

Chair  
Economic Growth and Infrastructure Committee

**Efficiency and contestability of the New Zealand dairy industry – amendments to the Dairy Industry Restructuring Act 2001 and the Dairy Industry Restructuring (Raw Milk) Regulations 2012**

**Proposal**

1. This paper proposes amendments to the Dairy Industry Restructuring Act 2001 (DIRA) and the Dairy Industry Restructuring (Raw Milk) Regulations 2012 (Raw Milk Regulations), largely arising from the recent review of the state of competition in dairy markets. This paper also proposes new regulations for ongoing monitoring of dairy markets and technical amendments to the DIRA to recognise the change in management arrangements for the New Zealand Dairy Core Database that was agreed by Cabinet in 2014.

**Executive Summary**

2. The DIRA and the Raw Milk Regulations regulate the activities of Fonterra in relation to its suppliers and competitors to ensure that New Zealand dairy markets remain contestable, and therefore operate efficiently, despite Fonterra's dominant position in the New Zealand dairy markets.
3. The need for the DIRA regulatory provisions is contingent on sufficient competition developing in New Zealand dairy markets. Once sufficient competition is in place, competitive pressure, rather than the DIRA regulatory provisions, should drive the efficiency of New Zealand dairy markets.
4. Therefore, the DIRA contains statutory review provisions, requiring an assessment of the state of competition in the dairy markets and options (if any) for a transition pathway to deregulation. A statutory review of DIRA was triggered in 2015. If the DIRA is not amended, the key efficiency and contestability provisions will expire in the South Island by 31 May 2018.
5. The statutory review of the state of competition in the dairy markets, undertaken by the Commerce Commission, found that the current state of competition is not yet sufficient to ensure the efficient and contestable operation of the dairy markets in the absence of the DIRA regulatory regime.
6. The Commerce Commission also recommended that any transition pathway to deregulation should take a staged approach and initially involve removing elements of the regulatory regime that contribute least to efficiency and contestability. To this end, the Commerce Commission identified two areas of potential focus: the open entry requirement for new dairy conversions, and independent processors' milk entitlements under the Raw Milk Regulations.

7. In June 2016, the Ministry for Primary Industries (MPI) consulted on a package of changes to the DIRA regulatory regime. Consultation provided new information about potential impacts on downstream domestic markets arising from reduced entitlements to raw milk under the Raw Milk Regulations, particularly for Goodman Fielder. As a result, I have decided to defer consideration of these particular changes until further work has been done.
8. In the meantime, I propose to progress a number of other changes to the DIRA and the Raw Milk Regulations designed to:
  - ensure the efficient operation of New Zealand dairy markets by retaining the DIRA regulatory regime at this stage with a provision to review the state of competition in the near future;
  - smooth the pathway towards future deregulation by removing elements of the regime that contribute least to its efficiency and contestability objectives; and
  - signal future deregulation by managing industry's expectations about availability of and eligibility for raw milk under the Raw Milk Regulations.
9. To ensure the efficient operation of New Zealand dairy markets, I propose to amend the DIRA regulatory regime by:
  - removing the default expiry provisions and the market share thresholds in the North and South Islands which trigger a review of the state of competition;
  - requiring a review of the state of competition to commence during the 2020/21 dairy season;
  - requiring a review at five yearly intervals thereafter if competition has not yet been considered to be sufficient;
  - provide more flexibility in relation to the scope and process provisions of future state of competition reviews; and
  - enabling ongoing monitoring of the developments in the dairy markets through improved information collection powers and new regulations for collecting information on milk solids collected from farmers.
10. These efficiency-enhancing amendments will ensure that the DIRA regulatory regime continues to apply until sufficient competition in dairy markets develops, while also ensuring that the risk of the DIRA regulatory regime remaining in place too long is minimised.

11. To smooth the pathway towards future deregulation, I also propose to amend the DIRA regulatory regime by:
  - allowing Fonterra discretion to refuse milk supply from new dairy conversions; and
  - reducing the forecasting flexibility currently available to independent processors in purchasing raw milk from Fonterra under the Raw Milk Regulations.
12. These provisions were found to contribute least to efficiency and contestability and can therefore be removed now to smooth the pathway towards future deregulation without undermining the regime's overall objectives.
13. To further signal future deregulation, and help manage expectations around the future availability of raw milk under the Raw Milk Regulations, I propose to amend the DIRA regulatory regime by:
  - reducing the total volume of raw milk that Fonterra must supply to independent processors under the Raw Milk Regulations from 795 million litres to 600 million litres in a season; and
  - removing the requirement for Fonterra to supply raw milk to large export-focused processors under the Raw Milk Regulations. The volume of regulated milk that other processors are entitled to will remain unchanged.
14. I also propose to make a number of minor and technical amendments to the DIRA unrelated to the Commerce Commission's review of the state of competition.
15. These changes are broadly consistent with MPI's discussion document and other consultation, with the exception of the trigger for the next review of the state of competition, and one further proposal that has now been deferred. These are discussed further in this paper.
16. There will be a high level of industry interest in the package of changes. Opinions are generally divided between Fonterra and its shareholding farmers, who would like to see the contestability and efficiency provisions of DIRA removed sooner, and other participants in the dairy industry, who are more likely to consider that some form of regulation continues to be needed.

## **Background**

### *The DIRA: contestability and efficiency provisions*

17. The DIRA was passed in 2001 to enable the formation of Fonterra through the merger of New Zealand's two largest dairy co-operatives and the New Zealand Dairy Board. At that time Fonterra collected 96 percent of New Zealand's total raw milk production. To address the company's dominance, the DIRA, together

with the Raw Milk Regulations, contains provisions to promote efficiency and contestability in dairy markets, including:

- Open entry - Fonterra must accept all applications to become a shareholding farmer and must accept all milk supplied by shareholding farmers.
- Open exit - Fonterra must allow shareholding farmers to withdraw from the co-operative without unreasonable restrictions or penalties.
- The 20 percent rule - Fonterra shareholding farmers can allocate up to 20 percent of their weekly production to independent processors.
- Milk price monitoring - 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.

