The Tatua Co-operative Dairy Company Limited

Response to Terms of Reference for the

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

July 2018

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SUBMITTER

Formed in 1914, The Tatua Co-operative Dairy Company Ltd (Tatua) is one of the few dairy companies in New Zealand that has remained unchanged by merger or take-over. The Company operates as a co-operative, with 107 supplying shareholders and concentrates its business activities in the added value and higher technology sectors. The Tatua business model can be considered as being part dairy processor and part food producer.

Having had a long history of trading dairy materials, including raw milk, with other New Zealand dairy companies as part of its normal business activities, Tatua continues to take a keen interest in all milk markets. We are grateful for the opportunity to provide our unique view of the dairy industry and markets.

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EXECUTIVE SUMMARY

1.1 Tatua welcomes the opportunity to contribute to this review. We agree that the dairy industry is of significant national interest, and plays a key role in New Zealand's economic, environmental and social wellbeing and ongoing prosperity. The DIRA regulatory regime plays an important role within the industry and it is sensible to review how it can best achieve its objectives.

1.2 DIRA regulation and its effects must be viewed in context. The New Zealand dairy industry is entering a new phase that will give rise to new behaviours and different outcomes than the previous 16 years. Dairy farming is under increasing pressure to be more sustainable and responsible, and industry growth has slowed. New entrants have successfully established but overall excess processing capacity is now likely to drive increased farm gate competition.

1.3 One of the main lessons learned from the past is that competition is vital to drive efficiency. In the period 2002-2007 there was strong growth but no real competition at the farm gate and Fonterra did not appear to improve its efficiency. This changed when independent dairy companies started to gain a significant share of raw milk from 2008 onwards. In that sense, DIRA has had a positive effect on the sector because it enabled new entrants to become established and create competitive tension in the market.

1.4 Tatua has continued to successfully operate over the past 16 years by limiting its milk supply growth and using its commodity ingredients business as a foundation for development of a robust value-added business. Being a co-operative has been no impediment. As the whole industry moves into a period of lower (or zero) milk growth, the previous industry imperatives around processing increasing milk volumes have become less relevant. We anticipate that value-add will become increasingly important in future as processors seek to retain their raw milk supply.

1.5 With increased competition in many dairying areas, the ability to retain (or grow) milk supply will be a key success factor for individual dairy processors. Against this background, and in the absence of DIRA, Fonterra would have a strong incentive to use its market dominance to supress farm-gate competition. For example, proliferation of long-term supply contracts (in absence of the open-entry-and-exit regime) could effectively shut down the farm-gate milk market, ultimately to the detriment of the sector.

1.6 The presence of independent processors has initiated the development of a factory gate milk market. This has allowed Tatua to, once again, participate with business partners in the commercial exchange of raw milk components and other materials.

1.7 Tatua believes a strong Fonterra Co-operative is good for New Zealand. The co-operative model provides an essential risk management function for the whole dairy sector, because it passes the effects of market volatility onto the farming sector which has the greatest financial value and resilience. In the absence of a dominant Fonterra Co-operative, and Fonterra reference milk price there is a real risk that long term farm returns would diminish, resulting in erosion of farm resilience, and at the extreme, failure of the farm-gate milk market in some regions.

1.8 Tatua accepts that the regulatory requirement for Fonterra to accept offers of milk supply may have included areas with a high intrinsic environmental value. However, this is fundamentally an issue arising from regional planning decisions, resource consents and other factors outside the scope of DIRA. In the case of so-called 'uneconomic milk' Tatua is open to adjustment of DIRA to avoid this outcome, but suggests caution in undermining the otherwise overwhelming benefits of competition and notes also that this issue will become irrelevant as milk-growth slows or reverses.

INDUSTRY CONTEXT

2.1 The terms of reference correctly identify that by 2001 the industry structure with the New Zealand Dairy Board (NZDB) had become untenable. Several restructure attempts had been made throughout the previous decade, and meanwhile industry consolidation had continued apace leading to only four dairy companies, including Tatua, remaining. The only two clear options available for a restructure were to divide the assets of the NZDB between the companies, or to have a 'mega-merger'. The decision was made to allow the merger on condition that the Dairy Industry Restructuring Act 2001 (DIRA) contain provisions to restrain the resulting company (Fonterra) from acting anti-competitively. Tatua was part of that process but chose to remain independent with confidence that the DIRA regulation would provide ongoing protections, particularly in the farm-gate milk market and factory-gate milk market. The 2015 Commerce Commission Review concluded that these protections remained necessary.

