COMMERCIAL IN CONFIDENCE

9 April 2001

Chair, Cabinet

FACILITATION OF THE PROPOSED DAIRY INDUSTRY MERGER: PAPER ONE

Executive Summary

1. On 23 January 2001 Cabinet agreed that the government's objective for the dairy industry should be to maximise the returns from the industry to New Zealand while protecting the interests of New Zealand dairy farmers and consumers.

2. The dairy industry is unusual in that it is highly regulated in terms of structure, marketing and commercial arrangements. This structure is unsustainable because of the emerging dynamics of both the domestic and global dairy markets.

3. Government has been asked to legislate to authorise the proposed Global Dairy Company (GDC) merger. The merger would provide the most expeditious way forward from the current unsustainable situation. However, it would also result in the formation of a large virtual monopoly that, without an effective regulatory regime, would face strong incentives to use its power to minimise the overall level of contestability in the domestic markets for raw milk, dairy ingredients and dairy consumer products. This would result in risks to innovation, export earnings, farmer incomes and New Zealand consumers.

4. An alternative to the proposed approach would be for the government to actively lead a process of dairy industry reform with the objective of facilitating the evolution of two or more vertically integrated export companies operating within a normalised regulatory environment. The benefits from such an approach would be potentially larger, but achieving them would take longer and would carry greater uncertainty, particularly if the benefits were partly contingent on each company securing offshore merger partners.

5. The available evidence indicates that the proposed GDC merger would produce greater net benefits than the current unsustainable industry structure. The trade-off is between the short-term certainty of the GDC merger and the potentially larger benefits of the alternative, which would almost certainly take longer to achieve and would carry greater uncertainty of achievement. The alternative would require active Government leadership to secure industry support in a context where there may be initial industry and farmer resistance.

6. If Ministers decide to facilitate the merger, the accompanying paper seeks agreement to the method for exempting the merger from the Commerce Act and the package of regulatory measures intended to mitigate the likely detriments of the merger. The detail of this regulatory package has been developed by officials in consultation with GDC

proponents and has involved negotiations between the Minister of Agriculture and GDC on several key elements of the package. The Minister of Finance has considered the tax implications of the merger.

Proposal/summary

7. This paper:

- advises Cabinet on:
  - the proposed merger of New Zealand Dairy Group, Kiwi Co-operative Dairies Limited and the New Zealand Dairy Board;
  - the public policy issues that would arise from the merger proceeding;
- seeks Cabinet decisions on:
  - whether or not to facilitate the proposed merger;
- seeks Cabinet agreement to:
  - a communications plan to ensure that farmers and other stakeholders are aware of the Government's decisions on the proposed GDC merger; and
  - a timetable that would result in the detail of any required regulatory package being completed in May, the introduction of legislation into parliament by the end of May and its enactment by the end of September.

8. New Zealand Dairy Group (NZDG), Kiwi Co-operative Dairies Limited (Kiwi) and the New Zealand Dairy Board (NZDB) propose a mega-merger to form a new dairy co-operative – Global Dairy Company (GDC). Proponents of the merger have sought the Government's facilitation for it by way of a Commerce Act exemption and other necessary legislation.

9. The merger, as originally proposed, would have resulted in a number of detriments that would have had implications for Government's broader objectives for the dairy industry and competition law. In order to address these issues, if Ministers decide to facilitate the merger, a package of regulatory measures has been developed.

10. The proposed package of regulatory measures is presented in the accompanying paper entitled Dairy Industry Merger Proposal: Paper Two: Regulatory Package and Tax Provisions. This paper also describes the detriments and public policy issues that the regulatory measures are designed to address.

Background

11. GDC would be a near monopoly that would account for around 7% of GDP, around 20% of total exports, around 96% of dairy exports, around 96% of the New Zealand raw milk market and around 50% of the domestic dairy market. Associated with the proposed merger would be the cessation (after one year) of NZDB's single-desk exporting functions.

12. The merger proponents sought legislation to:

- facilitate the merger;
- remove NZDB's statutory powers as the single desk exporter of dairy products (effective one year after the legislation is enacted);
- provide GDC with certain (concessionary) tax provisions;
- provide GDC with exclusive access to tariff quota markets; and
- exempt the merger from the business acquisition provisions of the Commerce Act 1986, thus avoiding the need for normal Commerce Commission authorisation.

13. On 23 January 2001 Cabinet agreed, inter alia, that (CAB Min (01) 1/3 refers):

  a. The government's objective for the dairy industry should be to maximise the returns from the industry to New Zealand while protecting the interests of New Zealand dairy farmers and consumers;

  b. In considering whether to pass special legislation to authorise the GDC merger, the government needs to be satisfied that:

    i.) Options for refining the GDC merger proposal (including options for regulatory controls) to increase its benefits and/or mitigate its detriments, have been explored with industry;
    ii.) The benefits and detriments of a proposed merger have been accurately determined;
    iii.) A proposed merger is consistent with the government's broader objectives for the dairy industry and its relevant policies;
    iv.) A proposed merger is a better outcome than other outcomes likely to emerge should the merger not proceed; and
    v.) Farmers have had access to sufficient objective information regarding a proposed merger to make informed decisions on its merits or otherwise.

14. Officials subsequently worked with GDC proponents to explore and develop a package of regulatory measures to mitigate the public good issues arising from the proposed merger. Extensive agreement has been reached with GDC proponents on the overall shape of a regulatory package to support the proposed merger.

15. There were a small number of issues on which agreement was not reached between officials and GDC proponents. The Minister of Agriculture subsequently met with GDC proponents to negotiate these issues. The Minister of Finance also considered a number of outstanding tax issues. These matters are now resolved between Ministers and GDC, and the outcomes of their negotiations are reflected in this and the accompanying paper.

Comment

Should the Government Agree to Facilitate the Merger?

16. Regardless of whether or not the proposed GDC merger is to proceed, the dairy industry's regulatory environment is widely regarded, by those within the industry, as unsustainable and in need of change. The industry is highly regulated in terms of its structure, marketing and commercial arrangements. For instance, only co-operative companies are allowed to hold shares in the NZDB, it has an export monopoly, and the Board's pricing behaviour is exempt from the Commerce Act.

17. There is considerable pressure mounting within the industry for the removal of the NZDB single desk. Both NZDG and Kiwi are currently moving offshore through acquisitions in Australia. Tatua, a small co-operative, has for a long time pursued its own niche market and high value strategy. These companies are all attempting to expand into new markets. However, under the current regulatory environment, none can adequately control their overseas marketing, a key element of each company's business. The proposed GDC merger is a direct response from Kiwi and NZDG, who have previously competed against each another, to the constraints of the current regulatory environment.

18. On balance, the GDC merger and the associated regulatory package is better than a continuation of the current status quo, a view supported by research commissioned by officials into the dynamics of the global dairy industry. The main benefits of the merger proposal are:

- Moving within a relatively short time frame to allow dairy food processors to directly manage their overseas marketing and exporting (and all of the associated costs, risks and potential benefits). This could be expected to result in the rapid expansion of the niche dairy product sector, which includes manufacturers, marketers and exporters such as Tatua and Kapiti Cheeses;
- exposure of the industry, once the merger has concluded, to all of the commercial disciplines of the Commerce Act;
- the early integration of processing and marketing activities, which will facilitate improved market signals in the industry and some potential for rationalisation; and
- broad shareholder and farmer support for the proposal, including the removal of the single desk.

19. The proposed merger also has detriments. The main ones are:

- risks to the earnings of farmers and the nation arising from the continued management of almost all of New Zealand's dairy exports by a single entity with a single business strategy and set of business tactics (all the eggs in one basket);
- the continued under performance of innovation, including the evolution of new and higher value products, through insufficient diversity and competition in the production, marketing and exporting of New Zealand dairy products;
- the creation of a large monopoly that, without an effective regulatory regime, may use its dominant market position to reduce the overall level of contestability in both the domestic consumer product and raw milk markets. This might reduce pressure on the industry to be efficient in its processing of raw milk. If so, it

would over time result in losses of export earnings, lower farmer incomes, and price increases for consumers; and

- the creation of a large co-operative without a cornerstone shareholder, or major competitor, capable of maintaining pressure on management to perform. The shareholder council allowed for in GDC's constitution is unlikely to have the resources, specialist knowledge or influence to do this.

20. While a regulatory package has been developed to help mitigate the above risks, it needs to be noted that there is always the risk that elements of the package may not work as intended. This has been the experience in other markets. While GDC is not a natural monopoly, in the same way as an electricity or telecommunications company, it will have considerable market dominance, especially in the domestic raw milk market, and may behave in ways unanticipated by law makers and regulators. It may also attempt to change the rules to maintain its dominant market position.

