Ministry for Primary Industries
Manatū Ahu Matua

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Modifying Fonterra's obligations under the Dairy Industry Restructuring Act 2001 (DIRA) regulatory regime

Regulatory Impact Assessment material

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Purpose and structure of this document

The purpose of this document is to inform and support key policy decisions taken by Cabinet in relation to the package of regulatory proposals to modify Fonterra's obligations under the Dairy Industry Restructuring Act 2001 and the Dairy Industry Restructuring (Raw Milk) Regulations 2012 (the DIRA). This document is designed to be read in conjunction with the Cabinet paper that seeks policy decisions to amend the DIRA, available at: www.mpi.govt.nz/dira-review

The package of regulatory proposals has arisen from the review of the DIRA and its impact on dairy industry performance. The review was carried out by the Ministry for Primary Industries (MPI) in accordance with the Government's terms of reference released in May 2018 and available at: www.mpi.govt.nz/dira-review.

The structure and content of this document is as follows:

- **Background and context** section sets out key background information, including industry and regulatory settings and other context relevant to the package of regulatory proposals.
- **Regulatory Impact Assessments** section contains five stand-alone Regulatory Impact Assessments, one for each issue that has resulted in recommendations for change, and includes:
    - *Coversheets* that highlight the issues the Minister of Agriculture and Cabinet need to readily access, and helps identify aspects of the Regulatory Impact Assessments that may warrant closer scrutiny; and
    - *Impact Assessments* that present the outcomes of MPI's impact analysis process and provides a summary of MPI's advice to the Minister of Agriculture and Cabinet on the problem definition, objectives, identification and analysis of the range of feasible options, and information on implementation arrangements.
- **Appendix** section summarises MPI's analysis of issues and industry concerns that were consulted on and considered as part of the review process but have not resulted in recommendations for change.

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Background and context

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Dairy industry is New Zealand’s key export earner

The New Zealand dairy industry plays a key role in the nation’s economic, environmental and social wellbeing and ongoing prosperity. The industry is one of New Zealand’s **largest export earners,** employing around 50,000 people. Fonterra is New Zealand’s largest company and the only New Zealand-based and fully New Zealand-owned multinational firm with significant global scale and reach.

The dairy industry, like most economic activities, extracts resources from and disposes wastes into the environment. However, given the industry’s size and characteristics of land/resource use, its incentives and abilities to adopt sustainable environmental management practices play a key role in the environmental wellbeing of New Zealand as a whole.

The dairy industry’s performance is therefore **of significant national interest.**

2001 legislative reform enabled the dairy industry to compete strongly globally, but introduced regulatory safeguards to manage risks domestically

In 2001, Parliament enabled the New Zealand dairy industry to implement significant structural change aimed at transforming the dairy industry’s performance for the benefit of all New Zealanders. The two largest dairy co-operatives (undertaking collection and processing of 96 percent of all milk produced in New Zealand) and the New Zealand Dairy Board (a statutorily-mandated single desk export marketing board) had merged into a single farmer-owned dairy co-operative company, Fonterra.

The merger aimed to create a company with sufficient scope and scale to **compete strongly in international dairy markets;** produce cost efficiencies and productivity improvements through its size, full vertical integration, and industry-wide co-ordination of dairy product manufacturing and marketing activities; and create impetus for a strategic shift from commodity to value-added processing of New Zealand milk production.

The merger also created **significant risks** associated with the loss of competition **in New Zealand dairy markets**. A company with such significant domestic dominance, and its associated market power, could act in ways that might lead to a less efficient and innovative processing industry in New Zealand, thus leading to reduced farmer returns and economic value to New Zealand over time, as well as potentially charging excessive prices and/or limiting quality and variety of dairy products to New Zealand consumers.

Given the significance of Fonterra to the New Zealand dairy industry, and the importance of the dairy industry to the New Zealand economy as a whole, it was critical to ensure that there was sufficient performance pressure on Fonterra to ensure that it did not operate to the detriment of the long term dynamic efficiency of the dairy industry.

