



# Review of Raw Milk Regulations

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# 1 Introduction

During 2007 and 2008, MAF conducted a review of the Dairy Industry Restructuring (Raw Milk) Regulations 2001 (Raw Milk Regulations). Following that review, the Raw Milk Regulations were amended to:

- replace the default pricing formula for raw milk available under the Raw Milk Regulations with a price of “farm gate milk price plus \$0.10 per kilogram of milksolids”;
- set the volume of milk that Fonterra is required to supply at up to 600M litres; and
- introduce a pro rata quantity rationing rule that would be employed in the event of excess demand for regulated raw milk.

The Dairy Industry Restructuring Act 2001 has since been amended to:

- allow, but not require, the Minister of Agriculture to use an auction system or any other method for determining the price and allocation of regulated raw milk; and
- set new market share thresholds for expiry of the Dairy Industry Restructuring Act and introduce a process for a review of the state of competition in dairy markets once the new thresholds are met.

In October 2010, the Minister of Agriculture announced that a subsequent review of the Raw Milk Regulations would commence in March 2011 to ensure that the Raw Milk Regulations remain fit for purpose.

Following initial stakeholder engagement in March 2011, this consultation document seeks stakeholder feedback on a number of issues related to possible improvements to the current working of the Raw Milk Regulations.

Dairy industry stakeholders will be aware that, in addition to this review of Raw Milk Regulations, MAF has been undertaking work to:

- design a regulatory regime to accommodate Fonterra’s proposal on Trading Among Farmers that meets government’s policy objectives; and
- better understand Fonterra’s farm gate milk price setting mechanism.

These issues, although related to the review of the Raw Milk Regulations, are outside the scope of this consultation document. Despite being progressed separately, it is MAF’s intention not to proceed with recommending any regulatory amendments to the Raw Milk Regulations until work on Fonterra’s farm gate milk price setting mechanism is completed and the wider implications can be fully considered.

Dairy industry stakeholders will also be aware that MAF is considering issues arising from farm gate milk sales by farmers direct to consumers. These issues are subject to a separate consultation process that will be undertaken in the near future. These issues are not related to the Dairy Industry Restructuring Act 2001 and the Raw Milk Regulations.

## 2 Information for Submitters

Written submissions on the issues raised in the consultation paper are invited from all interested parties. The closing date for submissions is Friday 2 September 2011, 5pm. Submissions should be directed to:

Regulation & Competition Team  
Sector Performance Policy  
Ministry of Agriculture and Forestry  
PO Box 2526  
Wellington 6140

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Submissions will be considered by officials in the preparation of advice to Ministers. Specific questions have been posed to submitters, but these are only suggestions. Submissions on all issues that are within the scope of this consultation document will be considered. Submissions backed by evidence and argument will carry more weight than statements of opinion.

### 2.1 POSTING AND RELEASE OF SUBMISSIONS

MAF may post all or parts of any written submission on its website at [www.maf.govt.nz](http://www.maf.govt.nz). Unless you clearly specify otherwise in your submission, MAF will consider you to have consented to posting by making a submission.

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### 2.2 PRIVACY

The Privacy Act 1993 establishes certain principles with respect to the collection, use, and disclosure of information about individuals by various agencies including MAF. It governs access by individuals to information about themselves held by agencies. Any personal information you supply to MAF in the course of making a submission will be used by MAF only in conjunction with the matters covered by this document. Please clearly indicate in your submission if you do not wish your name to be included in any summary of submissions that MAF may publish.

## 3 Background

### 3.1 WIDER REGULATORY CONTEXT

Upon its creation, Fonterra collected approximately 96 percent of New Zealand's milk production. Given this dominant market position it was necessary for government to regulate the behaviour of Fonterra in relation to its farmers and potential competitors in New Zealand dairy markets.

The regulatory regime is set out in Subpart 5 of the Dairy Industry Restructuring Act 2001 (DIRA) and the Dairy Industry Restructuring (Raw Milk) Regulations 2001. It consists of a suite of pro-competition provisions that have the purpose of promoting the efficient operation of New Zealand dairy markets by ensuring:

- contestability in the market for farmers' milk; and
- that independent processors are able to obtain raw milk and other dairy goods and services, necessary for them to compete in dairy markets.

Contestability in the market for farmers' milk (i.e. the farm gate milk market) and independent processors' ability to obtain raw milk directly from farmers are provided through DIRA's requirement that Fonterra operate an open entry and exit regime. This means that Fonterra must accept all milk supply offers from dairy farmers in New Zealand and allow relatively costless exit from the co-operative upon the request of farmer-shareholders. These requirements ensure that Fonterra cannot "lock in" its farmer-suppliers and, as a consequence, Fonterra faces commercial incentives to pay efficient prices for farmers' milk and capital invested in Fonterra.

The DIRA, through the Raw Milk Regulations, also compels Fonterra to make available up to five percent of the raw milk it collects from farmers to independent processors at either an agreed or regulated price.

The entire regulatory regime is, however, transitional in nature. It was designed to expire at a point where the dairy markets had become workably competitive. At this point, special regulatory provisions, beyond the general competition law, would become unnecessary. To this extent, the DIRA contains sunset clauses.

The DIRA pro-competition provisions also work in parallel with, and are supplementary to, the general competition provisions of the Commerce Act 1986.