21. The key question for Government is whether or not it wishes to facilitate the proposed merger.

22. Officials consider it likely that the evolution of two or more strong export-focussed co-operatives operating under a regulatory environment subject to the full provisions of the Commerce Act and other relevant commercial law could provide greater long-term gains than the proposed GDC merger. This is because:

- two or more companies will compete on the basis of two or more different business strategies. This spread of strategies should result in less risk to the earnings of farmers and the nation;
- two or more competing companies are more likely to encourage innovation and best practice in production, marketing and exporting; and
- two or more competing companies are likely to result in greater disciplines on the industry as a whole to be efficient. Over the long run, this should result in better earnings for farmers, lower prices for consumers and increased export earnings.

23. While officials believe that the industry would approach Government to facilitate such a reform if the GDC merger did not proceed, the timing of such an approach is very uncertain. If the government decided not to facilitate the GDC merger, the onus would probably be on it to lead a process of regulatory reform in order to address the significant issues that are currently impeding the performance of the industry. Although the long-term outcomes might be better than those associated with the proposed GDC merger, this might take some time to achieve (which could impose significant costs on the industry), and might involve considerable effort by the Government, especially if it encounters initial industry and farmer resistance. The uncertainty of this alternative is exacerbated given that its larger benefits are likely to be contingent, to some extent, on each company securing offshore merger partners, such as in Australia.

24. It should be noted that there is an outside risk that the merger may not proceed even with Government facilitation. It requires 75% support from the shareholders of each of Kiwi and NZDG. While such support is likely, it cannot be guaranteed. If farmer approval was not obtained, the onus might fall on the Government to facilitate an alternative approach to industry reform in order to reduce the economic costs of adjustment given the current problems with the industry's regulatory environment.

Exemption from the Commerce Commission Authorisation Process

25 If Government is to facilitate the merger, a decision is required on how. GDC proponents have requested an exemption from the merger/acquisition provisions of the Commerce Act. An alternative option might involve introduction of a Bill to implement the proposed merger, and the Commerce Commission proceeding to consider the merger proposal in light of the regulatory environment around it.

26. There are pros and cons to the proposed Commerce Act exemption. The main advantage is speed and certainty. The merger, pending shareholder support, would definitely proceed.

27 The main disadvantage is its potential to set an unwanted precedent. In addition, it would mean that the merger proposal would proceed with a lower level of scrutiny than that which the Commerce Commission, with its powers to obtain information, could give it.

28. The Commerce Act prohibits mergers that might create dominant market positions, unless a merger would result in such benefits to New Zealand as to justify it. The GDC proponents have made it clear that without an exemption the merger would not proceed.

29. In undertaking its analysis of benefits and detriments, the Commerce Commission's mandate would be broad enough to apply to the dairy industry. It would be able to take into account benefits to New Zealand from overseas markets, and it is familiar with the operation of dairy co-operatives, having already considered (and approved) a number of dairy co-operative mergers. The Commission would also have direct access to complete and extensive commercial and other information from the companies proposing the merger that is not available to Ministers or officials.

30. It is not possible to predict whether the Commerce Commission would authorise or decline the merger.

31. By exempting the merger from the business acquisition provisions of the Commerce Act, a precedent might be created that other industries, such as the meat industry, may attempt to exploit. If so, this would result in a weakening of the Government's competition policy objectives.

32. The main argument for exempting this merger arises from the current degree of dysfunction created by current regulation. The dairy industry is unusual in that it is highly regulated in terms of structure, marketing and commercial arrangements and any change will require legislation to give it effect. Exempting the merger from the business acquisition provisions of the Commerce Act would facilitate the early and certain reform of the industry's regulatory environment. Once the merger is complete, GDC would be exposed to the full disciplines of the Commerce Act which currently do not apply to the Dairy Board.

Mechanism for facilitating the merger

33 If Ministers wish to exempt the merger from the business acquisition provisions of the Commerce Act, it is proposed that it be by a deemed authorisation under sections 58

and 67 of the Commerce Act together with a package of regulatory measures designed to mitigate the likely detriments of the merger.

34. The details of the proposed deemed authorisation are provided in the accompanying paper together with those of a comprehensive regulatory package designed with the objective of mitigating, but not eliminating, the likely detriments of the merger. Most of these regulatory measures would end once GDC's market power diminished. Officials will be reporting back to Ministers on this in their further design of the regulatory package and prior to the introduction of any necessary legislation.

Implications of the merger and proposed regulations for farmers and other stakeholders

Third Party Processors

35. (deleted under OIA section 9(2)(b)(ii) & section 9(2)(d)(iv)).

36. Third party processors are generally expected to benefit from their ability to export independently (including, eventually, to quota markets). It is therefore anticipated that the removal of the single desk will accelerate the expansion of both existing and new third party processors, especially those focusing on specialised, high value products. Their prospects would be dependent on the effectiveness of the proposed regulatory package, especially the measures to ensure open entry and exit of farmers from GDC, and their ongoing access to wholesale dairy inputs controlled by GDC, such as raw milk, cheese, butter and powders.

37. (deleted under OIA section 9(2)(b)(ii) & section 9(2)(ba)(i))

38. (deleted under OIA section 9(2)(b)(ii) & section 9(2)(ba)(i)).

39. (deleted under OIA section 9(2)(b)(ii) & section 9(2)(ba)(i)).

40. In light of the range of concerns raised by third party processors, officials propose to continue consultations with these processors over their concerns and proposals, and will report to Ministers on any matters which may require Ministerial intervention.

41. *GDC farmer shareholders*: The proposed open entry and exit regulations, price information and terms of supply are critical for the incomes of dairy farmers and their ability to realise their capital investment in GDC. If the regulations are ineffective, GDC management will be able to pay farmers less without risking a substantial loss of supply. Ensuring that GDC faces contestability in milk supply and end-markets will help ensure ongoing efficiency gains that should flow through to the incomes and capital of farmers. The success or otherwise of GDC's global business strategy will have a big impact on farm incomes and asset values GDC's proposal to fund offshore expansion through borrowings and retentions from farmers would seem to increase farmers' risk levels.

42 *GDC sharemilkers*: The proposal to allow sharemilkers to purchase shares in GDC and other co-operatives will give them another option in saving for farm ownership.

43. *Dairy goat farmers*: Officials have consulted with the Dairy Goat Co-operative, which represents the vast majority of the goat industry, regarding the implications of dairy reform for their industry. (deleted under OIA section 9(2)(b)(ii) & section 9(2)(ba)(i))

44. (deleted under OIA section 9(2)(b)(ii) & section 9(2)(ba)(i))

45. (deleted under OIA section 9(2)(b)(ii) & section 9(2)(ba)(i)). Officials are considering the concerns of the Dairy Goat Co-operative and will report further to Ministers.

46. *Non-GDC farmers* (including GDC suppliers who might switch to another processor): The impacts on this group derive from GDC productivity, and any industry-wide effects on farm incomes, asset values, and the price benchmark GDC sets for other potential processors Ownership of the LIC and other industry good services are also important in terms or whether non-GDC farmers can continue to access the industry's intellectual property.

47. *New Zealand consumers*: Any reduction in competition may lead to price rises in consumer products. This in turn depends on the effectiveness of divestment of NZ Dairy Foods from GDC and post-merger arrangements between the two companies. Some possibility of consumer price rises exists. Dairy food expenditure represents 9.6% of an average household's daily food bill.

48. *Employees in dairy processing and marketing*: The main effects arise through (a) any changes in dairy farm and processing product volumes (important for levels of employment) and (b) productivity growth (important for both employment and incomes). It is likely that there will be staff transfers and redundancies as a result of GDC rationalising some activities, especially those associated with head office and marketing functions.

49. *Regional impacts*: These arise through demand from industry suppliers, and expenditure from incomes earned, and depend on the location of future farming and processing, and any relocation of activities. While information is scarce, it should be noted that:

- most growth in farming and processing is likely to be in the South Island, with small increases possible in the lower North Island and little in the upper North Island;
- the expected relocation of activities at this stage is the transfer of marketing and administrative functions from current locations in Waikato, Taranaki and Wellington to the new GDC head office in Auckland, with several hundred jobs transferred or disestablished. Changes to processing can be expected over time; and
- it is possible that GDC may move over time to differentiate the milk price it pays on the basis of local competition for supply and transport differentials. Differential pricing could impact on land values, with upward pressure in areas of high demand that are close to processing facilities, and downward pressure in areas of lower demand that are further from processing facilities.

Implications for international commitments and trade negotiations

50. The NZDB is presently notified to the WTO as a State Trading Enterprise and is subject to specific rules relating to such entities. GDC, which would embody the NZDB and the two main dairy co-operatives, is likely to remain notifiable as an STE, at least in its first year. (deleted under OIA section 9(2)(d)).

