Mataura Valley Milk

Feedback on MPI’s Terms of Reference for

REVIEW OF THE

DAIRY INDUSTRY RESTRUCTURING ACT 2001

AND ITS IMPACT ON THE DAIRY INDUSTRY

30 June 2018

SUBMITTER

Mataura Valley Milk is the vision of local, founding shareholders who saw the need to add more value to farmer and shareholder returns than the traditional New Zealand dairy farming/processing model. This vision is shared by our New Zealand and overseas investment partners to produce exceptional nutrition for a growing world. Construction and commissioning of our nutrition plant at McNab, near Gore, is nearly complete as part of a $240 million investment to manufacture and produce premium nutritional powders and creams for high-end markets. Our purpose-built nutrition plant, one of the world’s most technologically advanced, will employ 65 fulltime staff, with production scheduled to start in August 2018.

As a new entrant in the New Zealand dairy industry, with significant investment committed to the venture, Mataura Valley Milk is highly interested in the industry’s future. We are grateful for the opportunity to contribute to the future of the industry, and the regulatory framework within which it operates.

Contact details
Mataura Valley Milk
19 Ballast Rd,
East Gore,
McNab 9771
Phone: 0800 686 455 (0800 MV MILK)

Executive Summary

MVM is a new dairy company whose aspirations are closely aligned with the objectives of high-value production and processing, as well as achieving sustainable and inclusive economic growth. These aspirations are implicit in MVM's design and implementation, from MVM's focus on nutritional products to the conditions of the supply agreed with MVM's supplying farmers. MVM has already showed in its submissions for resource consent that it is contributing $90 million in benefits to Southland. MVM's stakeholders and investors, including a significant number of Southland farmers, have a strong interest in this review.

MVM understands that the New Zealand dairy industry is already in a new phase of low (or zero) milk growth and fierce competition for milk supply between the dairy companies. As a result, the previous performance of the DIRA regulations and the behaviours of industry participants in previous phases with high milk growth may not be a reliable guide to future behaviours.

The DIRA farm-gate contestability regime (free-entry-and-exit) is vital to the industry and MVM because it allows all dairy companies to compete fairly for milk supply on farm gate milk price, without a large incumbent being able to get in ahead of the market and lock out competitors before they can get established. MVM plans to pay a premium farm gate milk price to secure milk supply, and its high value strategy will underwrite this approach. Other independent milk companies with high-value strategies have already demonstrated success in this regard. Farm-gate competition is the key incentive mechanism driving the industry to improve itself.

The importance of competition to improving industry efficiency, innovation and performance is also clear in the historical record. The initial phase of DIRA before any real competition emerged (i.e. 2001 – 2007) saw very little improvement in key metrics of efficiency. This contrasts directly with the subsequent phase with multiple competitors (2007-2015), where Fonterra clearly responded by reducing costs and improving asset utilisation. This effect is a very real benefit of DIRA.

The factory-gate regulatory regime with regulated raw milk volumes made available to qualifying companies at regulated prices has also been vital to MVM getting established. In the wider scheme of things, these volumes are not significant. However, in their absence there would be no competition at the farm gate.

MVM would be reluctant to see DIRA used to manage externalities that are better dealt with in other regulation and processes already designed for that purpose. MVM also suggests that DIRA should not be used to resolve any dairy companies' internal issues. It is primarily there to manage the very real risks that came from allowing the 2001 mega-merger to proceed and create a dominant market participant. Those risks remain, and so regulations to manage them must also remain.

Contents

page

Executive Summary **1**

1.0 Objectives **3**

1.1 Review Objectives 3

1.2 MVM Comments on the Objectives 3

2.0 Scope: Export-Orientated Dairy Sector **4**

2.1 Benefits of 2001 Industry Restructure 4

2.2 Effects of Contestability Regime 5

2.3 Distribution of Benefits and Risks 7

2.4 Incentives to Higher Value 8

2.5 Contestability 'Fit for Purpose' 10

2.6 Changes to Contestability Regulations 10

2.7 Regulatory Alternatives 11

Attachment 1: Three Phases of NZ Dairy Industry Since 2001 ..... **12**

Attachment 2: MVM Comparable Returns Analysis **13**

Attachment 3: Farm Gate Milk Price Performance **14**

1.0 Objectives

1.1 Review Objectives

MVM understands this review has a much broader scope than either the 2015 Commerce Commission review of dairy industry competitiveness, or the (abandoned) 2016 MPI Review of DIRA.