Special legislation, in the form of the Dairy Industry Restructuring Act 2001 (DIRA), authorised the restructure to go ahead to enable the anticipated benefits to be realised. To **mitigate the risks** arising from **Fonterra’s domestic market power**, the DIRA also introduced a set of regulatory safeguards designed to promote the efficient operation of New Zealand dairy markets by ensuring:

- contestability for the supply of milk from dairy farmers; and
- competition in the wholesale supply of domestic consumer dairy products.

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Contestability for the supply of milk from farmers is provided primarily through the DIRA's requirements that Fonterra operate an open entry and exit regime for the shareholding farmers. This means that Fonterra must accept all milk supply offers from New Zealand dairy farmers who have purchased shares in Fonterra, and allow relatively costless exit of the shareholding farmers from the co-operative.

The open entry and exit requirements were designed to ensure that Fonterra, as a dominant market player, cannot create barriers to other dairy processors entering the industry by "locking" farmers in or out of Fonterra. This in turn aims to ensure that farmers' milk is able to flow to its highest value use, continuously testing and optimising the size, composition, strategy, and structure of the dairy industry. The open entry and exit regime was designed to put these commercial decisions squarely in the hands of dairy farmers, keeping the role of government to reducing barriers that may be created by a dominant industry player in an attempt to distort this flow.

Farmers' ability to relatively easily switch their supply to and from Fonterra was intended to put strong performance pressure on Fonterra of the type that would normally exist in a workably competitive market.

Contestability for the supply of milk from farmers is also supported by (among other things):

- the requirement for Fonterra's terms of supply to not discriminate between a new entrant and a shareholding farmer in the same circumstances;
- the requirement for Fonterra to calculate, and for the Commerce Commission to monitor, a benchmark price for farmers' milk against which farmers could then assess the adequacy of Fonterra's and other processors farm gate milk price offers;
- the structural and behavioural obligations that relate to Fonterra's current Trading Among Farmers capital structure; and
- the ability of other dairy processors to purchase up to 50 million litres of raw milk per annum from Fonterra at an agreed or regulated price, during their establishment phase.

Competition in the wholesale supply of domestic consumer milk products is provided for by the DIRA regulatory requirements on Fonterra to:

- divest 50 percent of its domestic product manufacturing assets to provide for a national wholesale competitor at scale;
- supply the divested entity (now Goodman Fielder) with up to 250 million litres of unprocessed milk per annum, at an agreed or regulated price; and
- supply other dairy processors with up to 50 million litres of unprocessed milk per annum, at an agreed or regulated price.

Competition in the wholesale supply of domestic consumer milk products reduces the risk of exposing New Zealand consumers to higher prices, less choice and lower quality of dairy products. Without a viable national competitor at scale, Fonterra would be a dominant wholesale supplier of dairy products in New Zealand. It would then have the ability to exercise market power and charge excessive wholesale prices, which (if not absorbed by the retail industry) would flow through to New Zealand consumers.

The regulatory requirement on Fonterra to supply its key domestic rival with unprocessed milk was necessary to ensure that the then newly-formed competitor (now Goodman Fielder) was able to start operating, as it did not at the time have its own milk supply from farmers. Commercial negotiations at the time (backed by the regulatory requirement) resulted in Fonterra entering into a long term commercial contract to supply the divested entity with up to 250 million litres of unprocessed milk per annum. In the long term, it was expected that the divested entity would develop its own sources of unprocessed milk supply and become an independent competitor.

The regulatory requirement on Fonterra to supply other dairy processors (including specialty cheese, chocolate and ice-cream producers) with milk was intended to ensure that these typically small-scale operators were able to source milk according to their unique demand characteristics. This in turn was aimed at promoting the development of an innovative and vibrant food sector in New Zealand.

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The DIRA regulatory safeguards were designed to operate in conjunction with the general provisions of the Commerce Act 1986, and the need for them is contingent on Fonterra retaining dominance in New Zealand dairy markets.

