Ministry for Primary Industries
Manatū Ahu Matua

Discussion Document

Proposed changes to the Dairy Industry Restructuring Act 2001 and Dairy Industry Restructuring (Raw Milk) Regulations 2012

MPI discussion document
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Growing and Protecting New Zealand

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CONTENTS	**II**
PURPOSE	**1**
SUBMISSIONS	**2**
BACKGROUND	**3**
OBJECTIVES	**6**
SCOPE	**6**
PART 1: SUNSET PROVISIONS	**7**
Option 1: Do not amend the sunset provisions	7
Option 2: Amend the sunset provisions	9
Preferred option for the sunset provisions	10
PART 2: RAW MILK REGULATIONS	**11**
Option 1: Do not amend the Raw Milk Regulations	12
Option 2: Large, export-focused processors cease to be eligible for regulated raw milk	13
Option 3: Reduce the volumes of regulated raw milk available	15
Option 4: Reduce the forecasting flexibility for regulated raw milk	17
Preferred option for the Raw Milk Regulations	18
PART 3: OPEN ENTRY FOR NEW DAIRY CONVERSIONS	**19**
Option 1: Do not amend the open entry provisions	20
Option 2: Amend the open entry provisions for new dairy conversions	20
Preferred option for open entry for new conversions	21
PART 4: PROVISIONS WHERE AMENDMENTS ARE NOT RECOMMENDED	**22**
The 20 percent rule	22
The milk price monitoring regime	22
MONITORING AND EVALUATION	**23**
SUMMARY OF OPTIONS	**24**
NEXT STEPS	**25**
GLOSSARY	**26**

Purpose

The Ministry for Primary Industries (MPI) invites comment from interested parties on proposed amendments to the Dairy Industry Restructuring Act 2001 (DIRA) and the Dairy Industry Restructuring (Raw Milk) Regulations 2012 (the Raw Milk Regulations).

The proposals in this document are informed by a Commerce Commission report on the state of competition in the New Zealand's dairy industry. That report is available at: http://www.comcom.govt.nz/regulated-industries/dairy-industry/report-on-the-state-of-competition-in-the-new-zealand-dairy-industry/.

Submissions

MPI welcomes written submissions on the proposals contained in this document. All submissions must be received by MPI no later than 29 June 2016.

Submissions should be sent directly to: dairy.consultation@mpi.govt.nz

You can also submit online through our website: https://www.mpi.govt.nz/news-and-resources/consultations/proposed-changes-to-the-dairy-industry-restructuring-act-2001

Or, should you wish to forward hard copy submissions, please send them to the following address to arrive by close of business on 29 June 2016.

Dairy Consultation
Sector Policy
Ministry for Primary Industries
PO Box 2526
Wellington 6140
New Zealand

We will consider all relevant material made in submissions, so you are welcome to provide information supporting your comments. Please make sure you include the following information in your submission:

- the title of this consultation document;
- your name and title;
- your organisation's name (if you are submitting on behalf of an organisation), and whether your submission represents the whole organisation or a section of it; and
- your contact details (that is, phone number, address, and email).

Submissions received after 29 June 2016 may not be considered.

Submissions are public information

Please note that your submission is public information. Submissions may be the subject of requests for information under the Official Information Act 1982. The Official Information Act specifies that information is to be made available to requesters unless there are sufficient grounds for withholding it, as set out in the Official Information Act. Submitters may wish to indicate grounds for withholding specific information contained in their submission, such as if the information is commercially sensitive or if they wish personal information to be withheld. MPI will take such indications into account when determining whether or not to release the information.

Background

1. New Zealand is a top global dairy exporter. Dairy makes up approximately 40 percent of New Zealand's total primary sector exports. In the 2014/15 year, dairy export revenue totalled $14,050 million. The New Zealand dairy industry employs over 48,000 people on farms and in processing and wholesaling.
2. In the 2014/15 dairy season over 1.8 billion kilograms of milk solids were produced from over 5 million cows. Around 95 percent of New Zealand dairy products are exported.
3. Across New Zealand, nine different dairy processors currently compete with Fonterra for farmers' milk supply. There are many other companies in New Zealand that do not collect large volumes of milk from farmers but are nonetheless involved in the processing, exporting, or domestic wholesaling and retailing of dairy products.

The Dairy Industry Restructuring Act

4. New Zealand's largest dairy processor, Fonterra, was established in 2001 from a merger of the two largest dairy co-operatives and the New Zealand Dairy Board. The industry sought to realise efficiencies of scale and scope in the collection and processing of farmers' milk and to compete in international dairy markets to the overall benefit of New Zealand.
5. The DIRA regulates two markets:
   - the farm gate market, which is raw milk sold by farmers and purchased by dairy processors
   - the factory gate market, which is raw milk traded between processors
6. Upon its 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 for farmer suppliers to prevent them 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.
7. To address Fonterra's market dominance, the DIRA includes provisions in Part 2, Subparts 5 and 5A to promote the efficiency and contestability of the New Zealand dairy industry. Among other things, these provisions require that:
   - Fonterra must accept all applications to become a shareholding farmer and must accept all milk supplied by shareholding farmers (open entry);
   - Fonterra must allow shareholding farmers to withdraw from the co-operative without unreasonable restrictions or penalties (open exit);
   - Fonterra shareholding farmers can allocate up to 20 percent of their weekly production to independent processors (the 20 percent rule); and
   - Fonterra must publish a milk price manual and detail how the base milk price in each dairy season is calculated. The Commerce Commission reviews both the manual and setting of the base milk price (milk price manual).

8. Regulations made under the DIRA (the Raw Milk Regulations) contain further provisions to facilitate the entrance of independent processors to New Zealand dairy markets and enable them to obtain the raw milk necessary for them to compete in dairy markets.

9. Fonterra must supply, at a regulated price, up to 50 million litres of raw milk per season to any independent processor and up to 250 million litres per season to Goodman Fielder. The price of regulated raw milk is the farm gate base milk price for that season plus reasonable transport costs.

