MIRAKA
nurturing our world

24 February 2012

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Tena koe

Please find enclosed an email copy of the Miraka submission on the Proposal to Amend the Dairy Industry Restructuring Act (DIRA). A number of reports have been attached to this submission. These reports are for **official use only** and are not to be released under the Official Information Act to any third party without the written permission of Miraka. Moreover, as the submission contains reference to these reports a second version suitable for public release has been included. The full version of the Miraka submission is also **not to be released** to any third party under the Official Information Act, or for any other reason, without the written permission of Miraka.

We are extremely disappointed that none of the proposals made by the Ministry of Agriculture and Forestry (MAF) have addressed Miraka concerns raised in previous submissions. The proposals as drafted, will continue to lock in advantages to Fonterra, that are both unfair and anti-competitive with the only real change being that this will be more transparent than in the past.

We urge you to seriously consider the concerns that Miraka have raised in our submission so that solutions can be found that are:

a) Fair to all parities

b) Independent of Fonterra

c) Transparent in operation and that will allow for a competitive and contestable dairy industry in Aotearoa.

Naku noa, na

Kingi Smiler
Chairman
Miraka Limited

## Submission to:

### The Ministry of Agriculture and Forestry

Response to MAF Discussion Paper No: 2012/1

*Proposals to Amend the Dairy Industry Restructuring Act*

- *Review of the Raw Milk Regulations*
- *Review of Fonterra's Milk and Share Price Setting*
- *Regulatory Regime to Accompany Fonterra's Capital Restructuring*

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### Date:

24 February 2012

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***Disclaimer****: Due to the very short timeframe associated with the current consultation process, these reports have been finalised within a very compressed timeframe. It is therefore possible that the reports contain minor errors of a non-substantive nature.*

## *About Miraka*

Miraka Limited[1] is a new entrant to the dairy processing industry (incorporated in 2009) and is the first majority owned Māori independent processor in New Zealand. Miraka has a plant located at Mokai, 30km northwest of Taupo. This plant commenced operations, as scheduled, on 1st August 2011.

Miraka is backed by Wairarapa Moana, Tuaropaki Trust, Waipapa 9 Trust, Hauhungaroa Partnership, Tauhara Moana Trust, Huiarau Farms and Te Awahohonu Forest Trust. Collectively, these organisations have an asset base of over $1 billion and milk approximately 18,000 cows; providing Miraka with a significant Māori supplier base.

Miraka intends to source its milk from the central plateau area and is accessing regulated milk under the *Dairy Industry Restructuring (Raw Milk) Regulations* ('the Raw Milk Regulations').

The plant will include a milk reception area, evaporator, an eight tonne/hour spray drier and powder storage bins. The plant has the capacity to process over a million litres a day from 50,000 cows. A unique feature of the Mokai plant is that it will utilise electricity and steam from the nearby Tuaropaki geothermal power station, thereby providing Miraka with a commercial and environmental advantage over plants that rely on fossil fuels.

Miraka's immediate focus is on the production of whole milk powder (WMP). However, the site has been configured so that additional driers and other plant can be commissioned at a later date. Miraka has a number of a number of key strategic relationships, including international marketing relationships with *Global Dairy Network*[2]and Vietnam based *Vinamilk*[3]and a strategic investment relationship with the Māori Trustee.

Miraka Limited is here for the long term. The alliance of Māori Trusts and Incorporations who founded this company have the same vision of sustainable business practices and securing long term returns for their shareholders, both now and for future generations, from land that will never be sold.

1 See: http://www.miraka.co.nz
2 See: http://www.globaldairynetwork.com/
3 See: http://www.vinamilk.com.vn/eng/?vnm=market&id=14

# ***Part 1***: *Executive Summary*

*Introduction*

1. Miraka Limited (Miraka) welcomes the opportunity to make a submission to the Ministry of Agriculture and Forestry (MAF) regarding:

    a. The findings of the Interdepartmental Investigation into Fonterra's Milk Price Manual (Fonterra MPM);
    b. The legislative requirements to enable the introduction of Fonterra's trading among farmers (TAF) proposal; and
    c. MAF's proposed allocation regime regarding regulated milk.

2. In compiling this submission, Miraka has sought the following expert advice:

    a. Deloitte Corporate Finance (Deloitte) in terms of a quantitative analysis of Fonterra's MPM.
    b. Professor Patrick Rey, a regulatory and competition policy expert from the University of Toulouse, in terms of economic analysis of Fonterra's MPM.
    c. Professor Tony van Zijl, Consulting Director at Sapere and Director of the Centre for Accounting, Governance and Taxation Research at Victoria University of Wellington in terms of financial analysis of Fonterra's TAF proposal.
    d. Dr Michael Pickford, economic consultant and former chief economist, New Zealand Commerce Commission, regarding the competition policy implications of Fonterra's MPM.
    e. Mr Kieran Murray, economist and chairman Sapere on economic and competition policy advice.
    f. Mr John Shaskey, Executive Director Global Dairy Network Limited, on internal dairy market dynamics.

*Fonterra's MPM and TAF Proposal*

3. The acceptance of Fonterra's current MPM by MAF as the basis for setting the farm gate milk price for the New Zealand Dairy Industry is **methodologically incorrect** and **wrong in principle** because:

    a. Fonterra's MPM employs a pricing approach that originated in natural monopoly industries such as network utilities (i.e. gas pipelines) where competition is impractical. It is therefore inappropriate to use this methodology, even in a modified form, as the dairy processing market is contestable and can support workable competition.

b. The concept of 'the next efficient processor' as defined by MAF[4] (and employed by Fonterra) confuses the concept of 'the next plant' (i.e. a new plant) with a 'marginal plant'.[5] If MAF's view is that marginal cost pricing is to be employed then standard economic analysis is that the marginal plant is the **least** efficient one rather than the **most** efficient.[6]

c. Fonterra's MPM creates a '**super-competitor**'[7] that 'cherry picks' the best features of Fonterra and a new entrant and then uses these as the basis for setting the industry-wide farm gate milk price. Given a hybrid firm of this nature can **never exist**, it is impossible for any firm, including Fonterra, to compete with it.

d. Fonterra's MPM drives up the farm gate milk by up to **50 cents kgMS**.[8] This artificially squeezes processor margins and leads to a situation that can be characterised as vertical foreclosure.[9]

4. Fonterra's MPM therefore sets an artificially high industry-wide farm gate milk price. This represents:

   a. A significant barrier to entry;
   b. Is incompatible with any credible notion of contestability or workable competition; and
   c. Is inconsistent with the purpose of the *Dairy Industry Restructuring Act* (DIRA) or the legislative and parliamentary intent that underpins DIRA.

5. The problems outlined above have been further compounded by a number of incorrect assumptions, namely:

   a. **That the DIRA open entry and exit regime incentivises Fonterra to set a fair and competitive farm gate milk price**.

   Fonterra is permitted to set its own farm gate milk price on the assumption that DIRA imposes sufficient commercial incentives to ensure Fonterra sets a fair and competitive price. This assumption is incorrect as:

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4 See: MAF, *Key Findings from the review of Fonterra's Milk Price Manual* (January 2012)
5 The correct interpretation of the marginal plant is that it is the *__least__* efficient plant that is 'just holding on' rather than the *__most__* efficient plant. A good New Zealand example is found in the wholesale electricity market, where it is the most expensive (i.e. least efficient generator) that set the nodal price.
6 See: Rey (*opt cit*), Pickford, M. *A Review of the Compass Lexecon Report on Fonterra's Pricing of Regulated Milk in the Dairy Processing Industry* (15 November 2011) pg. 15; and Murray, K, *Fonterra's raw milk price and realistic opportunities for competition to enter the market* Sapere (23 February 2012) pg. 5
7 See: Deloitte, *Review of Milk Price Calculation* (22 February 2012) pg. 7
8 Ibid, pg.7
9 See: Rey, P. Review of the milk pricing methodology of Fonterra (February 2012)

i. The elasticity of supply for milk is extremely low (0.32),[10] so an artificially high milk price will not result in a 'tsunami of milk'; and
ii. At the current Fonterra share price, new milk supplies are self-funding in terms of financing new processing assets. This means new milk supplies to Fonterra represents *economic* rather than *uneconomic* milk.[11]

The corollary is Fonterra is able to set an artificially high milk price indefinitely and with impunity.

b. **That international dairy markets are insatiable and any increase in product supply will have no effect on international prices**.