## 3.2 RAW MILK REGULATIONS

The key provisions of the Raw Milk Regulations attempt to replicate the elements of a private contract. To this end, the Raw Milk Regulations set out quantity, price and terms and conditions for the sale of raw milk by Fonterra to independent processors. The key provisions of the Raw Milk Regulations currently are:

<b>Access</b>	Each independent processor has access to a maximum of 50 million litres of regulated milk (with the exception of Goodman Fielder who can access up to 250 million litres) in a season for as long as the Raw Milk Regulations are in place.
<b>Total Quantity</b>	Up to 600 million litres of regulated milk can be accessed by all independent processors from Fonterra in a season. Should the total demand from independent processors exceed the total volume available under the Raw Milk Regulations, a pro rata quantity rationing rule would apply, whereby all independent processors would be scaled back.
<b>Regulated Price</b>	The regulated price is Fonterra's farm gate milk price plus 10 cents per kilogram of milk solids. The farm gate milk price reflects the price Fonterra pays its farmers. The additional 10 cents captures the extra cost to Fonterra of providing independent processors with the option of "flattening" the profile of the regulated milk.
<b>"October rule"</b>	The quantity of regulated milk available to an independent processor in each of the months in the dairy season (except for winter months) is set at 110 percent of the quantity of regulated milk taken by that independent processor during the month of October.
<b>Forecasting rules</b>	The Raw Milk Regulations require independent processors to provide a forecast to Fonterra three months prior to delivery. This forecast is then confirmed seven days prior to delivery, with a plus or minus 40 percent margin. The forecast is confirmed again one day in advance of delivery with a plus or minus 20 percent margin. An independent processor is only required to pay for what it takes (not what it said earlier it would take), within the bounds of the above requirements.
<b>Payment scheduling rules</b>	Regulated price is currently based on an ex-post pricing system, as the key component of the regulated price (the farm gate price that Fonterra pays its farmers) is not set until August/September after the close of the dairy season in May. This results in a "wash-up" payment the following season.

## 3.3 DEMAND FOR REGULATED RAW MILK

As shown in the table below, there has been a steadily increasing take of regulated milk by independent processors<sup>1</sup>.

Season	Millions of Litres
2001/02	300
2002/03	302
2003/04	299
2004/05	320
2005/06	353
2006/07	333
2007/08	408
2008/09	441
2009/10	466
2010/11	510

<sup>1</sup> These volumes are subject to variation depending on what is included in or excluded from the calculation, i.e. winter milk, milk taken outside of the Raw Milk Regulations etc.



Independent processors accessing regulated milk tend to fall into one of the following categories:

- Vertically integrated independent processors, who are in the business of sourcing milk from farmers. In 2010/11 dairy season, there were five such processors, which together, took about 237 million litres of regulated milk, i.e. 46 percent of the total regulated milk accessed under the Raw Milk Regulations, which equates to approximately 1.5 percent of the total milk collected in New Zealand in 2010/11 season.
- Dairy food and beverage companies, who choose not to source their milk supply directly from farmers, instead relying on the wholesale supply of raw milk available under the Raw Milk Regulations. In 2010/11 dairy season, Goodman Fielder (Fonterra's key competitor in the domestic dairy product market) accessed approximately 213 million litres of regulated milk. The other 20 dairy food and beverage companies together took about 60 million litres of regulated milk in 2010/11 season, this accounted for approximately 12 percent of the total volume of regulated milk, which equates to approximately 0.38 percent of the total milk collected in New Zealand.

There have been a number of disputes concerning the definition of "independent processor". An independent processor is currently defined in DIRA s 5(1) as "a processor of milk or milk solids or dairy products who is not an associated person of Fonterra". The disputes have been around the issue of whether an independent processor can contract a third party to do the initial processing of the milk. The Commerce Commission made a determination, which has to date been upheld by the Court of Appeal, that the term "independent processor" does allow an independent processor the freedom to contract a third party to perform some or all of the production process for milk, milk solids or dairy products. The Commission considers that this interpretation best gives effect to the purpose of promoting the efficient operation of dairy markets in New Zealand. MAF understands that Fonterra is seeking leave to appeal this decision.

## 4 Objectives of the Raw Milk Regulations

The Raw Milk Regulations are one component of the pro-competitive regulatory measures to support the overall purpose of DIRA of promoting the efficient operation of dairy markets.

The objectives of the Raw Milk Regulations are to:

- provide for an entrance pathway for independent processors into the farm gate milk market; and
- support competition in the domestic dairy product markets.

### 4.1 ENTRANCE PATHWAY

Contestability for milk supply at the farm gate encourages Fonterra to set efficient prices for milk and shares. A necessary condition for contestability is low barriers to entry and expansion.

Independent processors who are in the business of sourcing milk directly from farmers tend to rely on wholesale milk supply (i.e. milk sourced from another processor) at the initial stages of their operations as they find themselves in a “catch 22” situation. That is, farmers want to see a processing plant before committing supply and financiers want an assurance of sufficient milk supply before providing the finance for plant construction. To create potential barrier to entry for new independent processors looking to enter the farm gate market, Fonterra could choose not to supply wholesale milk to these processors.

By providing new entrants to the farm gate market with a critical mass of raw milk on regulated terms, the Raw Milk Regulations provide independent processors with an entrance pathway into the farm gate market.