(deleted under OIA section 9(2)(d)).

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Implications for Treaty Claims

53. The previous Government undertook a dairy industry reform process during 1998-9 that resulted in the Dairy Industry Restructuring Act 1999 (DIRA). A contemporary Treaty claim (Wai 790) was lodged with the Waitangi Tribunal in August 1999, as a result of the passage of the DIRA, by the Parininihi ki Waitotara Incorporation (PKW). The claim asserts that the DIRA prejudiced their interests in the land they lease as dairy farms under the Maori Reserved Lands Act 1955. This claim has not been resolved and the issues that it raises need to be considered in the design and conduct of any proposed new consultation with Maori on dairy industry reform.

54. (deleted under OIA section 9(2)(h))

55. Accordingly, it is proposed that MAF will undertake consultation with groups of Maori dairy stakeholders at a series of regional meetings after any agreement in principle to the proposed package by Cabinet. The views of Maori would be considered, before the details of the proposed merger and regulatory package are finalised by Government.

56. On 4 April officials held a preliminary meeting with representatives of PKW and the Federation of Māori Authorities to advise them of the proposed reform package and process including proposals for further consultation. (deleted under OIA section 9(2)(j) & section 9(2)(ba)(i)).

Tax and Fiscal Implications

57. Tax implications including proposals for tax concessions to facilitate the GDC merger are discussed in the accompanying paper.

58. There may be fiscal implications arising from the enforcement of the proposed regulations. These implications are expected to be relatively minor but have not yet been assessed by officials. Officials will report on fiscal implications with their further advice on the detailed design of the regulations.

Legislative implications

59. The merger and regulatory package require legislation if they are to proceed. GDC proponents have indicated that they want this legislation introduced prior to their shareholders voting on the merger on about 10 May.

60. Officials strongly advise against rushing the drafting and introduction of what will be a very important and complex piece of legislation affecting 20% of New Zealand's exports. To do so would allow too little time for refining the detail of the regulatory package and for consulting with affected stakeholders including Maori. Officials are of the view that late May is the earliest possible date for the introduction of legislation.

61. In the absence of legislation before late May, it is recommended that the Minister of Agriculture issue a government policy statement to ensure that farmers are aware of the Government's intentions in respect of the merger including the detail of any proposed regulatory package GDC proponents could also delay their vote if they wished.

Compliance Cost and Regulatory Impact Statement

62. A compliance cost and regulatory impact statement is attached as Annex 1.

Next Steps

63. If Cabinet agrees in principle to exempt the merger from the Commerce Act, it is recommended that officials be directed to undertake further work to develop the detail of the regulatory package to a level sufficient to draft legislation. In doing so, it is recommended that officials consult with affected parties and industry participants to ensure the workability and effectiveness of the regulatory package. On completion of this work, Ministers would be asked to confirm the details of the package and to agree to the introduction of legislation. A "best endeavours" timetable for this work is shown in the table below

Mon 9 April	Cabinet considers and decides in principle on merger proposal and regulatory package.
W/c 9 April	If necessary, ad hoc group of Ministers meets with GDC proponents to explain government's policy decisions and clarify any outstanding issues.
Mid April	Government releases its decisions regarding the merger and associated regulatory package.
Mid April	If the merger is to proceed, GDC proponents send formal merger proposal to farmers.
Early May	Government confirms its decisions to facilitate the merger, decides on the detail of the regulatory package, and agrees to introduce legislation.
Mid May	Farmers vote on GDC merger proposal.
Late May	Legislation introduced.
September	Legislation passed (assumes 13 week Select Committee consideration).

Consultation

64. This paper and its recommendations have been developed by the Ministry of Agriculture and Forestry, the Ministry of Economic Development and the Treasury in consultation with the Department of the Prime Minister and Cabinet, the Ministry of Foreign Affairs and Trade, the Inland Revenue Department and Te Puni Kokiri. It has also involved considerable consultation with GDC proponents on the details of the proposed regulatory framework and more limited consultation with Tatua, Westland, New Zealand Dairy Foods, Federated Farmers (including the sharemilkers section), Kapiti Cheeses and the Dairy Goat Co-operative.

Proposals for Publicity

65. GDC proponents have an active communications strategy. Their communications include media statements on progress of the merger and information mail-outs to farmers. Officials understand that GDC proponents are planning further information releases to farmers over the next month and will be formally putting the merger proposal to farmers in April for their ratification in May.

66. Farmers (and other stakeholders) need to know whether or not the government intends to facilitate the merger and what, if any, regulatory conditions it intends to place on GDC. Government's communications on these and other associated issues may influence whether or not the proposed merger gains the support of farmers.

67. For these reasons, it is recommended that the Minister of Agriculture continue to manage communications on the merger and a communications plan including:

- ensuring it is clear that government is facilitating the merger at the request of industry and farmers, not endorsing GDC's business plan and strategy, and that it is up to farmers and co-operative shareholders to form their own views on the merits or otherwise of GDC's business case;
- the statement through a range of media and fora, including the possibility of direct communications to farmers) of government's policy position on the merger following decisions in Cabinet; and
- a managed release of relevant policy papers (where appropriate) following the government's policy decisions on the merger.

Recommendations

68. It is recommended that Cabinet:

1. note that on 23 January 2001 Cabinet agreed, inter alia, that (CAB Min (01) 1/3 refers):

   1.1 The government's objective for the dairy industry should be to maximise the returns from the industry to New Zealand while protecting the interests of New Zealand dairy farmers and consumers;

   1.2 In considering whether to pass special legislation to authorise the GDC merger, the government needs to be satisfied that:

   1.2.1 Options for refining the GDC merger proposal (including options for regulatory controls) to increase its benefits and/or mitigate its detriments, have been explored with industry;

   1.2.2 The benefits and detriments of a proposed merger have been accurately determined;

   1.2.3 A proposed merger is consistent with the government's broader objectives for the dairy industry and its relevant policies;

1.2.4 A proposed merger is a better outcome than other outcomes likely to emerge should the merger not proceed; and

1.2.5 Farmers have had access to sufficient objective information regarding a proposed merger to make informed decisions on its merits or otherwise;

2. **note** that New Zealand Dairy Group, Kiwi Co-operative Dairies Limited and the New Zealand Dairy Board have requested legislation to authorise a mega-merger to form a new dairy co-operative – Global Dairy Company (GDC);

3. **note** that the dairy industry is unusual in that it is highly regulated in terms of structure, marketing and commercial arrangements and its structure is unsustainable because of the emerging dynamics of both the domestic and global dairy markets;

4. **note** that the proposed merger provides an opportunity to allow dairy companies to control their own marketing ~~and exporting~~ and to expose the industry to the full provisions of the Commerce Act at an early stage;

5. **note** that the proposed merger has detriments including the ongoing risks to farmers and the nation's earnings from being dependent on the success or otherwise of the business strategy of one near monopoly that, without an effective regulatory regime, may use its dominant market position to reduce the overall level of contestability in the domestic consumer product, ingredients and raw milk markets;

6. **note** that officials have worked with GDC proponents to develop a regulatory package to designed to facilitate the merger and mitigate its detriments, but that the success of the package is subject to the assumptions of officials on the behaviour of industry participants;

7. **note** the view of officials that an alternative to the proposed approach, that could be expected to result in greater overall benefits over the longer term, would be for the government to actively lead a process of dairy industry reform, within the shortest practicable timeframe, with the objective of facilitating the evolution of two or more competitive and export focussed companies operating within a regulatory environment subject to the full provisions of the Commerce Act and other relevant commercial law;

8. **note** that a decision on the preferred option involves a trade-off between the short-term certainty of the GDC merger, and the potentially larger benefits of the alternative which may take longer to achieve and carry greater uncertainty;

<u>EITHER</u>

9. **agree in principle** to facilitate the merger on the basis of a deemed authorisation under sections 58 and 67 of Commerce Act 1986 and the regulatory package described in the accompanying paper and subject to consultation with affected parties and final advice in May on the detail of the proposed regulatory framework;

9.1 agree to make best endeavours to meet the following timetable for finalisation of decisions on the proposed merger and any subsequent drafting and introduction of legislation that may be required:

W/c 9 April	If necessary, ad hoc group of Ministers meets with GDC proponents to explain government's policy decisions and clarify any outstanding issues.
Mid April	Government releases its decisions regarding the merger and associated regulatory package.
Mid April	If merger is to proceed, GDC sends formal merger proposal to farmers.
May	Government confirms its decisions to facilitate the merger, decides on the detail of the regulatory package, and agrees to introduce legislation.
Mid May	Farmers vote on GDC merger proposal.
Late May	Legislation introduced.
September	Legislation passed (assumes 13 week Select Committee consideration).