Dairy industry performance since the 2001 reform has been mixed…

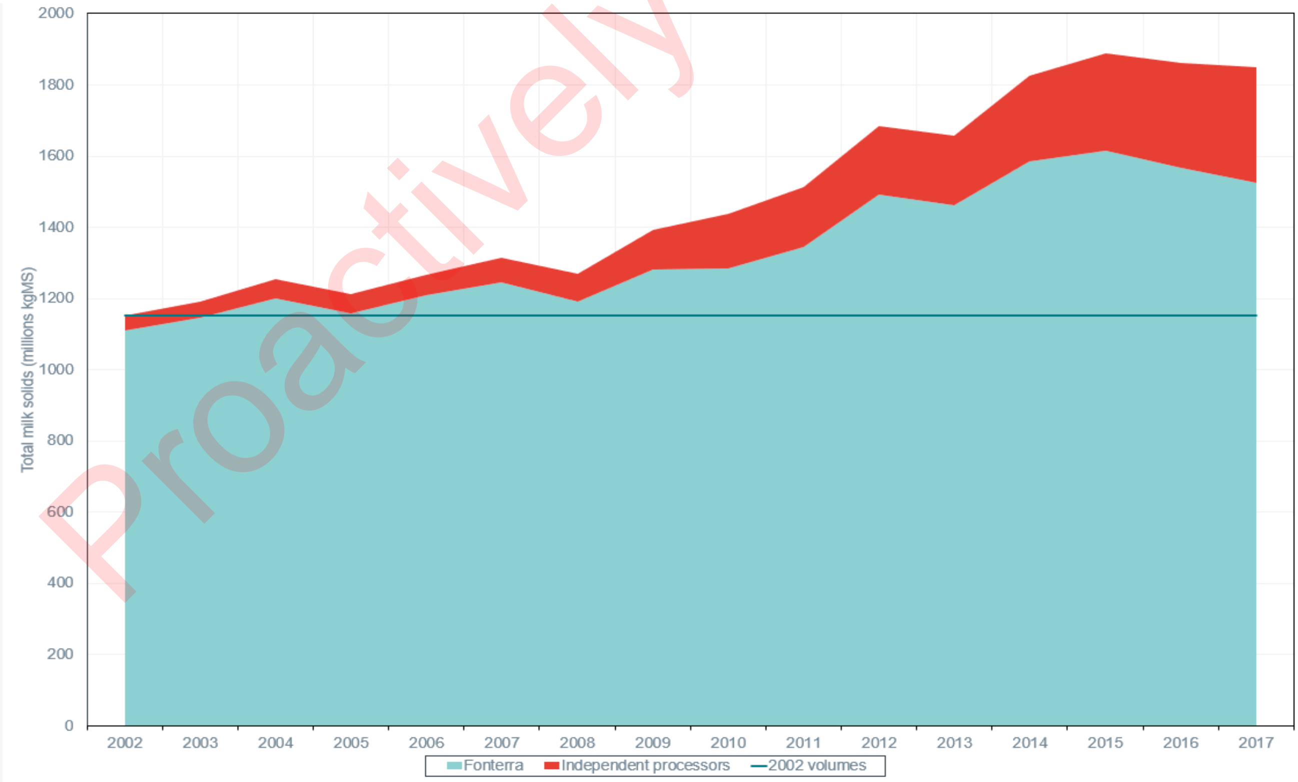
The **dairy industry growth has been significant**. Its contribution to per capita GDP is 74 percent higher than in 2001. Dairy export receipts have more than doubled since 2001, growing from $6.3b in 2001 to $17.1b in 2018.

New Zealand's dairy exports remain **strongly focused on commodities**, exposing the industry to international price volatility. The focus on commodities is particularly evident in Fonterra's export product mix. However, given the size and scope of Fonterra's business, combined with highly seasonal milk production, this outcome is not unexpected.

Since 2004, **a number of large export-focused dairy processors have established** in New Zealand and successfully secured milk supply from farmers. Most have focused on a mixture of commodity and higher value products, with the latter forming a growing segment of New Zealand's export products.

In most cases new dairy processors have been backed by foreign investors (some in partnership with New Zealand, and Māori interests). This has provided linkages to established international distribution and marketing chains, which has facilitated access to growing Asian markets.

Although volumes of New Zealand's milk production have grown, **Fonterra's share of total milk production has fallen** from 96 percent in 2001 to about 80.5 percent in 2018. As shown in the graph below, independent processors have played a significant role in expansion of the dairy sector since 2001, accounting for around 40 percent of the increase in milk solids collected since 2001, with Fonterra accounting for about 60 percent of growth in milk solids collected.