#### *The Raw Milk Regulations*

18. The Raw Milk Regulations are made under the DIRA. The Regulations facilitate the entry of independent processors to New Zealand dairy markets by enabling them to obtain an initial supply of raw milk while they establish financial backing and attract farmer suppliers. The Regulations also support competition in downstream domestic markets for dairy products.
19. 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<sup>1</sup> up to a combined maximum total of 795 million litres per year. 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.
20. The Raw Milk Regulations were amended in 2012 to provide that, from 1 June 2016, an independent processor ceases to be eligible for regulated milk once its own supply of milk from farmers has reached 30 million litres for three consecutive seasons.<sup>2</sup>

#### *Other functions of the DIRA: dairy herd improvement.*

21. Separately to the efficiency and contestability provisions that manage competition in the dairy markets, the DIRA includes provisions to support dairy herd improvement, including arrangements for the management of industry good data to support genetic gain.

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<sup>1</sup> Goodman Fielder is a consumer food company which owns a large number of food brands in New Zealand along with a range of non-dairy brands. It is Fonterra Brands' main competitor in the New Zealand domestic consumer market for fresh milk and other dairy products.

<sup>2</sup> The dairy season runs from 1 June to 31 May the following year.

## **A review of the state of competition in the dairy industry was triggered in 2015**

22. The efficiency and contestability provisions in the DIRA are intended to be transitional, with deregulation to occur when there is sufficient competition. The DIRA therefore provides for default expiry of the contestability and efficiency provisions. Default expiry is 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.
23. The market share threshold in the South Island was met in the 2014/15 dairy season, when independent processors collected 22 percent of milk solids. Consequently, the key contestability and efficiency provisions - open entry and exit requirements, the 20 percent rule and milk price monitoring requirements - will expire in the South Island by 31 May 2018 unless the DIRA is amended before then. Provisions enabling Trading Among Farmers and the Raw Milk Regulations would continue to apply until the 20 percent market share threshold is reached in the North Island.
24. The fact that the 20 percent market share threshold has been met in the South Island is not conclusive evidence of sufficient competition and efficient dairy markets. Therefore the DIRA requires that a detailed review on the state of competition in the New Zealand dairy industry be undertaken, and specifies the nature of this review. On 2 June 2015, I requested a report from the Commerce Commission with terms of reference agreed in consultation with the Minister of Commerce and Consumer Affairs.
25. The Commerce Commission released its report on 1 March 2016. The report found that the current state of competition is not yet sufficient to warrant deregulation at this time. The Commerce Commission recommended removing the default expiry provisions and resetting the triggers for a further review at the point when independent processors achieve a market share of 30 percent in the North or South Island or after five years (the 2021/22 season).
26. The Commerce Commission also recommended that any transition pathway to deregulation should take a staged approach and initially involve removing elements of the regulatory regime that contribute least to efficiency and contestability. To this end, the Commerce Commission suggested 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, as a possible pathway to deregulation; and
  - the open entry provisions, so that Fonterra no longer has to accept an application from a new conversion to be a shareholding farmer.
27. I directed MPI to consult stakeholders in June 2016 on proposals to reset the expiry provisions, amend the open entry provisions regarding new dairy conversions, and amend the Raw Milk Regulations to further reduce reliance on access to regulated milk.

### *Downstream markets*

28. Consultation indicated there is significant risk to the domestic consumer market in proceeding with any reduction to regulated milk entitlements for processors supplying downstream domestic markets, in particular Goodman Fielder.
29. The domestic consumer market for dairy products is characterised by milk originally supplied by two large processors (Fonterra and Goodman Fielder) and a number of smaller companies. Fonterra and Goodman Fielder are the main nationwide suppliers of fresh milk and other dairy products. Smaller processors primarily provide a range of speciality cheeses and yoghurts.
30. Goodman Fielder and a number of the small niche processors are heavily reliant on regulated milk, particularly during the winter months given their need for year-round supply to make short-life dairy products, such as fresh milk. These processors have not identified alternative sources of supply, as Fonterra is the only significant provider. This raises risks for the consumer market in terms of choice, price, and availability of household staples.
31. MPI must work with other agencies to better understand the future state of downstream markets, particularly the domestic market, and the role regulated raw milk plays in ensuring competition for New Zealand consumers before developing and assessing options to proceed in this area.
32. I therefore propose not to reduce the regulated milk entitlements of Goodman Fielder and small processors to regulated milk at this time, pending further work to be undertaken.

### **A: Proposed Amendments to the DIRA and the Raw Milk Regulations arising from the Commerce Commission's review of the state of competition**

#### **Summary of proposed changes**

33. I seek Cabinet's agreement to a package of amendments to the DIRA and the Raw Milk Regulations to:
  - ensure the efficient operation of New Zealand dairy markets by retaining the DIRA regulatory regime at this stage with a provision to commence a review of the state of competition during the 2020/21 season;
  - smooth the pathway towards future deregulation by removing elements of the regime that contribute least to its efficiency and contestability objectives; and
  - signal future deregulation by managing industry's expectations about availability and eligibility for raw milk under the Raw Milk Regulations.

34. The package will:

- remove the default expiry and market share thresholds;
- require a review of the state of competition to commence during the 2020/21 dairy season;
- require ongoing reviews at five yearly intervals thereafter, if competition has not yet been considered to be sufficient;
- provide more flexibility in relation to the scope and process provisions of future state of competition reviews;
- allow Fonterra discretion to refuse to accept supply from new dairy conversions;
- enable ongoing monitoring of the developments in the dairy markets through improved information collection powers and new regulations for collecting information on milk solids collected from farmers;
- remove the requirement for Fonterra to supply raw milk to large, export-focused processors under the Raw Milk Regulations;
- reduce the forecasting flexibility currently available to independent processors in purchasing raw milk from Fonterra under the Raw Milk Regulations; and
- reduce the total volume of raw milk that Fonterra must supply to independent processors under the Raw Milk Regulations from 795 million litres to 600 million litres in a season.

35. Other DIRA efficiency and contestability provisions will remain unchanged. These are the 20 percent rule, which allows Fonterra shareholding farmers to allocate up to 20 percent of their production to other processors, and the milk price monitoring regime.