The stated main purpose of the review is to "consider the effectiveness of the DIRA regulatory regime and its impact on the New Zealand dairy industry across a range of parameters, including incentives and/or disincentives it creates for the industry to transition to:

- higher value New Zealand-based dairy production and processing; and
- more sustainable environmental practices on and off farm.

The terms of reference place this purpose in context of "the Government's economic strategy is to improve the wellbeing and living standards of New Zealanders through sustainable and inclusive growth", and the significance of the dairy industry's performance as "the dairy industry plays a key role in the nation's economic, environmental and social wellbeing and ongoing prosperity".

1.2 MVM Comments on the Objectives

MVM is a new dairy company whose aspirations are closely aligned with the objectives of high-value production and processing, as well as achieving sustainable and inclusive economic growth. These aspirations are implicit in MVM's design and implementation, from MVM's focus on nutritional products to the conditions of the supply agreed with MVM's supplying farmers.

MVM understands that the main purpose and design of the original DIRA 2001 was to manage the detrimental effects of the merger to form Fonterra, i.e. a lessening of competition facilitated by an extraordinary exemption from the Commerce Act creating for Fonterra a position of market dominance in the farm gate milk market (as it affects farmers), the factory gate milk market (as it affects other processors) and the NZ domestic consumer market (as it affects NZ consumers). The most recent DIRA review affirmed that this purpose remains relevant, and this is also the current position of MVM.

MVM understands that the intent of this review is not to re-scope DIRA to encompass other areas of regulation, but rather to understand if there is any merit in suggestions that DIRA had unintended consequences in those other areas. MVM takes the broad view that these suggestions have little merit and will address these specifically in the subsequent sections covering the scope of the review.

MVM is encouraged that the terms of reference contemplate how the DIRA regulations might better achieve the objectives. MVM holds the view that this is a better use of the combined energies and expertise of stakeholders, versus arguing whether DIRA should continue at all. In our view, DIRA is a necessary consequence of the industry restructuring decisions made in 2001 whose effects are still very much present in the New Zealand dairy industry today.

The objectives are forward looking, but many of the questions asked in the scope are retrospective. This potentially implies that history might be a suitable guide for the future. MVM suggests that the New Zealand dairy industry has entered a crucial third phase since 2015[1]. The first phase from 2001 to 2007 was characterised by strong milk growth and virtually no competitive pressures at the farm or factory gate. The second phase commenced around 2008 with the establishment and growth of new independent processors that created regional competition for milk, but in the context of overall milk growth. This second phase came to an end after 2015 when the pattern of strong overall milk growth ceased. The third phase, in which we now operate, is characterised by low or zero milk growth, and the high likelihood of over-capacity in processing. It is vitally important that this DIRA review fully understands how this third phase for the dairy industry might develop, and what new dynamics will emerge as a result.

[1] See Attachment 1: Phases of the NZ Dairy Industry Since 2001

2.0 Scope: Export-Orientated Dairy Sector

The terms of reference outline the scope of the review in two parts, with the first part dealing specifically with the export-orientated dairy sector. This is phrased as a number of questions, and so MVM's response to these is organised similarly.

2.1 Benefits of 2001 Industry Restructure

Q1. 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?

Summary of MVM Response to Q.1:

MVM recommends MPI gives consideration to both benefits realisation and risk mitigation by DIRA. Also, MPI must consider how to navigate the inherently contradictory goals of the 2001 restructure – which will mean first working out what the ideal future state for the sector should be, and secondly considering the different motivations of participants and stakeholders including agency issues.

MVM Comments to Q.1:

The 2001 industry restructure was one of three options considered, namely "Status Quo" where the dairy board continued to exist, "Vertical Integration" where the dairy board assets would be split between the dairy companies and each would operate independently, or the "GlobalCo Merger" where Kiwi Dairies, NZDG and the NZDB merged to form a dominant vertically integrated company.
The anticipated benefits and risks associated with these options were analysed at the time and can be found in "The Quigley Report on Dairy Megamerger, 2001". MVM notes that in 2001 the Commerce Commission and MAF officials concluded that the risks outweighed the benefits of the mega-merger but were then over-ruled by the Minister.

MVM suggests that question 1 should be revised to include "anticipated risks" as it was these, not the benefits, which were the primary drivers of DIRA regulation, i.e. mitigation of the risks posed by creating a single dominant market participant with a special exemption from the Commerce Act.

In any case, the main anticipated benefits from the merger (to form Fonterra) were a coordinated approach to market, improved coordination of production with marketing, as well as market efficiencies from central planning (i.e. with less duplication of assets). Insofar as DIRA facilitated the merger these must be considered. However, as we now approach multiple milk processing developments by new independent dairy companies including MVM, the 'duplication' benefit may be rendered redundant. Also, with a significant number of independent dairy companies all competing in the same export markets, the 'market coordination benefit' may no longer apply. In fact, it is clear that the desire for contestability has always been in direct conflict with the desire for any supposed benefits from centralised planning and marketing. This inherent contradiction in DIRA goes to the very heart of the issue.