While addressing the “catch 22” situation, the entrance pathway should also encourage independent processors to source milk on standard commercial terms directly from farmers. This ensures that investment in dairy processing capacity is efficient over the longer term.

### 4.2 COMPETITION IN THE DOMESTIC DAIRY PRODUCT MARKETS

Fonterra’s dominant position in the wholesale milk market may also harm competition in downstream domestic dairy product markets.

To support downstream competition in domestic consumer product markets, Fonterra was required to divest its NZ Dairy Foods business (now Goodman Fielder) and undertake to provide the divested entity with access of up to 250 million litres of regulated milk a season. This allocation was a negotiated outcome between government and the promoters of the dairy merger.

The Raw Milk Regulations also protect the position of other independent dairy processors who compete in downstream dairy markets but rely on raw milk as an input. Since the Raw Milk Regulations have been in effect, a number of small dairy food and beverage companies have built their business models based on the regulated milk supply rather than having it outsourced to dairy processors or sourcing it directly from farmers.

#### Questions:

1. What objectives of the Raw Milk Regulations cited above do you agree/disagree with, and for what reasons?
2. What additional objectives, if any, do you think should be considered for the Raw Milk Regulations, and for what reasons?

## 5 Regulatory Design Characteristics

To achieve the objectives of the Raw Milk Regulations, MAF considers the following regulatory design characteristics to be desirable:

- Independent processors seeking entrance to the farm gate milk market should have access to sufficient quantity of regulated milk necessary for them to overcome the initial “catch 22” entry barrier.
- Independent processors should be encouraged to establish alternative sources of raw milk supply rather than rely on sourcing regulated milk from Fonterra on an ongoing basis.
- Access to regulated milk should be on terms that are equivalent to those on which Fonterra purchases its raw milk from farmers; this includes price, quality, product profile, etc. To the extent that regulated milk differs from raw milk Fonterra purchases from farmers (e.g. regulated milk is of a flatter profile and of guaranteed quality) the terms for sourcing regulated milk should fairly reflect these differences.
- The design of the Raw Milk Regulations should be mindful of the economic costs to Fonterra of providing regulated milk and the potential under-utilised capacity which may affect its incentives to invest.
- The Raw Milk Regulations should be consistent with the general principles of good regulatory practice of promoting regulatory certainty, predictability of regulatory outcomes, as well as transparency, cost-effectiveness and timeliness of regulatory processes.

### Questions:

3. What regulatory design characteristics for the Raw Milk Regulations do you agree/disagree with, and for what reasons?
4. Do you consider that some of the above regulatory design characteristics are not desirable? If so, which ones and why?
5. What additional regulatory design characteristics, if any, do you think should be considered for the Raw Milk Regulations, and for what reasons?

## 6 Issues with the Current Raw Milk Regulations

Over the last few years a number of issues to do with the current working of the Raw Milk Regulations have been raised with MAF by various industry stakeholders. While a number of those issues have been considered in the course of the previous reviews of the Raw Milk Regulations and have been resolved, there are still outstanding issues.

### 6.1 ISSUES CONSIDERED AS BEING RESOLVED

- Uncertainty over the potential expiry of the DIRA, including the Raw Milk Regulations, has been addressed by introducing new thresholds for expiry, instituting a process for review once the new thresholds are met, and providing a lead time for the removal of the Raw Milk Regulations.
- The perceived mispricing of the regulated milk by the default pricing formula that artificially unbundled Fonterra's payout was addressed by replacing that formula with Fonterra's farm gate milk price plus \$0.10 per kilogram of milksolids.

### 6.2 ISSUES OUTSIDE THE SCOPE OF THIS REVIEW

- Consideration of concerns over how Fonterra sets its farm gate price is part of a separate work stream currently being undertaken by MAF and other government departments.
- The definition of an independent processor is being contested in Courts. It would not therefore be appropriate to consider this issue as part of this review.
- The allocation of up to 250 million litres of regulated milk in a season to Goodman Fielder is not considered to be appropriate for review due to it being a negotiated outcome at the time of Fonterra's creation.
- Concerns over access to regulated milk by independent processors, on the basis of them exporting their product into the same markets as Fonterra, are not considered appropriate for review because "end-use" discrimination could present trade policy concerns.

### 6.3 ISSUES CONSIDERED IN THIS REVIEW

The key issue to be considered in this review is whether the Raw Milk Regulations are providing an efficient entrance pathway into the farm gate milk market for independent processors.

Currently all independent processors, regardless of the extent to which they source their own milk supply from farmers, have the ability to access regulated milk on an ongoing basis.

When independent processors who are no longer new entrants to the farm gate market take regulated milk, this replaces raw milk that would have otherwise been sourced from farmers. This then reduces the additional competitive pressure that would have been placed on Fonterra in the farm gate market, had the milk been sourced from farmers.

Continued access to regulated milk by these independent processors also increases demand pressures on the total volume of regulated milk, potentially triggering the pro rata quantity rationing rule to be applied to all independent processors. This means that those who might still be in the early stages of their operations, and therefore reliant on accessing sufficient volume of regulated milk, would be rationed back.

Particular issues that arise when considering the effectiveness of the Raw Milk Regulations in providing an efficient entry pathway include:

- "who" should have access to regulated milk and "for how long"; and

- “how much” regulated milk should an independent processor have access to.

