodity products increases the NZD volatility of outcomes for farmers and therefore increases their isk unnecessarily, which is exactly the opposite of what Fonterra intends;

- non-GDT sales should be excluded from the calculation. The inclusion of non-GDT sal s has increased the FGMP. It hard to understand why a customer would pay more fo a commodity product than the commodity price. One of the reasons might be because Fonterra g arantees the customer's access to a certain quantity of New Zealand product. That being the case, the price premium is for access rather than for the product and therefore should not be part of the FGMP calculation, especially if that access is something that only Fonter a can provide as a consequence of its size relative to the rest of the processors;

- we assume that the non-GDT sales of WMP, for example, are for WMP that has exactly the same specifications as the WMP sold on GDT. A small variation in product specification to customise it for a customer (eg, fat content), could lead to a price premium. If the product being sold is not of the same specifications as the reference commodity products, then it is clear that they are not actually reference commodity pr ducts and therefore should be excluded from the FGMP calculation; and

- it is unreasonable for the asset beta to be that of the HEP, which has the ability to pass all commodity-price risk back to fa mers when none of the processors, including Fonterra, have that ability. The proessors are all riskier therefore than the HEP and therefore the FGMP is routinely over-stated[14].

3.7.5 Non-discrimination

We think the non-d scrimination provisions should remain as they are. As an aside, it is not clear to us that Fonterra's MyMilk milk supply contract complies with the non-discrimination provisions in the Act. MyMilk does no obligate the supplier to become a Fonterra shareholder.

3.7 6 Raw-milk supply – farm gate market

In he farm gate market, the original intent of the raw-milk supply provisions was to give potential new entrants enough confidence around the supply of a base load of milk to build a new processing plant that would then attract its own supply. The existing provisions recognise that once a processing plant has its own supply, there would seem to be little need for Fonterra to continue to supply raw milk. That said, there is an argument that IPs building a second or third plant in different regions should get access to raw milk supplied by Fonterra on the same basis for the same reason. That argument's pros are:

[14] Note – this is a different discussion to the one that the Commerce Commission is currently having with the industry.

- the cost to Fonterra is nominal in comparison to anticipated benefits of the establishment of Fonterra;
- Fonterra's supply obligation would be temporary, as in order to have enough scale to be efficient, any new processing plant seems to need to have the capacity to process approximately 240 million litres of milk, so the processor has a strong incentive to recruit its own milk supply; and
- should a processor decide not to recruit its own milk, its size would be forever limited to 50 million litres.

3.7.7 Raw-milk supply – factory gate market

The factory gate market in New Zealand has not developed at all because, in our opinion, it is unreasonable to expect that processors will choose to sell milk at the FGMP, which is approximately their cost of milk, when they could manufacture it into a commodity or value-add product and by doing so, earn a return on their capital employed. That being the case, it would be reasonable to argue that the limits on raw-milk supply that is destined for the domestic marke need to be relaxed in order to increase competition in the domestic market. See section 3.13, below.

3.7.8 Would changes to the contestability provisions make the industry more or less efficient?

In our opinion, the open-entry provisions have led to dynamic inefficiency at the margin to the extent that they have contributed to capital being employed to convert land to dairy that probably would not otherwise been converted. To the extent that the damage has already been done, it is unlikely that this change will increase dynamic efficiency

In our opinion, any relaxation in the open exit provisions would almost certainly lead to Fonterra immediately moving to adopt what is common industry practice and lock in suppliers by extending the terms of their supply cont acts. That action would create significant barriers to entry to potential new entrants to the farm gate ma ket. Therefore, until it has been determined that there is sufficient farm gate competition, the open exit provisions should be retained. It is possible that farm gate competition should be assessed on a regional basis rather than on a North Island / South Island basis or on a New Zealand basis, as farm gate competition has only developed, to any reasonable degree, in the highest milk prod ing egions.

The changes we have recommended with respect to the base milk price would probably, on average, decrease the FGMP. We haven't tried to quantify the impact other than that we know that non-GDT sa es have, to date, contributed an additional 5-10 cents per kgMS to the FGMP. Any decrease in the FGMP is negative for farmers, but positive for processing company shareholders from a return on capital employed perspective. Having said that, to the extent that the changes increase transparency, farmers should benefit from clearer pricing signals. Any enhancement to processing company shareholder returns should continue to encourage potential investment in the sector (with milk-supply risk continuing to be the most significant start-up risk).