10. Subparts 5 and 5A of Part 2 of the DIRA work as a package by reducing farmers' switching costs and lowering barriers to entry for independent processors, thereby promoting competition in downstream domestic markets.

11. The DIRA provisions work in parallel with and are supplementary to the general competition provisions of the Commerce Act 1986.

Sunset provisions

12. Subparts 5 and 5A of the DIRA were always intended to be temporary until Fonterra faces sufficient competitive pressure from existing and potential future competitors in the domestic markets, supported by the general provisions of the Commerce Act. At that time, competitive pressure, rather than the regulation in Subparts 5 and 5A of the DIRA, would drive the long term growth and efficiency of the dairy industry.

13. The DIRA includes sunset provisions, which are triggered when independent dairy processors collect more than 20 percent of milk solids on or from dairy farms in either the North Island or South Island in any season.

14. Once a 20 percent market share threshold is met, the DIRA sets in motion a process for expiry of some of the DIRA provisions in the relevant island.

15. On 13 August 2015 the Minister for Primary Industries certified that the market share threshold in the South Island was met in the 2014/15 dairy season with 22 percent of milk solids collected by independent processors. Consequently, some DIRA provisions will expire in the South Island no later than 31 May 2018 unless the DIRA is amended before then.

16. The fact that the 20 percent threshold has been met in the South Island is not conclusive evidence of sufficient competition and efficient dairy markets. Therefore the DIRA also requires a detailed report on the state of competition in the New Zealand dairy industry.

The Commerce Commission report

17. On 2 June 2015, the Minister for Primary Industries requested a report from the Commerce Commission on the state of competition in the New Zealand dairy industry within terms of reference agreed in consultation with the Minister of Commerce and Consumer Affairs.

18. The terms of reference required the Commerce Commission to determine whether or not the state of competition in the New Zealand farm gate and factory gate dairy markets is sufficient to ensure efficient and contestable markets in the absence of Subpart 5 and 5A of the DIRA and the Raw Milk Regulations.

19. On 1 March 2016, the Commerce Commission released its report. The report found that the current state of competition is not yet sufficient to warrant deregulation at this time.

20. The report is available at: http://www.comcom.govt.nz/regulated-industries/dairy-industry/report-on-the-state-of-competition-in-the-new-zealand-dairy-industry/.

21. The Commerce Commission recommended removal of the default expiry provisions and another state of competition review:

- when independent processors achieve a 30 percent market share in the North Island or South Island; or
- after five years (the end of the 2021/22 season).

22. Adopting this recommendation in legislation would prevent the default expiry of DIRA provisions in the South Island in 2018.

23. The Commerce Commission also recommended that the Government consider amending:

- the Raw Milk Regulations, to facilitate the development of a functioning factory gate market and reduce dependence on regulated raw milk; and
- the open entry provisions, so that Fonterra no longer has to accept an application from a new conversion to be a shareholding farmer.

Objectives

24. The objectives for any amendments to the DIRA and/or Raw Milk Regulations are to:

- promote the efficient operation of dairy markets in New Zealand;
- ensure that New Zealand markets for dairy goods and services are contestable through a credible threat of independent processor entry and expansion;
- enable independent processors 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.

25. Policy options have been assessed against these objectives.

26. These objectives contribute to the Government's economic objectives, one of which is to increase exports as a percentage of gross domestic product. The dairy industry could play a significant role in achieving this objective because approximately 40 percent of New Zealand's total primary sector exports are dairy products.

Scope

27. This discussion document is structured in four parts:

Part 1: Sunset provisions
Part 1 considers whether or not the default expiry should progress in the South Island, or whether the current sunset provisions in the DIRA should be amended.
Part 2: Raw Milk Regulations
Part 2 considers options for amendments to the Raw Milk Regulations to facilitate the development of a factory gate market for non-DIRA milk.
Part 3: Open entry provisions
Part 3 considers options for amendments to the open entry requirement as they relate to new dairy conversions.
Part 4: Provisions where amendments are not recommended
Part 4 addresses the 20 percent rule and the milk price monitoring regime, which are outside the scope of this review, and to which no changes are proposed.

Part 1: Sunset Provisions

Background

28. The DIRA was implemented to promote the efficient operation of dairy markets in New Zealand. The DIRA provisions in Subparts 5 and 5A were always intended to be temporary until Fonterra faces sufficient competitive pressure.

29. The market share threshold provides a point at which to check whether Fonterra continues to have significant market power and whether Subpart 5 and 5A of the DIRA are still required. However, since a simple market share metric is not capable of fully assessing efficiency and contestability, the DIRA also requires a review of the state of competition.

30. Under the DIRA, once a threshold has been met and the Minister for Primary Industries has responded to a report on the state of competition, the default expiry must be initiated by the Governor-General. The expiry must occur before the end of the season following that in which the Order in Council is made. Passing an amendment to the DIRA is the only way to prevent the default expiry.

Commerce Commission finding

31. The Commerce Commission report found that the current state of competition in both the North and South Island, and New Zealand overall, is not yet sufficient to warrant deregulation at this time.

32. It stated that the current state of competition at both the farm gate and factory gate could not ensure the efficient and contestable operation of these markets in the absence of Subparts 5 and 5A of the DIRA.

33. The Commerce Commission recommended repealing the default expiry provisions and another state of competition review either:

    - when independent processors achieve a 30 percent market share in the North Island or South Island; or
    - after five years (the end of the 2021/22 season).

Option 1: Do not amend the sunset provisions

Description of option

34. Under this option the Government would not make any changes to the DIRA, the market share threshold would remain as in Subpart 5 of the DIRA.

35. The 20 percent market share threshold was met in the South Island in the 2014/15 dairy season with 22 percent of milk solids collected by independent processors.

36. Because the Minister for Primary Industries has certified that the market share threshold for the South Island has been met, all of Subpart 5 and 5A of the DIRA would expire in the South Island, with three exceptions:

    - Trading Among Farmers (TAF);
    - the Raw Milk Regulations; and
    - administrative provisions such as the functions of the Commerce Commission and Courts.