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While the growth of the dairy industry has had undoubted economic benefit, it has come at a **cost to the environment**. With rising international demand and high prices for dairy products, cow numbers have increased, and dairying has expanded into areas where production is less sustainable.

Commercial Sensitivity

New Zealand consumers have access to a **wide range of consumer dairy products**, across the basic, standard and premium product range and price points. With the current exception of butter, the retail prices of dairy products (including fresh milk) have moved in line with other retail grocery products.

Diversity in the consumer market is served by a **large number of small niche producers**, and two large-scale processors, Fonterra Brands and Goodman Fielder (both reliant on Fonterra for milk supply). Product ranges have expanded over time, particularly in the range of specialist and niche dairy products beyond cheese, including ice cream, and organic fresh milk.

In summary, since 2001, the dairy industry's economic contribution to New Zealand has more than doubled, and there has been significant processor entry and some product diversification, both in export-focused and domestic consumer dairy markets.

…and it is timely to consider the impact of the regulatory safeguards on industry performance

Some industry stakeholders expressed concerns that the DIRA regulatory safeguards are contributing to adverse industry performance outcomes. Specifically, there are concerns that the DIRA regulatory safeguards may be encouraging uneconomic and environmentally unsustainable milk production; preventing Fonterra from transitioning to higher value-add processing activities; and incentivising inefficient market entry by new dairy processors.

There are also **questions of whether** some of the **DIRA regulatory provisions are fit-for-purpose**; as well as whether the entire DIRA regulatory regime is still needed, given that Fonterra's share of the collection and processing of milk has reduced from 96 percent in 2001 to around 81 percent in 2018, and that the overall milk production volumes are expected to plateau.

To test the validly of these concerns and to ensure that DIRA regulatory regime remains fit-for-purpose, the Government commissioned MPI to undertake a comprehensive review of the DIRA regulatory regime and its impact on the industry's performance. The terms of reference for the review were released in May 2018 and are available at http://www.mpi.govt.nz/dira-review. The key questions for the review are:

- whether the DIRA is operating in a way that protects the long term interests of New Zealand dairy farmers, consumers, and the nation's overall economic, environmental and social wellbeing;
- whether, and if so the extent to which, the DIRA gives rise to any unintended consequences manifesting themselves in other parts of the wider regulatory system; and
- whether the purpose and form of the DIRA remain fit-for-purpose, given the dairy industry's current structure, conduct and performance, as well as the global and domestic challenges and opportunities facing the industry, the wider regulatory system within which it operates, and the Government's broader policy objectives.

This review builds on the 2016 review of competition in the New Zealand dairy industry undertaken by the Commerce Commission.[1]

[1] https://comcom.govt.nz/regulated-industries/dairy/projects/report-on-the-state-of-competition-in-the-new-zealand-dairy-industry

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MPI undertook an extensive industry consultation process…

Following the release of the terms of reference for the review, MPI engaged with **a large and diverse group of key industry stakeholders** to help clarify concerns, establish facts and build evidence to inform preliminary analysis of issues and options for potential legislative amendments. Specifically, MPI held **28 meetings** with various industry stakeholders and received **written input from 12 organisations**. MPI also commissioned two reports from an independent economic consultancy, Frontier Economics, on the performance of the New Zealand dairy industry and its underlying drivers. The industry input and consultancy reports can be found at http://www.mpi.govt.nz/dira-review.

Information gathered during this engagement process was used by MPI to undertake preliminary analysis of issues and options for change. This preliminary analysis was outlined in a **public discussion document,** which was released for consultation with the wider industry and public, in November 2018. The discussion document sought to test MPI's preliminary analysis of issues and asked for input on costs, benefits and other impacts of options to help ensure that any legislative amendments deliver the right outcomes and are workable.

A comprehensive public consultation process was then conducted for 14 weeks, closing in early February 2019. The consultation process consisted of **13 public meetings** throughout New Zealand (attended by **401 dairy farmers**); **22 face-to-face meetings** and workshops with dairy processors, industry representative groups, representatives of Māori interests, and environmental groups; and was supported by extensive communications to the sector via traditional and social media. MPI received **188 written submissions** on the discussion document.