2.2 The New Zealand dairy industry has evolved significantly since 2001, through several distinct phases. The first phase from 2002-2007 involved robust industry growth at 3.2 percent per annum but very little actual competition. Open Country was the only new entrant and accounted for just 1 percent of national milk collections by 2007. In contrast, the second phase from 2007 to 2015 saw higher annual milk growth of 5.5 percent but with significantly more competition. Fonterra continued to grow its milk collections at 3.7% per annum, while independents surged to 12 percent of total milk (growing at 36% per annum). The industry has now entered its third phase with very low milk growth, and more intense competition for supply. In the period 2015 to 2017, total milk production dropped 1 percent per annum while Fonterra's milk collections dropped 2.7 percent per annum and independents still grew their milk collections at 9 percent per annum. Fonterra's share of total milk in 2017 ended at 82 percent, which is still dominant[1] but less than previously. These figures are summarised below.

Key Measures on per annum basis	2002-2007	2007-2015	2015-2017
NZ Milk Growth	3.2% High Growth	5.5% High Growth	-1.0% Falling Production
Fonterra Milk Growth	2.4% High Growth	3.7% High Growth	-2.7% Shrinking
Independent Milk Growth	22% Very High Growth	36% Very High Growth	9% High Growth
Change in Fonterra Share of Milk	-0.29%	-1.16%	-1.46%

2.3 This has two important implications for this current review:

(a) A review of regulation is appropriate as the industry enters its third phase

(b) The behaviours and observations made in the earlier phases of DIRA are not necessarily a reflection of what can be expected in the future.

[1] See Tatua's 2015 submission to Commerce Commission, with calculation of relevant indices.

BENEFITS OF COMPETITION AT FARM GATE

3.1 Tatua sees significant benefits in DIRA regulation facilitating ongoing competition at the farm gate. In our view, the only justified means for export-orientated firms to secure milk supply (once their initial three-year establishment period under DIRA has ended) is by paying a competitive milk price. This means New Zealand farmers receive a fair value for their milk, and ensures this value is returned to the New Zealand regional economy through that payment.

3.2 Based on Tatua's assessment, the correlation between net milk price and ability to retain/grow milk supply is strong. It is evident that the companies which have either grown more slowly, or have lost milk to competitors, have done so because their farm gate milk price is not competitive.

3.3 The absence of real farm gate competition in the first phase 2002-2007 meant there was less stimulus for productivity and efficiency gains in the industry. The high growth of farming across all regions of New Zealand underwrote development of new processing capability, and in the absence of competition there was no immediate threat to being able to quickly utilise that capacity. Analysis of Fonterra's financial performance in this period verifies that this first phase saw little improvement in key efficiency metrics of assets and operating expenses per kilogram of milk solids. In contrast, the subsequent phase particularly from 2009 onwards saw definite efficiency gains. It is also apparent that the new entrants had relatively low operating cost and capital ratios in comparison to Fonterra.

3.4 This stimulus for efficiency is a clear consequence of DIRA, first in enabling the establishment of new processors and secondly in ensuring that farm gate milk remains contestable, i.e. available to contract. Tatua see this as an industry good. In absence of DIRA regulation at the farm gate, specifically the free-entry-and-exit rule, it is conceivable that Fonterra would seek to impose some restraint on its' farmer suppliers leaving the co-operative. A simple approach might involve long-term contractual commitments that farmers would be required to sign in the absence of any immediate alternative. The effect would be detrimental to any new processing development as it simply could not secure sufficient milk to become viable.

3.5 Competition at the farm gate is an equal stimulus for product development to generate sustainable returns above the level of commodity ingredients. This is Tatua's strategy, and it has served the co-operative and its shareholders well.

3.6 In the current environment there is a different risk attached to regulation around farm-gate milk price[2]. With static or declining milk volumes, and the very real likelihood of excess processing capacity, it is more likely that some companies will pay more than they can afford in the long term to secure milk in the short term. i.e. a procurement war similar to what has been seen in the meat industry at various times. This could escalate until one or more firms actually fails. The problem is that regulation of Fonterra's farm-gate milk price alone will not resolve the issue, given the involvement of other equally motivated participants. Also, it would seem unreasonable in the extreme to regulate the farm-gate milk price of independents. In any case, the current regulation relates almost

[2] From DIRA: 150A Purpose of this subpart

(1) The purpose of this subpart is to promote the setting of a base milk price that provides an incentive to new co-op to operate efficiently while providing for contestability in the market for the purchase of milk from farmers.

(2) For the purposes of this subpart, the setting of a base milk price provides for contestability in the market for the purchase of milk from farmers if any notional costs, revenues, or other assumptions taken into account in calculating the base milk price are practically feasible for an efficient processor.

entirely to transparency, with no real powers of enforcement, and the model has already been disregarded at times.

BENEFITS OF COMPETITION AT FACTORY GATE

4.1 DIRA regulation requires the mandatory supply of raw milk to various qualifying processors at fair prices. This has enabled new entrants to become established, exactly as planned. However, the current DIRA regulations should be seen as more of a substitute for a factory gate market, than actually facilitating the market.