The non-discrimination rules were established in order to ensure wealth was not transferred from one set of Fonterra supplier/shareholders to another, in an effort to frustrate potential new farm gate competition. That objective is still valid and therefore the non-discrimination provisions need to be retained. We understand that Fonterra is using its contract milk supply product, MyMilk, to recruit milk from targeted pockets of Westland supply. The MyMilk contract does not require suppliers to become Fonterra shareholders. Westland is a traditional co-operative company and all suppliers need to be shareholders.

Westland considers the MyMilk product to be an example of discriminatory behaviour.

The raw-milk supply provisions will continue to make the industry more efficient at the farm gate until such time as there is sufficient competition.

The relaxation of the raw provisions as they apply to the factory gate market will increase the efficiency of the industry to the extent that the current provisions actually inhibit domestic competi ion by limiting the size of the competitors.

3.7.9 What might we expect to see in the absence of the contestability provisions?

In the absence of the open exit provisions, we would expect to see Fonterra move quickly to protect its current milk supply, by extending its milk contracts and locking in suppliers.

In the absence of the base milk price provisions, we would expect to see:

- Fonterra transferring what would otherwise be value-add profit into the FGMP to protect its current milk supply, to attract new milk supp y, to the extent that it has spare capacity, and to discourage any additional farm gate competit on; and
- farmers making less informed production decisions because of lack of clarity around the milk price.

In the absence of the non-discriminat on p ovisions, we would expect to see Fonterra targeting other IPs suppliers by creating a multi-tiered milk price structure.

In the absence of the raw-milk supply provisions, we would expect to see investment in processing capacity by new processors disappear.

As a consequence of all o the above, we would expect relatively static milk supply shares between processing compa ies and therefore less investment in stainless steel and therefore the stalling of production-based company growth. That could lead to companies taking more risk with value-add strateg es eme ging as companies try and find a way to deliver value to their shareholders. It could also lead o mergers and acquisitions (subject to the Commerce Act).

3.7 10 How are Westland and its supplier / shareholders affected by these changes?

Westland's supplier / shareholders are unaffected by the proposed changes to the base milk price calculation.

Westland's supplier / shareholders would benefit from the proposed changes in the factory gate raw-milk supply, to the extent that it would effectively increase the company's milk supply.

3.8 If so, what changes, if any, are required to ensure that the extent of any unintended consequences, which may have arisen as a result of the DIRA contestability provisions, is reduced/removed, while any impact on the regime's ability to deliver on its policy objective is minimised?

See section 3.7.9, above, for discussion regarding the phasing out of the open-entry provisions.

3.8.1 How are Westland and its supplier / shareholders affected by these changes?

Westland's supplier / shareholders are unaffected by the open-entry recommendations.

3.9 If not, what should the alternative and/or new regulatory objectives be to ensure that the DIRA regulatory regime supports a well-functioning and high performing New Zealand based dairy production and processing industry, which manages resources effectively (including land, water, and capital) to produce high quality, high value dairy products?

Our observation would be that the DIRA contestability provisions have performed as intended with competition emerging at the farm gate with little in the way of unin ended consequences (other than possibly the open-entry provisions as commented above). There might be some disagreement with respect to the pace at which farm gate competition has emerged and whether or not that has been satisfactory. However, we do not think that any alternative or new regulatory objectives need to be added. We make the following comments:

- in the absence of major externalities, competitive industries, by definition, manage capital resources effectively;
- history suggests that natural resources need to be regulated in order to establish the acceptable boundaries within which they can be used. We think that those boundaries have now been established;
- ensuring that consumers have consumption choices ensures that product quality is sufficient from their pe spective on a cost-value basis;
- the deci ion to produce high value dairy products is a decision to be made by the shareholders of the various processing companies, as the strategic decision to move up the value chain requires access to capital (because it is more capital intensive than commodity product manufacturing) and it involves a risk-reward trade-off; and
- our hypothesis, based on observation, is that the strategic decision to move up the value chain comes after the processor has become an efficient commodity product manufacturer and after growth via the ability to access more milk supply slows. At that point, shareholders generally start pursuing other avenues to grow the company.

3.9.1 How are Westland and its supplier / shareholders affected by these changes?

Not applicable.