The information received from the submissions was supplemented with an **additional report** MPI commissioned from Frontier Economics to identify any market failures or sources of inefficiency that could arise in the absence of the DIRA regulatory regime, and consider potential remedies to the identified market failures. The industry submissions and Frontier Economics' report can be found at http://www.mpi.govt.nz/dira-review.

…and found that although the regulatory safeguards are still needed, there is scope for modification and improvement

The review found that despite the changes in the dairy industry structure and Fonterra's reduced market share, **Fonterra is still dominant**. Fonterra enjoys a significant incumbency advantage and may have an incentive to use it to lock farmers in or out of the co-operative and/or pay inefficiently high farmgate milk price, which may foreclose entry or expansion by other dairy processors. Fonterra's co-operative status is unlikely to provide sufficient counterbalance to such behaviour, as Fonterra's farmer-shareholders may not anticipate the long-term costs they might bear if rival processors are foreclosed – particularly if they are rewarded in the short-term with relatively high farmgate milk prices. As a result, there **remains a significant risk** that Fonterra may behave in a way that is detrimental to the long term interests of New Zealand dairy farmers, consumers and the wider economy.

MPI considers that, in the absence of the DIRA regulatory regime, Fonterra would have the ability and may have the incentives to remove or substantially weaken the current open entry and exit conditions for dairy farmers. Fonterra's co-operative status may mean that as suppliers of milk, Fonterra's existing farmer-shareholders would favour freedom of entry and exit. However, as investors in Fonterra, existing suppliers may prefer the short term benefit of having security of milk supply to ensure adequate utilisation of the co-operative's sunk investment over any longer term benefit arising from their ability to switch, enabled by the DIRA regulatory regime. Fonterra's policy on their suppliers' entry and exit at any point in time will depend on the relative balance of its existing farmer-shareholders short and long term incentives. A relatively short period of a moderately costly/risky exit conditions for Fonterra's existing farmer-shareholders could be sufficient for the performance pressure on Fonterra to be substantially weakened. Fonterra's farmer-

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shareholders may not have access to targeted and independent information to monitor Fonterra's performance effectively. Even if such information were available, individual farmers may not be sufficiently motivated to act on this information. Furthermore, Fonterra's scale, co-operative structure and governance arrangements make it difficult for individual farmers to influence the company's overall direction.

The review, therefore, found that the **DIRA, on the whole, is providing an effective and relatively low-cost means of managing the risk** of Fonterra behaving in a way that is detrimental to the long term interests of New Zealand dairy farmers, consumers and the wider economy.

The DIRA does not (materially) interfere directly with Fonterra's strategies, investment plans and pricing decisions. Instead it aims to ensure that farmers have access to transparent information about Fonterra's performance and are able to act on this information by freely switching their milk supply from and to Fonterra. The main purpose of the DIRA is to remove barriers to farmer-switching that might otherwise exist as a result of Fonterra's dominance.

MPI's analysis indicates that the DIRA regulatory safeguards have neither been the primary driver for the increased milk production, nor do they prevent Fonterra from transitioning to higher value-add processing activities or drive negative environmental outcomes. These trends had been the result of growing international demand for commodity dairy products, primarily from China, and Fonterra's business strategy. MPI also found that the DIRA enabled, rather than drove, the entry of new dairy processors, and that New Zealand consumers of dairy products appear to be relatively well served at present.

MPI did, however, find that **some of the DIRA provisions are operating in a way that creates unintended consequences and others are no longer fit-for-purpose and/or current**. These issues can be addressed by modifying the existing DIRA provisions. MPI's analysis of these issues and the recommendations for change are outlined in the accompanying package of regulatory proposals.

A number of policy issues and industry concerns were consulted on and considered as part of the review but have not resulted in recommendations for change. MPI's analysis of these issues is outlined in the Appendix.