37. These three areas would continue to have effect in the South Island and would only expire once the 20 percent market share threshold has been met in both the North Island and South Island.

38. Under this option, the default expiry of Subparts 5 and 5A of the DIRA would occur in the South Island by no later than 31 May 2018.

Analysis of option

39. In the North Island this option would not have any effect, as the 20 percent market share threshold has not yet been met. Subparts 5 and 5A of the DIRA would continue to apply.

40. In the South Island the default expiry by 31 May 2018 would likely affect competition and decrease the overall efficiency of the New Zealand dairy industry, as Fonterra would no longer be required to comply with open entry and exit and the milk price monitoring regime there.

41. The Commerce Commission found that the current state of competition is not yet sufficient to warrant deregulation in either the North or South Island at this time. Making no change to the sunset provisions would be contrary to the Commerce Commission's advice and could carry significant risks to the contestability and efficiency of the dairy industry, particularly in the South Island. It would mean that deregulation occurs before there is sufficient competition in the domestic dairy markets. Without the regulatory provisions in the South Island, the increases in competitive pressure over previous years could be lost.

Open entry and exit

42. The default expiry could potentially reduce any costs incurred by Fonterra as a result of open entry and exit in the South Island. However, the Commerce Commission did not identify any material costs on Fonterra as a result of it no longer operating open entry and exit and we do not consider this to be a significant benefit.

43. There is a risk that independent processors may face difficulties accessing raw milk from farmers. The expiry of open entry and exit provisions could mean farmers are less able to supply other processors, as they may be tied into longer term supply contracts and will lose the certainty that they could return to Fonterra.

44. The removal of the 20 percent rule in the South Island could result in costs to small, niche food processors if Fonterra no longer allows suppliers to split their milk volume between two processors.

Milk price monitoring regime

45. Fonterra would still have to operate under the milk price monitoring regime in the North Island and incur the associated costs for the Commerce Commission's monitoring process. There would be no cost difference in monitoring the milk price applicable in one island compared to Fonterra's national milk price.

46. In theory, Fonterra could use a different pricing methodology in the South Island following the default expiry. In practice this seems unlikely given Fonterra's current national pricing approach.

47. If Fonterra's pricing did vary between islands, Fonterra would have incentives to develop an alternative monitoring function to the Commerce Commission for the South Island to provide assurance to investors regarding the efficiency of the farm gate base milk price. Such an alternative may not be seen as independent to the same extent as the Commerce Commission and any cost would be over and above the current regime.

Option 2: Amend the sunset provisions

Description of option

48. Under this option, the DIRA would be amended so that there was no longer a default expiry. Instead, new market share thresholds in the DIRA would trigger another report on the state of competition in the New Zealand dairy industry and further consideration of whether regulation is still required.

49. The market share threshold would be amended so that the state of competition review occurs the sooner of either:

    - when independent processors achieve a higher percent market share in the North Island or South Island, for example 25 percent; or
    - after five years (anticipated to be the end of the 2021/22 season).

50. The next state of competition review would follow the process currently in section 148(2)(d) of the DIRA, requiring the making of recommendations regarding:

    - whether or not the market share thresholds in the DIRA should be reset; and
    - the options for a transition pathway to deregulation (if any) and whether a particular option or a set of options (if any) should be pursued.

Analysis of option

Resetting the market share thresholds

51. While the 20 percent threshold has been met in the South Island, Commerce Commission analysis indicates there remains insufficient competition to warrant deregulation at this time.

52. The Commerce Commission considered market share thresholds closer to 25 percent and determined that would likely still be too low to reasonably expect a finding of sufficient competition in the relevant dairy markets. After consideration of the advice from the Commerce Commission, we suggest it is prudent to monitor how this market progresses towards deregulation on a more regular basis and therefore consider that commissioning the next review at a 25 percent threshold provides better information to Government and stakeholders on the progress to deregulation.

53. The addition of a time bound review by 2021/22 provides a simple mechanism to ensure a review occurs within a reasonable period. This manages any scenario where sufficient competition emerges more quickly than reflected in the market share.

Removing the default expiry

54. To ensure the efficiency of the New Zealand dairy industry, a review needs to be undertaken before any deregulation occurs. Automatic expiry is resource-intensive and costly in the event that competition is insufficient to justify deregulation.

55. In the long term, any deregulation would be best progressed deliberately and in stages to manage the transition and provide certainty rather than through a blunt default expiry mechanism that results in rapid changes and costs to the industry.

Preferred option for the sunset provisions

56. The preferred option is to amend the sunset provisions as outlined in Option 2, preventing the default expiry in the South Island.

57. The evidence available suggests that regulation of the dairy industry remains necessary to promote the efficiency of the New Zealand dairy industry. Deregulation is only appropriate once there is sufficient competitive pressure to drive the long term efficiency of the New Zealand dairy industry. The preferred option allows more time for dairy markets to develop and enables a further review of the state of competition within a reasonable timeframe.

58. We seek your feedback on whether you agree with this option, whether or not the proposed threshold and timeframe are appropriate, and whether there are any further options you think should be considered.

GENERAL QUESTIONS ON PART 1: SUNSET PROVISIONS

1. Do you think the current default expiry should be allowed to occur or should the sunset provisions be amended? Why?
2. If the sunset provisions are to be amended, is a 25 percent market share threshold appropriate to trigger another review?
3. If the sunset provisions are to be amended, is a five year timeframe appropriate to trigger another review should the market share thresholds not be met?
4. If you do not agree with the above threshold amendments, what thresholds would be better and why?
5. What other option, if any, should be considered to amend the sunset provisions?

Part 2: Raw Milk Regulations

Background

59. The objectives of the Raw Milk Regulations 2012 are to:

- provide an entrance pathway for independent processors into the farm gate milk market; and
- support competition in downstream domestic markets for dairy products.