The main risks anticipated were related to the lack of incentives for a dominant organisation to innovate and invest in developing high-value products, as well as the propensity for dominant organisations to try and stifle competition. DIRA regulation has been largely effective in restraining Fonterra from exercising its dominant market power in the farm-gate milk market (aided by the courts in some cases, e.g. Studholme).

2.2 Effects of Contestability Regime

Q2. 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)?

Summary of MVM Response to Q.2:

MVM sees overwhelming benefit for the sector and economy overall in all DIRA contestability regulations and urges for them to be retained. However, MVM cautions that the (re-)actions of market participants are not always well anticipated or understood by regulators – often because of a failure to appreciate agency issues within each party.

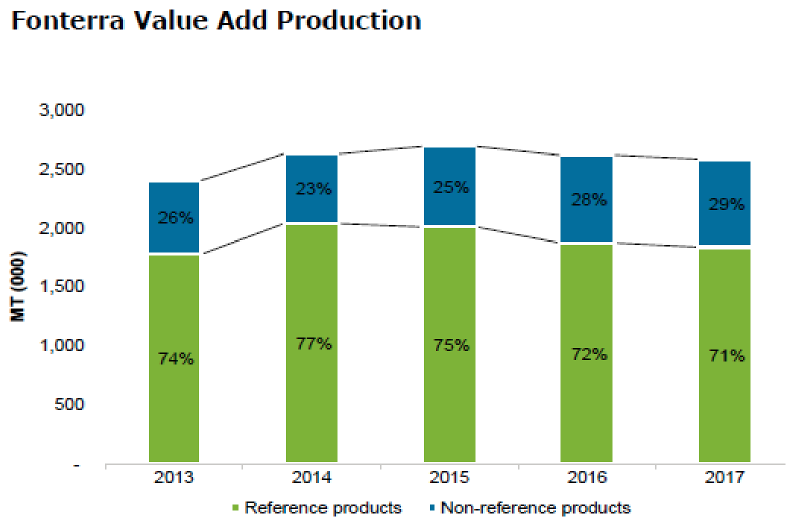
MVM Comments to Q.2:

There is strong evidence that the contestability regime has improved sector economic performance, both in efficiency of production and in innovation.

In regards to efficiency, there was no significant improvement prior to 2008 while Fonterra remained entirely dominant and relatively unchallenged i.e. Tatua did not seek additional milk volumes, Westland was constrained to collections on the West Coast (both had declined DIRA milk) and Open Country Dairies only took 1 percent of total milk which was less than total milk growth. However, by 2007 several new independents had emerged, specifically Synlait, Open Country Dairies and New Zealand Dairies. This competition, which occurred primarily at the farm-gate, showed the new independents had a material advantage through relatively less capital and lower operating costs per kilogram of milk solids (kgMS). This appears to have spurred Fonterra to a program of efficiency improvement across its manufacturing base and also its sales and marketing function from 2008 onwards. We think this vindicates the open-entry-and-exit regime, without which Fonterra could have effectively locked up the farm-gate milk market and remained unchallenged.

In regards to innovation, a major concern in 2001 was around creation of a dominant market entity having little incentive for innovation. MVM suggest the emergence of new independent dairy companies in the sector has been the primary driver of innovation, especially in value-added consumer products. Examples include Synlait's differentiated milks and related consumer products, a2 milk corporation, and in the domestic consumer space there is Lewis Road. [redacted]

[2] Source: Fonterra Annual Reports



The DIRA contestability regulations relating to establishment of new independent dairy companies include both making specific volumes of raw milk available to qualifying new independent export-orientated dairy companies at regulated prices, and also ensuring farm-gate contestability through the open-entry-and-exit regime. This has been critical to their establishment. However, these settings are not the primary driver of business strategy or structure for the new companies. The key drivers of strategy and structure for new independents have been:

- Availability of foreign capital, and the interest of foreign investors in New Zealand's dairy sector (NZ's overseas investment policy is a key factor).
- Commercial pragmatism in selecting milk powders as a key entry product that is readily tradeable[3] in the global market (assurance of cash flow).
- Economic and productivity realities in selecting a milk powder drier of sufficient scale to achieve efficiencies and cash flow for a sustainable business.
- The transparency of Fonterra's own economics (including globalDairyTrade and Trading Amongst Farmers), which provide a degree of risk management across the whole sector (see also discussion of cooperatives in Q3)

[redacted]

It would be disingenuous to claim that the overwhelming growth of milk production somehow forced New Zealand manufacturers, particularly Fonterra (obliged under DIRA to accept all requests to supply milk), to focus development on milk powder driers instead of 'value added' products. The preference for milk powder driers was always a rational economic decision driven by the relatively high returns[5] from milk powders, the manufacturing flexibility that driers provide, and the astonishing growth in demand for imported milk powders in key growth markets, particularly China. Any other

[3] The overall stream returns from milk powders have also been superior to alternative dairy product streams.