3.10 Is the domestically-focused dairy sector operating in the long-term interests of New Zealand consumers?

3.10.1 The domestic market

The domestically-focused dairy sector in New Zealand makes up a small proportion of total dairy production. The fresh-milk market in New Zealand currently consumes approximately 600M litres of milk, which accounts for 5 percent of total annual production of 20.7B litres of milk.

There are three key channels to market; grocery (supermarkets), route (petrol stations, dairies, small convenience stores) and food service (cafés, catering companies, hotels, restaurants, institutions and the like). Grocery is the largest of these channels with sales comprising approximately 60 percent of the total volume. Figure 9, below, depicts these three channels.

Figure 9: Three channels to market in domestically-focused dairy sector

3.10.2 The domestic market before DIRA

Before DIRA came into place in 2001, the domestic market was dominated by New Zealand's two large dairy co-operatives; NZDG and Kiwi. NZDG traded domestically under the company Dairy Foods, while Kiwi's main sales company was Mainla d. The private label brands held by these two competitors had a combined grocery market share of around 95 percent.

3.10.3 The 2001 DIRA reform

The 2001 DIRA regulations combined the operations of NZDG and Kiwi, establishing Fonterra, with an effective monopoly in the domestic dairy market. With a near monopoly structure, the key concern became regulating t e market power of the company, particularly in regards to consumer prices and competition. A the opposition MP Bill English said in Parliament at the time of the First Reading of the Dairy Industry Restructuring Bill:

"this bill is the product of a political deal between the Government and the dairy industry, and part of that deal is that the industry accepts a degree of regulation to mitigate the effective monopoly with which it sets out. Parliament now has a public interest job to do, and that job is to ensure that a regulatory regime comes into place that protects consumers and protects suppliers." [15]

These protections were:

[15] Refer Hansard, 26 June 2001, p 10059.

- to require one of the two founding companies of Fonterra, the New Zealand Dairy Group (NZDG), to divest its domestic consumer business, New Zealand Dairy Foods (NZDF);
- to give NZDF's (eventual) new owner, GF, guaranteed access to 250M litres of raw milk p.a. from Fonterra at the DIRA price while DIRA remained in place; and
- to supply other IPs with up to 50M litres of raw milk per annum, at the DIRA price.

In order to assess how DIRA has impacted on consumers in the domestically-focused New Zealand dairy market, we need to assess the current state of competition, and how this has changed since 2001

The domestic dairy market in New Zealand is dominated by Fonterra Brands NZ (FBNZ) and Goodman Fielder (GF), who between them own most of the brands previously owned by NZDG and Kiwi FBNZ is the dominant player, supplying a full range of dairy products and having market leadership ac oss all channels. GF is number two.

The lack of comprehensive market-share data limits the ability to draw firm onclusions with respect to how the retail market for dairy products in New Zealand has developed sin e the establishment of Fonterra. We therefore focus on the grocery sector as the main proxy for understanding competition in the consumer market.

The grocery channel makes up approximately 60 percent of the domestically-focused dairy market. FBNZ has a branded marker share of around 25 percent by volume and GF has around 11.5 percent. The smaller players combined have about 12 percent The balance is made up of supermarket house-branded fresh white milk, cheese and butter – which together account for around 50 percent of the total grocery dairy market.

The combined share of the private-label brands eld by FBNZ and GF is currently around 87 percent. This has decreased from 95 percent over he last 16 years. The combined market share of all the other participants in the grocery sector has increased from 5 percent to 13 percent.

Overall, if the grocery sector can be used as a proxy for the total consumer market, we would conclude that competition in the sector has increased since Fonterra was created and therefore that DIRA has been successful in p eventing FBNZ from exercising its market dominance.

3.11 Are there significant economies of scale in the collection and processing of farmers' milk into domestic consumer dairy products?

Economies of scale in the collection and processing of farmers' milk into domestic consumer products (and specifically fresh milk) exist on a relative basis. That is, the scale of a processor's domestic business relative to its total business (being domestic plus export). The scale economies exist in two areas: collection costs and the ability to manage daily variations in fresh milk demand (represented as capacity costs).

3.11.1 Collection costs

The New Zealand dairy industry is internationally cost-competitive, in part because New Zealand's temperate climate and abundant water allows the farming system to be a pasture-based system where milk production matches grass growth. The pasture-based system, however, means milk production is highly seasonal. Milk production in the peak month (October each year) is typically 20 times larger than the lowest milk-producing month (June each year).