60. The Raw Milk Regulations aim to do this by requiring Fonterra to supply, at a regulated price:

- up to 50 million litres of raw milk in a season to any independent processor; and
- up to 250 million litres of raw milk to Goodman Fielder in a season.

61. The maximum total volume of regulated milk that Fonterra must supply is 795 million litres (last season the actual volume of regulated milk supplied was around half this volume). Monthly volume limitations apply and independent processors wishing to purchase regulated raw milk must provide Fonterra with forecasts of their intended purchases. There are limits to the extent to which the amount purchased can vary from the forecast volume.

62. The price of this regulated milk is prescribed as the farm gate base milk price for that season plus reasonable transport.

63. From 1 June 2016, an independent processor ceases to be eligible for regulated milk once its own supply has reached 30 million litres for three consecutive seasons.

Commerce Commission finding

64. The Commerce Commission report found that:

- competition in the factory gate market is very limited;
- without Subparts 5 and 5A of the DIRA, Fonterra would be able to increase the price of raw milk it sells to other domestic processors; and
- this would likely result in higher prices for dairy products in downstream domestic retail markets.

65. The Commerce Commission considers the pathway to deregulation would be smoothed by facilitating the development of a functioning factory gate market for non-DIRA milk. They recommended that the Government consider options for changes to the Raw Milk Regulations to facilitate such development, including:

- remove DIRA entitlements;
- investigate the price of regulated raw milk;
- reduce the entitlements of processors (including Goodman Fielder) to regulated milk;
- tighten the forecast tolerances allowed for in the Raw Milk Regulations.

66. The options identified below are designed to address the Commerce Commission's findings. To varying degrees, the options aim to encourage a more competitive factory gate market while providing an entrance pathway for new processors to emerge.

Option 1: Do not amend the Raw Milk Regulations

Description of option

67. Under this option the Raw Milk Regulations would remain as they are; no amendments would be made.

Analysis of option

68. The Raw Milk Regulations were always intended to be temporary as they are only necessary until sufficient competitive pressure on Fonterra can be applied by the market. As there is not yet sufficient competitive pressure, retaining the Raw Milk Regulations would continue to provide an entrance pathway for independent processors into the farm gate milk market and support competition in downstream domestic markets for dairy products.

69. While competition at the farm gate is increasing over time, there is very little competition emerging in the factory gate market. The Raw Milk Regulations may be hindering the development of a functioning factory gate market for non-DIRA milk, as the ability to purchase regulated milk means there appears little reason for processors to participate in the factory gate market.

70. Retaining the Raw Milk Regulations in their current state will likely mean that:
    - the benefits of the Raw Milk Regulations continue to be realised; but
    - the lack of competition in the factory gate market may be perpetuated.

71. The costs and benefits of retaining the Raw Milk Regulations in their current state are summarised in the table below:

Costs	Benefits
May cause Fonterra to maintain excess capacity to manage milk volume uncertainty. The Commerce Commission estimated the cost of this uncertainty to be around $6 million per year.	Limits Fonterra's ability to exercise market power by increasing the factory gate milk price (the Commerce Commission estimated the efficiency cost of this price increase could be in the order of $3.5 million to over $13 million).
May hinder the development of competition in the factory gate market.	Supports the entry and expansion of processors in the farm gate, non-DIRA factory gate and downstream domestic markets.
Unlikely to provide a long term pathway to deregulation. If the factory gate market does not develop, the costs of deregulation in future will be higher as Fonterra will be able to exercise greater market power at the factory gate.	

Option 2: Large, export-focused processors cease to be eligible for regulated raw milk

Description of option

72. Option 2 involves amendments to the DIRA regime so that large, export-focused processors are no longer eligible for regulated raw milk.

73. It is proposed that 'large, export-focused processors' could be defined by reference to:

- processing capacity (over 100 million litres per annum); and
- percentage of production exported (more than 50 percent).

74. Under this option, Fonterra may require any processor to make a declaration that they are not a large, export-focused processor prior to the supply of regulated raw milk. Fonterra would only be able to require such a declaration at the start of a season, immediately following a processor's estimate of the total quantity of raw milk required for the season (see regulation 12 of the Raw Milk Regulations).

75. This option could take effect from the start of the 2019/20 dairy season. This may provide lead in time for future entrants to New Zealand dairy markets to plan their business in accordance with the regulatory change.

76. Under this option, the current eligibility limitations in the DIRA would still apply, meaning that small or domestic-focused processors with their own supply from farms of greater than 30 million litres for three consecutive seasons are no longer eligible for regulated milk.

Analysis of option

77. This option is intended to facilitate development of the factory gate market as new entrant, large, export-focused processors would have to purchase raw milk in the unregulated factory gate market or directly from farmers.

78. Goodman Fielder, smaller exporting processors and domestic processors would still have access to regulated raw milk. Smaller processors are likely to be less able to develop the collection infrastructure required to access raw milk direct from farmer suppliers. They are also less likely to be able to negotiate efficient access to factory gate milk, because of their scale. This option would continue to provide an entrance pathway for those less likely to be able to access raw milk directly from farmer suppliers, and for those more focused on producing products for the domestic market.

79. Part of the intent of the Raw Milk Regulations is to provide an entrance pathway by bridging any short term lack of supply for new processors. Under this option large, export-focused processors would no longer benefit from this entrance pathway. However, large processors are more likely to have either the capital to purchase raw milk in the factory gate market, or a better ability to attract farmer suppliers. Recent, limited examples of large, export-focussed processors entering the market indicate that supplies of regulated milk may not be critical for market entry. Many new entrants are large companies with established reputations that have been able to source milk directly from farmers.

80. Under the current Raw Milk Regulations, from 1 June 2016, an independent processor ceases to be eligible for regulated milk once its own supply has reached 30 million litres for three consecutive seasons. This requirement would remain, meaning that many large processors will no longer have access to regulated milk from 1 June 2016 and others will no longer have access to regulated milk from 1 June 2017. This option would therefore not have any effect on such processors.