Consideration is also required of whether:

- the current “total volume cap” of 600 million litres is sufficient;
- the pro rata quantity rationing rule is optimal for managing situations of excess demand; and
- the terms of supply of regulated milk achieve the objectives of the Raw Milk Regulations. In particular, whether:
  - the average margin of \$0.10 per kilogram of milksolids that compensates Fonterra for the cost of providing a flatter milk supply curve is appropriate;
  - current forecasting rules are affording too high a degree of “unpriced” flexibility to independent processors;
  - current ex-post pricing system for regulated milk presents a high degree of uncertainty for independent processors; and
  - there is a need to replace the “October rule” with a “November rule” in the South Island.

#### Questions

6. Do you agree/disagree with the proposition that the key issue to consider is whether the Raw Milk Regulations are providing an efficient pathway to the farm gate milk market?

7. Do you agree with the proposition that independent processors who are no longer new entrants to the farm gate milk market should not have access to regulated milk?

8. Do you believe that removing access to regulated milk for independent processors with their own established farm gate milk supply will drive more competition at the farm gate market?

9. Do you agree that the issues highlighted above all need to be addressed?

10. Do you believe there are any additional issues with the current Raw Milk Regulations that should be considered for review? If so, what are they and why?

## 7 Potential Options

A number of options could be considered to address each of the issues identified above. MAF considers that it would be more beneficial, at this stage of the policy development process, to consider the issues individually. However, clearly many of the issues are interrelated and therefore MAF invites interested parties to also consider these interrelationships when developing comments on the options.

### Who should have access to regulated milk and for how long?

A number of options could be considered to address the issue of independent processors with their own established supply of milk from farmers continuing to access regulated milk. These options include:

- 1. Retain the status quo.** Under this option all independent processors, including those with their own established farmer supply, would continue to have access to regulated milk for as long as the Raw Milk Regulations are in place. This option provides little incentive for independent processors to replace their take of regulated milk with own farmer supply and imposes costs on Fonterra. Retaining the status quo would, however, avoid the costs and potential uncertainty associated with regime change.
- 2. Introduce time bound limits for those with own farmer supply.** Under this option, access to regulated milk would be limited to a set period of time (e.g. first 3 seasons), for those who have some degree of their own farmer supply. This option would introduce strong incentives for independent processors to grow the amount of their own farmer supply sooner. It would also ensure that access to regulated milk is targeted to independent processors seeking an entrance pathway into the farm gate market and those without any of their own farmer supply. This option could, however, see independent processors who may otherwise have sought a small amount of own supply (but who did not have plans to grow big enough to rely solely on own supply), choose not to do so to avoid being subject to the “time bound limit”. It is also the case that any set time limit would be arbitrary and independent processors are likely to vary in the length of time it takes them grow and develop enough to rely solely on own supply. This would be particularly so where, for example, one of the years within the time limit was a year with severe climatic conditions impacting on milk supply.
- 3. Introduce “established own farmer supply” rule.** Under this option access to regulated milk by those with their own farmer supply would cease once a certain level of farmer supply is established (e.g. 100 million litres). This option would introduce stronger incentives to establish own farmer supply than is currently the case. Careful consideration would need to be given, however, to determining the right access threshold. This option could otherwise create a perverse incentive for independent processors to establish and maintain their own supply just below the access threshold (e.g. 99 million litres). It could also disincentivise independent processors from seeking their own supply at all.

#### Questions

11. Do you agree that access to regulated milk should not be provided to independent processors with their own established supply of milk from farmers?

12. What, in your opinion, are the pros and cons of introducing time bound limits to those independent processors with some degree of own farmer supply?
13. What, in your opinion, are the pros and cons of introducing a certain quantity of own supply (“established own supply” rule) after which independent processors would no longer have access to regulated milk?
14. If the option of “time bound limits for those with own farmer supply” were to be implemented, what in your opinion, is the optimal period of time that access to regulated milk should be limited to, e.g. 2, 3 or 5 seasons? Please explain your reasons.
15. If “established own farmer supply” rule was to be implemented, what, in your opinion, is the appropriate level of farmer supply that would ensure access to sufficient volume of regulated milk to enable an effective entry pathway while preventing some of the perverse incentives that may arise with this rule?
16. Are there any other options that should be considered to address the issue of independent processors with their own established supply of milk from farmers continuing to access regulated milk?

### How much regulated milk should an independent processor have access to?

A key purpose of the Raw Milk Regulations is to provide independent processors with a critical mass of raw milk to kick-start their processing operations, while incentivising them to seek alternative sources of raw milk supply rather than relying on regulated milk from Fonterra on an ongoing basis. Potential options include:

1. **Retain the status quo.** Under this option, all independent processors would be able to source up to 50 million litres in every season that they have access to regulated milk. MAF understands that 50 million litres would be sufficient to fill approximately one quarter of a standard milk processing plant. While this volume of regulated milk might be providing the critical mass necessary to overcome the “catch 22” entry barrier, it may not be as effective as some of the alternative options in incentivising independent processors to seek alternative sources of supply.
2. **Introduce gradual reduction in volume for those with their own farmer supply.** This option would provide independent processors intending to develop their own farmer supply with the ability to access a diminishing quantity of regulated milk over the period of the entry pathway. For example, up to 50 million litres in the first season, 40 million litres in the second season, 30 million litres in the third season, etc. Thereafter, the independent processor would be ineligible for further regulated milk. This option could still be effective in providing the critical mass of raw milk needed to kick start new processing operations, but may be more effective in signalling the need to develop alternative supply options sooner. However this option would be more complicated (and therefore potentially more costly) to administer and comply with.
3. **Introduce a smaller cap for those without own farmer supply.** This option would be additional to either of the options above. Under this option, independent processors not seeking own farmer supply would have access of up to 10 million litres of regulated milk a season (with exception of Goodman Fielder, who would continue to have access up to 250 million litres, and possibly also excepting those currently accessing regulated milk in greater volumes, e.g. Cadbury). This option would still provide small independent processors with sufficient volume of regulated milk but it would also provide the incentive to consider alternative supply options should these business wish to grow. However this option would create a more complex regime, with two different limits to administer. It may also be unnecessary, as currently no

small independent processors take more than 10 million litres, and therefore this option could be proposing regulatory change unnecessarily.

#### Questions

17. What volume of regulated milk do you consider to be sufficient to provide for the critical mass needed to overcome the initial “catch 22” entry barrier faced by the new entrants to the farm gate milk market?
18. What do you consider to be the pros and cons of allowing access to the same volume of regulated milk in each of the seasons that independent processors have access to regulated milk?
19. What do you consider to be the pros and cons of introducing a gradual reduction in volume over the access period?
20. Do you believe that introducing a smaller volume cap for independent processors without own farmer supply is desirable?
21. What would be the impact of introducing smaller volume caps for independent processors without their own farmer supply?
22. Are there any other options relating to how much regulated milk each independent processors should have access to that you think should be considered?

#### What should be the total volume of regulated milk?

While DIRA allows the total volume of regulated milk to be set at up to 5 percent of Fonterra’s milk supply, the Raw Milk Regulations currently set the total volume at 600 million litres. Options on setting the total volume of regulated milk include:

- 1. Retain the status quo.** Under this option, the current 600 million litres cap would be maintained. This level of total volume has, up until recently, been sufficient to provide all independent processors with access to regulated milk at their full entitlement. However, with the growing number of independent processors and with all independent processors continuing to access regulated milk on an ongoing basis (rather than for initial “catch 22” purposes only), this level of total volume is facing excess demand pressures. Depending on how the situation of excess demand is managed (which is discussed further below) this may have a positive effect on incentivising independent processors to seek alternative sources of milk supply rather than relying on regulated milk. However it could also mean that independent processors who are in their early development or those with no farmer supply, and who therefore rely on regulated milk, cannot access the amount they need.
- 2. Increase “total volume” to 5 percent of Fonterra’s total milk supply and review every 3 years.** Under this option, the total volume of regulated milk would be set at approximately 5 percent of Fonterra’s current supply and reviewed periodically (e.g. every 3 years), to ensure that it represents roughly 5 percent of Fonterra’s total milk supply. This option would enable a greater number of independent processors to access regulated milk but may be counterproductive in terms of incentivising independent processors to seek alternative sources of milk supply.



- 3. Introduce gradual reduction in “total volume”.** Under this option the total volume of regulated milk would be reduced over time as independent processors with their own farmer supply become established, e.g. as an independent processor establishes own farmer supply and ceases having access to regulated milk, the total volume of regulated milk would be reduced by the amount previously taken by that independent processor. This option would provide a certain number of new entrants with the entrance pathway into the farm gate milk market and send a strong signal of the need to develop alternative sources of supply. This option would likely, however, be ineffective in providing potential future new entrants with a sufficient pool of regulated milk.

#### Questions

23. Do you have a preference for a static amount of the “total volume” of regulated milk versus one that moves with Fonterra’s own milk supply volumes? Please explain your preference.
24. If the “total quantity” of regulated milk was to continue to be set below 5 percent of Fonterra’s milk supply, what do you consider the optimal level for the “total volume” provision to be and why?
25. Do you consider the option of gradual reduction in the “total volume” of regulated milk to be desirable? Please explain why.
26. Are there any other options relating to the total volume of regulated milk that you think should be considered?

#### How should excess demand for regulated milk be managed?

From time to time, situations of excess demand may occur. Options for managing excess demand situations include:

- 1. Retain the status quo.** Under this option, the current pro rata rationing rule would continue to apply and scale all independent processors’ take of regulated milk back, irrespective of their ability to switch to alternative sources of raw milk. This option would clearly signal the need for independent processors to develop alternative sources of milk supply. However, it may not be effective in providing newly established independent processors with sufficient volume of regulated milk to overcome the initial “catch 22” entry barrier and may disproportionately affect those not looking to source milk from farmers.
- 2. Introduce “priority ranking”.** This option would see the least established independent processors with their own farmer supply and those without own farmer supply, having the first call on the total volume of regulated milk available. Independent processors who are relatively well established with some of their own farmer supply would have access to the remainder. This option would provide new independent processors with an entrance pathway to the farm gate market and incentivise independent processors to seek their own supply over time as they take lower priority in situations of excess demand. However this option would be more complicated (and therefore potentially more costly) to administer and comply with.
- 3. Introduce an auction mechanism.** Under this option if an excess demand for regulated milk situation arises, regulated milk would be allocated using price. The price would be revealed through an auction mechanism where independent processors would bid for the right and the obligation to access regulated milk. Access itself would

continue to be provided on the then applicable terms and conditions, e.g. subject to individual processor volume cap, regulated price, forecasting and scheduling rules, etc. This option would allocate regulated milk to those who value it most and incentivise those with cheaper alternative sources of supply to switch away from regulated milk. This may be the most efficient way to manage excess demand; however, designing such an auction mechanism is highly complex (a number of possible auction design features are set out in the appendix) and would likely be costly to administer.