[4] [redacted]

[5] The critical analysis lies in comparison of marginal stream returns, i.e. the expected economic contribution of any given choice of dairy products and its co-products for the next standard unit of milk (versus the average stream return across all production).

decision would have represented destruction of shareholder value. Not only Fonterra but also the independents followed this rational approach.

In regards to environmental performance, we are aware of a spurious claim that the DIRA requirement for Fonterra to accept all offers of milk supply is somehow implicated in the development of environmentally unsustainable dairy farms (or at least new dairy farms in sensitive catchments, e.g. Mackenzie Basin). The decision to permit such developments rests with other authorities and regulations just as with any other land-use change. We also suggest that Fonterra has strong motivations to maintain and increase its milk supply[6], especially in this third phase of milk supply constraints, as do other dairy companies including MVM.

Parties within Fonterra are clearly frustrated that Fonterra's milk payment does not differentiate collection costs between suppliers, especially what might be termed "uneconomic milk". This is an internal matter for Fonterra and owes more to historical agreements than anything imposed on it by regulation. MVM suggests this should therefore be excluded from the scope of the review.

2.3 Distribution of Benefits and Risks

Q3. 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?

Summary of MVM Response to Q.3:

The distribution of benefits and risks within the dairy industry and the wider economy are both complex and dynamic. It also differs across regions and between companies.

We would like MPI to note that MVM's establishment provides $90 million of benefits to the Southland community. MVM is also prepared to defend the benefits of foreign investment as having been crucial to realising these benefits in the first place.

The terms of reference could also include the question risk management for the sector. Fonterra's dominant co-operative structure plays a key role for the sector that needs to be acknowledged.

While the dairy industry needs to consider benefits and risks to externalities such as environmental outcomes, MVM sees this as both a commercial imperative for each of the companies, and also something which is better managed by regulation and authorities other than DIRA.

MVM Comments to Q.3:

The distribution of benefits and risks across the sector is both complex and dynamic. Some of the dynamic factors include current market conditions, current seasonal farming conditions, company structure and ownership, the state of competition in each region, contractual arrangements and so on. It is not entirely clear how this question relates to DIRA, but the following points may be helpful.

In term of gross benefits of the dairy industry at a national level, these have been calculated in terms of national gross domestic product (GDP) in a number of reports[7].

In terms of specific benefits, MVM's establishment in Gore provides an estimated $90 million benefit to the Southland region. This was quantified in an economic study commissioned during MVM's

[6] Observe Fonterra's encouragement of milk growth, even to the extent of its subsidiary RD1 being the single largest importer of PKE supplementary feed. Part of this motivation lies in the way milk growth enables capital growth and replacement, which in turn drives modernisation and scale efficiencies.

[7] The New Zealand Institute of Economic Research (NZIER) report, commissioned by the Dairy Companies Association of New Zealand, showed in 2017 the industry contributed $7.8billion to New Zealand's GDP and was the country's largest goods exporter.

application for resource management. This benefit would not have been realised without support from both local and foreign investors. MVM's local investors include supplying farmers.

In terms of risk, a key consideration in the design of DIRA was for Fonterra to be a co-operative. Fonterra's cooperative ownership structure plays a key role in managing overall sector risk because the co-operative payout mechanism allocates virtually all market risk to supplying farmers[8]. This is very sensible when producing mainly commodities given the extreme volatility of global markets and foreign exchange rates, the relatively high collective valuation of supplying farming enterprises versus dairy companies, the relative resilience of farming enterprises, and the significant downside risk to dairy farming enterprises if their dairy company should fail.

Because Fonterra is the dominant market participant in New Zealand, and sets the benchmark for farmgate milk pricing, this has the interesting effect of also managing the risk for other independent dairy companies and their suppliers who set their farm-gate milk prices relative to Fonterra's price. There is a high risk of commercial failures (and then market failure) occurring if the industry is heavily reliant on volatile returns from commodity ingredients and a predominantly cooperative model does not set the benchmark farm-gate milk price in New Zealand.