81. However, large, export-focused processors that enter New Zealand dairy markets in future or who do not currently have their own supply of raw milk from farms would be affected.

82. Any costs to large, export-focused new entrants that result from this option could be passed on to consumers in export markets and, to a lesser extent, downstream domestic markets (if the processor also sells domestically).

83. The costs of the Raw Milk Regulations on Fonterra may not be significantly reduced because this option would only affect a narrow class of processors, many of whom will not be eligible for regulated milk from 1 June 2016 under the current regulations.

84. The benefits of this option may be greater if there are high numbers of new, large, export-focused processors entering the New Zealand dairy industry. Without new entrants in future, there may not be much development of the factory gate market under this option. Therefore, this option may be less effective than others at smoothing the pathway to deregulation.

85. Farmers may receive some, albeit limited, benefit as it could encourage any new entrants to seek out more direct supplier relationships and increase competition at the farm gate. The retention of open entry and exit would further ease access to raw milk at the farm gate for processors that would no longer have access to regulated milk as an entrance pathway.

QUESTIONS ON OPTION 2: LARGE EXPORT-FOCUSED PROCESSORS CEASE TO BE ELIGIBLE FOR REGULATED RAW MILK

6. Do you agree with the removal of eligibility for large, export-focused processors? Why?

7. A large, export-focused processor could be defined by reference to processing capacity (over 100 million litres per annum); and percentage of production exported (more than 50 percent). Do you agree with the definition of a large, export-focussed processor?

8. If you do not agree with the definition of a large, export-focused processor, what alternative definition would you suggest and why?

9. Would large, export-focused processors no longer being eligible for regulated raw milk have an impact on your business? If yes, what would the impact likely be?

10. Are there advantages and/or disadvantages of this option that have not been identified? If yes, what are they?

Option 3: Reduce the volumes of regulated raw milk available

Description of option

86. This option would involve staged reductions in the volumes of regulated raw milk that processors are entitled to take. For example, the total volume available each season could be reduced by 60 percent over three years as shown in the table below:

Season	Regulated volumes
Up to and including 2017/18	The existing volumes per season: 50 million litres 250 million litres for Goodman Fielder
2018/19	40 million litres 200 million litres for Goodman Fielder
2019/20	30 million litres 150 million litres for Goodman Fielder
2020/21 and all following seasons	20 million litres 100 million litres for Goodman Fielder

87. The incremental volume reductions would gradually shift an increasing portion of a processor's raw milk supply to the unregulated factory gate market or to the farm gate market (milk direct from farmers).

88. The timeframes for staged implementation of volume reductions would enable changes in demand for regulated milk to be observed over time. If combined with a reset of the market share thresholds (see Part 1), changes in demand could inform another review of the state of competition in the dairy industry.

Analysis of option

89. This option would likely have the most impact on the factory gate market, as some processors using regulated milk, particularly Goodman Fielder, may need to consider alternative sources as the available regulated milk volume dropped. New entrants of a reasonable size would also need to source milk in addition to the regulated milk available. This may also have a positive impact on the farm gate market.

90. This option could support the eventual deregulation of New Zealand's dairy markets, as it would gradually decrease the reliance on the Raw Milk Regulations and encourage processors like Goodman Fielder to look to either the factory gate or farm gate markets for their supply of raw milk. More processors may also consider selling to the factory gate market with increases in demand.

91. Option 3 would mitigate some of the costs to Fonterra that result from the Raw Milk Regulations by decreasing the amount of regulated milk that Fonterra is required to make available at a fixed price.

92. The costs of this option would fall on current and future purchasers of regulated raw milk. The extent of the costs would depend on the extent to which each processor currently purchases regulated milk.

93. Many small processors take less than 20 million litres per season and would therefore not be affected by this option. Processors that take more than 20 million litres per season would need to source any excess volumes from the unregulated factory gate market or direct from farmers. This could result in some benefits to farmers through any increase in farm gate competition.

94. The extent of costs also depends on a processor's ability to substitute regulated milk and the prices of the substitutes available. Large independent processors with their own supply of milk from farms would likely experience a lesser impact from this option. Regulated raw milk makes up a relatively small proportion of the raw milk they process. Furthermore, under the current Raw Milk Regulations, many large processors will no longer have access to regulated milk from 1 June 2016.

95. Goodman Fielder would likely be most affected by this option. It is unclear whether any reduction in regulated volumes would affect Goodman Fielder under their current contract with Fonterra. Upon expiry of any existing contracts, Goodman Fielder would need to enter the factory gate or farm gate market to source the majority of its raw milk.

96. For all processors, any costs from the reduction in regulated volumes could be passed on to consumers in export or downstream domestic markets.

QUESTIONS ON OPTION 3: REDUCE VOLUMES OF REGULATED RAW MILK AVAILABLE

11. Do you consider any changes to the volume of regulated milk to be appropriate? why?

12. Do you agree with the suggested volume reductions for regulated milk? Why? If not, what alternative volume reductions would you suggest, and why?

13. Would this option for staged reductions in the volumes of regulated raw milk have an impact on your business? If yes, what would the impact likely be?

14. Are there advantages and/or disadvantages of this option that have not been identified? If yes, what are they?

Option 4: Reduce the forecasting flexibility for regulated raw milk

Description of option

97. The current Raw Milk Regulations require independent processors wanting to purchase regulated milk, including winter milk, to provide Fonterra with an estimate for supply:

- at least three months before the date on which the milk is to be supplied (or 18 months in the case of winter milk); and
- at least one week before the date on which the milk is to be supplied.

98. The one week estimate may be up to 40 percent more or 40 percent less than the three month estimate. Fonterra may require the purchase of up to 80 percent of the quantity of raw milk estimated one week prior by the independent processor. The independent processor may also require Fonterra to sell up to 120 percent of the quantity of raw milk estimated one week prior by the independent processor.

99. These requirements provide Fonterra with some certainty about the volumes of milk it will be required to provide, allowing it to reduce costs associated with providing regulated milk.

