Ministry for Primary Industries
Manatū Ahu Matua

Terms of reference for the review of the Dairy Industry Restructuring Act 2001 and its impact on the dairy industry

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1 Government policy objectives

The goal of the Government's economic strategy is to improve the wellbeing and living standards of New Zealanders through sustainable and inclusive growth. This includes a focus on meeting the long term challenges facing New Zealand, which are identified as sustainable economic growth, higher value export returns and jobs paying higher wages, a healthy environment and a fair society. The Government's vision is to:

- build an economy that delivers shared prosperity through increased productivity and encourages new and higher value land-use,
- transition to a net zero emissions economy by 2050,
- help the regions to thrive, and
- move to higher value export returns through a progressive trade and investment agenda.[1]

The dairy industry plays a key role in the nation's economic, environmental and social wellbeing and ongoing prosperity. The industry is one of New Zealand's largest export earners, employing around 50,000 people. Fonterra is New Zealand's largest company and the only New Zealand-based multinational firm with significant global scale and reach. The dairy industry, like most economic activities, extracts resources from and disposes wastes into the environment. However, given the industry's size and characteristics of land/resource use, its incentives and abilities to adopt sustainable environmental management practices play a key role in the environmental wellbeing of New Zealand as a whole.

The dairy industry's performance is therefore of significant national interest, and is a key factor in ensuring that the Government's policy objectives are met.

2 Objectives of the review

In 2001, the New Zealand dairy industry had undergone significant structural change aimed at transforming its performance for the benefit of all New Zealanders. Special legislation, in the form of the Dairy Industry Restructuring Act 2001 (DIRA), authorised the restructure to go ahead so that its anticipated benefits could be realised.

At the same time, the DIRA created a set of regulatory safeguards designed to mitigate the risks to the long term interests of New Zealand farmers, consumers and the wider economy, which arose as the result of the new industry structure.

As outlined in the Annex, the DIRA regulatory safeguards were designed to promote the efficient operation of New Zealand dairy markets by ensuring:

- contestability for the supply of milk from dairy farmers, and
- competition in the wholesale supply of domestic consumer dairy products.

Over 16 years on, it is timely to review:

- whether the DIRA regulatory regime is operating in a way that protects the long term interests of New Zealand dairy farmers, consumers and the nation's overall economic, environmental and social wellbeing
- whether, and if so the extent to which, the DIRA regulatory regime gives rise to any unintended consequences manifesting themselves in other parts of the wider regulatory system
- whether the purpose and form of the DIRA regulatory regime remain fit-for-purpose, given the dairy industry's current structure, conduct and performance, as well as the global and

[1] As outlined in the Government's economic strategy https://www.beehive.govt.nz/speech/achievingshared-prosperity-outlining-governments-economic-strategy

domestic challenges and opportunities facing the industry, the wider regulatory system within which it operates, and the Government's broader policy objectives.

Although the review will focus on the DIRA regulatory regime, it will take account of the fact that the DIRA operates within, and has important linkages to, the wider regulatory system. This wider regulatory system includes, but is not limited to, the Resource Management Act, the Animal Welfare Act, the Health and Safety at Work Act, the Immigration Act, the Overseas Investment Act, the Financial Markets Conduct Act and the Commerce Act.

3 Scope and analytical approach for the review

The New Zealand dairy industry currently operates as two separate but connected sectors, namely an export-oriented sector and a domestically-focused sector. Fonterra is the only dairy processor of scale that operates in both as an integrated company.

The export-oriented dairy sector is responsible for collecting, processing and marketing 95 percent of the total milk production in New Zealand. It therefore plays a key role in the dairy industry's, and the whole of New Zealand's, economic and environmental performance. Although the domestically-focused sector accounts for only the remaining five percent of the total milk production, it is nevertheless important as dairy consumer products (especially fresh pasteurised milk) are seen by New Zealanders as an essential staple for households and specifically for young children's health and wellbeing. The review will therefore run two separate but connected lines of inquiry alongside each other, drawing on linkages and interdependencies as they arise.