MVM is initially pricing at a premium to the Fonterra farm gate milk price while it gets established and has a larger reliance on commodity powders. However, as MVM transitions towards higher-value products and de-links from the commodity market it will also move its milk pricing away from this approach. However, given the necessary reliance of the entire sector on exports it will not be possible to remove the risk of currency movement.

The distribution of risks might also include consider externalities to the dairy sector, meaning the benefits/costs/risks which accrue to parties outside the sector. The natural environment is one such externality. As stated in the commentary to Q2, we believe that regulatory incentives and restraints around environmental performance should be properly dealt with in environmental and resource management regulations. Furthermore, as dairy companies increasingly take responsibility for their image and reputation in consumer markets, there are clear commercial incentives available to them to manage farm environmental outcomes as part of an overall company commitment to sustainability[9]. MVM also takes this opportunity to highlight the requirements and incentives around farm performance contained in its own contracts with suppliers. MVM manages these externalities to protect its reputation and the image of its products with consumers, as well as with stakeholders in the Southland region.

2.4 Incentives to Higher Value

Q4. 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?

Summary of MVM Response to Q.4:

The underlying incentives for the dairy industry to transition to higher value New Zealand based dairy production and processing rely mainly on farm-gate competition for milk, not regulation. Competition means having to pay a competitive farm-gate milk price to secure milk supply. Given the size and market dominance of Fonterra, DIRA regulation has been (and remains) essential to enabling this competition.

With regards to the New Zealand dairy industry reliance on commodity milk powders rather than higher value products, this has been a rational economic choice and not a regulatory one. MVM

[8] Payout (i.e. the farmgate milk price x milk volume) is essentially the revenue generated by the cooperative less the costs of collection, manufacturing, distribution and sales. Hence when the market is high payout is high, but when the market is low payout is also low and the dairy company itself is sheltered from this market volatility.

[9] There are numerous precedents already in New Zealand for dairy company incentives (and mandatory requirements) around environmental, animal welfare and farm workplace performance.

would be concerned that regulation to incentivise “value-added” dairy manufacturing could carry significant risk of unintended consequences that won’t benefit New Zealand or the sector. The very definition of “value added” is problematic to creating useful regulation.

With regards to higher-value milk, this is also not a regulatory issue. Logically, it should be in the overall sectors’ interest to promote the provenance of New Zealand dairy, and also develop higher-value milks. However, the participants have not all been aligned on this, especially those with heavy investment in large-scale commodity ingredients supplied to multinationals. Irrespective of that, it will be important for any regulation to recognise and encompass diverse and differentiated milks in the future.

MVM Comments to Q.4:

MVM holds the view that farm-gate competition and higher value dairy production and processing are highly correlated. This belief underpins MVM’s business strategy and is reflected in MVM’s communications to prospective suppliers that explain how a notional farmer will benefit from supplying into our high value product strategy (see attachment 2). Evidence suggests the independent dairy companies paying the highest average farm-fate milk prices are also those with higher-value product strategies. This is outlined in attachment 3.

MVM does not accept that DIRA regulation has had a strong influence on the decisions and product strategies of dairy companies in the past. As outlined in the response to Q2 this is a commercial matter in which rational economic decisions have been made, i.e. to build milk powder driers primarily to produce whole milk powder for export. This strategy has been pursued by both Fonterra and most of the independent dairy companies. The main conditions that contributed to this strategy were the strong growth of milk, and the remarkable growth in demand for WMP from markets such as China. Obviously, the farm-gate and export market situation has changed, and dairy companies have/are now all moving away from a simple commodity milk powder strategy.

The question of higher value milks is a different issue. It is in New Zealand’s broad interest for dairy companies to promote the provenance of New Zealand dairy products generally. It is also in New Zealand’s interest to invest in differentiated milks and milk products such as organic, a2 or grass-fed. However, the industry is not fully aligned on this view.

The premise of scale efficiency behind the planned benefits of the 2001 mega-merger relied on an assumption that all milk was equal. The integrated supply chain inherited by Fonterra and further then developed over subsequent years continued this premise. Compounding this premise is the fact that Fonterra’s main business is selling commodity ingredients to multi-national companies who have absolutely no interest in recognising the provenance of New Zealand dairy products beyond the assurance of food safety. Furthermore, mechanisms such as the Fonterra Milk Price Manual rest on commodity prices and assumptions which attribute zero value to provenance or special production methods. These factors (and belief systems) have been self-reinforcing with strong commercial elements and are not a consequence of DIRA regulations.