100. Option 4 proposes increasing the level of certainty Fonterra has by reducing the extent to which a processor is able to vary their estimated regulated milk volume requirements. This option is summarised in the table below, using example figures:

	Variance between 1 week and 3 month estimates	Variance between 1 week estimate and contracted volume
Current regulations	1 week estimate can be 40% more or 40% less than the earlier 3 month estimate	Fonterra may require contract for up to 80% of estimated volume Purchaser may require contract for up to 120% of estimated volume
Amendment option	1 week estimate can be 20% more or 20% less than the earlier 3 month estimate	Fonterra may require contract for up to 90% of estimated volume Purchaser may require contract for up to 110% of estimated volume

101. This option could take effect from the start of the 2018/19 dairy season.

Analysis of option

102. Option 4 would shift some of the risks and costs associated with uncertain regulated volumes from Fonterra to purchasers of regulated raw milk. This would mitigate some of the costs to Fonterra that result from the Raw Milk Regulations.

103. The costs of this option would fall on current and future purchasers of regulated raw milk. The extent of the costs would depend on the quality of their forecasting of the volumes they required. Fonterra could charge a market price for any milk purchased in excess of the forecast variance allowed under this option. Fonterra could also refuse to sell raw milk in excess of the allowed forecast variance. For purchasers

wanting less raw milk than the forecast variance allowed under this option, Fonterra could require payment for 90 percent of the forecast volume.

104. As well as transferring some of the risks and associated costs to purchasers of regulated raw milk, this option may act as a disincentive to purchase regulated raw milk more generally. Processors could find purchasing raw milk at the farm gate or unregulated factory gate relatively more appealing because of the increased risk in the purchase of regulated raw milk.

105. Many large processors will no longer have access to regulated milk from 1 June 2016 and will not be affected by this option.

106. For all processors, any costs from the increase in the regulated price could be passed on to consumers in export or downstream domestic markets.

QUESTIONS ON OPTION 4: REDUCE THE FORECASTING FLEXIBILITY FOR RAW MILK

15. Do you consider the idea of changing the forecasting requirements to be appropriate? Why?
16. Do you agree with the specific changes to the forecasting requirements suggested in the discussion document? Why?
17. If you do not consider the suggested changes to the forecasting requirements to be appropriate, what alternative forecasting requirements would you suggest and why?
18. Would this option to amend the forecasting requirements impact on your business? If yes, what would the impact likely be?
19. Are there advantages and/or disadvantages of this option that have not been identified? If yes, what are they?

Preferred option for the Raw Milk Regulations

107. Our preferred option at this stage is to amend the regulations so that Fonterra no longer needs to sell regulated raw milk to large, export-focused processors. In addition, the volumes of regulated raw milk available to other processors would be reduced by 60 percent over three years. This is a combination of Option 2 and Option 3 above.

108. We seek your feedback on all available options, including combinations of options and options not described in this discussion document.

GENERAL QUESTIONS ON PART 2: RAW MILK REGULATIONS

20. Which of the options (or combination of the options) described in this Part do you prefer (if any) and why?
21. Are there other options, not described in this Part, which should be considered? If so, what are the potential costs and benefits of that option?

Part 3: Open entry for new dairy conversions

Background

109. The open entry provisions aim to reduce farmers' switching costs, lower barriers to entry for independent processors, and provide Fonterra with an incentive to set an efficient farm gate base milk price.

110. The current open entry and exit provisions mean that:

- Fonterra must accept applications to become a shareholding farmer, with some exceptions (open entry);
- Fonterra must allow shareholding farmers to withdraw from the co-operative without unreasonable restrictions or penalties (subject to the agreed terms of supply);
- Fonterra must not discriminate between shareholding farmers in the same circumstances;
- Fonterra must ensure that in any part of New Zealand a third of all milk solids produced within a 160km radius are supplied to independent processors or supplied to Fonterra under contracts that expire, or can be freely terminated by the supplier, at the end of each season.

111. The DIRA currently allows Fonterra to decline applications to become a shareholding farmer in the following limited circumstances:

- where the supply of milk solids obtainable from milk to be supplied by the applicant in a season is less than 10,000 kg;
- if the cost of transporting the milk of a new entrant exceeds the cost of transporting the most expensive current shareholding farmer's milk; or
- if the shareholding farmer fails to satisfy the applicable terms of supply (terms of supply are not prescribed but must not frustrate the purpose of the DIRA, an example might be having appropriate access to the property for a tanker).

Commerce Commission finding

112. The Commerce Commission recommended that the Government keep the open entry and exit provisions in place during any reforms to the Raw Milk Regulations, as they may help ensure the development of a factory gate market by facilitating further entry into, or expansion in, the farm gate market by independent processors that could then enter the factory gate market. They may also allow for independent processors to increase their own-sourcing of raw milk direct from farmers.

113. The Commerce Commission further recommended that the Government explore the option of removing open entry for new conversions, because open entry for new conversions contributes little to promoting efficiency in the farm gate market and potentially imposes costs on Fonterra. However, the Commerce Commission did not find evidence to suggest that these provisions currently impose material costs.

114. Aside from open entry for new conversions, we are not considering any further changes to open entry and exit at this time.

Option 1: Do not amend the open entry provisions

Description of option

115. Under this option the open entry provisions would remain as they are; no amendments would be made.

Analysis of option

116. Fonterra has stated that open entry for new dairy conversions imposes costs on them, due to the investment in processing capacity that may be required for large new conversions and the risk of asset stranding if a large new conversion were then to switch and supply a different processor.

117. The Commerce Commission did not find evidence to suggest that the costs of open entry were material. Increased supply and uncertain milk volumes are driven by changes in global commodity prices and the weather more so than open entry. Furthermore, growth in milk production is likely to mitigate any asset stranding risk. New Zealand has experienced a 6 percent compound annual growth rate in milk production over the last 5 years. Future projected milk pool growth is uncertain but is expected to be around 2 percent per year in the next five years. Fonterra also invests in excess capacity in order to have greater flexibility in its product mix and therefore generate more value.