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Regulatory Impact Assessments

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Coversheet #1: Obligation to accept all milk from new and existing farmer-shareholders

Advising agencies	*Ministry for Primary Industries*
Decision sought	*Approval to amend the Dairy Industry Restructuring Act 2001 to introduce two new exceptions to Fonterra's obligation to accept milk supply. These exceptions will enable Fonterra to more effectively manage its costs of new processing capacity and reputational risk.*
Proposing Ministers	*Hon Damien O'Connor, Minister of Agriculture*

Summary: Problem and Proposed Approach

What problem or opportunity does this proposal seek to address? Why is government intervention required?

In the absence of effective competition for farmers' milk supply, the DIRA – through its open entry and exit regulatory requirements – aims to impose performance pressure on Fonterra to continuously reduce costs and innovate. While the DIRA provisions are providing an effective and relatively low-cost regulatory substitute for the competitive market pressure on Fonterra, some of its provisions are imposing unnecessary costs on, and create some reputational risk for, Fonterra.

Problem 1: unnecessary costs arise from requiring Fonterra to accept milk supply from new dairy conversions

The current regulatory settings impose unnecessary costs on Fonterra. A key requirement of the DIRA open entry and exit regime is for Fonterra to accept milk supply from all dairy farmers wishing to become shareholders in Fonterra. The DIRA currently does not distinguish between existing and newly converted dairy farmers. Compared to existing dairy farmers, newly converting dairy farmers: a) are better placed to choose which processor they supply, as they do not face any barriers from an existing supply arrangement; and b) create additional forecasting uncertainty of future milk supply for Fonterra, causing it to invest in additional excess capacity.

While it is extremely difficult to isolate the effects of DIRA open entry requirements from Fonterra's other drivers of milk volume uncertainty (for example, weather conditions), it is likely to have some impact. Commercial Sensitivity [redacted]

Although the scale of the problem is relatively small, given the limited policy rationale for requiring Fonterra to accept milk supply from new dairy conversions, MPI considers that this requirement represents an unnecessary regulatory impost on Fonterra.

Problem 2: reputational risk

The DIRA open entry requirements, as currently drafted, create reputational risk for Fonterra (and the wider dairy industry). The way the DIRA open entry requirements operate means that Fonterra cannot refuse applications to become shareholders (and accept milk) from new and existing farmer-shareholders who are unlikely to meet Fonterra's standards, as set out in its terms of supply (including in relation to environmental, climate change, animal welfare, hygiene, and health and safety compliance). Such restrictions on Fonterra's discretion does not contribute to the purpose of the DIRA regulatory regime, and represents an unintended consequence.

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How will government intervention work to bring about the desired change? How is this the best option?

MPI recommends introducing two new exceptions to Fonterra's obligation to accept milk from new and existing farmer-shareholders under the DIRA open entry requirements. The new exceptions will allow Fonterra to refuse applications to become shareholders (and to supply milk) from new and existing farmer-shareholders if their milk is either:

1. supplied from newly converted dairy farms; and/or
2. unlikely to comply with Fonterra's terms of supply.

The proposed two new exceptions to the DIRA open entry requirements will enable Fonterra to more effectively manage its costs of new processing capacity and/or reputational risk, with minimal impact on the overall effectiveness of the DIRA regulatory regime.

Summary Impacts: Benefits and costs

Who are the main expected beneficiaries and what is the nature of the expected benefit?

Fonterra, as the regulated party, is the main beneficiary of the proposals in this Regulatory Impact Assessment. The proposed options provide Fonterra with additional tools to manage its costs of new processing capacity and reputational risk.

Where do the costs fall?

The proposals carry some implementation risks associated with complex legal drafting, creating opportunities for gaming by Fonterra, and giving rise to potential disputes. The proposals also reduce regulatory certainty for dairy farmers. Fonterra's decisions on whether or not to accept supply, under the proposed arrangements, would be based on a case-by-case basis and would inherently involve the exercise of discretion.

Consistent with the existing dispute resolution provisions in the DIRA, the costs of resolving any such disputes would be incurred by the Commerce Commission. The Crown subsequently recovers these costs from Fonterra via a levy. The Commerce Commission estimates the cost of carrying out an investigation at between $60,000 and $300,000, with an indicative timeframe of up to 12 months, depending on complexity. MPI does not consider that the actual number of disputes taken to the Commission will be high, given that Fonterra would need to have good reason (i.e. evidence) to refuse applications to become shareholders (and to supply milk) from new and existing farmer-shareholders.