Building on the competition analysis of the dairy industry carried out by the Commerce Commission in 2015/16.[2], the review will consider the following non-exhaustive list of questions:

3.1 EXPORT-ORIENTED DAIRY SECTOR

1. *To what extent have the anticipated benefits of the 2001 industry restructure been realised, both at the sector and company-specific level? What, if any, are the barriers and their underlying drivers to achieving those benefits, both at the sector and company-specific level?*

2. *To what extent and in what way is the DIRA contestability regime contributing to and/or impeding the sector's performance? Specifically, to what extent do the DIRA contestability provisions (vis-a-vis other industry and wider regulatory settings) impact on, and drive, the choice of business strategies, company structures, governance and ownership arrangements, value creation, investment in innovation and research and development and the environmental performance of the dairy industry (both at the production and processing levels of the New Zealand based dairy supply chain)?*

3. *Where/by whom are the benefits of the sector's performance being captured and the costs/risks incurred? What is the extent and distribution of the benefits and costs/risks across the dairy industry supply chain and the wider economy?*

4. *What, and how strong, are the existing incentives and disincentives for the dairy industry to transition to higher value New Zealand based dairy production and processing that global consumers seek out for a premium? What, and how strong, are the incentives and disincentives for organics and alternative dairy production methods and product manufacturing? What is the role of government in strengthening these incentives and/or reducing/removing the disincentives?*

5. *Does the DIRA regulatory objective of ensuring 'contestability for the supply of milk from farmers' remain fit for purpose, given the sector's current performance and its underlying drivers, global*

[2] http://www.comcom.govt.nz/regulated-industries/dairy-industry/report-on-the-state-of-competition-inthe-new-zealand-dairy-industry/

and domestic challenges and opportunities facing the industry, the wider regulatory system within which it operates, and the Government's policy objectives?

6. *If so, what changes, if any, are required to ensure that:*

   a. *the individual provisions of the DIRA contestability regime remain fit-for purpose and are consistent with the Government's wider policy objectives? For example, should large export-focused dairy processors continue to be able to purchase milk from Fonterra on regulated terms?*

   b. *the extent of any unintended consequences, which may have arisen as a result of the DIRA contestability provisions, is reduced/removed, while any impact on the regime's ability to deliver on its policy objective is minimised? For example, should the requirement for Fonterra to accept all milk supply offers from shareholding farmers and the ability for farmers to exit Fonterra be reconsidered (e.g. removed, modified or replaced with some other regulatory tool aimed to ensure contestability for the supply of milk from dairy farmers)? In the event of modifications to the current regulatory arrangements, what, if any, safeguards might be required to protect the long-term interests of farmers and consumers?*

7. *If not, what should the alternative and/or new regulatory objectives be, and what changes to the industry and/or the DIRA regulatory regime would be required to ensure that the DIRA regulatory regime supports a well-functioning and high performing New Zealand based dairy production and processing industry, which manages resources effectively (including land, water, and capital) to produce high quality, high value dairy products?*

3.2 DOMESTICALLY-FOCUSED DAIRY SECTOR

8. *Is the domestically-focused dairy sector operating in the long term interests of New Zealand consumers, in terms of e.g. availability, quality, pricing and range of consumer dairy products, as well as investment in innovation and value creation?*

9. *Are there significant economies of scale in the collection and processing of farmers' milk into domestic consumer dairy products, and the wholesale distribution of those products, given the small size of the New Zealand consumer market, its year-round demand characteristics and seasonal farmers' milk production (with the associated difficulties and costs of sourcing 'winter milk')?*

10. *What would the domestically-focused dairy sector look like (in terms of structure and range of business models) in the absence of the DIRA regulations? What (if any) are the barriers to such structure and business models developing over time? What is the impact of the current DIRA regulatory regime on such developments?*

11. *Does the DIRA regulatory objective of ensuring 'competition in the wholesale supply of domestic consumer dairy products' remain fit-for-purpose, given the dynamics of the domestically-focussed dairy sector?*

12. *If so, what changes (if any) would be required to ensure that the DIRA regulatory regime supports a well-functioning domestically-focused dairy sector that operates in the long term interests of New Zealand consumers?*