#### Questions

27. Do you consider the current pro rata rationing rule to be an adequate mechanism for managing excess demand for regulated milk?

28. Which of the alternative mechanisms do you consider to be most effective in managing excess demand? Please explain why.

29. Are there any other options relating to managing excess demand that you think should be considered?

#### How should the margin for the flattening of the seasonal supply curve be set?

The component of the regulated price formula that compensates Fonterra for providing independent processors with an option of “flattening” the profile of their regulated milk supply is currently set at the average margin of \$0.10 per kilogram of milksolids. This applies to all regulated milk taken during the season. However, averaging this cost out across the season may not be efficient in situations where independent processors do not take regulated milk in every month of the season. Options include:

1. **Retain the status quo.** This option would maintain a simple approach to pricing the cost to Fonterra of providing independent processors with the ability to flatten their regulated milk supply by setting the average margin across the season. This option may not however be compensating Fonterra fairly for providing access to regulated milk at average prices during the off-peak supply when raw milk is most valuable.
2. **Introduce a price schedule for different points of the season.** This option would see different margins set for different times of the season, e.g. peak and non-peak milk supply. This option could allow for a more efficient allocation of regulated milk as the independent processors would be able to take regulated milk when they need it (rather than having to take it in October). The margin that they would pay to compensate Fonterra would reflect the scarcity of milk supply at the time the milk is taken. For example, there could be a relatively low/no margin attached to the peak milk supply, with a slightly higher margin being set for the mid-season supply, and a significantly higher margin set for the regulated milk that independent processors took during the shoulder months of the dairy season. While this option may provide a more efficient mechanism for distributing milk across the season, it would add a considerable degree of complexity to the pricing and scheduling provisions of the Raw Milk Regulations.

## Questions

30. Do you consider the current simple averaging out approach to be acceptable? If so, do you believe that the current average margin of \$0.10 per kilogram of milksolids is adequate to compensate Fonterra for the cost of flattening the regulated milk supply curve? If not, what average margin would you recommend and why?

31. If a price schedule for different points of the season was introduced, what level of the margin would you consider to be appropriate to be set for the peak supply, mid-season and shoulder months supply?

32. Are there any other options relating to the seasonal supply curve that you think should be considered?

### What degree of flexibility should be provided for by forecasting rules?

To address the issues of the current “unpriced” flexibility in the independent processors’ ability to change their forecasts of regulated milk the following options could be considered:

- 1. Retain the status quo.** This option would retain the existing degree of “un-priced” flexibility in the forecasting rule. This would have the advantage of not requiring any regulatory change and the risk of unwanted regulated milk would continue to sit with Fonterra, who is arguably best placed to manage it. However this option may be inefficient, where those who do not genuinely need that degree of flexibility still access it, at a cost to Fonterra.
- 2. Reduce current flexibility.** This option would reduce the current degree of flexibility to make it more reflective of standard commercial terms. For example, the 40 percent margin could be reduced to 30, 20 or 10 percent. Similarly, the later 20 percent margin could be reduced to 10 percent. This option would reduce the degree of potential inefficiencies stemming from “un-priced” flexibility, but it is still a relatively blunt tool that may be providing unnecessary flexibility at a cost to Fonterra. This is particularly the case given the difficulty in determining exactly what degree of flexibility is necessary.
- 3. Introduce “pricing of the option”.** Under this option, independent processors could “opt in” to retain access to existing (or amended) flexibility provisions but be charged a certain additional margin, set in the Raw Milk Regulations, to compensate Fonterra for any changes in delivery forecasts. This option could result in a more efficient system, where those who need the flexibility would have it, but independent processors would compensate Fonterra for passing on this risk. This option would, however result in a more complex system where some independent processors would “opt in” while others wouldn’t, requiring the operation of different systems for different independent processors. Including this option in the Raw Milk Regulations could also have the effect of inhibiting parties from developing commercial solutions of their own to address the issue.
- 4. Introduce “take or pay” provisions.** Removing all flexibility by introducing a “take or pay” provision in the Raw Milk Regulations would incentivise independent processors to more accurately forecast their requirements for regulated milk, thus reducing the costs on Fonterra. Imposing a “take or pay” provision would also ensure consistency between supply options as processors that contract directly with farmers, including Fonterra, have a non-negotiable obligation to take farmers’ milk. However this option would mean that all the risk of unwanted regulated milk, for example in the

case of a plant break down, would fall on the independent processor, who may not be best placed to manage it.

#### Questions

33. Do you think flexibility provisions of some sort are necessary? If so, do you think the current level or a reduced degree of flexibility would be appropriate?

34. What flexibility arrangements are likely to prevail in standard commercial contracts?

35. If "pricing of the option" was to be introduced, what do you think the premium should be set at?

36. If a "take or pay" provision was to be introduced, what in your opinion are the key risks to independent processors and how these could these be managed?