Fonterra's 'super-competitor' assumes Fonterra's entire New Zealand domiciled milk production can be turned into a powder-based product mix. However, the assumed product ***volumes*** cannot be sold at the assumed product ***prices***, as the increase in product volume will cause international prices to fall.[12]

The product mix and product price assumptions employed by Fonterra's super-competitor are therefore logically inconsistent.

c. **That Fonterra's trading among farmers (TAF) proposal will lead to an efficient Fonterra share price**.

Without the starting point of an efficient *milk* price, Fonterra's TAF will not result in an efficient *share* price, or in other words, the TAF market will not discover an efficient share price when Fonterra controls both the milk price and the dividend policy.

A Fonterra share that trades at a substantial and permanent discount will have the effect of 'locking' farmers into Fonterra.[13]

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10 See: *Ibid* Murray, K Sapere pg 8. The figure of 0.32 has been employed by the Commerce Commission and was supplied by the Ministry of Agriculture and Forestry.

11 Switching to revenue streams rather than funding plant construction, it can be argued that additional milk will go into progressively lower returning products and this would lower Fonterra's overall milk price. This is correct. However, it is

- Inconsistent with the assumption made by Fonterra's super-competitor (and MAF) that international markets have an insatiable demand for powder products; and
- Irrelevant, as Fonterra's super-competitor is setting the farm gate milk price *not* Fonterra.

12 Shaskey, J. *Global Dairy Market – Pricing Benchmarks* Global Dairy Network (17 February 2012)

13 See*, Van Zijl, T*. *The Relationship of the farm gate milk price and the Fonterra share price to the ability of independent processors to compete with Fonterra,* Sapere (22 February 2012)

d. **The failure to consider switching premium**.

Like all independent processors, Miraka pays farmers a switching premium – which equates to 15 cents kgMS once all relevant factors are accounted for[14] – in order to secure farmer supply. However, neither Fonterra's MPM nor any of the MAF documents make any allowance for switching premiums.

Given the stated purpose of Fonterra's MPM is to replicate a hypothetically efficient market price, this is a significant analytical oversight as it implies Fonterra's MPM will always post an inefficiently high price.

6. For a company like Miraka the impact of Fonterra's super-competitor is an artificial increase in costs of up to $10 million per annum. When switching premiums at added this increases costs by an additional $3 million. While Miraka accepts that switching premiums are a legitimate part of the market, it is all but impossible to operate a profitable business when the starting point is an artificially high milk price.

7. Miraka concurs with the following conclusion tendered to MAF by Castalia:

> *A pricing approach based on Fonterra's actual costs (rather than hypothetically efficient costs) would enable efficient entry and promote outcomes that are more consistent with a workably competitive market.*[15]

8. Accordingly, it is Miraka's view:

   a. That the pricing approach to setting an industry-wide farm gate milk price must be based on Fonterra's actual costs.
   b. Fonterra's TAF proposal cannot proceed until there is a process in place to produce a fair, independent and transparent industry-wide farm gate milk price.
   c. That adequate assurances have not been provided that the combination of (1) a potentially illiquid and one-sided farmers' market and (2) a super-liquid derivatives market will prove an adequate substitute for share redemption by Fonterra
   d. That the proposals by MAF for a Milk Panel and Commerce Commission oversight as safeguards will not work due to the distortions created by Fonterra's MPM.

[14] 15 cents kgMS is calculated as follows: Miraka pays farmers a 10 cents kgMS but unlike Fonterra, does not apply a capacity charge to its suppliers. The absence of a capacity charge accounts for the additional 5 cents.

[15] See: Castalia, *The "Hypothetical Efficient Competitor" and Fonterra's Farm-gate Milk Price* (July 2011)

*Access to Regulated Milk*

9. Miraka made investment decisions, in good faith, on the basis of Government policy being non-discriminatory access to regulated milk with price based allocation.[16] Miraka is now caught, through no fault of its own, in a fundamental reversal in Government policy that imposes significant harm on the fledgling company – especially as 'the newest new entrant' that only commenced operations in August 2011.

10. Bluntly ceasing access to regulated milk in 2015 for any independent processor with a supply greater than 30 million litres will create an artificial 'race for the milk' in the Central North Island; as:

    a. Three processors (Tatua, Open Country Dairies and Miraka) in close proximity will lose access to regulated milk at the same time; and
    b. Unlike other regions (i.e. Canterbury, Southland) the growth in the milk supply in the Waikato/Bay of Plenty regions is low.

11. Miraka strongly recommends a first principles approach regarding access to regulated milk, with the starting point that regulated milk should be made available to all processors until the DIRA competition policy triggers have been met. Miraka accepts that given MAF has rejected price based allocation then this requires a bureaucratic rationing process if there is excess demand for milk.

12. Miraka considers an alternative approach is implementing the type of entrance pathway proposed by the Commerce Commission in 2008, which starts at 75 million litres and progressively abates away over eight years.[17]

13. Miraka further notes that as a consequence of a change in government policy, the switching premiums that farmers are likely to demand in the central North Island in the lead up to 2015 and immediately thereafter are likely to spike and thereby place independent processors at yet further competitive disadvantage.

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[16] Anderton, J. *Regulated Milk Price and Quantity the Same for next year*, (22 August 2008)
[17] Commerce Commission, *Review of the Raw Milk Regulations: Draft Views from the Commerce Commission* (22 May 2008) pgs. 19-22

*Conclusion*

14. If the Government proceeds with the legislative and regulatory package outlined in the MAF consultation document, the results will be:

    a. The progressive elimination of competition in the dairy processing market as no competitor can compete with Fonterra's super-competitor.
    b. The subsequent emergence of a 'Fonterra monoculture' as all future processing facilities will be built by Fonterra.
    c. Farmers ending up as 'captive suppliers' of Fonterra as switching will be impossible as there will be no firm to switch to.
    d. Unnecessary risks to New Zealand trade policy as incorporating the principles of Fonterra's MPM in legislation can be interpreted as granting Fonterra an exclusive privilege (which constitutes one of the tests for a *State Trading Enterprise*).

15. Given Miraka's concerns are substantive in nature and imply a fundamental redesign of the entire legislative and regulatory package, detailed policy alternatives have not been proposed at this time. However, it is clear that both Fonterra's MPM and the MAF's concept of 'the next efficient processor' are unfair, untenable and wrong.

16. Miraka has a range of suggestions and is willing to discuss these options with Government at an appropriate time. However, the starting point of that discussion must be a pricing system that is based on Fonterra's actual costs. In the interim, it is Miraka's view that the replacement to Fonterra's MPM must be:

    a. **Fair** to all parties
    b. **Independent** of Fonterra
    c. **Transparent** in operation

17. Given Fonterra's MPM has been artificially inflating the farm gate milk price for the past four years, and MAF's recommendations are completely untenable, Miraka seeks immediate relief in the form of:

    a. Option MP5, *Introduce a Benchmark Price; and*
    b. Option FVS2, *Introduce share guidance for Fonterra's share valuation.*

18. Both options are outlined in the *Draft MAF Regulatory Impact Statement* released as part of the suit of consultation documents. Option MP5 would see the farm gate milk price set by the Commerce Commission until a new regime was introduced; whereas option FVS2 would compel Fonterra to return to an unrestricted share valuation.