What are the likely risks and unintended impacts, how significant are they and how will they be minimised or mitigated?

Careful drafting of the legislative provisions will be required to minimise the risk of gaming. MPI will work closely with the Parliamentary Counsel Office to achieve as precise and clear legal definitions as possible. MPI will also be testing draft definitions with other government agencies and in particular the Commerce Commission as the enforcement agency. Other stakeholders and affected parties will provide further testing during the Select Committee process.

In addition, the legislation would specify the evidential basis on which Fonterra could decline an application under the proposed new exceptions. The existing non-discrimination provisions will also continue to apply to safeguard against potential gaming by Fonterra. The Commerce Commission will continue to operate in its current role of being the enforcement agency for disputes arising in relation to all DIRA provisions, including the two new exceptions proposed in this Regulatory Impact Assessment.

These mitigation strategies are expected to ensure that the proposed new exceptions to open entry are workable and the risk of unintended consequences is minimised.

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Identify any significant incompatibility with the Government's 'Expectations for the design of regulatory systems'.

MPI's proposed approach is aligned with the guidance provided in Government Expectations for Good Regulatory Practice (April 2017).

Evidence certainty and quality assurance

Agency rating of evidence certainty

MPI considers there is an adequate evidence base for the proposed amendments.

Evidence of unnecessary costs

The unnecessary costs come in the form of Fonterra having to invest in additional excess capacity to provide an extra buffer to accommodate the uncertain milk supply volumes from new dairy conversions. Quantifying the extent of these costs is extremely difficult because they cannot be robustly isolated from the business-as-usual costs, given Fonterra's existing manufacturing footprint and product mix, highly seasonal variability in milk supply, and Fonterra's business and investment decisions. In its 2015/16 analysis of the state of competition in the dairy industry, the Commerce Commission concluded that the DIRA open entry and exit provisions do not materially contribute to the milk volume uncertainty that Fonterra manages. Commercial Sensitivity [redacted]

Evidence of reputational risk

The DIRA, as drafted, creates a risk for Fonterra and the wider dairy industry's reputation. While the risk cannot be quantified, it is evident that the general public and international consumers are becoming increasingly sensitive to environmental and animal welfare concerns and the sustainability of milk production. A rare case of even perceived poor on-farm performance could be highly detrimental to Fonterra, the wider dairy industry and the New Zealand economy in general.

The proposal to introduce two new exceptions to Fonterra's obligation to accept milk supply is part of the wider package of regulatory changes aimed at modifying the current DIRA provisions to ensure that they do not create unintended consequences and remain fit-for-purpose.

MPI's policy development process commenced in May 2018, following the Government's release of the terms of reference for the review of the Dairy Industry Restructuring Act 2001 and its impact on the dairy industry. MPI engaged with a large and diverse group of key industry stakeholders to help clarify concerns, establish facts, and build evidence to inform preliminary analysis of issues and options for potential legislative amendments. MPI completed 28 engagement meetings and received written input from 12 organisations. MPI also commissioned two reports from an independent economic consultancy, Frontier Economics, on the performance of New Zealand dairy industry and its underlying drivers. The industry input and consultancy reports can be found at http://www.mpi.govt.nz/dira-review.

In November 2018, a discussion document, outlining issues and options for change, was approved for public consultation by Cabinet [CAB-18-MIN-0528 refers]. Comprehensive consultation was conducted for 14 weeks, closing on 8 February 2019. It involved 13 town hall meetings (attended by 401 dairy farmers), 22 face-to-face industry meetings and workshops, and was supported by extensive communications to the sector via traditional and social media.

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The option of allowing Fonterra to refuse applications from newly converted dairy farms was not included in the discussion document. However, several stakeholders (including Fonterra, Westland Milk Products, Danone, Fonterra's Shareholders Council and Federated Farmers) suggested exploring this option, particularly because it was considered, and assessed, in the context of the previous DIRA review, undertaken in 2016. MPI's 2016 Regulatory Impact Assessment, which included the consideration of this option is available at: https://www.mpi.govt.nz/law-and-policy/legal-overviews/regulatory-impact-statements/.