9.2 invite the Minister of Agriculture to oversee, in consultation with the Prime Minister, Deputy Prime Minister, the Minister of Finance and the Minister of Commerce, the work programme in 9.1 above including the implementation of a communications strategy to ensure that farmers, sharemilkers, minority processors and consumers are aware of the government's policy decisions in respect of the merger including the details of the proposed regulatory framework including:

9.2.1 ensuring it is clear that government is facilitating the merger at the request of industry and farmers, not endorsing GDC's business plan and strategy, and that it is up to farmers and co-operative shareholders to form their own views on the merits or otherwise of GDC's business case;

9.2.2 the statement through a range of media and fora, including the possibility of direct communications to farmers, of government's policy position on the merger following decisions in Cabinet;

9.2.3 a managed release of relevant policy papers (where appropriate) following the government's policy decisions on the merger;

9.3 note that while third party processors are generally expected to benefit from their ability to export independently (including, eventually, to quota markets) a number of potential issues have been identified in consultation with Tatua, Westland, Kapiti Cheeses and NZDF including:

9.3.1 (deleted under OIA section 9(2)(b)(ii) & section 9(2)(ba)(i));

9.3.2 (deleted under OIA section 9(2)(b)(ii) & section 9(2)(ba)(i));

9.3.3 (deleted under OIA section 9(2)(b)(ii) & section 9(2)(ba)(i));

9.3.4 (deleted under OIA section 9(2)(b)(ii) & section 9(2)(ba)(i));

9.3.5 (deleted under OIA section 9(2)(b)(ii) & section 9(2)(ba)(i));

9.3.6 (deleted under OIA section 9(2)(b)(ii) & section 9(2)(ba)(i));

9.4 direct officials to undertake consultation with industry stakeholders, including third party processors on the issues raised in 9.3 above and Maori on the proposed merger and associated regulatory package and to advise Ministers in the report in 9.5 below on any issues and necessary policy responses;

9.5 invite the Minister of Agriculture to report to Cabinet by May 2001 on the detail of the proposed regulatory package and a proposal for the introduction of legislation to facilitate the proposed GDC merger; and

9.6 invite the Minister of Agriculture to instruct the Parliamentary Counsel Office on the drafting of legislation to facilitate the proposed merger;

OR

10. direct officials to report to the Cabinet Economic Development Committee by May 2001 with proposals for the government to actively lead a process of dairy industry reform to facilitate the evolution of two or more vertically integrated export companies operating within a normalised regulatory environment; and

10.1 note that this would almost certainly require Government to lead a reform process that may not have, at least initially, the support of industry and farmers currently given to the GDC merger proposal.

Hon Jim Sutton
Minister of Agriculture

Annex 1

Regulatory Impact Statement

The Nature and Magnitude of the Problem and the Need for Government Action

1. The structure of the New Zealand dairy industry is determined by legislation that establishes the New Zealand Dairy Board and bestows upon it a monopoly in the export of dairy products. New Zealand Dairy Group, Kiwi Co-operative Dairies Limited and the New Zealand Dairy Board have proposed that they merge to form a new co-operative called Global Dairy Company (GDC).

2. If the merger is approved, GDC will have a virtual monopoly position in the market for the purchase of raw milk from New Zealand farmers, giving it the potential to use market power to the detriment of existing and potential dairy farmers, New Zealand consumers of dairy products, and other manufacturing and retailing companies operating in the New Zealand dairy industry. The proposed merger requires government to introduce legislation to enable the merger and to remove the export monopoly of the Dairy Board. It is also proposed that Government legislate to implement regulations to limit the potential for GDC to use its market power to the detriment of the New Zealand economy as a whole.

The Public Policy Objectives

3. The public policy objectives are to:

   - Maximise the economic performance of the dairy industry by allowing the structure of the industry to evolve in response to changes in the domestic and global dairy industry;
   - Remove the constraints on dairy industry performance created by the structure that is imposed by existing legislation (including the export monopoly of the Dairy Board);
   - Facilitate the emergence of new competition and new strategies in the dairy industry;
   - Limit the potential that dairy farmers, New Zealand consumers and other firms or co-operatives in the dairy industry are adversely affected by the use of monopoly power by GDC; and
   - Ensure lowest regulatory and compliance costs consistent with achieving the other public policy objectives.

Feasible Options

4. There are four feasible options for change.

5. *Competition between Kiwi and NZDG in all markets* - This option requires legislative change to remove existing statutory constraints and resolve the problems associated with the current structure of the industry, particularly the relationship between the Dairy Board and the co-operatives Two competitors having common ownership of the sole

marketing body is unsustainable. It would also have to resolve the allocation of property rights attending the public good activities and ownership of the co-operatives and the Dairy Board. While competition between two large co-operative companies based in and trading out of New Zealand is feasible, the resolution of the relationship between them and the Dairy Board presents substantial challenges for the design of a feasible option around this scenario.

6. *Merger with structural remedies of the type normally required by competition authorities* - This option would require divestment of a substantial viable competitor to GDC as part of the proposed merger so that GDC faced sufficient competition to largely remove its market power. In order to be a viable competitor to GDC in the domestic market, the divested entity would require access to an independent milk supply and an ability to export dairy products in its own right. This ability to export is necessary as the New Zealand domestic market is simply too small to support viable competition to GDC in processing manufactured dairy products. This option suffers from the problems of needing to regulate GDC to ensure the competitor can develop its own milk supply and of splitting the international marketing assets of the Dairy Board to enable independent exporting.

7. *Merger with the creation of a regulatory office having the capacity to calculate and set price* - Regulation of this type would be extremely intrusive on the operations of GDC. It would be subject to capture by GDC (given the need for the regulator to have a close working relationship with GDC). More importantly, this regime would reduce the accountability of GDC management for the performance of the co-operative by requiring that the regulator calculate many of the key prices that will determine the profitability of GDC.

8. *Merger with behavioural undertakings on supplier entry and exit, the creation of a wholesale market for milk, and other matters* - This option creates a regulatory structure that is easily removed if the market share of GDC decreases to the point where it no longer has market power, but at the same time provides GDC with incentives to facilitate the entry of new suppliers and new manufacturers into the New Zealand dairy industry.

9. The choice between these options must be influenced by the proposed continuance of the co-operative structure. It has implications for performance and the design of a regulatory regime that is in the public interest that may differ from firms with a non co-operative structure.

Net Benefit of the Proposal

10. The main benefits of the merger proposal are:

- Moving within a relatively short time frame to allow dairy food processors to directly manage their overseas marketing and exporting (and all of the associated costs, risks and potential benefits). This could be expected to result in the rapid expansion of the niche dairy product sector, which includes manufacturers, marketers and exporters such as Tatua and Kapiti Cheeses;
- exposure of the industry, once the merger has concluded, to all of the commercial disciplines of the Commerce Act;

- the early integration of processing and marketing activities, which will facilitate improved market signals in the industry and some potential for rationalisation;
- broad shareholder and farmer support for the proposal, including the removal of the single desk.

11. The proposed merger also has detriments. The main ones are:

- risks to the earnings of farmers and the nation arising from the continued management of almost all of New Zealand's dairy exports by a single entity with a single business strategy and set of business tactics (all the eggs in one basket);
- the continued loss of innovation, including the evolution of new and higher value products, through insufficient diversity and competition in the production, marketing and exporting of New Zealand dairy products; and
- the creation of a large monopoly that, without an effective regulatory regime, may use its dominant market position to reduce the overall level of contestability in both the domestic consumer product and raw milk markets. This might reduce pressure on the industry to be efficient in its processing of raw milk. If so, it would, over time, result in losses of income to farmers and price increases for consumers.

12. The available (mainly qualitative) evidence indicates that the proposed GDC merger will produce greater net benefits than the current unsustainable industry structure. The trade-off is between the short-term certainty of the GDC merger and the potentially larger benefits of the alternative, which may take longer to achieve. Exempting the merger transaction from sections 58 and 67 of the Commerce Act would facilitate the early reform of the industry's regulatory environment and the achievement of these benefits over the status quo.

Compliance Cost Statement

13. GDC proponents have agreed that they see efficient management of their operations in the future as requiring that they post prices at which farmers may enter and exit on demand, and at which milk may be bought and sold on demand. The principal compliance cost for GDC will therefore be in the requirement that it establishes this facility relatively quickly, including the need to hire staff and develop pricing methodologies over a shorter time frame than it might adopt in the absence of regulation.

14. The regulations place on GDC a requirement to manage and develop the market infrastructure associated with supplier entry and exit and the wholesale milk market. In other markets this cost is borne by all market participants, but the extremely high market share of GDC makes it most practical to place the requirement on it. Particularly for the wholesale milk market, with modern computer and communication technology it is unlikely that the cost of managing these markets will be significant.