The independent dairy companies have less vested interest in the “all milk is equal” argument and some have fully embraced the opportunity represented by higher-value, differentiated milks and production methods. Synlait in particular has pioneered its own ‘sleepy-time’ milk, as well as grass-fed dairy systems in New Zealand, and has also championed a2 milk production. Fonterra has now, after nearly two decades of fighting against a2 milk claims, now also licensed a2 milk, and we are aware of other participants who plan to do so.

One of the considerations for future regulation is how it will apply to differentiated milks. We think it is unlikely that organic and grass-fed systems will gain significant scale in the short term because these require upfront investment, up to a 3-year period before full certification is gained, and higher costs and production trade-offs. The pay-off for organic and grass-fed milk also carries some risk as it depends entirely on the dairy company performance. In contrast, a2 milk simply requires herd selection and breeding based on a genetic test, which is relatively inexpensive. Therefore, a2 milk is more likely to be a significant part of total NZ milk production within a decade. It is not clear if or how DIRA regulation could properly value or manage access to higher-value milk.

2.5 Contestability 'Fit for Purpose'

Q5. 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 and domestic challenges and opportunities facing the industry, the wider regulatory system within which it operates, and the Government's policy objectives?

Summary of MVM Response to Q.5:

MVM strongly asserts that the contestability objectives of DIRA must continue to apply. The only situation where they should not apply is in the unlikely event that Fonterra is de-merged back into Dairy Group and Kiwi Dairies. MVM does think that it is possible in the future for the regulated farm gate milk price to be below the actual farm-gate milk price. It is also possible for regional monopsonies other than Fonterra to arise in the future. It is not clear how these might be managed.

MVM Comments to Q.5:

The regulatory objective of ensuring 'contestability for the supply of milk from farmers' must be retained. The original DIRA regulations concerning market contestability were created as a condition of permitting the 2001 merger which formed a dominant market participant. Notwithstanding the fact that Fonterra has lost some share of milk from 96% to 82% over the last 16 years, it still qualifies by every measure as a dominant market participant with all the same attendant risks. It would be unconscionable to remove the contestability objective simply because of the passage of time.

The slowing (or reversing) of milk growth, and the likelihood of a fierce procurement war between dairy companies for raw milk supply, is significant. The immediate effect of this is likely to be higher farmgate milk prices at the expense of dairy company profits. This will then potentially lead to the regulated farmgate milk price for DIRA milk being a 'lowest common denominator' and possibly insufficient to actually procure milk.

The possible competition for milk could lead also to the failure of one or more of the dairy companies. One possible outcome from a market perspective would be for that winnowing process to leave groups of dairy farmers captured by a regional monopsony (i.e. only one viable dairy company collecting milk in their region) that does NOT have either a farmer-owned cooperative structure or any other guarantee of fair payment for milk. Thus, the future regulatory framework might usefully consider what would constitute a monopsony in milk collection, regionally or otherwise, and what obligations or constraints should be imposed on any dairy company that is in that position of being a monopsony.

2.6 Changes to Contestability Regulations

Q6a. If so, what changes, if any, are required to ensure that the individual provisions of the DIRA contestability regime remain fit-for purpose and are consistent with the Government's wider policy objectives? For example, should large export-focused dairy processors continue to be able to purchase milk from Fonterra on regulated terms?

MVM Response to Q.6a:

Competition is a key driver of efficiency and innovation. If new dairy companies can out-perform any incumbent in these areas and are able to sustain a higher milk price beyond the establishment period, then that must be an overall benefit to the sector. The difficulties of establishment represent a significant hurdle, even without access to 50 million litres per annum of regulated raw milk. The effect of removing this facet of DIRA would be to reduce the drivers for efficiency and innovation.

MVM also acknowledges that it has a direct interest in the DIRA regulations that require Fonterra to supply it with 50 million litres of raw milk per annum, for up to three years, and at a regulated price.

MVM investors and other stakeholders would be very surprised and dismayed if this entitlement was somehow removed.

Q6b. If so, what changes, if any, are required to ensure that the extent of any unintended consequences, which may have arisen as a result of the DIRA contestability provisions, is reduced/removed, while any impact on the regime's ability to deliver on its policy objective is minimised? 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?

MVM Response to Q.6b:

MVM sees no merit in the suggestion that the free-entry-and-exit provisions could be removed. Fonterra remains a dominant market participant, and its creation was only permitted on condition of these regulations. The only change that might be contemplated is that this provision might be broadened, i.e. that any dairy company that finds itself in a monopsony position should be regulated.

2.7 Regulatory Alternatives

Q7. 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?