*1: Remove default expiry, revise trigger for next review, and enable more flexibility in future reviews*

#### Proposal

36. I propose to amend the DIRA to remove the default expiry provision and prevent parts of the regime from expiring in the South Island in 2018. I also propose to remove the market share thresholds that are one of the current triggers of a review of the state of competition.

37. I propose to amend the DIRA to require that a review of the state of competition in the New Zealand dairy industry commences during the 2020/21 dairy season. Thereafter, if the regulatory regime remains in place, I propose that the DIRA requires a review at five yearly intervals on an ongoing basis, to enable the continued need for it to be further assessed.
38. I also propose that the requirements that the DIRA establishes around the recommendations of and process for future reviews should be amended to ensure reviews are not unnecessarily constrained.

#### Comment

39. Given that competition in the dairy industry is not yet sufficient, I consider that the DIRA regulatory regime should be retained at this stage, and that the key efficiency and contestability provisions should not be allowed to expire in the South Island by 31 May 2018.
40. The current default expiry of the efficiency and contestability provisions in the DIRA was included to signal a clear intent that the regulatory regime is transitional. Removal of the default expiry provision could be viewed as lessening this intent. However, the DIRA will continue to require review, with an appropriate trigger, as outlined below. The default expiry requirement imposes an unhelpful additional administrative step, and imposes time and scope constraints.
41. The current triggers for the review are either that the market threshold is met (in one or both islands) or a particular point in time is reached (for the recent review this was 1 June 2015).
42. The Commerce Commission recommended that the next review of the state of competition be triggered by the sooner of the 2021/22 season, or a 30 percent market share of independent processors in either Island.
43. I consulted publicly on a proposal that the next review be triggered by the sooner of the 2021/22 season, or a 25 percent market share. I proposed 25, rather than 30, percent in order to monitor how the dairy industry progresses towards deregulation on a more regular basis. Independent processors' market share in the South Island is currently [REDACTED]. Based on current trends, it is possible that the proposed 25 percent market share threshold may be reached in the South Island within the next five years.
44. Fonterra considered that, if the Government decided to introduce a revised threshold, it should be no more than 25 percent, and open entry and exit should expire as soon as it is reached. Goodman Fielder, Foodstuffs, the New Zealand Food and Grocery Council, independent processors and Federated Farmers supported the Commerce Commission's recommendation of a 30 percent market share threshold.



45. Relying on a market share, rather than a specific date, to trigger the next review of the state of competition creates uncertainty. Market share thresholds, although simple, are imperfect proxies of competition.
46. I therefore consider that the market share thresholds should be removed, and that the DIRA should require that the next review of the state of competition begin during the 2020/21 dairy season. This will give the industry certainty as to the timing of the next review. This does not preclude the government from initiating a review earlier, should competition develop more quickly than anticipated, or for any other reason.
47. The end of the 2020/21 dairy season will be three years after the amended DIRA comes into effect, and twenty years after the DIRA itself was enacted. The Commerce Commission considered that the next review should occur in 2021/22 (if not triggered earlier by the 30% market share threshold being reached). I prefer that the review begin a year earlier than this to reduce the risk of regulating the industry for longer than is necessary.
48. To ensure the next review is not unnecessarily constrained, I consider that the DIRA's statutory requirements around the review of the state of competition should be revisited. For example:
- The DIRA requires the review to include options for a transition pathway to deregulation (if any). The assumption that deregulation will occur may prevent the development of other options that would better contribute to the efficiency and contestability of the dairy industry.
  - The DIRA currently requires the agency undertaking a review of the state of competition to also recommend options (if any) for a pathway to deregulation if competition is found to be insufficient. It also specifies that the agency undertaking the review can be either the Commerce Commission or another government agency. I consider there is merit in unbundling the highly complex and technical competition analysis function (i.e. the question of whether or not there is sufficient competition in dairy markets) from the public policy advice function that would follow. I consider that, for the purposes of a future statutory review, it would be prudent for the DIRA to enable these advisory functions to be separated and not necessarily be required to be carried out by a single agency.
49. A cross-government review, led by MPI, will be necessary in order to take into account consumer impacts and other relevant considerations.
50. I consider that the removal of the default expiry provision, together with a revised timing trigger for the next review, and an amended process for future reviews is appropriate. It will allow for a more comprehensive and measured consideration of the state of competition and the impact of regulation when the next review is triggered.

2: *Allow Fonterra discretion to refuse supply from new dairy conversions*

Proposal

51. I propose to amend the open entry provisions to give Fonterra discretion to refuse an application to become a shareholding farmer, where the application relates to a new dairy conversion. For the purposes of the DIRA a new dairy conversion would be considered to be dairy farming on land that had not been used for dairying in the five years prior to an application being made to Fonterra.
52. I propose that this amendment would come into effect from the start of the 2018/19 season, to allow a transitional period for any plans that are currently underway to establish new dairying operations.
53. A new dairy conversion is not intended to include situations such as the extension of an existing dairy farm into land that had not previously been used for dairying, or the subdivision of an existing dairy farm into smaller units that are sold to new owners.

Comment

54. The open entry and exit provisions are the cornerstone of the efficiency and contestability provisions in the DIRA. They reduce farmers' switching costs to enable independent processors to obtain access to raw milk, which lowers barriers to entry and therefore enables competition. The open entry and exit provisions also incentivise Fonterra to set an efficient farm gate milk price to manage its supply from farmers.
55. In its report on the state of competition in dairy markets, the Commerce Commission found no evidence that the open entry and exit provisions resulted in material costs to Fonterra, and that they provided an important safeguard. The Commerce Commission did, however, suggest that consideration be given to removing open entry for new dairy conversions, as it did not consider that this facilitates competition at present.
56. Submissions received during the consultation process were largely in favour of the proposal to amend open entry for new dairy conversions. However, Fonterra and Fonterra shareholders felt that the proposal did not go far enough. Fonterra wished to see the requirement to accept any new entrant as a shareholding farmer largely removed, [REDACTED]  
[REDACTED]  
[REDACTED] However, the Commerce Commission found that these costs were not material and could be managed by Fonterra.
57. I consider that the open entry and exit provisions remain an essential factor in supporting the development of efficient dairy markets in the absence of sufficient competition. The proposal to remove new dairy conversions from these provisions is a practical measure to address an area that provides little

benefit to contestability and may lead to some inefficiency, and may lead to better land use and resource allocation decisions.