The multiple between the highest and lowest milk-producing months would be more than twenty if Fonterra did not specifically incentivise farmers to produce winter milk for the domestic market by paying them a margin over the FGMP for their milk.

The demand for fresh milk in the domestic market does not match the seasonal milk supply curve of the industry. The domestic demand for milk is flat over a given year meaning that approximately the same amount of milk is demanded for domestic consumption in every day of every month of the year

Fresh milk for domestic consumption goes to five designated factories: four in the North Island and one in the South Island.

Our best estimate is that approximately 10 to 15 percent of New Zealand farmers produce winter milk. In other words, milk that is destined for domestic consumption. The collection cost scale economy exists for one or both of the following reasons, either:

a. the milk produced by the winter milkers is collected and t ansported to the closest plant for processing into whatever product that plant produces for 10 months of the year (which could be but need not be one of the five designated f esh milk plants) and only has to go to one of the five designated fresh milk factories for two months of the year; and/or

b. the number of winter milk suppliers required is ery low relative to the total number of winter milk suppliers. Given the premium required to attract winter milkers, it follows that the higher the ratio of winter milk suppliers to the total number of suppliers, the higher the premium required or the larger the catchment area.

3.11.2 Capacity costs

We understand that daily demand fo fresh milk can vary by 30 percent. That means that the fresh milk supplier needs access to 15 percent more milk everyday than the average daily amount to meet demand on high-demand days and needs to be able to find an alternative buyer for or to process 15 percent of the milk on low-demand days. The relative cost of being able to manage this daily variation diminishes with scale. The smal er the proportion of fresh milk demand to total milk supply, the smaller the cost of having processing capacity standing idle on those days when fresh milk demand is high and the smaller the cost of havi g to hold processing capacity in reserve "just in case" for those days on which fresh milk demand i low.

3.11 3 Pre-merger structure

Given the seasonal milk curve and the non-seasonal nature of domestic demand, it is no surprise that the original two large pre-merger domestic businesses were subsidiaries of very large export businesses (NZDG and Kiwi). Both NZDG and Kiwi had large ingredient businesses to funnel their excess milk through to manufacture and export as long-life products (through the New Zealand Dairy Board at the time).

3.12 What would the domestically-focused dairy sector look like (in terms of structure and range of business models) in the absence of the DIRA regulations?

The domestic market regulations under DIRA ensure that Fonterra supplies milk to GF and other IPs at a regulated price, for sale in the domestic market. Almost all milk, cheese and butter sold in the domestic market is supplied by Fonterra under this system. Absence of the DIRA would thus allow Fonterra unregulated control of this domestic milk supply, with power over the price and quantity with which it on sells base products.

The 2016 report by the Commerce Commission provides an assessment of the efficiency and equity effects of abolishing the regulations that require Fonterra to supply raw milk to processo s that produce dairy products to the domestic market.

The Commission estimates that without these domestic DIRA regulations:

- Fonterra would have the ability to use its dominant position to increa e the factory-gate raw-milk price by around 25 percent;
- consumers would face a resultant price rise of around 6 p r ent; and
- this would lead to a transfer of wealth from New Zeala d consumers to milk suppliers of between $51M and 92M p.a.

3.13 Does the DIRA regulatory objective of ensuring "competition in the wholesale supply of domestic consumer dairy products" remain fit-for-purpose, given the dynamics of the domestically-focussed dairy sector?

DIRA gives these two firms a privileged position in the domestic dairy market, creating a challenging environment for other competitors.

One of the key constraints for competitors in the domestic dairy market is their milk entitlement. With access to a maximum of 50M litres of milk per annum, smaller firms are limited in their ability to grow their domestic mark t share. Though GF has access to a larger entitlement of 250M litres, its ability to grow beyond i s cu rent market share is also restricted. These caps on milk supply from Fonterra mean firms are not able to compete for new high-volume contracts without switching product from an existing customer or sourcing milk directly. Considering the scale an IP would have to reach to overcome the costs of winter milk and efficiently produce its own milk for use in the domestic market, it hard to foresee a growth pathway without the ability to increase access to Fonterra's milk.

Regulatory uncertainty presents another obstacle for competitors in the domestic market. Regulatory uncertainty inhibits investment as potential investors cannot be sure what their investment horizon is.

3.14 If so, what changes (if any) would be required to ensure that the DIRA regulatory regime supports a well-functioning domestically-focused dairy sector that operates in the long-term interests of New Zealand consumers?