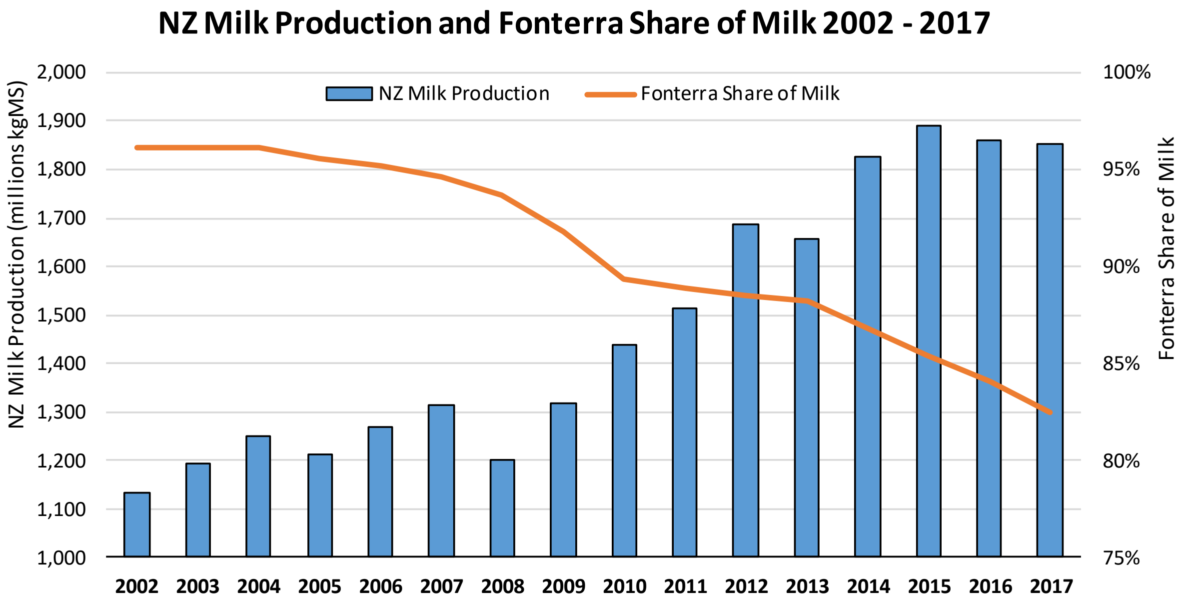
MVM Response to Q.7:

MVM does not choose this option but reserves the right to comment on (or rebut) whatever alternatives might be proposed. On that note, MVM would welcome being included in any dialogue that might occur between now and the publication of a discussion document.

Attachment 1: Three Phases of NZ Dairy Industry Since 2001

New Zealand dairy industry has entered a crucial third phase since 2015. The first phase from 2001 to 2007 was characterised by strong milk growth and virtually no competitive pressures at the farm or factory gate. The second phase commenced around 2008 with the establishment and growth of new independent processors that created regional competition for milk, but in the context of overall milk growth. This second phase came to an end after 2015 when the pattern of strong overall milk growth ceased. The third phase, in which we now operate, is characterised by low or zero milk growth, and the high likelihood of over-capacity in processing.

These three phases for the New Zealand dairy industry are shown below.



Phase 1 2001 - 2007	Phase 2 2007 - 2015	Phase 3 2015 -
Strong Milk Growth Little farm-gate competition	Very Strong Milk Growth Increasing farm-gate competition	No Growth Intense competition

Attachment 2: MVM Comparable Returns Analysis

Comparable Returns Analysis

The annual return to a notional farmer supplying 100,000 KgMS per annum before expenses and other revenue is estimated to be $694,000 for an MVM farmer compared to $654,000 for a Fonterra farmer. There is also material upside to MVM's returns in terms of dividends and capital appreciation.

- The table opposite summarises a comparable returns analysis between MVM and Fonterra taking into account different milk price, dividend and supplier share assumptions.
- The analysis is based on a notional farmer supplying 100,000 KgMS per annum.
- The base milk price is assumed to be $6.50 per KgMS for both MVM and Fonterra. MVM is assumed to pay a supplier premium of $0.20 per KgMS, seasonal incentives of $0.105 per KgMS and quality incentives of $0.25 per KgMS. Fonterra is assumed to pay no seasonal incentives with capacity adjustments embedded into the base milk price.
- Fonterra is assumed to pay a dividend of $0.40 per KgMS based on recent dividend payments. MVM is assumed to pay no dividends, however this represents a material upside, especially after the first few years of operations (both in terms of dividends and capital appreciation).
- It is assumed that MVM supplier shares will cost $2.15 per KgMS based on analysis undertaken by MVM management. Fonterra supplier shares are assumed to have a cost of $6.50 per KgMS.
- The cost of capital on supplier shares is assumed to be 5.5% based on a notional bank borrowing cost.
- The analysis highlights that the annual return to a notional MVM farmer is $694,000 ($6.94 per KgMS) compared to $654,000 ($6.54 per KgMS) for a Fonterra farmer (before expenses and other revenue).