15. Perhaps the main cost to GDC of the regulations will be the need to adequately provide for open entry. Where it is an issue, it is likely to take the form of bringing forward in time expansions in capacity and/or some additional transportation costs. But it is open entry that is key to mitigating a co-operative's monopsony power.

16. The actions of GDC will be subject to challenge through an arbitration and adjudication mechanism, and GDC will be required to invest in defence of its actions and to resource the mechanism (enforcement body). This is considered reasonable because it is the monoposony power of GDC that the proposal facilitates that is the sole source of the undertakings that potentially require adjudication. GDC and its contracts will be subject to the Commerce Act in the usual way.

17. The regulatory scheme has been designed to rely on parties reporting potential complaints. It therefore has very low monitoring requirements and very low information disclosure requirements. In consequence the enforcement body need only meet to hear complaints.

18. The regulatory regime has a sunset clause that is tripped when competition reaches a certain point in each of the North and South Islands. Most regulation, therefore, appropriately ends when the benefit of it has been dissipated by the emergence of competition.

19 Compliance costs are minimized because only GDC is required to comply with the behavioural undertakings: since only GDC has market power, there would be no obvious welfare benefits from imposing these behavioural undertakings on other companies in the New Zealand dairy industry.

20. Divestment of NZ Dairy Foods and creation of a new ownership structure for Livestock Improvement Corporation (LIC). The costs of divesting NZ Dairy Foods will fall on GDC, as will the costs of creating a co-operative ownership structure for LIC.

Consultative Programme Undertaken

21 The proposed regulatory regime has been developed in consultation with GDC proponents. It is largely agreed with GDC, although there are a small number of issues on which agreement has not been reached. There have also been limited consultations with minority co-operatives (Tatua and Westland), New Zealand Dairy Foods, Kapiti Cheeses and Federated Farmers. Further consultation with affected parties will occur in the detailed design of the regulatory package and prior to a final decision to introduce legislation to facilitate the merger

9 April 2001

Office of the Minister of Agriculture

Chair, Cabinet

DAIRY INDUSTRY MERGER PROPOSAL: PAPER TWO: REGULATORY PACKAGE AND TAX PROVISIONS

Proposal/Summary

1. This paper details a possible regulatory package and tax provisions to apply if the Government decides to authorise the proposed Global Dairy Company (GDC) merger. It is to be read with Paper One on the Dairy Industry Merger Proposal, which sets out the overarching decisions required.

Background

2. The regulatory package was developed by officials, and has been agreed with proponents of GDC as a package that could apply if the Government decided to legislate to authorise the merger.

Main Features of the Package

3. The main aspects covered in the regulatory package are:
   - regulating for open entry and exit of farmers to GDC;
   - regulating raw milk markets, and providing regulation making powers for other dairy markets;
   - New Zealand Dairy Foods divestment;
   - arrangements for non-participating co-operatives;
   - regulation of exports – single desk transition and quota;
   - Commerce Act deemed authorisation;
   - termination of restrictions on GDC;
   - industry good issues;
   - GDC ownership and corporate form.

4. These are discussed below, and the detail is set out in Annex 1. Also discussed are the tax implications of the merger proceeding.

Open Entry and Exit to GDC

5 Regulating for open entry and exit of farmers to GDC is the heart of the regulatory package Because of GDC's near monopoly status and its associated market power it may have both the incentive and the ability to create barriers to new milk suppliers joining the co-operative or switching from GDC to other processors. One of the possible mechanisms available to GDC for this purpose would be manipulation of the milk price and its own share value. It could, for example, use returns from equity investments to cross-subsidise the New Zealand milk price, making entry of a competitor more difficult and discouraging suppliers from switching to another

company. This in turn would give GDC's management a degree of protection from competitive pressures.

6 To mitigate this risk it is proposed to regulate for open entry to GDC for any farmer wanting to supply GDC at its posted share price, as well as open exit from GDC. Under this proposal GDC would face strong incentives to set fair milk prices and share prices. If GDC set the milk price too high or share price too low it would face an influx of milk. If it set the milk price too low or its share price too high, it would face a loss of suppliers to its competitors (or out of the industry).

7 The main measures to ensure open entry and exit are:

- requiring GDC to publish milk and share prices;
- requiring GDC to accept applications from farmers to supply (with the ability to defer for a season if GDC has insufficient processing capacity);
- requiring GDC to give entering and exiting farmers a degree of certainty about the price they will pay or receive for their shares; and
- providing for an enforcement mechanism such as a disputes body (not yet developed).

8. See section 1 (para 1 onwards) of Annex 1 for more detail.

Raw Milk Market and Other Dairy Markets

9 GDC could attempt to stop its farmers switching their supply of milk to its competitors through the terms of its milk supply contracts with farmers (eg long contracts with long notice provisions). The package contains provisions to address this, including a requirement that in a given area at least 33% of contracts can be terminated without penalty by suppliers in any year. GDC would also be obliged to offer one-year contracts to all farmers who want them.

10. GDC would control almost all of the New Zealand wholesale milk market. Unless farmers switched their supply from GDC, other processors would need to source their milk from GDC. The terms and conditions of these trades would be important to the ongoing viability of other local dairy processors, including NZ Dairy Foods. Potentially, GDC could use its overwhelmingly dominant position to control the supply and/or price of raw milk, cheese, powders and other ingredients to third party processors.

11. GDC would face access obligations to supply certain volumes of milk to other processors on particular terms. At this stage it is not proposed to regulate markets for other dairy products, but to provide regulation making powers in case it becomes necessary in the future.

12. See section 2 (para 21 onwards) of Annex 1 for more detail.

New Zealand Dairy Foods Divestment

13 In order to provide for some level of domestic competition, NZ Dairy Group's 50% shareholding in NZ Dairy Foods would be divested. The merger authorisation would be conditional on the divestment taking place within one year.

14. See section 3 (para 28) of Appendix 1 for more detail.

Arrangements for Non-Participating Co-operatives

15 Tatua and Westland may or may not join the merger, although Tatua in particular seems unlikely to join. In order to protect their commercial interests, it is important that if they reject the merger they can quickly access payment for their shareholding in the NZ Dairy Board. The package provides for the rapid initiation of procedures for paying out non-participating co-operatives.

16. With respect to their other concerns (as discussed in Paper One), it is proposed that the government reserve the right to intervene if reasonable agreements are not negotiated between GDC and the co-operatives within a defined timeframe. The ultimate sanction on GDC is to delay the introduction of legislation.

17. See section 4 (para 29 onwards) of Annex 1 for more detail.

Regulation of Exports – Single Desk Transition and Quota

18. The orderly disestablishment of the single desk operation of the Dairy Board would result in one of the main benefits of the merger - the introduction, over time, of competition to New Zealand's export marketing of dairy products. The package provides that:
   - there would be a one-year transition period for the single desk, mainly to allow time for the Dairy Board to renegotiate contracts; and
   - during this transition period, existing export permit holders and Westland would be able to export dairy products (deleted under OIA section 9(2)(d)).

19. Successive governments have negotiated quota rights for dairy products to overseas markets. These quota rights were negotiated for the benefit of the industry and New Zealand as a whole. (deleted under OIA section 9(2)(d)).

20. The regulatory package provides for:
   - an initial exclusive allocation of quota to GDC for six years (to 2007), phasing out over the following four years as a new allocation mechanism is phased in; and
   - the legislation to state principles of:
     - maximising capture of quota rents for New Zealand; and
     - ensuring that the beneficiary of the rents should be the dairy industry.

21. In addition, it is proposed that:
   - terms of reference for the policy development process to develop a quota allocation mechanism be considered by Cabinet prior to the introduction of merger legislation in May 2001;
   - Ministers agree to announce decisions on a future quota allocation mechanism by the end of 2001, with a view to enacting legislation in 2002, to give certainty to exporters; and
   - the 1999 QuotaCo model but with the company being a co-operative (ie a company that would allocate quota access on a competitive basis and return quota rents to farmers in the form of dividends) would be the fallback position for a

future allocation mechanism if another mechanism were not identified that both the Government and GDC preferred.

22. See section 5 (para 31 onwards) of Annex 1 for more detail.

Commerce Act Deemed Authorisation

23. If the Government decides to exempt the merger from the requirement to obtain Commerce Act authorisation, the package provides for this to be achieved by means of a deemed authorisation. Certain clauses of the GDC constitution and merger transactions would be deemed to be authorised under sections 58 and 67 of the Commerce Act. Following the merger the Commerce Act would apply in full.