118. Fonterra has some options to mitigate and reduce the materiality of any costs associated with open entry and milk supply uncertainty. These include:

- longer term contracts (to the extent allowed under the DIRA);
- tactical pricing in order to fill surplus capacity; and
- a transport cost component in the farm gate milk price.

Option 2: Amend the open entry provisions for new dairy conversions

Description of option

119. Under this option the open entry provisions would be amended so that Fonterra would no longer have to accept an application to become a shareholding farmer, where the application was in relation to a new dairy conversion.

120. New dairy conversions could be defined as a collection point from which no dairy processor has collected cows' milk since 2001 (the year that the DIRA took effect). Defining new conversions by reference to a collection point or milking shed means than an extension of an existing dairy farm would still benefit from open entry.

121. This option could take effect from the start of the 2018/19 season. Transitional provisions could apply so that new dairy conversions that are already underway would still benefit from open entry. This would recognise the planning, investment, consenting, and construction that may have already occurred in reliance on the existing DIRA provisions.

Analysis of option

122. The benefits of this option to Fonterra is that it may reduce the risk that Fonterra invests in capacity without having any security of ongoing supply. This risk may be significant for very large conversions. However, the Commerce Commissions did not find evidence to suggest that open entry currently imposes material costs on Fonterra.

123. Allowing Fonterra to choose whether or not to accept an application from a new conversion to become a shareholding farmer would put it in a better position to negotiate longer term supply contracts. This may enable Fonterra to better manage

its investment in processing capacity and mitigate any associated costs. However, the 33 percent rule in section 107(3) of the DIRA would still apply and limit the number of long term contracts Fonterra is allowed in any area.

124. Under this option, Fonterra would continue to be required to accept an application to increase the volume of milk supplied by an existing shareholding farmer. Fonterra would also continue to be required to accept applications to become a shareholding farmer from dairy farmers that currently supply another processor.

125. While this option benefits Fonterra, it would involve risks for persons that carry out dairy conversions in future, as they would no longer have certainty that Fonterra would accept their supply.

126. In most cases, particularly in regions where there are more dairy conversions, Fonterra would likely still have commercial incentives to continue to compete for farmers' milk. This means the impacts of this option are not expected to be significant.

Preferred option for open entry for new conversions

127. Our preferred option at this stage is to amend the regulations so that Fonterra would no longer have to accept an application to become a shareholding farmer, where the application was in relation to a new dairy conversion.

128. We seek your feedback on whether you agree with this preferred option, whether the proposed definition is appropriate, the impact of these options on your business and whether there are any other options you think should be considered.

GENERAL QUESTIONS ON PART 3: OPEN ENTRY FOR NEW DAIRY CONVERSIONS

22. Would you prefer open entry to remain unchanged, do you think that open entry should not apply for new dairy conversions, or are there other options you think are more appropriate?

23. New dairy conversions could be defined as a collection point from which no dairy processor has collected cows' milk since 2001 (the date the DIRA was passed). Do you agree with the suggested definition of a new dairy conversion?

24. If you do not agree with the suggested definition of a new dairy conversion, what alternative definition would you suggest and why?

25. Would removing open entry for new dairy conversions impact on your business? If yes, what would the impact likely be?

26. Are there advantages and/or disadvantages of this option that have not been identified in the discussion document? If yes, what are they?

Part 4: Provisions where amendments are not recommended

The 20 percent rule

129. Under section 108 of the DIRA, Fonterra shareholding farmers are entitled to allocate to independent processors up to 20 percent of their weekly production throughout the season. Any farmer using this rule must give Fonterra notice of the arrangements for the collection of milk allocated to independent processors. Fonterra may require milk supplied to independent processors to be stored in a separate milk vat to the vat used for Fonterra milk.

130. Some small niche food processors use the 20 percent rule. Some have business models that are dependent on the rule because they:

- take small volumes; and
- value the relationship with the supplier and understanding of how and where the milk is produced.

131. The Commerce Commission found that the rule should remain in force as Fonterra otherwise has the ability and incentives to use its market power to the detriment of these small niche processors and consumers in downstream domestic markets.

132. The Commission recommended that the Government consider the separate vat requirement given the potential regulatory and cost burden it places on small processors.

133. To date, there is no evidence that Fonterra has required two vats. In the absence of evidence of a problem, our preferred option is to maintain the status quo, monitor the way the rule is used, and consider regulatory changes if problems arise in future.

The milk price monitoring regime

134. The milk price monitoring regime was added to the DIRA in 2012. The regime is intended to promote the setting of a base milk price that provides an incentive to Fonterra to operate efficiently while providing contestability in the market for the purchase of milk from farmers.

135. The Commerce Commission reports annually on Fonterra's milk price manual and base milk price calculation. In general, the Commerce Commission has found that the price set by Fonterra is consistent with the efficiency and contestability purpose in the DIRA.

136. In the Commerce Commission's 2014/15 base milk price calculation review, it was noted that Fonterra had made good progress in increasing the transparency of information on how it calculates the base milk price. The Commerce Commission is also working with Fonterra, independent processors, and other stakeholders as part of the Commission's ongoing evaluation to further increase transparency and conclude on the efficiency and contestability of further components of the base milk price calculation.

137. The Commerce Commission has found that there are costs to Fonterra associated with the milk price monitoring regime (the Commerce Commission's monitoring costs are funded through a levy on Fonterra). However, similar costs are likely to exist even without the milk price monitoring regime because of shareholder demand for transparency and efficient pricing.

138. Having the monitoring undertaken by the Commerce Commission (rather than an appointed auditor or similar) helps ensure independence and improvements in transparency over time.

139. The milk price monitoring regime has only been in place since 2012 and since then has functioned as intended. We do not propose any changes to the milk price monitoring regime at this time.