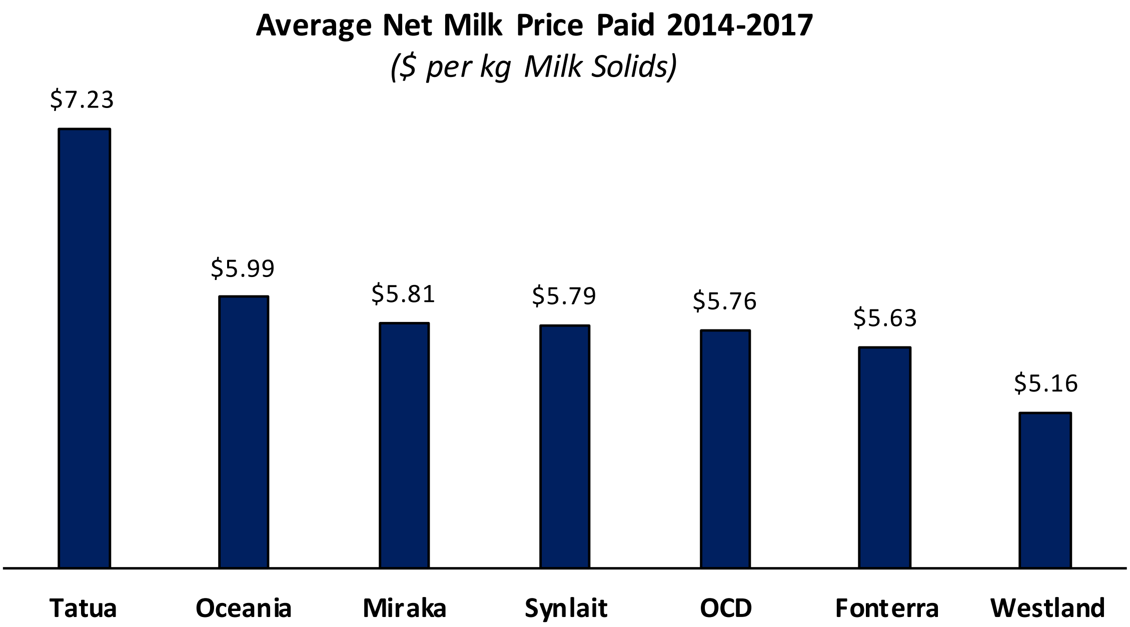
Comparable Returns Analysis

$ / KgMS	MVM	Fonterra	Variance
Key assumptions:			
Milk production (KgMS 000)	100	100	-
Milk price:			
Base milk price	6.50	6.50	-
MVM supplier premium	0.20	-	0.20
Seasonal incentives	0.11	-	0.11
Quality incentives	0.25	-	0.25
Total	**7.06**	**6.50**	**0.56**
Dividend	-	0.40	(0.40)
Capital assumptions:			
Cost of supplier shares	2.15	6.50	(4.35)
Cost of capital %	5.5%	5.5%	0.0%
Return analysis ($000):			
Milk revenue	706	650	56
Dividend	-	40	(40)
Cost of capital on supplier shares	(12)	(36)	24
Total annual return	**694**	**654**	**39**
Return analysis ($ / KgMS):			
Milk revenue	7.06	6.50	0.56
Dividend	-	0.40	(0.40)
Cost of capital on supplier shares	(0.12)	(0.36)	0.24
Total annual return	**6.94**	**6.54**	**0.39**

MVM - Information Flyer - 21 December 2017

Attachment 3: Farm Gate Milk Price Performance

To make a fair comparison between the farm gate milk prices of different companies, this should be net of any retentions or financing costs for mandatory supplier share capital (i.e. a “net milk price”). The following table summarises the net milk price paid by market participants over the past four seasons. The correlation between net milk price and ability to retain/grow milk supply is strong. The two lowest-paying participants have not been able to retain milk supply in the past two years. The other market participants all have a queue of offers to supply.



There is also a similarly strong correlation with higher value products. Miraka has a significant part of its milk going to UHT liquid products and consumer products, while Synlait has significant infant formula capacity as well as differentiated milks. Oceania is focussed on both infant formula and UHT liquid consumer products.