24. See section 6 (para 38 onwards) of Annex 1 for more detail.

Termination of Restrictions on GDC

25. The regulations restricting GDC's activities would be lifted on an island by island basis where practical, once GDC's market power was reduced. In general, regulations that are intended to mitigate GDC's market power would be lifted, while ongoing arrangements such as quota allocation would remain in force. For the North Island, the threshold would be independent manufacturers collecting 12.5% of milksolids per year. For the South Island, the threshold would be independent manufacturers collecting 65 million kg of milksolids per year, of which at least one manufacturer east of the Southern Alps was collecting at least 25 million kg of milksolids per year. For comparison, Westland processes about 28 million kg of milksolids per year.

26. See section 7 (para 40 onwards) of Annex 1 for more detail.

Industry Good Issues

27. The Livestock Improvement Corporation owns the national dairy herd database, and provides breeding and farm advisory services. Under the package it would become a co-operative owned by users (farmers and sharemilkers only). GDC would be able to contract with it for non-exclusive access to the database. The contract would require Government approval if it was concluded prior to the LIC becoming fully independent of NZDB and GDC.

28. Other industry good provisions include:

- the Dairy Research Institute, which undertakes dairy processing research, would transfer into GDC;
- an incorporated society called Industry Good Inc would apply to collect levies for industry good activities and commission providers of that work. This would maintain separation between funding and provision of industry goods Interim and ongoing governance has yet to be agreed. GDC/NZDB would provide transitional funding for industry good activities for a fixed period;
- Dexcel (an industry good provider contracted by Industry Good Inc) would be maintained as an independent entity outside GDC ownership and control; and

- the need to continue regulating herd testing and the collection and dissemination of data for the national breeding objective and/or for animal traceability will need further consideration.

29. See section 8 (para 43 onwards) of Annex 1 for more detail.

GDC Ownership and Corporate Form

30. **Sharemilkers:** The package provides for all dairy co-operatives (including GDC) to allow sharemilkers to purchase shares from their landowners by agreement. This is proposed to take effect irrespective of whether the merger proceeds, and would implement a key recommendation of an earlier industry-wide working party on sharemilker issues.

31. **Corporate form:** The package requires a 50% vote of the GDC Shareholders' Council to authorise a change to GDC's co-operative status (as well as a special resolution of the shareholders which requires 75% support).

32. See section 9 (para 53 onwards) of Annex 1 for more detail.

Efficacy of the Regulatory Package

33. It is difficult to assess the likely efficacy of the package. Risks include that it was developed very quickly, and its main feature (regulating for open entry and exit) is not based on a model existing elsewhere. Based on the information available, officials consider that it has a reasonable prospect of mitigating the main competitive detriments of the proposed merger. While most consulted parties accept that open entry and exit will create strong disciplines on GDC's pricing in the medium term, concerns have been raised by NZ Dairy Foods about the regime's efficacy, particularly in the short term. Officials will consider these concerns in their development of the regulations. There is also the risk that industry participants including GDC will not react in the ways expected of them by law makers and regulators.

Tax Provisions

34 GDC proponents have requested certain (concessionary) tax provisions as part of the proposed merger. These have been discussed with the Minister of Finance and Revenue and this paper incorporates the Minister of Finance and Revenue's advice to Cabinet on these. Decisions on the tax issues need to be made in the context of the whole package negotiated between the GDC proponents and the Government, and an assessment of whether facilitating the proposed merger is in the national interest.

35. The main tax issues of concern to GDC proponents are the transfer to the post-reform GDC of the NZDB's available subscribed capital (ASC) and the losses of the two amalgamating co-operatives.

Available Subscibed Captial

36. Available subscribed capital (ASC) represents companies' equity contributions by their shareholders and can be distributed to shareholders tax-free upon the cancellation or

redemption of shares under certain circumstances. The NZDB has $50 million "ordinary" ASC and will accumulate $140 million of ASC each year from June 2001 to June 2006, giving another $840 million of ASC. This annual contribution of ASC does not arise from any explicit equity contribution of the NZDB shareholders but is the outcome of negotiations it had with the previous Government in 1996.

37. GDC proponents request that the Government allows the NZDB's ASC to transfer to GDC. They contend that this will better equip GDC to manage the risk that farmers will exit from GDC. Without the ASC of the NZDB, GDC proponents contend that there is a risk of a tax impost on farmers, upon redemption of their shares in GDC. This risk is remote, as it would require redemption of more than 20% of GDC's shares.

38. From a tax policy perspective, there is no strong argument for acceding to this request. However, if Cabinet decides that facilitating the proposed merger is in the national interest, the Minister of Finance and Revenue recommends that the ASC of the NZDB be transferred to GDC as part of the merger. This treatment was provided for in the Dairy Industry Restructuring Act 1999 (DIRA). The transfer of ASC from the NZDB to GDC will not impact on fiscal provisions, as this policy would not have changed since DIRA.

Shareholder continuity

39. GDC proponents seek legislation that would allow tax losses of Kiwi and NZDG to transfer to GDC. They estimate that Kiwi and NZDG will have accrued tax losses of (deleted under OIA section 9(2)(b)(ii) & section 9(2)(ba)(i)) by 1 September, the likely date of the proposed merger. Current law would ensure that these losses would expire upon amalgamation, due to GDC not satisfying the shareholder continuity threshold for the carry forward of these losses. GDC proponents contend that there is no underlying change in economic ownership and that the companies are effecting Government policy by restructuring, and cite the electricity sector reform as a precedent. GDC proponents are seeking also that the same apply to the imputation credit account balances of the co-operatives, but the imputation credit balances are not significant.

40. GDC proponents have advised officials that they will be able to enter into tax planning structures to utilise (deleted under OIA section 9(2)(b)(ii) & section 9(2)(ba)(i)) that will have accrued by 1 June 2001 but are unlikely to be able to utilise the remaining (deleted under OIA section 9(2)(b)(ii) & section 9(2)(ba)(i)) that will accrue over June, July and August.

41. The largest risk associated with providing for the maintenance of losses is the precedent it will create. Other taxpayers may seek legislative exemption from loss carry forward provisions in a future restructuring, at a significant revenue cost, should the Government allow losses to be carried forward in this instance.

42. From a tax policy perspective, there is no strong argument for allowing the losses of the amalgamating co-operatives to transfer to GDC. However, if Cabinet agrees that facilitating the proposed merger is in the national interest, the Minister of Finance and Revenue recommends that the losses and imputation credit balances of the co-operatives be transferred to GDC as part of the merger. This tax treatment was not provided for in the 1999 DIRA.

43 The transfer of Kiwi's and NZDG's losses to GDC will not impact on fiscal provisions as GDC can utilise losses already accrued and, had merger timing not been driven by Government's legislative programme, the merger would be timed so as to avoid an unnecessary tax penalty.

Share swap

44. GDC proponents request legislation that would ensure that the receipt of shares issued by GDC in respect of shares held by shareholders in Kiwi and NZDG would not constitute a dividend or a dutiable gift. The Minister of Finance and Revenue recommends that this request be accepted, as it is consistent with current policy. This income tax treatment was provided for by the 1999 DIRA, although gift duty was not.

New Zealand Dairy Research Institute (NZDRI)

45 NZDRI is a charity. Current charity law requires that, upon winding up, the property of a charity must vest in another charity. GDC proponents request that the property of NZDRI vest in a non-charitable, and therefore taxable, company without any tax implications arising on the transfer. This is contrary to current tax policy.

46. There has been general agreement between GDC proponents and officials in the negotiation of the package that the property of NZDRI will vest in a non-charitable company owned by GDC.

47. From a tax policy perspective, there is no strong argument for the property of NZDRI to vest in a non-charitable company. However, if Cabinet agrees that facilitating the proposed merger is in the national interest, the Minister of Finance and Revenue recommends that the transfer of the property to a non-charitable company occur without any tax implications. This treatment was provided for in the 1999 DIRA. Furthermore, if this proposal is agreed to, rules will have to be enacted to establish a cost basis for the future tax treatment of that property.

Accrued expenditure

48. GDC proponents request that any accrued expenditure in the Dairy Board, NZDRI and Livestock Improvement Corporation (LIC) be carried forward to their respective post-reform entities. In the instance of LIC and NZDRI, the Minister of Finance and Revenue recommends that these requests be declined, as they could constitute a transfer of a tax deduction from tax-exempt entities to taxable entities – which is contrary to current policy.

49. With respect to NZDB, the Minister of Finance and Revenue recommends that this request be accepted as for tax purposes NZDB is essentially changing its constitution only.

Shares in LIC

50. The shares in LIC's successor entity will be distributed to farmers and sharemilkers. GDC has requested that receipt of these shares in shares is not a dutiable gift or a dividend. Whether a dutiable gift or a taxable dividend arises on the allocation of the shares will depend on what rights farmers and sharemilkers currently own, if any, and

their value, and what rights they will receive and their value. However, if Cabinet agrees that facilitating the proposed merger is in the national interest, the Minister of Finance and Revenue recommends that the receipt by farmers and sharemilkers of shares in the new entity should not constitute a dutiable gift and a dividend. This treatment was provided for in the 1999 DIRA.

