MPI Filenote: Body of e-mail received from Miraka alongside inputs

Please find attached the following two attachments, namely:

1. The February 2012 Miraka submission to MPI in response to the then proposals to amend the DIRA; and
2. A summary of Miraka's key points as outlined in this morning's meeting.

I am happy that you share both documents with your colleagues.

And please pass our thanks on to the entire team for their generosity in terms of time this morning – it is very much appreciated.

NB: I am happy to provide the attachments outlined in the 2012 paper if you want to see the originals – just let me know.

I note that since 2012, Professor Rey has increasingly been acknowledged as the leading authority on the issue of vertical foreclosure and margin squeeze. Indeed, Professor Rey was the lead author on the seminal papers on the subject with Professor Jean Tirole – who was the 2014 Nobel laureate in Economics.

Some thoughts....

I always look at old reports with more than a hint of trepidation, as Old Father Time has a tendency of making a mockery out of what seemed – at the time – to be well founded predictions, ironclad forecasts and robust analytics. Having re-read the paper I must say I am pleasantly surprised with the content and consider the analytics have held up rather well. For example, whilst I was wrong about the magnitude of the impact of HEC on both independents and contestibility (I under-estimated both the affect ComCom would have in reducing some of the worst excesses of the 'super competitor' along with the resilience of the independents) and I also over-estimated the 2015 Waikato 'race for the milk' (this coincided with historically low pay outs so securing addition supply to replace regulated milk was relatively easy) I was nevertheless spot on regarding:

1. Open entry and exit proving to be completely ineffective in terms of imposing a pricing discipline on Fonterra; as this assumed a highly elastic supply response from farmers - when the reality was the opposite (with MAF estimating an elasticity of only 0.32). This implied that the prophesized 'tsunami of uneconomic milk' would never eventuate.
2. To the extent that Fonterra faced an increased milk supply (be it a tsunami or otherwise) then that milk would be 'economic' as long as the Fonterra share price was above about $4.50 and DIRA compelled farmers to 'share up' – as incoming milk supplies would be self-funding in terms of financing additional processing capacity (so in this sense Fonterra was naturally hedged)
3. TAF also proving to be ineffective as market discipline on Fonterra as the milk price essentially set the dividend policy, which then set the share price – with the milk price being wrong to start with. Indeed, TAF has simply made transparent Fonterra's extremely poor financial performance (amply illustrated in a recent TBD report) meaning investors have priced the units accordingly

(and given Fonterra is a farmer-owned cooperative, a combination of a high milk price/low share price is not at all surprising, despite Professor Willig arguing the exact opposite).

Due to the three points above, I argued a light-handed regime based on supposed market disciplines, transparency and ComCom monitoring would be totally inadequate – indeed, the phrase I used at the time was this was 'like giving ComCom a ring side seat to watch a bank robbery'. This resulted in two alternatives being proposed by Miraka: proceed with a light handed regime – abliet based on 'Fonterra actuals' or proceed with HEC and have ComCom setting the milk price.

The passage of time has shown this analysis to be both prescient and correct.

At this point a witch hunt or assigning fault is futile – as it wont change anything. However, to paraphrase Wellington retailing legend Alan Martin, 'it's the putting right that counts' and this review provides the opportunity for 'the putting right' to occur.

This leads me to the second document – Miraka key messages for the upcoming review.

As discussed this morning, Miraka's primary focus in on competition issues – despite having useful initiatives in terms of environmental management, human and animal welfare, and 'value add' production.

In terms of a remedy Miraka accepts that a pricing regime based on Fonterra 'actuals' is not feasible. Miraka's focus has therefore been on amending and fine tuning the existing system rather than trying to supplant it. To this end Miraka's focus is squarely on:

1. Retaining, for competition policy purposes, the farmer switching on a 'no arguments basis' part of the open entry and exit regime; and
2. Reducing the level of vertical forclosure being imposed on the industry via the MPM by better defining the meaning of 'practicably feasible', instituting a resolution mechanism and [potentially] a penality mechanism to ensure enforcement.

Miraka also considers there is also considerable merit in subpart 5A clearly stating the efficiency and contestiblity have an equal weighting – with a broader definition of what is mean by efficiency.