# *Part 2: Detailed Analysis*

1. Part 2.1 is organised as follows:

    a. Firstly, the implications of a growing milk supply (which has the potential to be the feedstock for a competitive and innovative industry) and extremely high industry concentration (which offers protection against value-destroying excess fragmentation) are explored.
    b. Secondly, legislative intent and policy principles are investigated and Fonterra's objectives regarding milk pricing issues are examined.
    c. Finally, DIRA is examined to ascertain whether it adequately addresses the tensions between the public interest and Fonterra's private interests.

## ***2.1 Context and principles***

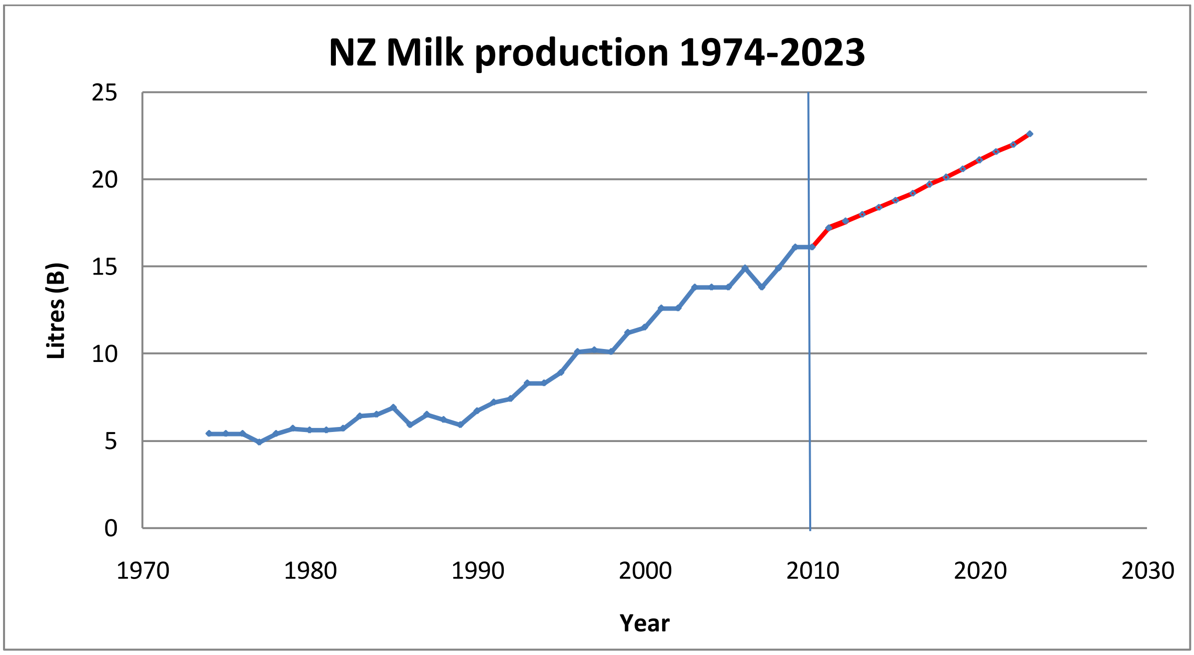
### *2.1.1. Industry context: A growing milk supply*

2. In terms of industry context, New Zealand has the unique position of having 4.5 million dairy cows but only 4.4 million people. By necessity, New Zealand has developed the world's largest export dairy industry – of the 17.2 billion litres (1.5 billion kgMS) of milk produced during 2010/11 season, over 95% was exported as commodities or ingredients.  This can be contrasted with most other countries, where dairy production is solely for domestic consumption with exports being a fringe activity (if they occur at all).

3. Over the next decade New Zealand's milk supply is forecast to grow by over 30%, which is an additional 5.4 billion litres (470 kgMS).  This additional milk will be almost entirely exported.  This will require substantial investment in new processing facilities – and yet further investment in research, marketing and product development if New Zealand is to extract more *value* from its increasing *volume* of dairy exports.

4. It is important to understand just how much 5.4 billion litres is: to put it into context, 5.4 billion litres is approximately 60% of Australia's *total* milk production (and Australia is the world's second largest exporter of dairy commodities) so represents a 'game-changing' feedstock that has the potential to create a competitive, innovative, and simply enormous export industry.

5. Critically, unlike other industries, the risk of excessive and value destroying excess is very low.  This is because the starting point is an extremely high level of market concentration – Fonterra collects almost 90% of New Zealand's total milk production. For example, if Fonterra only secured *half* the forecast growth in milk supply it would still be processing over 80% of New Zealand's milk supply in 2023 (and still would process 70% if it did not increase its milk supply *at all*).



*Source: LIC-DairyNZ (historical), OECD-FAO (forecast section only)*

6. **Concerns that competition will somehow lead to excessive and value destroying fragmentation of the dairy industry are therefore alarmist and inaccurate. A growing milk supply means competition is a positive – rather than a zero – sum game**.

*2.1.2 Legislative and policy principles*

7. Fonterra is a creature of Parliament, as the merger processes that created Fonterra being authorised on the basis of an exemption to the *Commerce Act*. The *quid pro quo* was that a competition policy was wrapped around Fonterra to ensure the public interest was preserved. The nature of this arrangement is neatly summarised as follows:

   *Members should bear in mind that this bill is the product of a political deal between the Government and the dairy industry, and part of that deal is that the industry accepts a degree of regulation to mitigate the effective monopoly with which it sets out. It is not part of the deal that the dairy industry has a monopoly; Parliament is specifically removing the monopoly powers of the board. A lot of the discussion has been to the effect that the regulatory regime should mitigate those monopoly effects.* (Hon Bill English, First Reading Speech, Hansard, 2001)

8. At the centre of pro-competition regime was the notion of **contestability**. As explained by then Agriculture Minister Hon Jim Sutton:

   *The bill seeks to create a* ***contestable*** *environment in which competitors to Fonterra have a realistic opportunity to enter the New Zealand dairy industry. To create contestability, it is important that farmers exiting Fonterra receive adequate compensation for the value of their shares in the cooperative.* (Second reading speech, Hansard 2001)

9. The rationale behind seeking a contestable environment was encapsulated by Damien O'Connor, who chaired the Primary Product Select Committee (the Committee charged with hearing submissions to the *Dairy Industry Restructuring Bill*):

   *The third key principle that this Government has adhered to was that the legislation should protect the rights of minorities---be they small exiting companies, farmers who want to sell their milk to someone else, or new enterprises yet to be invented, or even thought of, that want to add value to the milk that comes from this country's cows.* (Third reading speech, Hansard 2001)

10. Contestability was based on a process of farmer switching, where farmers could leave Fonterra on a 'no arguments' basis and take their equity invested in Fonterra with them. Sutton explains:

    *The beauty of the fair value exit and entry is that the company has to set a price, and that price will be the same for the people who are leaving as for those who are joining. Everybody must get the same price for milk. So if the company, when it makes that division, should pitch the price of milk too high and the value of shares too low---which is what a company might do if it wanted to prevent a competitor from entering the market---then it will be flooded with new milk. It would certainly have to pay the same price for that milk as for all other milk, but it would not have profitable markets for it.*

    *On the other hand, if the price of shares is set too high, and the price of milk too low, then the opposite will happen: there will be a flood of applicants wanting to take their money out of the company in order to set up a competing cooperative. They will go that way. There is a cunning pressure on the company to set that price right. It is a market mechanism, as opposed to a bureaucratic mechanism, and that is the strength of it.* (Committee of the Whole House, Hansard 2001)

11. Contestability rests on a process of farmer switching, commonly known as *the open entry and exit regime*. Open entry and exit therefore performs two functions:

    a. It ensures competitors can secure a milk supply from farmers; and
    b. Incentivises Fonterra to set a fair and competitive farm gate milk price and an efficient share price.