4.2 Tatua's primary interest in the factory-gate milk market is access to (or sale of) milk components in addition to its own milk supply. One of the key principles for dairy processing companies is that the product mix must be balanced to fully utilise all the components in the milk supply such as casein, whey and milk fat. This is a particular challenge for most smaller processing operations where the incremental nature of processing capacity imposes relatively greater constraints. Trading with other dairy processing companies achieves a better result for all parties, and is why Tatua actively trades milk products and components with various independent dairy companies.

4.3 The same is not true in dealing with Fonterra, which has a large and diverse enough operation that it has little need to exchange raw materials with smaller parties. It is also likely that agency and delegation issues within Fonterra provide little incentive for trading. This is a commercial reality which regulation should not attempt to resolve.

4.4 It is unlikely that removing DIRA's factory gate regulations would affect Tatua's ongoing ability to trade milk products and components, but given that the factory gate milk market remains thin, it may discourage new entrants.

BENEFITS OF THE CO-OPERATIVE MODEL

5.1 One of the foundations of the 2001 Industry Restructure was that Fonterra would be a co-operative. A central co-operative principle is that the profits of the enterprise are returned to the supplying members. The Tatua Co-operative maintains this principle across the whole of its business. The Fonterra milk price mechanism achieves this for Fonterra's core dairy ingredients business. Also, while Fonterra farmers are still required to hold a majority of their units, this also remains largely true for Fonterra as a whole.

5.2 Fonterra's market dominance in New Zealand means that it sets the benchmark for farm gate milk prices. This means that Fonterra's dominance combined with its co-operative structure and farm-gate milk price helps ensure global market returns are reflected in the milk price received for all dairy farm operators, including those supplying independently owned processors.

5.3 In the absence of a co-operative Fonterra, milk producers supplying independently owned processors would likely bear the impact of global market and foreign exchange downturns, but not necessarily obtain the full rewards of positive market performance. In dairying regions with no or little farm-gate milk competition this could lead to an erosion of long terms returns and reduced on-farm resilience.

5.4 The current review must consider the consequences if the New Zealand dairy sector did not have a dominant co-operative dairy company setting the benchmark farm-gate milk price. Experience in overseas dairy industries highlights the risks including farmers being effectively captured by investor-owned dairy companies and potentially market failure at the farm gate. Accordingly, Tatua sees the benefits of Fonterra being commercially successful, and will also strongly oppose any suggestion that Fonterra should not remain a co-operative.

UNEXPECTED EFFECTS OF DIRA

6.1 Tatua accepts that the New Zealand dairy industry must act responsibly in all its activities and their effects. This means managing environmental, animal welfare and workplace environment outcomes, for example. This is an imperative for both dairy farmers and dairy companies who value a positive reputation.

6.2 There are suggestions that DIRA has had an unexpected detrimental effect on the environment, specifically that DIRA has contributed to the undesirable development of dairy farming activity in environmentally sensitive areas and/or areas with otherwise intrinsically high environmental value. The development of dairy farms in Mackenzie Country is given as an example, because DIRA required Fonterra to accept the offer of milk supply from those farms.

6.3 Tatua rejects the notion that DIRA should be re-constructed to achieve outcomes other than the efficient functioning of the industry itself. The issue of Mackenzie Country, and indeed all land-use change, is properly the business of other Government regulation and policy (i.e. Resource Management Act, National Environmental Standards, and National Policy Statements) and of the affected Regional Councils (i.e. Regional Policy Statements, Regional Plans). If there was any failure in regards to permitting dairy conversions in Mackenzie Country, it resides with those parties. It is disingenuous to suggest that DIRA's free-entry-and-exit rules are responsible.

6.4 Tatua does accept that the free-entry-and-exit rules <u>may</u> have required Fonterra to accept "uneconomic milk" from new suppliers in some instances – i.e. where the additional costs of collection and return to a processing site are too high. Also, that it <u>may</u> have been required to build capacity that was then stranded when farmers left to supply another party. However, we make the following points in relation to this:

(a) The net effect of "uneconomic" collection is likely negligible

(b) Dairy conversions in New Zealand have now largely slowed, so will be negligible anyway

(c) It is doubtful that Fonterra would have otherwise scaled back capacity development to allow competitors to become established in key milk growth regions.

6.5 There has been a further suggestion that DIRA's requirement for Fonterra to accept all milk offered, in conjunction with high milk growth, somehow forced it to focus on developing large-scale commodity ingredients processing capacity rather than developing a sustainable value-added business. In our view, the decision to build a large powder-processing capacity across New Zealand has been economically rational based on relative stream returns and market demand. Independents have focussed on milk powder driers for the same reason. Whatever the case, the current industry phase with low/zero/declining milk growth renders this argument obsolete. It will be competition rather than regulation which drives innovation in value-added milk products.

Tatua is grateful for the opportunity to comment on the above issues. We would welcome the opportunity to further discuss any aspect of our response.