37. Are there any other options relating to the flexibility provisions that you think should be considered?

38. Do you believe the option of introducing a "November" rule would add a great deal of complexity in administering both "October" and "November" rules? If so, how do you believe this could be managed?

39. Are there any other options relating to peak supply that you think should be considered?

#### Should there be more certainty around payment for regulated milk

The payment for regulated milk is currently based on an ex-post pricing system, where the final price for farm gate milk (which is the key component of the regulated milk price) is not set until August/September after the close of the dairy season in May. This presents a number of challenges for independent processors, as the final price for their key input is somewhat uncertain (although guided by Fonterra's quarterly forecasts) until well after the marketing and product mix decisions have been made.

Options to address this issue include:

- 1. Retain the status quo.** This option does not mitigate the current concerns but would remain consistent with how Fonterra and other processors with their own supply pay their own farmers. It also allows for innovative commercial solutions to address this issue to be developed.
- 2. Introduce set pricing (potentially quarterly).** This option would use Fonterra's quarterly forecast for the farm gate milk price as the final farm gate price for that quarter. A risk management margin would be introduced to compensate Fonterra for bearing the risk of volatile milk prices, i.e. the likely situation that the farm gate component of the regulated price may result in being less than the farm gate price Fonterra pays its own farmers at the end of the season. This mechanism could be included in the Raw Milk Regulations as an option, alongside the current ex-post pricing mechanism, and independent processors could choose which pricing method they prefer. This option would provide more price certainty to those independent processors who need it. The additional risk management margin would ensure that Fonterra would be compensated for bearing the risk of price volatility. The ability to opt in or out provides an efficient solution as those independent processors who value the increased price certainty would be paying for it. This option would, however, result in a more complex system where some independent processors would "opt in" while others wouldn't, requiring the operation of different systems for different independent processors. Including this option in the Raw Milk Regulations could also

have the effect of inhibiting parties from developing commercial solutions of their own to address the issue.

#### Questions

40. Do you think the option of price certainty should be provided for in Regulations, or should it be a negotiated commercial solution?
41. If you do consider it should be provided for in the Regulation, do you think that quarterly is the appropriate timing for set pricing?
42. If a risk management margin were to be introduced, what do you consider would be an appropriate margin?
43. Are there any other options relating to payment scheduling that you think should be considered?

#### Should the October rule apply in both North and South Islands

The provisions under the “October rule” are based on the premise that the peak of the seasonal supply of raw milk occurs in October. While this might be true for the North Island, it may not be the case for the South Island where, due to different climatic condition, peak milk supply tends to occur a month later, in November. To account for this, the following options could be considered.

- 1. Retain the status quo.** This option would maintain the current nationally uniform approach, which ensures consistency and ease of application, but would not address the potential discrepancies associated with a different peak month in the South Island.
- 2. Introduce “November rule” for the South Island.** This option would replace the “October rule” with the “November rule” in the South Island. While it could ensure a better fit with regard to the seasonal supply curve in the South Island, it would also create a degree of complexity and administrative difficulty, especially for independent processors whose operations span both Islands.

#### Questions

44. Do you agree that the peak for milk supply in the South Island is more likely to fall in November than in October?
45. Do you consider introducing the “November rule” for the South Island to be of critical importance? If so, please explain why.

## 8 Summary of Questions

Specific questions summarised below have been posed to submitters, but these are only suggestions.

For more information on making a submission, please refer to page 2 of this document. Note that the closing date for submissions is Friday 2 September 2011, 5pm.

### Summary of Questions:

1. What objectives of the Raw Milk Regulations outlined in this document do you agree/disagree with, and for what reasons?
2. What additional objectives, if any, do you think should be considered for the Raw Milk Regulations, and for what reasons?
3. What regulatory design characteristics for the Raw Milk Regulations do you agree/disagree with, and for what reasons?
4. Do you consider that some of the above regulatory design characteristics are not desirable? If so, which ones and why?
5. What additional regulatory design characteristics, if any, do you think should be considered for the Raw Milk Regulations, and for what reasons?
6. Do you agree/disagree with the proposition that the key issue to consider is whether the Raw Milk Regulations are providing an efficient pathway to the farm gate milk market?
7. Do you agree with the proposition that independent processors who are no longer new entrants to the farm gate milk market should not have access to regulated milk?
8. Do you believe that removing access to regulated milk for independent processors with their own established farm gate milk supply will drive more competition at the farm gate market?
9. Do you agree that the issues identified as being within the scope of this document all need to be addressed?
10. Do you believe there are any additional issues with the current Raw Milk Regulations that should be considered for review? If so what are they and why?
11. Do you agree that access to regulated milk should not be provided to independent processors with their own established supply of milk from farmers?
12. What, in your opinion, are the pros and cons of introducing time bound limits to those independent processors with some degree of own farmer supply?
13. What, in your opinion, are the pros and cons of introducing a certain quantity of own supply ("established own supply" rule) after which independent processors would no longer have access to regulated milk?
14. If the option of "time bound limits for those with own farmer supply" were to be implemented, what in your opinion, is the optimal period of time that access to regulated milk should be limited to, e.g. 2, 3 or 5 seasons? Please explain your reasons.