12. The corollary is that while Fonterra has the <u>*ability*</u> to artificially increase its farm gate milk price, as long as the 'milk tsunami' argument holds it does not have the <u>*incentive*</u> to do so. It is for this reason **DIRA leaves the methodology for setting both its milk price and share price solely to Fonterra**, with the only necessary requirements in terms of open entry and exit being:

    a. Fonterra remains an open cooperative;
    b. Fonterra must pay the same issue and redemption price for shares within a single season;
    c. A contracting rule is imposed that ensures farmer supply within a region is not 'locked up' and

d. A binding redemption risk is imposed (where a farmer who is leaving Fonterra must be paid out in full, in cash within 30 days from the end of the season).

13. From the outset, concerns were raised as to whether the open entry and exit regime – whilst elegant in theory – would actually work in practice. For example:

*The regulatory package that has been developed to protect New Zealand farmers and other manufacturers and exporters from Fonterra's monopoly position is pretty much as conceived or outlined in the bill, but under close examination it is obvious that great reliance has been placed on automatic entry and exit rights at the same price. The fact that shares could become nominal seemed scarcely to concern the officials. They insisted that the lack of anything in the bill or the regulatory package itself to require Fonterra to adhere to fair value entry and exit did not matter, because Fonterra would have strong commercial pressures not to set entry and exit prices above or below a fair value.*

*I found that incredible.*

*We were faced with an industry that had had decades of almost open entry and exit at the same price, at a nominal value, yet they were confident that somehow the new commercial pressures would mean that we did not need to worry about making sure there was the fair value that so many in the industry had been marketing around the farmers as the key protective feature of this structure.* (Stephen Franks, Second Reading Speech, Hansard 2001)

And:

*The select committee became aware of the ability of Fonterra to talk up or talk down the shares. The select committee gave much consideration to whether we should be legislating a direct linkage between what the bill refers to as the surrender value of a person exiting, and the fair value as prescribed in the [Fonterra] constitution as set down by the shareholders' council.*

*After much deliberation we accepted the officials' viewpoint that the open exit and open entry regime will provide the necessary commercial framework.* (Gavin Herlihy, Second reading speech 2001)

14. Concerns notwithstanding, open entry and exit was preserved with the legislative and Parliamentary intent captured in section 4(f) of DIRA, which states:

*The purpose of the Bill is –*

*(f) Promote the efficient operation of dairy markets in New Zealand by regulating the activities of new coop [Fonterra] to ensure New Zealand dairy markets are **contestable**.*

15. Given a light-handed regulatory approach based on industry self-regulation, is useful to ascertain Fonterra's milk pricing principles. As stated in Fonterra's Constitution, its overriding principle is **maximisation of the milk price**. For example:

*The Milk Price should be the **maximum** amount that the Company, reflecting its status as a properly managed and efficiently run sustainable co-operative. (Annexure 1: Milk Price Principles, pg 48)*

16. This is then linked through to Fonterra's MPM, which states:

> *Fonterra will always act to legitimately protect the interests of the Co-operative and its farmer shareholders, including through the setting of the Farmgate Milk Price. This Manual should be read and interpreted in the context of this competitive (and changing) environment.*
>
> *Fonterra's Constitution contains a set of Milk Price Principles and requires the Manual to reflect those Principles.* (Milk Pricing Manual, page 3)

17. Without over intellectualising, there is clearly a strong tension between the principles underpinning of DIRA (i.e. ensuring **contestability**) and those of Fonterra (i.e. **maximising the milk price**). This places enormous emphasis on the effectiveness of the open entry and exit regime, because if DIRA was found to be ineffective it naturally follows that:

    1. Fonterra can set an artificially high farm fate milk price;
    2. Fonterra's can sustain an artificially high farm gate milk price indefinitely as there is no countervailing force from DIRA;[18]
    3. Given the role the Fonterra farm gate milk price plays in terms setting an industry-wide farm gate milk price, an artificially high Fonterra farm gate milk price quickly turns into a problem characterised by **vertical foreclosure**.[19]

18. **Given the inherent tensions between the public interest (captured in DIRA) and private interests (expressed in Fonterra's Constitution) the linchpin to the entire system is the open entry and exit regime and its ability to act as an effective and sufficient constraint on Fonterra's private interests.**

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[18] In this situation, the only countervailing force would be from within Fonterra, and would hinge on whether farmer-shareholders strictly preferred a combination of an artificially high milk price/artificially low share price over an efficient milk price/efficient share price. As MAF notes, given that 80% of a farmer's investment in the dairy industry is reflected in the value of the dairy farm, it is reasonable to posit the former as being preferred because (1) artificially high milk prices are likely to be capitalised into land values and (2) artificially low share prices make increasing production relatively easier as the entry cost in terms of purchasing a new milk-backed share is lower.

[19] Vertical foreclosure occurs when a firm controls access to, or sets the price of access to, a 'bottleneck facility' (e.g. a railroad). In either case, the monopolist can act in an anti-competitive fashion by either restricting a competitor's access to that bottleneck facility; or alternatively, setting the price of access at such a level as to make the rival unprofitable once the access price has been paid. Given Fonterra the sets the benchmark price for a farm gate supply via the Fonterra farm gate milk price, raw milk can be conceptualised as a bottleneck facility and would impact on competitors though both the <u>*access*</u> route (as it will become progressively harder to convince farmers to switch) and the <u>*pricing*</u> route (as milk represents 80% of a processor's costs so an artificially high milk price would soon squeeze competitors' margins).

*2.1.2. Does open entry and exit work?*

19. Miraka's view is the current open entry and exit regime only 'half works'; in that while the farmer switching provisions function well, the DIRA 'checks' in terms of the 'milk tsunami' argument are completely ineffective (and have been since 2001).

20. Miraka has two arguments regarding the ineffectiveness of the DIRA checks, namely:

    a. ***Low elasticity of supply***: The elasticity of supply for a farm gate milk supply is estimated by the Commerce Commission, based on information supplied by the Ministry of Agriculture and Forestry, to be 0.32. This is highly inelastic.

       This implies that farmers are relatively insensitive to a price change and if Fonterra was to artificially increase its milk price then it will be faced with a 'milk ripple' rather than a 'milk tsunami' (with the corollary that Fonterra will not face the problem outlined in paragraph 10 regarding unprofitable markets).

    b. ***New milk supplies being self funding***: Fonterra is a 'new generation' cooperative, so:

       a. All new milk supplies require farmer-suppliers to buy additional 'wet shares'; and
       b. The current Fonterra share price is sufficient to fund the average cost of financing new processing assets.[20]

       This implies that milk supply growth is self-funding in terms of generating necessary equity to construct new processing facilities. Indeed, this is precisely what cooperatives have done since time immemorial.

21. In terms of empirical data:

    a. an 8 tonne/hour powder plant has an average processing cost of around **$4.74** kgMS (which is a $90M build cost divided by 19M kgMS plant capacity);
    b. a 16 tonne/hour drier, such as the one being built at Darfield by Fonterra, has an average processing cost of **$4.16** kgMS (which is a $150M build cost divided by 36M kgMS capacity);

[20] Given a processing facility such as a drier needs high capacity utilisation to be profitable (i.e. more than 75% capacity utilisation to achieve break-even) it is appropriate to use average costs rather than marginal costs.

c. Fonterra's current share price has been administratively set by Fonterra at $**4.52**, despite having a restricted valuation of only **$4.18**.