Though competition in the domestic dairy market has increased since the establishment of the DIRA, there is potential for regulatory change that would further support a well-functioning market. We suggest that to improve competition in the domestic dairy market two main changes are required:

1. Fonterra be required to supply all of the raw milk required by any domestic dairy produc s market competitor with no special regulatory entitlement or limits; and
2. full accounting separation of Fonterra and FBNZ.

3.14.1 Requiring Fonterra to supply 100 percent of the raw milk required by any domestic dairy products market competitor with no special regulatory entitlement or limits

The current caps on the amount of DIRA milk GF and IPs can acquire, of 250M litres and 50M litres p.a., respectively, would be removed subject to the total amount required being supplied to the domestic market. All milk acquirers would be subject to audits to confirm that the DIRA milk supplied went into the domestic market. A penalty would be required if the milk acquired was used to produce exports rather than to supply the domestic market.

The proposed change has the potential to lead, over time, to a more innovative and competitive dairy products market:

- It would allow successful niche participants to grow to scale without the associated costs of an ingredient business to balance milk supply;
- it provides competitive neutrality amongst current and potential buyers of raw milk at the factory-gate; and
- it allows Fonterra to capture the economies of scale in collecting and processing milk for the internationa market while not penalising domestic consumers of dairy products.

This change would avoid the detrimental effects on competition resulting from the current caps.

There s a risk that this change could disincentivise IPs from having an independent supply when enter ng the domestic dairy products market. This change could therefore partially reinforce Fonterra's dominance and discourage competition at the farm-gate. Nevertheless, because it is unlikely that a large IP would establish a presence in the domestic market without an exporting arm, this is less of an issue. As New Zealand currently exports 95 percent of total milk production, it is unlikely that this option (which is limited to the domestic market) will have a significant impact on the incentives of an IP considering sourcing independent milk supply. In summary, the benefits should outweigh any potential costs.

3.14.2 Requiring accounting separation of Fonterra and FBNZ

Requiring accounting separation of Fonterra and FBNZ, while leaving FBNZ as part of the Fonterra group, would go some way towards providing a level competitive playing field between domestic competitors but with no change in Fonterra's dominance of factory-gate supply. Fonterra could be required to account for FBNZ as a separate entity.

Allocative efficiency would be likely to be somewhat improved under this option. If monitored appropriately by non-supplier shareholders and the Commerce Commission, this approach would reduce the risk of Fonterra assisting FBNZ to retain or increase its market share by cross-subsidising FBNZ. The issue of allocative inefficiency, if Fonterra was not required to supply milk at regulated prices would remain, although in the long run the entry of IPs into the domestic market, encouraged by removal of FBNZ privileged position, could introduce a constraint on Fonterra.

Dynamic efficiency would also be improved, possibly substantially, since IPs considering entry into the domestic market would have a degree of protection against competitive non-neutrality, by Fonterra. As noted above, in the long run the entry of IPs into the domestic market could reduce and eventually eliminate the effect of Fonterra's dominance in the factory-gate market

3.14.3 How are Westland and its supplier / shareholders affected by these changes?

The change should enhance Westland's ability to compete domestically because, like any other domestic competitor, Westland would similarly be able to buy milk destined for the domestic market from Fonterra and by so doing effectively access Fonterra's milk collection scale economies in the same fashion as the other domestic competitors.

The change would also effectively result in a marginal increase in total milk supply for Westland, as it would be able to channel into export markets the milk that it would otherwise have been selling into the domestic market.

4. Regional development

4.1 Is regional development enhanced by DIRA?

It is generally accepted that the dairy industry has been beneficial for the New Zealand economy. If that is the case, given the dairy industry is a regional industry, it follows that it has been beneficial for the regions.

We consider that the "contestability" provisions of DIRA have helped make the industry more efficient than it otherwise would have been. That being the case, again, it follows that the contestability provisions of DIRA have been beneficial for the regions, which is the same thing as saying that regional development has been enhanced by these aspects of DIRA.

Instead, Westland believes that its operation as an IP has made it essential to the regional economy, especially given the company is biggest private sector employer on the West Coast. With its move to higher value products, Westland's economic "spill-over" effects will also increase, particularly enabling further growth in employment opportunities, secondary businesses to meet demand and sustainability of the vital transport links such as west-east rail, of which Westland is the largest user.