Minority shareholders in NZDB

51 Both Tatua and Westland have raised the issue of whether any profit arising from the sale of their shareholding in NZDB would be taxable. Inland Revenue has written to both co-operatives advising them that, on the basis that the shares are held on capital account, any profit on sale would not be subject to income tax.

Consultation

52. Consultations are reported in Paper One.

Financial Implications

53. Financial Implications are reported in Paper One.

Human Rights

54. There are no inconsistencies between the proposals in this paper and the Human Rights Act 1993.

Legislative Implications

55. A Bill and associated regulations would be required to implement the package. The Dairy Industry Restructuring Bill has a category 2 slot in the legislation programme (must be passed in 2001).

Regulatory Impact Statement

56. A regulatory impact statement is attached to Paper One.

Publicity

57. Publicity is discussed in Paper One.

Recommendations

58 It is recommended that Cabinet:

Regulatory Package

1 **note** that the detailed regulatory package set out in Annex 1 has been developed by officials in consultation with Global Dairy Company (GDC) proponents, and has been agreed with GDC proponents;

1.1. note that the main features of the regulatory package in Annex 1 are:
   1.1.1. regulating for open entry and exit of farmers to GDC;
   1.1.2. regulating raw milk markets, and providing regulation making powers for other dairy markets;
   1.1.3 providing for the divestment of New Zealand Dairy Foods;
   1.1.4. providing transitional arrangements for dairy co-operatives that do not participate in the merger;
   1.1.5. (deleted under OIA section 9(2)(d));
   1.1.6 providing arrangements for quota access, including an initial six-year period of exclusive access to GDC followed by a four-year phase in of a new allocation mechanism yet to be determined;
   1.1.7. providing for a deemed Commerce Act authorisation for the merger transaction;
   1.1.8 providing for the lifting of restrictions on GDC once its level of market power decreases;
   1.1.9. providing for Livestock Improvement Corporation (LIC) to be a user-owned co-operative separate from GDC;
   1.1.10. providing arrangements for the provision of industry goods;
   1.1.11. requiring that all dairy co-operatives (including GDC) must allow sharemilkers to purchase shares from their landowners (by agreement);
   1.1.12. requiring a 50% vote of GDC's Shareholders' Council for any change to GDC's co-operative structure;

2. agree, if Cabinet decides to legislate for the GDC merger, that the regulatory package in Annex 1 will apply;

3. agree to announce decisions on a future quota allocation mechanism by the end of 2001, and announce an intention to introduce quota legislation in early 2002 with a view to enacting it by the end of 2002;

4. invite the Minister of Agriculture and Trade Negotiations to report to Cabinet prior to the introduction of merger legislation (in May 2001) with proposed terms of reference for the policy development process to develop a quota allocation mechanism;

5 invite the Minister of Agriculture and Trade Negotiations to report to Cabinet by 15 November 2001 with proposals for a future quota allocation mechanism, with the fallback mechanism to be the Quotaco model as set out in the Dairy Industry Restructuring Act 1999 but under co-operative ownership in the event that an alternative mechanism preferable to both the Government and GDC cannot be identified;

Tax Provisions

6. **note** that the resolution of the tax issues associated with the proposed restructuring should be made in the context of the whole package negotiated between the GDC proponents and the Government, and an assessment of whether facilitating the proposed dairy merger is in the national interest;

7. **agree** that the available subscribed capital (ASC) of the New Zealand Dairy Board (NZDB) amounting to $50 million "ordinary" ASC and $840 million deemed ASC be transferred to GDC as part of the merger;

8. **agree** that the losses and imputation credit balances of New Zealand Dairy Group (NZDG) and Kiwi Co-operative Dairies Limited (Kiwi) be transferred to GDC as part of the merger;

9. **agree** that the share swap as part of the merger does not constitute a dutiable gift or a dividend;

10. **agree** that the transfer of property in New Zealand Dairy Research Institute (NZDRI) to a taxable entity as part of the merger not give rise to any tax implications and that rules be established to provide a cost basis for the future tax treatment of that property;

11. **agree** that post merger entities of Livestock Improvement Corporation (LIC) and NZDRI not be entitled to claim a tax deduction for accrued expenditure incurred by LIC and NZDRI during the period that they were exempt;

12. **agree** that the post conversion NZDB be entitled to claim a tax deduction for the accrued expenditure incurred by the NZDB prior its conversion to a company incorporated under the Companies Act;

13. **agree** that the receipt of shares in the post merger LIC by farmers and sharemilkers not constitute a dutiable gift or a dividend; and

14. **note** that, provided both Tatua's and Westland's shareholding in NZDB are held on capital account, any profit on the sale of that shareholding would not be subject to income tax.

Hon Jim Sutton
Minister of Agriculture

Encl

Annex 1

Detailed Regulatory Package

1. Open Entry and Exit to GDC

Publishing GDC's Prices

1 GDC must publish at least annually (but more frequently if it wishes) the value of farmers' equity in GDC, the price paid to farmers for the supply of milk, and the wholesale price of milk in New Zealand. The milk price to farmers can be historical.

Accepting Applications to Supply GDC

2. In normal circumstances, if an application to supply GDC is made by 28 February in any year, GDC must accept it for the season starting on 1 June of that year:
   - GDC must start posting share prices from, at the latest, 15 December;
   - thereafter, GDC may post whatever prices at whatever frequency it considers best;
   - a shareholder wishing to enter may lock in the current posted price, plus or minus 7.5%;
   - a shareholder wishing to enter may opt to take the June price;
   - GDC must accept applications to enter until at least 28 February;
   - a deposit of 20% of the posted share price at the time of application must be paid within 21 days of acceptance or 28 February, whichever is earlier; and
   - the balance of the share payment is payable in late July or 2 months before supply commences.

3. If accepting applications for the following season would be beyond GDC's processing capacity in a region:
   - GDC will post a "capacity constraint notice" notice and a share price by 15 December;
   - farmers who make applications by 28 February the next year will be accepted for supply in the season commencing on 1 June 15 months later;
   - GDC can accept supply for the season immediately following the application by mutual agreement;
   - a refundable deposit of 10% of the current posted share price may be paid at the time of application – this will ensure that the final share price paid does not differ by more than plus or minus 7.5% from the posted share price at the time of application to supply;
   - if the refundable 10% deposit is not paid, the applicant will pay the share price set at the beginning of the season in which supply commences;
   - for all applicants, a (further) deposit will be payable by the 28 February three months before the season in which supply commences, to bring the total deposit to 20% of the estimated share price; and
   - the balance of the share payment is payable in late July or 2 months before supply commences, whichever is later

4 GDC does not have to accept supply from any farmer who would impose on GDC transportation costs for the collection of milk that are greater than those of any existing

farmer in a catchment. Catchment areas are to be centred around factories. This clause will cease to apply if and when GDC adopts a policy of differential payments to farmers based on transportation cost differentials. In the latter situation, GDC will be required to treat like with like.

5 Quality requirements for new suppliers must be the same as those of existing farmers.

Accepting applications to cease supplying GDC

6. GDC must start posting share prices from, at the latest, 15 December.

7. Thereafter, GDC may post whatever prices at whatever frequency it considers best.

8. A shareholder wishing to exit may lock in the current posted price, plus or minus 7.5%.

9. A shareholder wishing to exit may opt to take the June price.

10. GDC must accept applications to exit until at least 28 February.

Payments to shareholders leaving GDC

11. GDC would have 30 working days from the end of the season to pay farmers.

12. Exiting shareholders will normally be paid out in cash or capital notes at GDC's discretion.

13. GDC will issue and list capital notes on the NZ Stock Exchange at least 6 months prior to the first date of any potential exit opportunity for shareholders.

14. GDC will make best endeavours to organise a broker panel to place capital notes for those who wish to sell.

15. If GDC must pay out more than a net 5% of shares in any year, and the GDC Board considers that paying out all shares in cash or capital notes would materially adversely affect GDC's ability to carry out its current business plan, then GDC will pay cash or capital notes for shares totalling at least 5% of all shares currently on issue. Thereafter, GDC may pay cash, capital notes and/or preference shares at its discretion. (GDC proposes to do this on a pro-rata basis.)

16. Preference shares will be tradable and will be convertible into GDC shares or capacity notes at face (100%) value.

17. The dividends on preference shares will be cumulative.

Milk Vats

18. GDC will sell vats to a new processor or farmer at fair market value if a farmer switches from GDC.

Enforcement

19. Officials propose that a disputes body will adjudicate on disputes over any matter that affects entry and exit Considerable work is still required on this measure. The test for considering any mechanism is whether it would provide net benefits over the Court system and GDC's Milk Commissioner.