15. If “established own farmer supply” rule was to be implemented, what, in your opinion, is the appropriate level of farmer supply that would ensure access to sufficient volume of regulated milk to enable an effective entry pathway while preventing some of the perverse incentives that may arise with this rule?
16. Are there any other options that should be considered to address the issue of independent processors with their own established supply of milk from farmers continuing to access regulated milk?
17. What volume of regulated milk do you consider to be sufficient to provide for the critical mass needed to overcome the initial “catch 22” entry barrier faced by the new entrants to the farm gate milk market?
18. What do you consider to be the pros and cons of allowing access to the same volume of regulated milk in each of the seasons that independent processors have access to regulated milk?
19. What do you consider to be the pros and cons of introducing a gradual reduction in volume over the access period?
20. Do you believe that introducing a smaller volume cap for independent processors without own farmer supply is desirable?
21. What would be the impact of introducing smaller volume caps for independent processors without their own farmer supply?
22. Are there any other options relating to how much regulated milk each independent processors should have access to that you think should be considered?
23. Do you have a preference for a static amount of the “total volume” of regulated milk versus one that moves with Fonterra’s own milk supply volumes? Please explain your preference.
24. If the “total quantity” of regulated milk was to continue to be set below 5 percent of Fonterra’s milk supply, what do you consider the optimal level for the “total volume” provision to be and why?
25. Do you consider the option of gradual reduction in the “total volume” of regulated milk to be desirable? Please explain why.
26. Are there any other options relating to the total volume of regulated milk that you think should be considered?
27. Do you consider the current pro rata rationing rule to be an adequate mechanism for managing excess demand for regulated milk?
28. Which of the alternative mechanisms do you consider to be most effective in managing excess demand? Please explain why.
29. Are there any other options relating to managing excess demand that you think should be considered?
30. Do you consider the current simple averaging out approach to be acceptable? If so, do you believe that the current average margin of \$0.10 per kilogram of milksolids is adequate to compensate Fonterra for the cost of flattening the regulated milk supply curve? If not, what average margin would you recommend and why?
31. If a price schedule for different points of the season was introduced, what level of the margin would you consider to be appropriate to be set for the peak supply, mid-season and shoulder months supply?
32. Are there any other options relating to the seasonal supply curve that you think should be considered?
33. Do you think flexibility provisions of some sort are necessary? If so, do you think the current level or a reduced degree of flexibility would be appropriate?

34. What flexibility arrangements are likely to prevail in standard commercial contracts?
35. If “pricing of the option” was to be introduced, what do you think the premium should be set at?
36. If a “take or pay” provision was to be introduced, what in your opinion are the key risks to independent processors and how these could these be managed?
37. Are there any other options relating to the flexibility provisions that you think should be considered?
38. Do you believe the option of introducing a “November” rule would add a great deal of complexity in administering both “October” and “November” rules? If so, how do you believe this could be managed?
39. Are there any other options relating to peak supply that you think should be considered?
40. Do you think the option of price certainty should be provided for in Regulations, or should it be a negotiated commercial solution?
41. If you do consider it should be provided for in the Regulation, do you think that quarterly is the appropriate timing for set pricing?
42. If a risk management margin were to be introduced, what do you consider would be an appropriate margin?
43. Are there any other options relating to payment scheduling that you think should be considered?
44. Do you agree that the peak for milk supply in the South Island is more likely to fall in November than in October?
45. Do you consider introducing the “November rule” for the South Island to be of critical importance? If so, please explain why.

**Please explain your answers.**



# Appendix 1

Table below outlines a number of possible features of an auction platform that could be used should an auction be a preferred method for managing excess demand for regulated milk.

Possible Auction Features	Reasoning
The auction would be established and operated by the Government rather than Fonterra.	This is to ensure independence of the auction process.
The auction would feature an online platform and employ a simple ascending format (c/f. TradeMe or EBay)	An online platform is preferred for its high level of functionality and convenience. A simple ascending format should be adequate to the task, and dovetail well with the open entry and exit requirements of sourcing milk directly from farmers.
The action could take place annually in late November of the season prior or done quarterly.	The November timing would be to link the timing of auction with the period Fonterra farmers can lodge an exit notice (15 Dec – 28 Feb) and thereby ensure that the auction would not generate price spiking behaviour. The annual auction could also be sufficient as independent processors would be able to build a portfolio of milk that they could then “draw down” across the season in accordance with the forecasting rules prevailing at the time.
The regulated price formula would continue to be “farm gate price + 10c”. This price would be the minimum price independent processors would pay for regulated milk.	The current regulated price formula ensures that independent processors do not obtain regulated milk at a lower price than Fonterra pays its suppliers.
Independent processors would have both the right and the obligation to purchase raw milk at the regulated price.	Risk managing instruments such as “puts” could be offered.
The Commerce Commission’s oversight role regarding the pricing of regulated milk would be retained.	This provides consistency with the status quo.
The Minister, via Regulations, would have the: <ul style="list-style-type: none"> <li>• ability to set an appropriate auction reserve price;</li> <li>• ability to amend the maximum quantity of regulated milk independent processors can bid for; and</li> <li>• permit the provision of risk managing instruments such as “puts”.</li> </ul>	These rules would provide the Minister to make adjustments to the auction as and if required.
Provisions would be made outside of the auction process: <ul style="list-style-type: none"> <li>• to manage the needs of “small” processors, and</li> <li>• for the provision of “winter milk”.</li> </ul>	This would be a pragmatic response to manage the issue of very small lot sizes and managing the lead times associated with winter milk.