22. Miraka further notes that MAF concedes that Fonterra has the ability to set an artificially high farm gate milk price, albeit only in the short run.[21] This is a serious omission because:

a. No definition of the 'short-run' is provided or consideration given to the effect that even short-run manipulation decisions by Fonterra could have on contestability and workable competition.
b. As noted in paragraph 20, given a low elasticity of supply, and a Fonterra share price of $4.52, Fonterra can manipulate the milk price indefinitely.
c. If DIRA was an effective regulatory regime then Fonterra should not be able to manipulate the milk price **at all**.

23. **The figures above show given a low elasticity of supply and that at the current Fonterra share price, DIRA is completely ineffective so Fonterra has both the *motive* and the *opportunity* to set an artificially high farm gate milk price on an indefinite basis**.

[21] See: MAF, *Draft Regulatory Impact Statement – Fonterra's Share Price Setting, Capital Structure and Share Valuation.*pg. 5

## ***2.2 Issues associated with setting an Industry-wide farm gate milk price***

24. Part 2.2 is structured as follows:

    a. First, a detailed investigation is undertaken of Fonterra's MPM;
    b. Secondly, consideration is given of the proposals regarding Commerce Commission oversight and the use of a Milk Panel; and
    c. Thirdly, additional milk pricing principles are considered.

### *2.2.1 Fonterra Milk Pricing Manual*

#### *2.2.1.1.* Key Principles

25. As previously noted, when Fonterra sets it farm gate price, it is also setting the farm gate milk price for the entire dairy industry. This implies the decisions make by Fonterra effectively set the cost line for all other processors in New Zealand (as a rule of thumb, purchasing milk comprises 80% of a processor's costs).

26. It is in this context of an industry-wide pricing issue that the previous discussion regarding the ineffectiveness of DIRA is so worrying, which quickly draws attention to Fonterra's MPM.

27. Fonterra has employed the methodology outlined in its MPM since 2008. Fonterra's MPM employs a 'hypothetical efficient competitor' (HEC), which is essentially an 'imaginary Fonterra' that processes the same volume of milk as Fonterra but turns it a higher returning bundle of products (from a notional product mix) at a lower cost (from a more efficient plants, lower overhead costs, etc).

28. In simple terms, Fonterra's HEC is akin to Fonterra's 'imaginary friend'. By definition, the 'imaginary friend' will always be able to pay a higher **theoretical** farm gate milk price than Fonterra **actually** can. This is then assumed to be the hypothetically efficient market price, or the farm gate price for milk that would be paid ***if*** there was a competitive market.

29. The use of a construct like a HEC originated in industries such as railways, electricity and gas reticulation, and telecommunications; as these industries are characterised by natural monopoly characteristics. In simple terms, this means it is inefficient for a competitor to build an alternative facility or network, which leaves the incumbent firm in a position whereby it can extract monopoly rents. In such a situation, the application of a tool such as a HEC is a 'necessary evil' as competition is unable to abate those rents away.

30. The dairy processing sector does not exhibit the type of natural monopoly characterists typified by network utilities. Indeed, each aspect of the value chain (i.e. farmer supply, collection, first stage processing, marketing, transportation, second stage processing, and retailing) is capable of supporting workable competition. This implies that the use of a HEC is not only inappropriate from a methodological perspective but is not required from a practical one either – as the emergence of workable competition will perform the same role in a much more efficient manner.

31. Herein lies the crux of the competition policy problem: by applying a methodology designed to handle natural monopoly problems to an industry, such as dairy processing, that does not exhibit natural monopoly characteristics, **a monopoly problem is created**. This is because setting the industry price on the basis of 'the hypothetically efficient market price' imposes a significant barrier to entry as the profits that would have reasonably attracted competitive entry are largely abated away.

32. As outlined by MAF, even in the absence of any form of manipulation, even an efficient firm will only be able to earn its weighted costs of capital (WACC). Whilst earning WACC is a necessary and sufficient condition to **sustain** a firm within an industry, it is by no means clear whether this is sufficient for a firm to **enter** an industry – as a return higher than WACC, or a higher WACC, is required.

33. When Fonterra changed its milk pricing methodology is 2008 (and its share pricing methodology in 2009) it was not immediately obvious what the extent of the over pricing would be. It is therefore important to note that until 2006 Fonterra set the farm gate milk price on the basis of its **actual costs and revenues** and it was on this basis that firms such as Open Country, Synlait, New Zealand Dairies and Miraka choose to enter the dairy processing market.

34. This implies that since 2008, the farm gate milk price has been set on the basis of Fonterra's **'imaginary friend'** rather than Fonterra's actual performance; with the consequence that all independent processors – including Miraka – have had to pay an elevated farm gate milk price that is based on Fonterra's views of what a hypothetically efficient market price would be.

35. The corollary is that independent processors are competing with Fonterra's 'imaginary friend' (as is Fonterra itself) rather than Fonterra directly This leads directly to the situation outlined by Castalia[22] whereby:

    a. an independent processor that was **more** efficient than Fonterra but **less** efficient than Fonterra's imaginary friend would be unable to enter (or remain) in the market, whilst

[22] *Opt cit*. pg. i

b. the less efficient Fonterra can remain in the market as it can fund the higher milk price demanded by the HEC internal transfer pricing from its dividend stream.

36. Miraka acknowledges that like all economic reports, the Castalia paper is by no means perfect. Those imperfections, however, do not detract from the core message of the report that Fonterra's MPM is anti-competitive in design and implementing a milk price based on Fonterra's **actual** costs is much closer to any credible notion of workable competition.

37. A milk price based on Fonterra 'actuals' is also consistent with legislative intent, parliamentary intent, and the purpose of DIRA.

*2.2.2.2:* Quantitative analysis of Fonterra's MPM by Deloitte

38. Is Miraka's view that Fonterra use of a HEC to set its farm gate milk price is inappropriate and unnecessary. Nevertheless, it is important to clearly understand:

    a. the monetary difference is between a farm gate milk price based on Fonterra's actual performance and that of the HEC; and
    b. how that difference is accounted for.

39. Miraka jointly commissioned Deloitte to undertake a quantitative analysis of Fonterra's MPM. Deloitte found:

    a. Fonterra's HEC can be characterised as a 'super-competitor' that cherry picks the best features of Fonterra and a new entrant processor and uses the combination of both to set the farm gate milk price. Fonterra's 'super-competitor' is therefore internally and logically inconsistent.
    b. Given Fonterra's 'super-competitor' is a hybrid that cannot exist as a 'state of nature', no firm can ever match its performance (including Fonterra itself) as the super-competitor is a figment.
    c. To the extent MAF wants a proxy for a new entrant; the Fonterra MPM will **always** produce a farm gate milk price that is **too high**.
    d. The difference in farm gate milk price based on Fonterra and Fonterra's' super-competitor' was assessed at being between **33-50 cents kgMS** before the addition of switching premiums.

40. For Miraka, this represents additional costs of between **$6 and $10 million** per annum in milk supply costs.

41. The Deloitte report affirms Miraka's concerns that:

   a. The ineffectiveness of DIRA in terms of ensuring that Fonterra does not set an artificially high farm gate milk price; and
   b. The dangers of industry self-regulation in the context of a weak and ineffective regulatory environment.