3.3 OUTSIDE THE SCOPE OF THE REVIEW

The following dairy industry and regulatory settings are outside the scope of this review:

- Financial, environmental, and animal health and welfare performance of dairy farming in New Zealand. This aspect is being considered as part of the Ministry's Farm Systems Change project (refer to: https://www.mpi.govt.nz/growing-and-harvesting/dairy/farm-systems-change).
- Performance and regulatory settings of the dairy herd improvement industry. This issue will be the subject of a separate policy review process.
- International trade and market access rules for New Zealand dairy products. The Ministry of Foreign Affairs and Trade is responsible for trade policy, informed by the development of a New Progressive and Inclusive Trade Agenda.
- The legislative provisions around the allocation of quota access in overseas markets. There is currently no indication that the provisions would benefit from a review.

4 Process and timing of the review

The review will be led by the Ministry for Primary Industries in close collaboration with the Ministry for Business, Innovation and Employment, the Treasury, the Ministry for the Environment and the Ministry of Foreign Affairs and Trade.

Officials will be supported by a team of external experts in competition law and policy, economic regulation, corporate strategy and finance, as required. Officials may also seek input from the Commerce Commission on specific questions relevant to its jurisdiction.

The review will be run in an open and transparent manner and may seek information and input from stakeholders and interested parties throughout the process, including formal and informal consultation processes (e.g., through industry workshops, interviews, surveys, etc.).

The initial focus for the review will be on building an understanding of the dairy industry's performance and the impact of the DIRA regulatory regime on it. This stage of the review will concentrate on establishing facts and building evidence necessary to test and review the objectives of, and rationale for, the DIRA regulatory regime. Wherever possible, the review will look to draw on pre-existing sources of information to minimise the need for the dairy industry to supply information that is already publicly available. Information that is not readily available in the public domain will be requested from the relevant industry sources, who are expected to make it available in a timely and satisfactory manner.

Breakdown of key stages in the review process and an indicative timeline for the completion of the review are set out in the table below.

Indicative timeline for the DIRA review:

Key stages of the review process	Indicative timing
Public release of the terms of reference	May 2018
Stage 1: determining facts and building evidence	
Issues identification: • Initial stakeholder meetings • Analysis of issues and identification of options	May – Aug 2018
Stage 2: considering options for change	
Options identification and analysis: • Development of public consultation document • Release of public consultation document • Public consultation process • Analysis of submissions • Regulatory Impact Analysis	Sept – Dec 2018
Report to Government: • Overall findings of the review • Policy recommendations for regulatory change	Early 2019
Stage 3: Implementation of review's findings	
Legislative change process: • Drafting of the Bill • Parliamentary processes	During 2019

Annex: Original purpose and form of the DIRA regulatory regime

The DIRA was enacted in 2001 to enable the dairy industry's move to a new industry structure, aimed at providing for a transformational change in the industry's performance for the overall benefit of all New Zealanders.

At that time, the two largest dairy processing co-operatives (together collecting 96% of all milk produced by dairy farmers in New Zealand) and the New Zealand Dairy Board (a statutory single-desk exporter of all dairy products) were seeking to merge into a vertically-integrated New Zealand farmer-owned co-operative company, Fonterra. The merger was sought to provide the dairy industry with:

- greater collection, processing and marketing economies of scale and scope, and
- a new strategic impetus that would see more of the dairy processing sector move towards the higher end of the dairy value chain, to the overall benefit of all New Zealanders.

The dairy industry asked the then Government to facilitate the merger through special legislation, by-passing the need for scrutiny by the Commerce Commission. The Commerce Commission, in a draft determination in 1999, had rejected the case for the merger under the provisions of the Commerce Act 1986.[3] The Commission found that, when compared against other possible industry structures, the proposed merger was likely to have led to a less efficient and innovative dairy processing industry in New Zealand, potentially reducing farmer returns and economic value to New Zealand over time, and significantly lessen competition in the domestic consumer dairy products market to the long term detriment of New Zealand consumers.