- 3: *Retain existing powers and establish additional powers to monitor dairy markets*

### Proposals

58. I propose that the DIRA retain the regulation making power to require Fonterra and independent processors to provide information on the collection of milk solids in order to maintain oversight of the farm gate market. I propose that regulations are now provided for so Fonterra and independent processors have ongoing requirements to make returns with information on the collection of milk solids; including:
- Keeping records of milk solids collected from farms.
  - Providing returns in a prescribed form.
59. I also propose to amend the DIRA to include a new regulation-making power that would enable the monitoring of other aspects of dairy markets, such as the factory gate market. This would, for example, require persons supplying or purchasing raw milk through the factory gate market to provide periodic returns on the volume of raw milk traded.

### Comment

60. The DIRA contains provisions to enable the Government to monitor the share of milk solids collected by Fonterra and independent processors for the purposes of determining whether the market share thresholds for review of the DIRA have been met. The DIRA also contains a regulation making power in section 115 to require Fonterra and independent processors to provide information on milk solids collected at the farm gate.
61. As I have proposed to remove the market share thresholds from the DIRA, the information gathering powers for assessing the threshold in the DIRA would no longer apply. There is, however, an ongoing need for the existing information to continue to be provided, to help inform the Government's monitoring of the developments in the farm gate milk markets.
62. New regulations under section 115 need to be provided for so there are ongoing requirements to provide information on milk solids collected at the farm gate. These regulations will be similar to the existing requirements to provide information under the thresholds assessment, including requiring processors to keep records of milk solids collected from farms and provide returns in a prescribed form.
63. These new regulations will not impose any additional compliance costs for Fonterra or independent processors as these parties are already compelled to provide this information.

64. I also consider that it would be appropriate to have the ability, via regulation, to monitor other aspects of dairy markets, particularly developments in the factory gate market. Such monitoring will help inform the analysis and any decisions taken in the context of a future review.

4: *Remove the requirement for Fonterra to supply regulated milk to large, export-focused processors*

#### Proposal

65. I propose to amend the Raw Milk Regulations to remove the requirement for Fonterra to supply regulated milk to large, export-focused independent processors from the beginning of the 2019/20 season. I propose that the criteria for being considered a large, export-focused processor should be the capacity to process more than 100 million litres of milk in a season, and exporting more than 50 percent of production by volume. Processors taking regulated milk would be required to provide a return to Fonterra that shows they do not meet these criteria.

66. The volume of regulated milk that Fonterra is required to supply to other processors will remain unchanged.

#### Comment

67. The key benefits of the proposal are that:

- it clearly signals to existing and future processors that the current regulatory regime is not permanent, and encourages them to find ways of operating without it; and
- it incentivises different entry points into New Zealand's factory gate market and a focus on higher-value products, rather than incentivising primary processing of raw milk at a time when the industry has excess capacity.

I consider that there is little risk that this proposal will prevent the entry of new processors.

68. The continued provision of regulated milk may inadvertently encourage further investment in the primary processing of raw milk, with marginal benefits to value-add and innovation, at the expense of other ways that new processors could enter dairy markets.

69. All existing large, export-focused processors either do not access regulated milk; have already lost their access due to having their own supply; or will lose their access at the end of this season for the same reason. [REDACTED]

[REDACTED]

[REDACTED]

70. In its review, the Commerce Commission suggested that:

*“There appear to be diminishing marginal benefits from further [independent processor] entry in some regions and at least the potential for existing [independent processors] to expand into other regions. In this context an option could be to remove DIRA entitlements, particularly for [independent processors] that are largely serving the competitive international markets.”*

71. Submitters to MPI’s discussion document generally supported the proposal to remove the requirement for Fonterra to supply regulated milk to large, export-focused processors, although some independent processors observed that it could lead to fewer new processors entering the market in the future. Some independent processors considered that regulated milk was helpful to them in establishing in New Zealand.

72. The loss of regulated milk could make entry marginally more expensive for some potential future entrants, as access to regulated milk may be useful in facilitating minimum viable capacity utilisation of a smaller processor’s plant during its first years.

73. However, access to regulated milk is not the main consideration for new processors establishing in New Zealand. [REDACTED]

74. No large processor could be reliant on regulated milk, even its entry phase. To be efficient, a large milk processing plant requires a capacity of at least 200 million litres per season, although many existing large independent processors have a much larger capacity of 300 to 500 million litres. It is not economic to operate a milk processing plant at significantly less than capacity. Because the maximum 50 million litres of regulated milk only fills a quarter of a minimum plant (or a sixth of a 300 million litre plant, or a tenth of a 500 million litre plant), processors must secure unregulated supply for the bulk of their milk requirements from day one.

75. In the 2014/15 season the average dairy farm produced around 1.8 million litres of milk, whereas a large dairy farm could produce 6.5 million litres. This means that a processor would need to convince 28 average dairy farmers or only eight large ones to replace the 50 million litres that it would have been entitled to under the Raw Milk Regulations.

76. Processors also have a number of alternatives to using regulated milk, including seeking supply from farmers (which has the added benefit of increasing competition at the farm gate), seeking unregulated supply from Fonterra or other processors (which has the added benefit of increasing competition at the factory gate), or using inputs other than raw milk, such as milk powder.

77. Maintaining the open entry and exit provisions largely unchanged is the key mitigation for ensuring new processors are able to enter and expand by attracting farmer suppliers. These provisions will help to minimise any marginal additional costs to new entrants from this proposal.
78. I therefore consider that the risks of this proposal are small, and are outweighed by the benefits of signalling to the industry that the DIRA regime is not permanent, and that different points of entry are possible.