Any change to the DIRA provisions should not put this economic growth at risk.

5. Environmental considerations

5.1 Does regional development lead to more appropriate and innovative environmental solutions?

Environmental solutions required in the regions are likely different from those required in larger urban areas because the causes of the environmental problems are probably not the same. That is not the same as saying that the solutions are more appropriate or innovative.

The activities of New Zealand dairy farmers are constrained by existing legislation such as the Resource Management Act, the Animal Welfare Act and the Health and Safety at Work Act amongst others.

From an environmental perspective, we would argue that it is inappropriate for DIRA to also include any environmental restrictions for two reasons:

- dairy farmers in New Zealand should be bound by the same environmental constraints as everybody else; and
- including environmental constraints in different pieces of legislation is bound to lead to legislative conflicts and confusion.

Westland as a company, mainly operates in a unique environment and as a responsible IP fosters its farmer-shareholders to develop and implement more suitable, innovative and effective environmental solutions. This include farming practices which are unique to the West Coast's topography and climate that maintains productivity sustainably and protects the natural environment.

6. Fonterra Co-operative Group Limited

6.1 Should it remain a co-operative?

The question of the appropriate organisational form (eg, co-operative or not) of an enterprise is one for shareholders to answer. There are both advantages and disadvantages to being a co-operative:

- as a co-operative, Fonterra cannot go beyond the bounds of its supplier/shareholders fo equity capital. Even though the subordinated nature of the milk-price payment to farmers gives Fonterra better access to debt than an ordinary company, that access is ultimately limi ed without access to additional equity resources;

- Fonterra is essentially two businesses within a single entity: a commodity and near-commodity business and a value-add business. The commodity and near-commodity busi ess is an easy fit into a co-operative structure because it is a business that the supplier / shareholders understand and can fund. The value-add business is not an easy fit because it is higher risk, more capital intensive, and less tangible; and

- in most co-operatives, the board of directors is either en irely   ade up of supplier/shareholders or they make up the majority. In our view, that structu e is satisfactory for a commodity or near-commodity co-operative because the product is only one-step removed from primary production. It is less satisfactory the furthe up the value-chain the co-operative moves because the board of directors becomes more reliant on management, which means that it loses its ability to hold management to accoun

- In Fonterra's case, the board of di ectors composition problem is exacerbated by a nomination process that gives the existing board of directors the ability to veto almost any potential candidate's nomination and to herefore effectively control the on-going composition of the board of directors; and

- in this case, Fonterra, as a co-operative, appears to be at a competitive disadvantage versus the ordinary companie when trying to recruit new milk. Having to buy Fonterra shares in order to supply it versus not having to buy, say, Synlait shares to supply it has seen Fonterra come out on the   rong side of the competition. Synlait suppliers can decide to buy shares as well, but that decision is quite separate from a decision to become dairy farmers and grow milk.

If Fonterra choses to remain a co-operative Westland maintains that it must operate as a <u>genuine</u> co-operative on behalf of its farmer shareholders.

7. Conclusions

There is still a need for the DIRA. The DIRA contestability provisions have helped protect the long-term interests of New Zealand dairy farmers, consumers and the nation's overall economic wellbeing. It has opened up competition to others but not as many or as quickly as it could have.

It is recognised that the dairy industry's environmental impact has got worse as intensification has increased and as land has been converted to dairy. We consider that, at the margin, DIRA's open entry provisions may have contributed to this outcome and could be phased out without imposing signi icant costs. We would not want to see unfettered entry available.

The environmental situation has been acknowledged by farmers and efforts are n place to mitigate adverse effects of dairying. However, any further environmental protections required should be imposed by generic environmental legislation rather than through DIRA.

Although fit for purpose, we recommend these changes to the DIRA, includ ng to the milk price methodology which would increase the transparency of the calculation and appear less manipulated.

- We contend that open entry (and open re-entry) could be phased out. To be clear, by open entry and re-entry we mean milk from new dairy on ersi ns, we do not mean that Fonterra could choose not to collect milk from an existing dairy farm. Open entry has contributed to the development of marginal farming land so we would support that area closed to entry. Westland does not wish to see a situation whereby any fa mer would not have their milk collected.
- the base milk price provisions remain crucial but these are changes we recommend:
    - Fonterra's average curren y conversion rate should be excluded from the calculation;
    - non-GDT sales should be excluded from the calculation; and
    - the asset beta used should not be that of the hypothetical efficient processor but that of the industry. (Note – this is a different discussion to the one that the Commerce Commission is currently consulting on.);
    - Fonterra should supply the 100 percent of the raw milk required by any domestic dairy products market competitor; and
    - full accounting separation and reporting of Fonterra and FBNZ.