42. Miraka is therefore of the view that nothing short of abandoning Fonterra's MPM will suffice.

*2.2.2.3. Summary of economic advice commissioned by Miraka*

43. Miraka also jointly commissioned three independent economists[23] to assess the implications of Fonterra's MPM on contestability in the milk processing market. These views can be summarised as follows (with reports provided in the appendices to this submission):

   a. ***Professor Patrick Rey***

      i. The structure and set up of Fonterra is akin to an organisation of a cartel that permits farmers to capture rents at the expense of a range of parties, including impendent processors and domestic consumers of dairy products.
      ii. The creation of Fonterra led to the establishment of a vertically integrated entity that has the incentive to foreclose downstream markets by degrading an independent processors access to regulated milk or through raising the farm gate milk price.
      iii. The removal of competitive pressures on Fonterra, combined with an atomistic shareholder base, may give Fonterra additional incentives to foreclose its downstream rivals.
      iv. Squeezing competitors' margins is not in farmers' long term interests as it could result in higher processing costs than would arise from a competitive market.
      v. Fonterra's MPM appears to rely on some **average** plant of Fonterra (dedicated to the product mix that its rivals seem to be targeting). However, in a competitive market, prices are instead determined by the cost of the **marginal plant** – that is, the **least** efficient plant amongst those operating.

[23] The economists commissioned were Professor Patrick Rey (Toulouse School of Economics), Dr Michael Pickford (former Chief Economist, the New Zealand Commerce Commission), Kieran Murray (Chairman of Sapere [formerly LECG])

vi. An approach based on Fonterra's MPM will bias the milk price upwards, which would prevent rivals from progressively replacing less efficient plants and have the same effect on Fonterra.

b. ***Dr Michael Pickford***

i. Fonterra's MPM will understate costs and overstate revenues.
ii. The MPM is a highly complex document that affords Fonterra a high degree of discretion with, at the very least, the perception that Fonterra has a serious conflict of interest as it is simultaneously the regulator and regulated firm.
iii. A correct regulatory focus for an industry that is potentially competitive is to promote competition, which requires a farm gate milk price based on the 'actual Fonterra' rather than a 'notional fully efficient Fonterra'.
iv. The marginal plant is the **least** efficient plant rather than the **most** efficient one.

c. **Kieran Murray**

i. MAF appears to have been diverted from its initial analysis (which was correct) by a misconception regarding the nature of the 'marginal plant', in that MAF has incorrectly assumed that the marginal plant is the **most** efficient plant when the correct economic interpretation is that it is the **least** efficient one.
ii. MAF has an internally inconsistent position in that it cannot simultaneously argue that DIRA provided an effective check on Fonterra when it also argues that the elasticity of supply for raw milk is very low.

44. The advice above, particularly the shared view regarding the definition of the marginal plant, is important for the following reasons:

a. ***Clarification***: It sheds useful insight and clarification into the claim that new entrants are 'picking the eyes out of the [dairy] industry' by only targeting 'high returning product streams' thereby 'leaving the rump for Fonterra'.

This view assumes the marginal plant is the most efficient one when, as noted above, it is the least efficient one or the facility that is 'just hanging on'.[24] In reality, competition is a process of 'creative destruction' where more efficient plants cannibalise less efficient ones with the market being

[24] New Zealand's wholesale electricity market provides practical example of this principle occurring in practice, as the electricity price is set on a half hourly basis at various nodes around the country with competing 'bids' by generators regarding price. The price is resolved as the highest bid (representing the *least* efficient plant) is used to set the nodal price for that half-hourly time slot.

indifferent as to who builds the new plant (i.e. the incumbent or a new entrant) **as long as it gets built**.

As the incumbent, Fonterra is likely to the operator of the ‘marginal plant’. This also means that the marginal Fonterra plant is at risk from new entrants **and** Fonterra alike. The analysis from Rey, Pickford and Murray shows that due to Fonterra’s MPM:

i. In a world where there is a static milk supply, Fonterra would be poorly incentivised to upgrade or replace its asset base; and
ii. In a context of an increasing milk supply, only Fonterra is able to build new plants as actual or potential rivals have been foreclosed.

This implies that Fonterra’s MPM has the consequence of acting like a ‘white knight’, in that it:

i. Protects Fonterra’s sunk investment in its marginal processing assets, which would otherwise be ‘stranded assets’ with little or no residual value; and
ii. Permits Fonterra to reinvest in its processing assets, should it wish to do so, behind a protective shield and without the complexities of dealing with rivals.

The result is a situation that is incompatible with DIRA’s purpose, as stated in section 4(f), to:

> *Promote the **efficient** operation of dairy markets in New Zealand by regulating the activities of new coop [Fonterra] to ensure New Zealand dairy markets are **contestable**.*

In summary, neither the efficiency nor the contestability objectives being satisfied, and the reason this has be able to occur is that **the regulation of Fonterra’s activities though DIRA has been ineffective.**

### *2.2.2.4*. MAF advice and analysis

45. The advice tendered by Rey, Pickford and Murray also reaffirms that the advice tendered to MAF by Castalia was correct. In the interests of completeness, Castalia's conclusion is restated below:[25]

> *Fonterra's current approach to setting the raw milk price creates a barrier to entering the market for processing raw milk. By subtracting the costs of a hypothetical efficient processor (HEC) that is more efficient than Fonterra from the retail price of milk, the methodology prevents entry from processors that are more efficient than Fonterra (but less efficient than the hypothetical benchmark). A pricing approach that used Fonterra's actual costs (rather than hypothetically efficient costs) would enable efficient entry and promote outcomes that are more consistent with a workably competitive market.*

46. It is interesting that MAF's initial views were broadly similar to Miraka's (and the advice that Miraka has received). MAF's views are stated thus:

> *Officials were initially concerned that Fonterra's use of notional revenues and costs is manifestly inappropriate and would lead to a farm gate milk price being set at an unrealistically high level, especially for entry into milk processing.*
>
> *Officials' key consideration was around the setting of the 'normal' weighted average cost of capital (WACC).*
>
> *This exercise resulted in an apparent difference in the farm gate milk price of approximately $0.20 to $0.30 per kilogram of milk solids (i.e. 3 to 4 percent) between the farm gate milk price paid, and what the farm gate milk price would have been had Fonterra earned its assumed WACC on its comparable New Zealand milk business. This exercise raised some concerns as the result could be interpreted as Fonterra paying out a higher than efficient farm gate milk price, at the expense of its own profit.*

47. However, as MAF explains, officials had a change in views:

> *A shift in officials' thinking came about during the analysis of economic theory of how the farm gate milk price be set in a contestable market. This analysis showed that, given the export-oriented nature of the New Zealand dairy industry, dairy processors operating in a competitive farm gate milk market would compete to acquire raw milk at the farm gate and sell most of it as milk powder in a global dairy market at international prices that they cannot influence. Competition at the farm gate market would have the effect of driving the farm gate milk price up to the point where the next milk processing plant would just cover its total costs (including capital costs).*

48. Miraka considers that the proposition as described in paragraph 47 is uncontroversial as it merely describes a market in action. The basic point is that to the extent a 'rent' exits between costs of production in New Zealand and international prices for a reference good (i.e. whole milk powder [WMP]), then that rent represents a 'pure profit making opportunity'. It would therefore be reasonable to expect entrepreneurs to take advantage of that pure profit making

[25] *Opt. cit* Castalia

opportunity until any rent has been abated. Indeed, this is nothing more than a standard neoclassical analysis involving arbitrage or an Austrian interpretation[26] of the market being a discovery process.

49. Miraka, however, does not agree with the MAF's conclusion, which is:

> *Consideration of the "next efficient plant", i.e. taking a forward-looking view of revenues and processing costs, is necessarily reliant on notional rather than actual figures. This approach to setting a farm gate milk price is consistent with:*
>
> - *the outcome expected in a contestable farm gate milk market; and*
> - *the conceptual approach used in Fonterra's Milk Price Manual.*
>
> *While this provides a broad level of comfort with Fonterra's conceptual approach to setting its farm gate milk price, the extent to which Fonterra's HEC is optimised[27] in practice is important because this sets the bar for entry into the processing sector.*

50. As noted in section 2.2.2.3, the passage above suggests that MAF has confused the notion of 'a new plant' and/or 'a new entrant plant' with the concept of the 'marginal plant'. In doing so, MAF has missed the point that the marginal plant is the **least** efficient one rather than the **most** efficient. It therefore follows that MAF's approach based on 'the next efficient plant' is wrong.