5: *Reduce forecasting flexibility for regulated milk*

79. The Raw Milk Regulations require independent processors wanting to purchase regulated milk to provide Fonterra with an estimate for supply:
- at least three months before the date on which the milk is to be supplied; and
  - at least one week before the date on which the milk is to be supplied.
80. Currently, the Raw Milk Regulations allow independent processors a degree of flexibility between the volume that they estimate they will need three months out, the estimated volume one week out, and the volume that they actually take on the day of delivery.
81. The one week estimate may be up to 40 percent more, or 40 percent less than the three month estimate. On the day of delivery, Fonterra may require processors to purchase up to 80 percent of the volume estimated one week earlier, and the processor may require Fonterra to supply up to 120 percent of the estimated volume.

Proposal

82. I propose to increase the level of certainty that Fonterra has about volumes of milk required, by reducing the extent to which independent processors are able to vary their estimated regulated milk requirements as follows:
- Variance between one week and three month estimates: a processor's estimate of the volume it will need one week out from delivery must be within 20 percent of the three month estimate.
  - Variance between one week estimate and contracted volume: Fonterra may require a processor to contract for up to 90 percent of the volume estimated one week earlier, and the processor may require a contract for Fonterra to supply up to 110 percent of the estimated volume.

Comment

83. The current settings allow for fairly large variations in milk ordered versus milk taken, with the risk borne by Fonterra. The ability to vary forecast requirements

may also make regulated milk more attractive than un-regulated milk, meaning that processors are not incentivised to look elsewhere for supply.

84. Submissions generally supported reducing forecasting flexibility, although some processors considered that reducing flexibility would have a disproportionately large impact on processors to deal with a problem that is of a very small impact to Fonterra.
  85. I consider that the increased efficiency of making this change outweighs the impacts on independent processors.
- 6: *Reduce the prescribed quantity of regulated milk that Fonterra must make available to independent processors*

### Proposal

86. I propose that the total volume of regulated milk that Fonterra must make available to independent processors should be reduced from 795 million litres to 600 million litres per season.
87. This volume is sufficient to cover current forecast demand and provides a surplus to accommodate any demand from further new entrants. It is desirable that this amendment be made as soon as possible, by Order in Council, as it relates to the current dairy season and is not contingent on the implementation of other proposals in this paper. Implementing it now will provide certainty for Fonterra as to the theoretical maximum amount of milk that the company is required to make available.

### Comment

88. The Raw Milk Regulations require me to review from time to time, but at intervals of not more than three seasons, the maximum total quantity of raw milk that Fonterra must make available to independent processors in a season. I reviewed the regulated volume in May 2016.
89. This review is a separate statutory requirement from the review of the efficiency and contestability provisions in the DIRA.
90. Demand for regulated milk has fallen significantly since the current maximum volume was set in 2012. In the 2015/16 season, the total amount of regulated milk that Fonterra supplied to independent processors, including Goodman Fielder, was about 390 million litres, approximately 49 percent of the regulated maximum. Fonterra's preliminary forecast demand for regulated milk for the current season is 335 million litres, which is 45 percent of the current regulated maximum, and 59 percent of the new regulated maximum.
91. The fall in demand reflects increases in large independent processors' own supply, and this trend is likely to continue, regardless of any of the other changes recommended in this paper.

92. I consider that this change will not impact existing processors' ability to access regulated milk, given that demand for regulated milk is well below the lower maximum value. However, the change will signal reducing entitlements to regulated milk to come in future.

**Other changes to the DIRA not arising from the Commerce Commission's review of the state of competition**

93. I am also proposing changes to the DIRA and an associated appropriation that do not arise from the Commerce Commission's review of the state of competition.

**B: Fonterra levy and appropriation structure**

*Fonterra levy*

94. The Commerce Commission has a number of enforcement functions under the DIRA. Fonterra bears most of the Commerce Commission's costs of enforcing the DIRA regime as it is the prime beneficiary of the regime. These costs are recovered through an annual levy process.
95. The DIRA specifies the levy process and the functions that the levy funds. The functions are:
- making determinations;
  - enforcing the contestability and efficiency provisions of the DIRA;
  - enforcing these determinations in the High Court; and
  - conducting reviews of Fonterra's milk price and its milk price manual.

Proposal

96. I propose amendments to the DIRA to simplify the levy process. The proposed amendments would reduce the frequency at which regulations need to be made to set the levy. To address under- and over-recovery, I propose an annual process for refunds and invoices rather than the current wash-up process. I propose that these amendments would take effect in the 2018/19 financial year.

Comment

97. The current process for setting the levy is time-consuming and inefficient as it means that the Government must make regulations every year to recover the costs of enforcing the DIRA regime. The current wash-up process lacks transparency and can be subject to errors.
98. Officials will work with Parliamentary Counsel to design a process that balances transparency and efficiency in setting the rate of the levy and notifying this to Fonterra.



### *Appropriation structure*

99. The Commerce Commission's enforcement functions under the DIRA are funded through an appropriation in Vote Business Science and Innovation that includes both Crown and levy funding. The Minister for Commerce and Consumer Affairs is the responsible Minister for this appropriation.
100. The Commerce Commission receives \$1.245 million per annum for its DIRA enforcement role under the non-departmental output expense *Enforcement of Dairy Sector Regulation and Auditing of Milk Price Setting* appropriation. This appropriation is currently split into levy- and Crown-funded components:
- The levy-funded component is up to \$0.907 million per annum. Fonterra has not been levied the full \$0.907 million in recent years.
  - The Crown-funded component is up to \$0.338 million per annum to maintain the Commerce Commission's standing capacity and public reporting/education activities that are non-leviable (including state of competition reviews such as the one just completed). This component is also rarely drawn down in full.
101. The Commerce Commission's dairy funding was increased to its current level in March 2012 in order to fund the new milk price monitoring regime. At the time there was considerable uncertainty as to how the new regime and Fonterra's Trading Among Farmers capital reforms would impact on the scope and cost of the Commerce Commission's work.
102. Since that time, the Trading Among Farmers capital reforms have been implemented and the Commerce Commission has completed two annual cycles of its milk price monitoring activities, allowing greater clarity about the real level of expenditure. The Commerce Commission has also been able to realise cost efficiencies, and has seen a decline in its demand-driven dairy determination activity. As a result, the Commerce Commission's estimates of ongoing costs for milk price monitoring are below the current indicative funding level of \$0.907 million per annum.
103. At the same time, the Commerce Commission has been required to complete the state of competition report under the DIRA (at a cost of approximately \$0.900 million) and may be required to complete a similar report in the coming years. It will be important that the Commerce Commission has adequate resource to conduct this work when required.