20. Note: The terms and conditions of supply contracts will be subject to the relevant provisions of the Commerce Act.

2. **Raw Milk Market and Other Dairy Markets**

Terms and Conditions of Supply of Milk from Farmers to GDC

21. Supply contract terms should not be used to foreclose the raw milk market to competitors.

22. GDC will offer suppliers one year contracts (but would be able to enter into longer term contracts by agreement, subject to the points below).

23. At any point in time, 33% of milk produced within a 160km radius of any point in New Zealand must be either supplied to someone other than GDC, or supplied to GDC under a contract which expires (or was able to be terminated at the supplier's option without penalty) at the end of the current season. This will complement GDC's obligations under section 36 of the Commerce Act.

24. GDC's shareholders will have the right to allocate up to 20% of their farm's daily milk production to non-GDC processors, without discrimination by GDC. Any milk supplied to competitors of GDC will have to be stored in a separate vat.

Raw milk trading between GDC and other dairy food processors: short term

25. GDC has proposed that it will publish a short term price (say monthly in advance) for raw milk trading. Prices can vary based on location, volume, certainty of supply, and a small margin is allowed between the sale and purchase price. It is proposed that the Government not regulate for this market in the first instance.

Regulation of raw milk and other dairy markets

26. The Government will regulate to impose access obligations on GDC with respect to the raw milk market, and will have the power to regulate with respect to other markets. This includes the establishment of an enforcement body to provide speedy adjudication on any disputes arising from contracts and commercial arrangements. In the first instance, the Government intends to use these powers to regulate the raw milk market.

27. There will be an access obligation on GDC with respect to the supply of raw milk to small processors (deleted under OIA section), via medium-term contracts. GDC will face access obligations as follows:

- supply of raw milk to anyone who asks;
- a total volume cap of 400 million litres/year;

- (deleted under OIA section 9(2)(b)(ii)) GDC can impose a 50 million litre/year cap on individual processors;
- with respect to winter milk, GDC (deleted under OIA section 9(2)(b)(ii)) must accept any volume sought by other processors (subject to these processors providing advance notice (up to 18 months) of their winter milk requirements);
- GDC's payout less annualised share value, plus transport costs and winter milk premium, is the default transfer price (this price is established retrospectively);
- GDC is entitled to reasonable notice of each processor's requirements for the following year(s). The notice period will be finalised in drafting of regulations;
- GDC and customers are free to negotiate alternative pricing arrangements if they wish (eg a mix of fixed and retrospective pricing);
- (deleted under OIA section 9(2)(b)(ii)).

3. New Zealand Dairy Foods Divestment

28 NZ Dairy Group's 50% shareholding in NZ Dairy Foods (NZDF) will be divested to provide competition on the domestic market. The merger authorisation will be conditional on the NZDF divestment taking place within one year.

4. Arrangements for Non-Participating Co-operatives

29. If Tatua and Westland continue NZ Dairy Board shareholding post-merger, then the value of shareholding for the purpose of valuation will be fixed at the current season's production levels.

30. With respect to Tatua and Westland realising the value of their NZ Dairy Board shares:

- the non-binding notice of exit in clause 12.8 of the Dairy Board constitution must be given within 10 days of the passing of the legislation. The date as at which the Board is valued and the date on which the shares change hands are to be determined;
- the procedure in the Dairy Board constitution applies from there – instruction of a valuer, draft report from the valuer, and 20 working days for the co-operatives from the mailout of the draft valuation within which to make a binding decision on exit;
- if a co-operative makes a binding exit decision, the constitution goes on to provide for the finalisation of the valuer's report, then arbitration rights;
- an exiting co-operative is to be paid out immediately following the final valuation, regardless of whether arbitration is to occur. A wash-up might be needed following arbitration if the arbitrator differed from the valuer. The only condition is that no payment and exit could occur (but arbitration could continue) if the amalgamation of GDC, NZDG and Kiwi had not occurred;
- if a co-operative made a binding decision to exit, then the deemed authorisation allowing it to join GDC would terminate, and any subsequent merger with GDC would be fully subject to the Commerce Act

5. Regulation of Exports: Single Desk Transition and Quota

Single desk transition

31. There will be a transitional period for the single desk of 12 months from the date of enactment of the legislation.

32. During the transitional period, there will be (deleted under OIA section 9(2)(d)) exemption from the export monopoly for all current holders of export permits and Westland (deleted under OIA section 9(2)(d)).

Quota

33. There will be an initial allocation of quota rights to GDC on an exclusive basis for six years. This means that for each individual quota market, the period of exclusive allocation ends with the expiry of the quota year that ends in 2007.

34. Following the expiry of the period of exclusive allocation to GDC, quota will remain allocated to GDC until it is re-allocated according to new procedures. Such new allocation procedures will be provided for in legislation.

35. The amount of quota from the initial allocation to be reallocated in each of the following 4 years will be calculated so that an approximately equal proportion of the initial allocation is re-allocated in steps of 25% per year in each of the 4 years.

36. The legislation will note (subject to drafting) the principles of:
    - maximising the capture of quota rents for New Zealand;
    - understanding that the beneficiary of the rents should be the dairy industry.

37. In respect of Westland and Tatua, arrangements relating to their supply into quota markets and access to quota rents for the initial period are to be settled contractually between NZDB/GDC and Tatua, and NZDB/GDC and Westland. (deleted under OIA section 9(2)(b)(ii) & section 9(2)(j)).

6. Commerce Act Deemed Authorisation

38. Clauses 2, 3, 4, 5, 7, 9 and 10 of the GDC constitution will be deemed to be authorised under sections 58 and 67 of the Commerce Act, excluding GDC's right to amend its terms and conditions under clause 9 of is constitution. Divestment of NZ Dairy Foods will be included as written undertaking and referenced in a divestment deed.

39. Deemed authorisation will be needed for subsequent purchase of the Dairy Board shares from non-participating co-operatives.

7. Termination of Restrictions on GDC

40. The regulations restricting GDC's activities will be lifted on an island by island basis where practical, once GDC's market power is reduced

41 For the North Island, the threshold will be independent manufacturers collecting 12.5% of milksolids per year in the North Island market.

42. For the South Island, the threshold will be independent manufacturers collecting 65 million kg of milksolids per year, with at least one manufacturer east of the Southern Alps collecting at least 25 million kg milksolids per year.

8. Industry Good Issues

43 The Livestock Improvement Corporation (LIC) will be a co-operative owned by users (farmers and sharemilkers only), and will be completely separate from GDC/NZDB.

44. GDC will contract with LIC with respect to future access to the database. Such access will not be on an exclusive basis, and the contract(s) will require Government approval. Such requirement for Government approval will lapse when LIC is fully independent.

45 GDC is to propose a mechanism for addressing issues about ongoing ownership of LIC to ensure it remains user owned and controlled and ongoing access to LIC's database. The resolution and implementation of any such mechanisms will be subject to Government approval.

46. The Dairy Research Institute will transfer into GDC, subject to appropriate valuation and transfer of animal welfare and environment related activities to industry good providers such as Dexcel.

47. An organisation to be called Industry Good Inc will be formed to collect levies for industry good activities and commission providers of that work. Interim and ongoing governance has yet to be agreed.

48. Dexcel will be maintained as an independent entity outside GDC ownership and control. It will be an industry good provider contracted by Industry Good Inc.

49. GDC/NZDB will provide transitional funding for industry good activities for a fixed period to be defined. It will be long enough for Industry Good Inc to obtain funding for those activities under the Commodity Levies Act if it acts with reasonable speed. Funding provided for this purpose will be excluded from the assets of the NZDB for the purpose of settling with non-participant minority shareholders of NZDB.

50. The need to continue regulating herd testing and the collection and dissemination of data for the national breeding objective can be considered in a slower timeframe. In the interim, the current regulations, which effectively ensure compulsion for entry of data, will continue to apply but with Industry Good Inc taking over the present functions of NZDB related to data access (this is subject to satisfactory resolution of interim and long term governance arrangements for Industry Good Inc).

51. In the meantime, data directly related to the national breeding objective and industry statistics are to be made available industry-wide at no greater cost than a cost recovery basis

52. The need to regulate for animal traceability can be considered in slower time. In the meantime, traceability data are to be made available industry-wide at no greater cost than a cost recovery basis.

9. GDC Ownership and Corporate Form

53. The legislation will provide that all co-operative dairy companies (including GDC) must allow for sharemilkers to purchase shares from their landowners (by agreement). This will apply with or without the merger.

54. A 50% vote of the Shareholders' Council would be required to authorise changes to GDC's co-operative status (as well as a special resolution of the shareholders).