Monitoring and evaluation

140. The Government has been monitoring the share of milk solids collected by Fonterra and independent processors in the North Island and South Island.

141. Under the preferred option for the sunset provisions, the DIRA would continue to require all dairy processors to keep a record of the kilograms of milk solids collected and provide that record to the Minister upon request. This will enable ongoing monitoring of the market share thresholds in the DIRA.

142. Under the preferred option the market share thresholds would trigger a comprehensive report on the state of competition in the New Zealand dairy industry. That report would be an opportunity for further evaluation and review of whether the chosen policy options are achieving their objectives.

143. Monitoring the development of the factory gate market for raw milk could be done through interviews and information requests during a further report on the state of competition in the dairy industry. Alternatively, the Government could undertake proactive monitoring of milk solids purchased in the unregulated factory gate market. This could be done through the same annual milk solid collection survey but would require an amendment to the DIRA to require dairy processors to keep and provide a record of factory gate purchases of unregulated raw milk.

QUESTIONS: MONITORING AND EVALUATION

27. Do you think that the Government should monitor the development of the unregulated factory gate market for raw milk?

28. What impact on your business would there be as a result of keeping, and providing to the Government, a record of milk solids purchased in the unregulated factory gate market?

Summary of options

144. The table below summarises the options considered in this Discussion Document and the Government's preferred options.

Part 1: Sunset provisions
Option 1 (status quo): Do not amend the current sunset provisions, allowing default expiry of most of Subpart 5 and 5A of the DIRA (excluding Trading Among Farmers and the Raw Milk Regulations) in the South Island.
Option 2 (preferred option): Remove the default expiry and reset the market share thresholds so that a further state of competition review occurs the sooner of either: • when independent processors achieve a 25 percent market share in the North or South Island; or • after five years (anticipated to be the end of the 2021/22 season).
Part 2: Raw Milk Regulations
Option 1 (status quo): Do not amend the Raw Milk Regulations.
Option 2: Remove large, export-focused processors eligibility for regulated raw milk.
Option 3: Incrementally reduce the volumes of regulated raw milk available to all independent processors.
Option 4: Reduce the forecasting flexibility for regulated raw milk by reducing the extent to which processors are able to vary their estimated regulated milk volume requirements.
Option 2 + 3 (preferred option): Remove the requirement on Fonterra to sell regulated raw milk to large, export-focused processors and reduce the volumes of regulated milk available to other processors.
Part 3: Open entry provisions
Option 1 (status quo): Do not amend the open entry provisions.
Option 2 (preferred option): Remove the requirement on Fonterra to accept an application to become a shareholding farmer where the application was in relation to a new dairy conversion.

Next steps

145. Following submissions, officials will advise the Minister for Primary Industries and Cabinet on policy options. Unless the Government decides to maintain the status quo (default expiry provisions remain in place), final policy decisions will require a bill to be drafted and introduced to Parliament.

146. Any bill to amend the Dairy Industry Restructuring Act 2001 would likely be introduced to Parliament in late 2016.

147. There will be a further opportunity for stakeholders to engage with proposed policy decisions and the specific wording of a bill at Select Committee.

Order in Council for the default expiry

148. Because the Minister for Primary Industries has certified that the market share threshold has been met in the South Island and responded to the Commerce Commission report, the default expiry process must continue.

149. The Governor General must declare by Order in Council that certain provisions in the DIRA will expire in the South Island by 31 May 2018.

150. The making of this Order in Council is a mandatory process and does not indicate the Government's intention. The outcome of the consultation based on this discussion document and any resulting legislative amendments will determine whether or not the Order in Council for expiry takes effect on 31 May 2018 or is repealed.

Glossary

Term	Definition / Explanation
20 percent rule	means the rule in section 108 of the DIRA
Base milk price	means the price per kilogram of milk solids that is set by Fonterra for a dairy season
Commerce Commission	means the independent Crown entity established under section 8 of the Commerce Act 1986 whose purpose is to achieve the best possible outcomes in competitive and regulated markets for the long term benefit of New Zealanders
Commerce Commission report	means the *Report on the state of competition in the New Zealand dairy industry* prepared by the Commerce Commission under section 148A of the Dairy Industry Restructuring Act 2001 and available at: http://www.comcom.govt.nz/dmsdocument/14111
DIRA	means the Dairy Industry Restructuring Act 2001
Dairy season	means a period of 12 months beginning on 1 June in a year and ending on 31 May in the following year
Downstream domestic markets	means the wholesale and retail markets for dairy products in New Zealand
Factory gate market	means the market where raw milk is traded between different dairy processors in New Zealand
Farm gate market	means the market where raw milk is sold by farmers and purchased by dairy processors
Independent processor(s)	means a processor of raw milk or milk solids or dairy products who is not Fonterra or associated with Fonterra
Milk price manual	means the manual that must be maintained by Fonterra under section 150F of the DIRA
Milk price monitoring regime	means the process in Part 2, Subpart 5A of the DIRA by which Fonterra sets the base milk price and is monitored by the Commerce Commission
Milk solids	means the milk-fat and protein components of raw milk
Non-DIRA milk	means raw milk that is not sold by Fonterra under the Raw Milk Regulations, for example raw milk that is traded between processors in an unregulated factory gate market
Open entry	means the rules in sections 73 to 96 of the DIRA
Open exit	means the rules in sections 97 to 107 of the DIRA
Raw milk	means untreated milk from a cow and includes organic milk, but does not include (i) milk or components produced under special conditions or (ii) colostrum
Raw Milk Regulations	means the Dairy Industry Restructuring (Raw Milk) Regulations 2012
Regulated milk	means raw milk purchased under the Raw Milk Regulations
Select Committee	means the committee of Parliament to which a bill is referred for examination
Shareholding farmer	means a dairy farmer who is registered as the holder of Fonterra co-operative shares
Trading Among Farmers (TAF)	means Fonterra's capital structure enabled by sections 109A to 109N of the DIRA and includes the Fonterra Shareholders' Market and the Fonterra Shareholders' Fund