### Proposal

104. I have also consulted with the Minister of Commerce and Consumer Affairs, and we propose changes to appropriations to better reflect the function of this funding, and to set it at the appropriate level.
105. The Minister of Commerce and Consumer Affairs and I propose to transfer the \$0.338 million Crown contribution from the *Enforcement of Dairy Sector Regulation* appropriation to the *Enforcement of General Markets Regulation*

appropriation. This will allow the Commission to make better use of this funding across the forecast period while maintaining its availability for future DIRA competition reviews.

106. To this end, we also propose to change the scope of the *Enforcement of General Markets Regulation* appropriation as follows, with effect from 1 July 2017:

*“This appropriation is limited to the administration, education, enforcement, reporting and adjudication activities of the Commerce Commission in relation to the Commerce Act 1986, the Fair Trading Act 1986, the Credit Contracts and Consumer Finance Act 2003, and the Dairy Industry Restructuring Act 2001”.*

107. We further propose to reduce the levy-funded component of the *Enforcement of Dairy Sector Regulation* appropriation from \$0.907 million to \$0.757 million, to match the Commerce Commission’s estimated ongoing costs.

### **C: Technical amendments regarding the manager of the New Zealand Dairy Core Database**

#### Background

108. Genetic improvement of New Zealand’s dairy herd delivers significant benefits to both the industry and the wider economy. Genetic improvement is supported by data for evaluating dairy animal characteristics and productivity. Some key data are held in the New Zealand Dairy Core Database (the core database).
109. The DIRA contains provisions relating to herd testing and the core database. The core database includes historical information on more than 35 million animals, with a new generation added each year. Information held in the core database is used by farmers, companies involved in genetic improvement, and researchers.
110. Access to the data must be approved by an Access Panel, appointed by the Minister for Primary Industries.
111. In 2014 Cabinet enabled the transfer of the core database from Livestock Improvement Corporation (LIC) to the industry good body, DairyNZ [EGI Min (14) 7/9]. In January 2015 I gave notice in the *Gazette* that responsibility for the management of the core database had been transferred on 27 November 2014.

#### Proposal

112. I propose to make the following technical amendments to the DIRA to:

- Update references to the manager of the core database so that LIC is no longer identified as the manager.

- Ensure that the obligations formerly discharged by LIC as the manager of the core database are imposed on DairyNZ as manager (for example, but not necessarily limited to, a requirement to retain the core database, a requirement that the manager of the core database must be an industry good body, reversion of the core database to the Crown if the manager ceases to operate or no longer wishes to discharge the function).
- Update regulation-making powers consistent with the change of manager of the core database, including the provision of appropriate criteria to enable the appointment of a new manager (such as, where the current manager ceases to be an industry good body, is no longer capable of carrying out the functions of manager, or has failed to maintain the core database or comply with the requirements of the DIRA).
- Provide that the Access Panel continues, for the time being, to have oversight of LIC's copy of the core database, as agreed by Cabinet in 2014.
- Retain any residual obligations on LIC as a result of its retention of a copy of the core database.
- Address any other technical matters consequent on the transfer of management responsibilities.

### Comment

113. These amendments are the minimum technical changes that are required to recognise the current status of management arrangements for the core database.
114. While DairyNZ is now the custodian of the core database, a number of further steps are still required to fully complete the transfer, which will require some time to effect. The transfer will be fully complete when herd testing data collected by parties other than LIC itself can be directly input to the dairy core database, rather than, as now, having to flow through LIC's system. Cabinet noted in April 2016 that, until the transfer has been completed, certain statutory obligations on LIC, together with Access panel oversight of LIC's copy of the database, will remain in place [EGI Min (14) 7/9 refers].

### **Consultation**

115. The Treasury, Ministry of Business, Innovation and Employment (MBIE), Ministry of Foreign Affairs and Trade and Te Puni Kōkiri have been consulted. The Department of the Prime Minister and Cabinet has been informed.
116. Treasury and MBIE support the continuation of the DIRA regime in both the North and South Islands given the Commerce Commission found that the market would be more efficient with the regime in place. Both agencies consider it is possible that the proposals to amend the DIRA and the Raw Milk Regulations may provide marginal efficiency benefits.

117. However, Treasury and MBIE have concerns with the proposed amendments to the Raw Milk Regulations to remove the current time-limited entitlements for large export-focused processors, given that the Commerce Commission found insufficient competition to support deregulation and identified risks (for example: Fonterra increasing the price of raw milk above competitive levels before an effective factory gate market has developed) with premature removal of the Raw Milk Regulations.
118. In terms of the signal to future processors, agencies agree that there are likely to be unexplored efficiencies and potential innovations in downstream dairy markets. These could be feasibly be accessed via multiple market entry points, including secondary processing. Treasury and MBIE therefore support work on downstream dairy market efficiency and contestability. However, the Treasury and MBIE are not convinced that the proposals targeting export focused processors would address these inefficiencies. It is unclear whether the Raw Milk Regulations are facilitating an early entrance pathway to opportunities in downstream markets, or hindering their development, as the Cabinet paper suggests.
119. The Treasury and MBIE's key concern is that there is a risk that future competitiveness of the industry could be reduced by removing an entrance pathway for potential processors. While an established large independent processor may be able to operate without access to regulated raw milk, and alternative entrance pathways may be viable for some processors in certain regions, some new entrants may struggle to reach a viable scale without initial access to regulated raw milk while they develop their own supply.
120. Evidence suggests that some new processors are able to enter without using the Raw Milk Regulations, particularly investors with access to capital and international markets. Treasury and MBIE, however, do not consider it follows that removing access provisions will stimulate investment in secondary processing. If the Raw Milk Regulations have not been a factor in entry decisions, removing ineffective entrance pathways for players who want to contest international markets is unlikely to send a clear signal about how to invest. Treasury and MBIE consider contestable markets and efficient pricing, in line with the statutory purpose of DIRA, should set signals about future investment.
121. Stakeholders have been consulted on proposals in this paper. Dairy industry stakeholders were consulted on proposals regarding the amendment of the DIRA and the Raw Milk Regulations in response to the Commerce Commission's report through a discussion paper, public meetings and individual meetings with major processors. The feedback received is noted against each of the proposals discussed in this paper.
122. Fonterra supports the proposed amendment of the prescribed total maximum volume of regulated milk that it must supply under the Raw Milk Regulations, and the proposed changes relating to its levy.