The then Government accepted the case put forward by the dairy industry and allowed the merger to go ahead. To mitigate the risks highlighted by the Commerce Commission, the Government introduced a set of regulatory safeguards aimed at promoting the efficient operation of New Zealand dairy markets by ensuring:

- contestability for the supply of milk from dairy farmers[4], and
- competition in the wholesale supply of domestic consumer milk products.

Contestability for the supply of milk from farmers

Contestability for the supply of milk from farmers was provided primarily through the DIRA's requirements that Fonterra operate an open entry and exit regime for the shareholding farmers. This means that Fonterra must accept all milk supply offers and allow relatively costless exit from the co-operative upon request of its shareholding farmers.

The open entry and exit requirements were intended to ensure that Fonterra cannot create barriers to other dairy processors entering the industry by "locking" farmers in or out of Fonterra. This in turn aims to ensure that farmers' milk is able to flow to its highest value use, continuously testing and optimising the size, composition, strategy and structure of the dairy industry. The regime was designed to put these commercial decisions squarely in the hands of dairy farmers, keeping the role of government to reducing barriers that may be created by a dominant industry player in an attempt to distort this flow.

Farmers' ability to relatively easily switch their supply to and from Fonterra was thought to put strong performance pressure on Fonterra of the type that would normally exist in a workably competitive market.

Contestability for the supply of milk from farmers is also supported by (among other things):

[3] https://www.comcom.govt.nz/dmsdocument/10313

[4] The concept of "contestability" generally refers to the ease with which new firms can enter and exit a market. In this context it refers to dairy processors' ability to source milk from farmers. It is different to the concept of "competition" (which is predicated on dairy processors actually sourcing milk from farmers) because it does not rely on or require dairy processors to do so. It simply ensures that they can.

- the regulatory requirements for the Commerce Commission to monitor Fonterra's base milk price-setting processes,
- the structural and behavioural obligations that relate to Fonterra's current Trading Among Farmers capital structure, and
- the ability of other dairy processors to purchase up to 50 million litres of unprocessed milk per annum from Fonterra at an agreed or regulated price, during their establishment phase.

While the *ex-ante* provisions of the open entry and exit regime were intended to send strong incentives to Fonterra to operate efficiently, the monitoring of Fonterra's milk price setting processes and the provisions relating to the trading of Fonterra's shares were put in place to provide for an *ex-post* scrutiny and assurance that the incentives are working as intended.

Competition in the wholesale supply of domestic consumer milk products

Competition in the wholesale supply of domestic consumer milk products was provided for by the DIRA regulatory requirements on Fonterra to:

- divest 50 percent of its domestic product manufacturing assets to provide for a national wholesale competitor at scale,
- supply the divested entity (now Goodman Fielder) with up to 250 million litres of unprocessed milk per annum, at an agreed or regulated price, and
- supply other dairy processors with up to 50 million litres of unprocessed milk per annum, at an agreed or regulated price.

Competition in the wholesale supply of domestic consumer milk products reduces the risk of exposing New Zealand consumers to higher prices, less choice and lower quality of dairy products. Without a viable national competitor at scale, Fonterra would be a dominant wholesale supplier of dairy products in New Zealand. It would then have the ability to exercise market power and charge excessive wholesale prices, which (if not absorbed by the retail industry) would flow through to New Zealand consumers.

The regulatory requirement on Fonterra to supply its key domestic rival with unprocessed milk was necessary to ensure that the then newly-formed competitor (now Goodman Fielder) was able to start operating, as it did not at the time have its own milk supply from farmers. Commercial negotiations at the time (backed by the regulatory requirement) resulted in Fonterra entering into a long term commercial contract to supply the divested entity with up to 250 million litres of unprocessed milk per annum. In the long term, it was expected that the divested entity would develop its own sources of unprocessed milk supply and become an independent competitor.

The regulatory requirement on Fonterra to supply other dairy processors (including specialty cheese, chocolate and ice-cream producers) with milk was intended to ensure that these typically small-scale operators were able to source milk according to their unique demand characteristics. This in turn was aimed at promoting the development of an innovative and vibrant food sector in New Zealand.