51. The corollary of the 'next efficient plant' approach being wrong is that it necessarily follows that the conceptual approach outlined in the Fonterra MPM is also wrong.

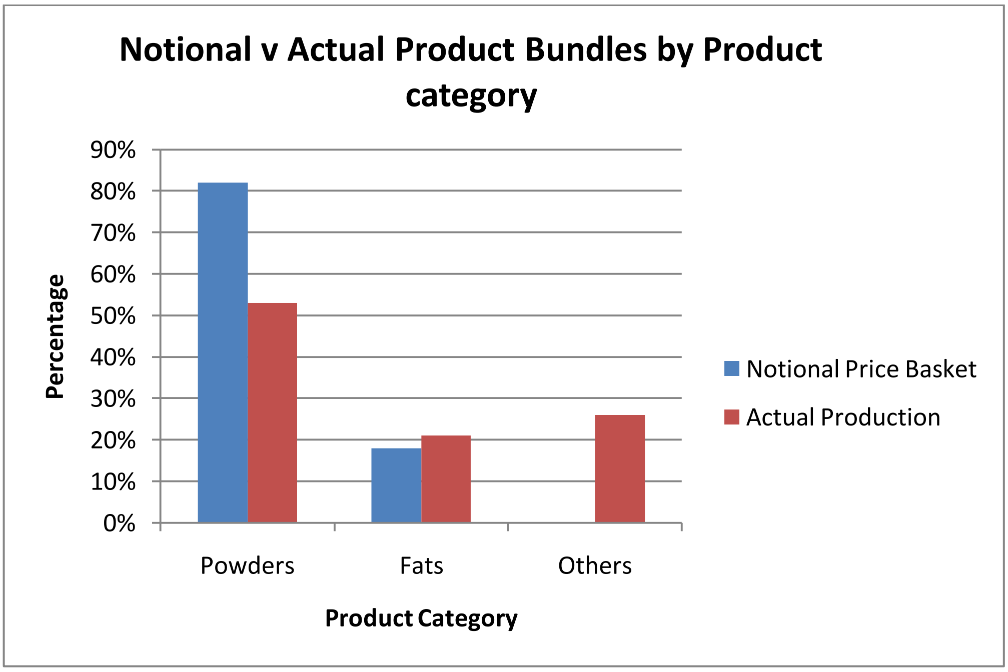
[26] An 'Austrian approach' (typified by the works of Von Mises, Hayek and, more recently Kirzner) provides useful insights into the questions at hand as it specifically focuses on the market adjustment processes. Given knowledge is decentralised, Austrians picture the market as a discovery process with the future being subject to radical uncertainty – in that it is both unknown and unknowable. This places a central focus on the role of the entrepreneur in terms of coordinating plans. An Austrian there would fundamentally reject that notion of an objective, stable and predictable future where at least some prices (in the current example, international dairy prices) are 'given'. Taking this a step further, the entire notion of a HEC is likely to be considered a scientistic fallacy.

[27] The term 'optimised' requires some further investigation as this is an unusual usage of the concept. One possible explanation is that the term relates to the term 'infeasible optimisation' outlined in the August 2011 Covec Memorandum. The gist of the Covec argument is while Fonterra's HEC employs notional values in terms of factors such as product mix, the choices made do not represent 'an infeasible optimisation'. This can be contested as follows:

- It completely misses the type of internal inconsistency problem between values raised by Deloitte in terms of the HEC being a 'super-competitor'
- It completely misses the internal inconsistency problem within a value. As outlined in paragraph 52 the notional product mix employed by the HEC is internally inconsistent as the HEC would be unable to sell the notional volumes based on the actual prices as the volume increases assumed are material enough to shift international markets.
- It also misses the point that in terms of vertical foreclosure, a notional value does not need to be optimised to impose serious economic harm.

52. Miraka considers that the problem above has been further compounded by the following issues:

a. **An assumption that international dairy markets are insatiable and any increase in product supply will have no effect on international prices or farmer returns**: Fonterra's super-competitor employs a notional product mix based a 'powder stream' (i.e. WMP. SMP + AMF, etc.). This is illustrated in the graph below.




Source: Fonterra Cooperative Dairy Group, 2010 Annual Results – Market Briefing 18 October 2010 page 16 (data only)

Both the MPM and MAF appear to make the implicit assumption that international powder markets are insatiable and can absorb an increase in supply without any corresponding change in international prices.

This is not correct – given WMP is primarily a traded product (as it is a substitute for liquid milk) and Fonterra has a dominant position in world markets regarding WMP, it would be impossible for the super-competitor to sell the hypothetical **volumes** at the actual assumed **prices** as the additional volumes would drive down international prices, thereby reducing returns to farmers.[28]

The result is that Fonterra's 'super-competitor' not only exhibits an internal consistency **between** key assumptions but in the case of product mix, **within** a single assumption as well.

[28] *Opt cit.* Shaskey Global Dairy Network

b. ***Failure to take account of switching premiums***: Covec[29] make the working assumption that a rational farmer would be indifferent between supplying different processors as long as the total packages are identically priced. The commercial reality is that farmers are not indifferent and requires some level of inducement.[30]

As is the case with all independent processors that collect a farm based supply, it has been necessary for Miraka to pay a switching premium to secure a farm-based supply. Miraka's premium is in two parts: firstly, Miraka pays 10 cents kgMS margin over the Fonterra farm gate price and secondly, Miraka does not impose a capacity charge on its farmers. This means the total switching premium is closer to 15 cents kgMS.

Miraka does not contest the existence of switching premiums or the amount paid, as both are considered part and parcel of a functioning market. Miraka's concern, however, is that neither the Fonterra MPM nor MAF's analysis takes any account of switching premiums and given they are a feature of the market need to do so.

In addition to raising a question about analytical completeness, the existence of switching premiums raises a wider methodological question: given the intuition behind using an ECPR (efficient component pricing rule) approach is to replicate what an efficient market price would be, it necessarily follows that if independent processors have to pay a switching premium additional to the ECPR price then the resultant farm gate milk price is inefficiently high.

53. In addition to being methodologically incorrect, employing the 'next efficient processor' methodology leads to the following absurdities. For example:

a. A firm that is **more** efficient than Fonterra but less efficient then the super-competitor is unable to compete.
b. Even if a firm was **equally** efficient as an internally consistent HEC it still cannot compete in the presence of switching premiums.
c. Given Fonterra's cost assumptions, to be more efficient than the HEC (so substantially more efficient than Fonterra) requires the competitor to build a plant equal in size to **the largest drier in the world**.
d. In all the situations above, the **less** efficient Fonterra is able to remain in business as it is able to fund a higher farm gate milk price by transfer pricing from dividends.

[29] Small, J. *Valuation of Fonterra's Shares,* Covec (5 December 2011)
[30] A similar pattern exits across other industries (e.g. retail electricity markets, telecommunication markets, etc) as the customer switching process contains numerous 'frictions'.

*2.2.2.5* Commerce Commission Oversight and the Milk Pricing Panel

54. In addition to Fonterra's TAF proposal (considered in the next section), MAF outlines two additional initiatives to provide assurance that Fonterra's farm gate milk price is fair and competitive, namely:

    a. Introduce a Milk Pricing Panel with a role to oversee the price calculation process with the majority members having no supply relationship with Fonterra; and
    b. Introduce a monitoring and oversight regime involving the Commerce Commission.