## **Financial Implications**

123. The recommendations in this paper have no financial implications. Proposals regarding changes to the Commerce Commission's appropriation structure are fiscally neutral.

## **Legislative Implications**

124. The proposals in this paper require amendment of the Dairy Industry Restructuring Act 2001 and the Dairy Industry Restructuring (Raw Milk) Regulations 2012.
125. A Dairy Industry Restructuring Amendment Bill is included in the 2016/17 legislation programme as a category 5, to be referred to a Select Committee in the year.
126. Amendments to the DIRA will be effected through this Bill. Amendments to the Raw Milk Regulations will be progressed in parallel through Cabinet. The exception is the amendment to the maximum total quantity of raw milk that Fonterra must make available to independent processors in a season. This will need to be progressed by Order in Council as soon as possible so that it can enter into effect in the current season.

## **Regulatory Impact Analysis**

127. The Regulatory Impact Analysis (RIA) requirements apply to the proposals in this paper and a Regulatory Impact Statement (RIS) has been prepared and is attached.
128. Treasury's Regulatory Impact Analysis team (RIAT) has reviewed the RIS prepared by MPI and associated supporting material, and considers that the information and analysis summarised in the RIS partially meets the quality assurance criteria.
129. RIAT assessment: The RIS relies on analysis by the Commerce Commission and sets out a possible future direction for regulatory decision makers. However, both the costs of the existing regime and the impacts of uncertainty for investors about future regulatory arrangements is unclear – particularly for smaller players and potential entrants. Importantly, the RIS does not identify a preferred option regarding the entrance pathway (the Raw Milk Regulations).

130. A RIS on the transfer of the Dairy Core Database was completed in 2014. No RIS is needed for the amendments to DIRA to simplify the process for recovering the Commerce Commission's enforcement costs because the amendments relate to administrative arrangements, and have no impacts on Fonterra or other parties.

### **Publicity**

131. I propose to issue a media statement on decisions arising from the review of the efficiency and contestability measures in the DIRA.

## Recommendations

132. The Minister for Primary Industries recommends that the Committee:

### *Dairy Industry Restructuring Act 2001(DIRA): Review of subparts 5 and 5A*

1. **note** that the DIRA includes efficiency and contestability provisions in subparts 5 and 5A to address Fonterra's dominant position in dairy markets until sufficient competition develops;
2. **note** that on 13 August 2015 I certified that the 20 percent market share threshold that triggers sunset provisions in the DIRA was met in the South Island in the 2014/15 dairy season, when independent processors collected 22 percent of milk solids;
3. **note** that efficiency and contestability provisions (open entry and exit, the 20 percent rule and milk price monitoring) will expire in the South Island by 31 May 2018 if the DIRA is not amended beforehand;
4. **note** that there is provision in the 2016 Legislation Programme for a Dairy Industry Restructuring Amendment Bill, with a category 5, to be referred to a select committee within the year;
5. **note** that the Commerce Commission's report on the state of competition in dairy markets, published March 2016, found that competition in dairy markets is not yet sufficient to warrant deregulation at this time and proposed a number of changes to the DIRA and Raw Milk Regulations for the Government's consideration as a pathway to deregulation;
6. **note** that the Ministry for Primary Industries publicly consulted options for amending the DIRA and the Raw Milk Regulations, informed by the Commerce Commission's findings;
7. **agree** that the DIRA be amended to:

#### Default expiry and sunset provisions

- 7.1 remove the default expiry provisions relating to contestability and efficiency provisions;
- 7.2 remove the market share threshold triggers for review of the state of competition;
- 7.3 require that a review of the state of competition commence during the 2020/21 dairy season;
- 7.4 require further reviews thereafter at five yearly intervals;
- 7.5 allow more flexibility in the recommendations and process for future reviews of the state of competition and downstream markets;

#### Open entry

- 7.6 allow Fonterra discretion to decline an application to become a shareholding farmer when the application is in respect of a new dairy conversion;

- 7.7 provide a transitional period to allow for dairying conversions that are currently underway;
- 7.8 provide that a new dairy conversion is dairy farming established on land that had not been used for dairying in the five years prior to an application to become a shareholding farmer being made to Fonterra;

#### Monitoring

- 7.9 provide that the obligation on Fonterra and independent processors to maintain records and provide prescribed information on the collection of milk solids from farmers continues to apply, by authorising the drafting of new regulations under section 115 of the DIRA, which would be modelled on the current process requirements of section 147 of the DIRA;
- 7.10 add a regulation-making power to enable the Minister to require the provision of information to support the monitoring of dairy markets (such as the factory gate market);

#### *Dairy Industry Restructuring (Raw Milk) Regulations 2012*

- 8. **agree** to amend the Dairy Industry Restructuring (Raw Milk) Regulations 2012 to:

#### *Either*

- 8.1 remove the requirement for Fonterra to supply regulated milk to processors that have a processing capacity of over 100 million litres of milk per season and export more than 50 percent of their production by volume [MPI recommendation];

#### *Or*

- 8.1 do not remove the requirement for Fonterra to supply regulated milk to processors that have a processing capacity of over 100 million litres of milk per season and export more than 50 percent of their production by volume [Treasury, MBIE recommendation].