Wi h regard to the domestic market, the shape of the New Zealand milk curve versus the domestic demand curve and the absence of a factory gate market mean that domestic competitors are largely reliant on Fonterra for their milk supply.

The raw milk supply provisions therefore essentially limit the size of domestic competitors by limiting their access to 50M litres of milk (or 250M litres in the case of Goodman Fielder (GF)). Limited access to milk together with uncertainty with respect to on-going access to that milk has limited investment in the domestic market. The cap should be removed and all participants in the domestic market be given equal access to DIRA milk. Full accounting separation and reporting of Fonterra and FBNZ is required to ensure that FBNZ's ability to compete in the domestic market is not being subsidised by another part of the business.

We also believe that the DIRA has created some perverse outcomes in regard to dominant player behaviour and we are unsure if this can be adequately regulated against. An example was the experience of Westland during the collection and processing black outs created by Cyclone Fehi in 2018 which affected 600 businesses in the West Coast region. Instead of supporting each other, as others do in such crisis situations, the dominant player used its market position to offer non-Fonterra farmers very low, 'take it or leave it', prices to take the milk. Given the only other alternative was to dump the milk this could have resulted in negative environmental impact.

The DIRA legislation currently has no recourse for such dominant behaviour and Westland would support official efforts to curb these scenarios again, particularly given the worsening predicted effects and frequency of climate change events.

Appendix 1: Calculation of Fonterra's capital value including assumed merger benefits

In 2001, the initial Fonterra share price was set at $3.85 and there were initially 1,110,153,888 shares on issue. This gave Fonterra an initial market capitalisation of $4.3B.

Added to this is the (then) present value of the estimated annual merger benefits ($310m per year or $223.2m after tax assuming a 28 percent tax rate). Assuming that the required return on equity is 9 percent (which is in-line with current market estimates of Fonterra's cost of equity and is likely historically prudent given the period over which we are estimating the change in capital value), the ($2001) present value of the annual merger benefits equates to $2.5B. The theoretical value of Fonterra's equity immediately post-merger was therefore $6.8B or $6.08 per share.

That equity value is required to generate a return of 9 percent per annum. That return could either be via an annual dividend or it could be capital growth or some combination of both (Re*(1-Div)). We have assumed the dividend policy to be 70 percent (consistent with the mid-point of Fonterra's stated dividend policy).

After the 16 years (2001 to 2017) this results in a total expected equity value of $10.3B.

In addition, as milk supply increases, new shares are issued and new is equity raised. From annual filings, we know there have been just under 500M new shares issued and $2.6B of new equity raised – on average $5.24 per share. For simplicity, we have assumed that the same number of shares have been issued for the same price each year.

The expected value of this new equity is now $3.2B.

The total expected value of equity is therefore $13.5B. If we divided $13.5B by the number of shares currently on issue we get a theoretical share price of $8.43.

The actual calculations are presented in Table 5, below.

Table 5: Theoretical share price calculation

Original Fonterra shares on issue	1,110,153,888
Value per share	$3.85
Original Fonterra equity value	$4,274,092,469
Anticipated annual benefit (pre tax)	$310,000,000
Anticipated annual benefit (after tax)	$223,200,000
Cost of equity	9.0%
PV of anticipated annual benefits	$2,480,000,000
Theoretical merger equity value	$6,754,092,469
Theoretical merger equity value per share	$6.08
Average dividend rate	70%
Years	16
Theoretical equity value now	$10,344,133,092
Theoretical value of those share now	$9.32
Total number of shares on issue now	1,606,932,511
Total number of shares issued since the merger	496,778,623
Average number of new shares issued per year	31,048,664
2001 Subscribed Equity	$3,229,000,000
2017 Subscribed Equity	$5,833,000,000
New equity raised	$2,604,000,000
Average equity raised per year	$162,750,000
Average share issue price	$5.24
Theoretical current value of equity raised since the merger	$3,203,978,505
Theoretical total current equity value	$13,548,111,597
Theoretical current value per share	$8.43