55. Miraka agrees with MAF that there is lack of a transparency associated with the process for setting the Fonterra farm gate milk price. However, Miraka's major point is that in addition to a transparency issue, there is also a substantial and overwhelming methodological problem – with the latter being the more material issue. Given the two proposals are solely designed to address the transparency problem; Miraka considers it highly unlikely they will adequately resolve the methodological problem as well.

56. More fundamentally, it is Miraka's view that for a monitoring regime to be effective, the system or process being monitored must be fundamentally sound in the first place. This is not the case with Fonterra's MPM – a factor further exacerbated by the ineffective nature of DIRA.

57. It is also Miraka's view that it is unreasonable and inappropriate to expect a monitoring and over sight process to also perform the role an assessment and redesign process. Miraka therefore considers that neither the panel nor Commerce Commission monitoring will be effective in terms of supporting a fair and competitive Fonterra farm gate milk price as the proposed methodology is wrong in principle and will perpetuate an unfair and anti-competitive regime.

*Section conclusion*

58. It is Miraka's fear that the numerous anti-competitive features of Fonterra's MPM and its proposed incorporation into DIRA will give substance to the arguments made by international critics that Fonterra is a **State Trading Enterprise**.

59. **Miraka considers:**

    a. **Fonterra's MPM is an anticompetitive and internally-inconsistent fiction that is flawed in concept and execution**;
    b. **MAF's analysis of Fonterra's MPM is inadequate as fundamental assumptions have been missed, ignored or are simply wrong**;

c. **The replacement milk pricing system must be consistent with the purpose of DIRA and reflect the principles of being**:

    i. **Fair to all parties**
    ii. **Independent of Fonterra**
    iii. **Transparent in operation**

60. **Such is the seriousness of this issue that Miraka considers**:

    a. **It is impossible for the Government to proceed with the proposed *Dairy Industry Restructuring Amendment Bill*;**
    b. **Immediate and urgent work is required to developing an alternative system for setting an industry-wide farm gate milk price**
    c. **The Government has no choice but to proceed with an alternative method to set the farm gate milk price.**

**61. Miraka considers that Option MP5, *Introduce a Benchmark Price* where the farm gate milk price is determined by the Commerce Commission is the only viable option and must be introduced prior to the commencement of the 2012/13 dairy season. Both options are outlined in the Draft MAF Regulatory Impact Statement provided as part of the suite of consultation documents.**

## ***2.3 Issues associated with Trading Among Farmers (TAF)***

62. For a new entrant like Miraka a liquid market for farmer supply is critically important. As previously outlined, Miraka considers the current farmer switching provisions of the open entry and exit regime function well.

63. As outlined in our submission of March 2011, Miraka would not object to Fonterra's TAF proposal as long as it can be credibly shown that:

    a. The TAF market is both liquidity and stable so is a close substitute to share redemption by Fonterra; and
    b. The TAF market will result in an efficient share price otherwise an artificially low share price will create a negative feedback loop that sustains an artificially high farm gate milk price.

64. Miraka has not been provided with any assurance that MAF's proposal for a $500 million fund is either a necessary or sufficient condition to ensure market liquidity, with the Covec paper[31] (enclosed as part of the package of consultation documents) raising credible and worrying concerns.

65. Given our considerable and unanswered concerns, Miraka jointly commissioned Professor Tony van Zijl of Victoria University to provide an expert opinion on whether Fonterra's TAF proposal is likely to lead to an efficient share price (and thereby, as MAF suggests, assist in reinforcing a fair and competitive milk price).

66. Professor van Zijl found:[32]

    a. TAF will not achieve an efficient **share** price if the starting point is an artificially high farm gate **milk** price especially when Fonterra controls both the milk price and dividend policy (which directly affect the share value).
    b. Independent processors would need to pay a premium of >$1.00 in order to leave farmers exiting Fonterra 'no worse off'. This is highly significant and would pose a major barrier to entry to independent processors competing with Fonterra for milk from farmers.

67. **Based on the expert opinion of Professor van Zijl, it is Miraka view that Fonterra's TAF proposal cannot proceed until a system is in place to ensure a fair and competitive milk price. In the interim, Miraka recommends that the Government proceed with option FVS2, *Introduce share guidance for Fonterra's share valuation* (outlined in the Draft MAF Regulatory Impact Statement) which requires Fonterra to value its share on an unrestricted basis.**

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[31] *Opt cit.* Small, J Covec
[32] *Opt cit.* Van Zijl, T Sapere

## ***2.4 Issues associated with limiting access to Regulated Milk***

68. As outlined in Miraka's submission to the Regulated Milk Access Review [September 2011], Miraka supports the concept of **non-discriminatory** access to regulated milk with **price** based allocation. Indeed, it was on this basis that Miraka made business decisions, in good faith, only to find that MAF has executed a 180 degree u-turn in terms of its advice to Government: in that the Ministry now favours **discriminatory** access with allocation via **quantity based rationing**.

69. The proposed changes strongly favour Fonterra as it has long sort to eliminate or, at the very least, severely restrict access to regulated milk for any firm that represents a competitor. Moreover, bluntly ceasing access to regulated milk in 2015 for any independent processor with a supply greater than 30 million litres will create an artificial 'race for the milk' in the Central North Island; as:

    a. Three processors (Tatua, Open Country Dairies and Miraka) in close proximity will lose access to regulated milk at the same time; and
    b. Unlike other regions (i.e. Canterbury, Southland) the growth in the milk supply in the Waikato/Bay of Plenty regions is low; so
    c. The switching premiums that farmers are likely to demand in the central North Island in the lead up to 2015 and immediately thereafter are likely to 'spike'.

70. It necessary for officials to understand the effect that a myriad of small changes have had on farmer switching decisions (i.e. the substantial reduction in value of the Fonterra share, the artificial increase in farm gate milk price, the effect that 'sharing up and down' has had on farmer budgets regarding growth milk etc) and the prospect of initiatives like TAF are having (i.e. farmers are unwilling to switch as they believe once TAF starts operating the share price will rise so leaving now implies 'leaving money on the table' leading to a 'sticky exit' situation).

71. The simple result is that Miraka's concerns outlined in the February 2011 submission to MAF have been borne out: there is already a situation typified by 'over easy entry' and 'sticky exit'. It is within the context outlined above that the cynical nature of Fonterra's claim regarding 'enhancing farm-gate competition' needs to be viewed.

72. Miraka is 'the newest new entrant' and only commenced operations in August 2011. Miraka therefore finds itself, through no fault of its own, and solely due to a reversal in Government policy, adversely affected and placed at considerable commercial disadvantage.

73. Miraka therefore considers it is necessary to return to first principles. For example:

   a. Miraka fails to understand why Goodman Fielder continues to be given special treatment and considers there is no reason why they should not also secure a farm-based supply.
   b. Miraka considers it inconsistent for the DIRA sunset clauses to be extended (a move supported by Miraka) on the basis that Fonterra still can exert market power yet regulated milk suppliers to medium sized independent processors such as Miraka are now limited to three years.

   Miraka therefore considers that, as originally intended, access to raw milk by independent processors needs to remain available until the DIRA triggers are met.

74. Miraka notes an alternative approach specifically designed for new entrants has been suggested by the Commerce Commission. This starts at 75 million litres and progressively abates away over eight years.[33]

75. **Miraka considers that Government needs to re-examine this issue as the current proposals will impose considerable and unreasonable commercial disadvantage on independent processors such as Miraka**.

[33] Commerce Commission, *Review of the Raw Milk Regulations: Draft Views from the Commerce Commission* (22 May 2008) pgs. 19-22