- 8.2 reduce the flexibility permitted to independent processors in forecasting their requirements for regulated milk to:
  - variance between one week and three month estimates: one week estimate can be 20 percent more or 20 percent less than the earlier three month estimate;
  - variance between one week estimate and contracted volume: Fonterra may require a contract for up to 90 percent of estimated volume. The purchaser may require a contract for up to 110 percent of estimated volume;

- 9. **note** that the volume of regulated milk that Fonterra is required to supply to processors that are not large, export-focused processors will not change;



10. **note** that the total maximum volume of raw milk that Fonterra must supply to independent processors in a season must not exceed five percent of the total volume of raw milk collected by Fonterra;
11. **note** that I have reviewed the prescribed maximum in accordance with the requirement in the Raw Milk Regulations that the maximum be reviewed at intervals of not more than three seasons;
12. **agree** to amend the prescribed maximum from 795 million litres to 600 million litres, to take effect in the 2016/17 season;

*Fonterra levy and Commerce Commission appropriation structure*

Levy

13. **agree** to amend the DIRA to simplify the process for setting a levy to recover the Commerce Commission's costs of monitoring Fonterra, and to provide for refunds and invoices in the case of over- or under-recovery to take effect from the 2018/19 financial year;

Appropriation structure for the Commerce Commission

133. The Minister for Commerce and Consumer Affairs recommends that the committee:
  14. **agree** to transfer the current Crown funding component of \$0.338 million in the Commerce Commission's *Enforcement of Dairy Sector Regulation and Auditing of Milk Price Setting* appropriation to the Commerce Commission's *Enforcement of General Market Regulation* appropriation to allow better utilisation of this funding across the forecast period;
  15. **agree** to a reduction in funding for the Commerce Commission's *Enforcement of Dairy Sector Regulation and Auditing of Milk Price Setting* appropriation of \$0.150 million per annum to reflect the Commerce Commission's estimated ongoing costs following the realisation of cost efficiencies over recent financial years;
  16. **note** that the reduction in funding proposed in recommendation 15 is fiscally neutral to the Crown as this component of the appropriation is recovered through levies on Fonterra Group Limited;

17. **approve** the following fiscally neutral adjustment to give effect to the policy decisions in recommendations 14 and 15, with no impact on the operating balance:

	\$million – increase/(decrease)				
<b>Vote Business, Science and Innovation Minister of Commerce &amp; Consumer Affairs</b>	<b>2016/17</b>	<b>2017/18</b>	<b>2018/19</b>	<b>2019/20</b>	<b>2020/21 &amp; Outyears</b>
Non-Departmental Output Expense: Commerce and Consumer Affairs: Enforcement of Dairy Sector Regulation and Auditing of Milk Price Setting	(0.488)	(0.488)	(0.488)	(0.488)	(0.488)
Non-Departmental Output Expense: Commerce and Consumer Affairs: Enforcement of General Markets Regulation	0.338	0.338	0.338	0.338	0.338
<b>Total operating</b>	<b>(0.150)</b>	<b>(0.150)</b>	<b>(0.150)</b>	<b>(0.150)</b>	<b>(0.150)</b>

18. **agree** that the proposed changes to appropriations for 2016/17 above be included in the 2016/17 Supplementary Estimates and that, in the interim, the increase be met from Imprest Supply;
19. **agree** to amend the scope of the *Enforcement of General Markets Regulation* appropriation from 1 July 2017 to the following, to give effect to recommendation 14:

*“This appropriation is limited to the administration, education, enforcement, reporting and adjudication activities of the Commerce Commission in relation to the Commerce Act 1986, the Fair Trading Act 1986, the Credit Contracts and Consumer Finance Act 2003, and the Dairy Industry Restructuring Act 2001.”*

134. The Minister for Primary Industries recommends that the committee:

*Technical amendments regarding the management of the New Zealand Dairy Core Database*

20. **note** that, in accordance with decisions taken by Cabinet in 2014, industry good body DairyNZ has assumed responsibility for the management of the New Zealand Dairy Core Database in place of Livestock Improvement Corporation [EGI Min(14)7/9 refers];

21. **agree** that technical amendments be made to subpart 4 of the DIRA and in consequence to the Dairy Industry (Herd Testing and New Zealand Dairy Core Database) Regulations 2001, to:

- 20.1 update references to the manager of the core database so that LIC is no longer identified as the manager;
- 20.2 ensure that the obligations formerly discharged by LIC as the manager of the core database are imposed on DairyNZ as manager;
- 20.3 update regulation-making powers consistent with the change of manager of the core database, including the provision of appropriate criteria to enable the appointment of a new manager;
- 20.4 retain any residual obligations on LIC arising from its retention of a copy of the core database;
- 20.5 provide that the Access Panel continues, for the time being, to have oversight of LIC's copy of the core database;
- 20.6 address any other technical matters consequent on the transfer of management responsibilities;

*Next steps*

22. **invite** the Minister for Primary Industries to issue drafting instructions to the Parliamentary Counsel Office to:

21.1 amend the Dairy Industry Restructuring Act 2001 and the Dairy Industry Restructuring (Raw Milk) Regulations 2012 to:

- give effect to decisions arising from the review of the state of competition in dairy markets in respect of Part 2, subparts 5 and 5A of the DIRA and Dairy Industry Restructuring (Raw Milk Regulations) 2016;
- simplify the process for collecting an annual levy from Fonterra to recover most of the costs incurred by the Commerce Commission in relation to DIRA;
- amend the Commission's appropriation structure;

- make technical amendments to Part 2, subpart 4 of the DIRA to recognise the change in management arrangements for the New Zealand Dairy Core Database that was agreed by Cabinet in 2014;

21.2 amend Regulation 5(1) of the Dairy Industry Restructuring (Raw Milk) Regulations 2016, to change the prescribed maximum total amount of regulated milk that Fonterra must make available to independent processors from 795 million litres to 600 million litres;

23. **authorise** the Minister for Primary Industries to approve the final details of amendments during the drafting of the Dairy Industry Restructuring Amendment Bill and changes to the Dairy Industry Restructuring (Raw Milk) Regulations to give effect to the policy decisions in the above recommendations;

24. **note** that any changes will be reported to the Cabinet Legislation Committee when seeking approval for introduction of the Dairy Industry Restructuring Amendment Bill and changes to the Dairy Industry Restructuring (Raw Milk) Regulations.

Authorised for lodgement

Hon Nathan Guy  
Minister for Primary Industries