The final proposals take account of stakeholder feedback.

Quality Assurance Reviewing Agency:
The Regulatory Impact Assessment has been reviewed by a quality assurance panel with representatives from the Regulatory Quality Team at the Treasury and the Ministry for Primary Industries.
Quality Assurance Assessment:
The panel considers that the Regulatory Impact Assessment meets the quality assurance criteria.
Reviewer Comments and Recommendations:
While technically complex, a strong case has been made to refuse applications from farmers if their milk supply is unlikely to comply with Fonterra's terms of supply. The case is not as strong for refusing applications from newly converted dairy farmers because although they have more choice than existing dairy farmers who they sell to, their choices are still limited. The Regulatory Impact Assessment indicates that these proposals balance reducing costs and the unintended consequences of the open entry requirements for Fonterra, while ensuring minimal impact on the overall effectiveness of the regulatory discipline on Fonterra. Careful drafting of the legislative provisions will be required to minimise the risk of gaming by Fonterra.

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Impact Statement #1: Obligation to accept all milk from new and existing farmer-shareholders

Section 1: General information

Purpose

The Ministry for Primary Industries is solely responsible for the analysis and advice set out in this Regulatory Impact Statement, except as otherwise explicitly indicated. This analysis and advice has been produced for the purpose of informing key policy decisions to be taken by Cabinet.

Key Limitations or Constraints on Analysis

Scope

The policy development process that underpins the recommendations in this Regulatory Impact Assessment is focused on the changes to the current DIRA regulatory regime.

While MPI's policy review of the DIRA and its impact on the dairy industry required a contextual consideration of the dairy industry's performance and its underlying drivers, the scope for regulatory changes is limited to the current DIRA regime. As a result, the proposed regulatory changes take account of, but do not seek to directly affect the dairy industry's performance arising from (among other things):

- Fonterra's ownership model and business strategy
- trade and market access rules; and
- environmental regulation.

Assumptions and evidence

There is limited evidence to substantiate and isolate the costs on Fonterra arising from the DIRA open entry requirements. In its 2015/16 analysis of the state of competition in the dairy industry the Commerce Commission concluded that the DIRA open entry and exit provisions do not materially contribute to the milk volume uncertainty that Fonterra manages. Commercial Sensitivity [redacted]

There is also limited evidence of the extent of the actual, as opposed to potential, DIRA impact on Fonterra and the wider dairy industry's reputation. A key assumption underpinning MPI's analysis is that the reputational risk, and its potential impact on export markets, could be material if international consumers sought increasing assurance about on-farm performance. In this case, even a rare instance of perceived poor on-farm performance could lead to significant reputational damage to Fonterra and, given its place in the New Zealand dairy industry, the wider industry and the economy as a whole.

Responsible Manager

Emma Taylor
Director of Agriculture, Marine and Plant Policy,
Policy and Trade Branch
Ministry for Primary Industries

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Section 2: Problem definition and objectives

2.1 What is the context within which action is proposed?

The DIRA open entry and exit requirements, on the whole, provide a cost-effective regulatory response to manage the risks associated with Fonterra's dominance/market power in New Zealand dairy markets.

Regulation of a firm's market power (typically through price control) can impose significant costs on the regulated business, particularly when that regulation is prescriptive. The DIRA is a different form of economic regulation. It does not prescribe Fonterra's strategy, investment plans or pricing decisions. Instead, as outlined in the background section, the Appendix, and the accompanying Cabinet paper, the DIRA aims to mimic the dynamics of a workably competitive market for farmers' milk, by exposing Fonterra to business risks and costs that Fonterra would have faced if it did not have market power. This is achieved through the DIRA open entry and exit requirements that enable farmers to switch their supply to other dairy processors, "voting with their feet" to sanction perceived non-performance by Fonterra.

Fonterra considers that the DIRA open entry and exit requirements impose costs on the co-operative company and constrain its ability to make strategic business decisions. Specifically, Fonterra has argued that the open entry requirement to accept all dairy farmers' applications to become shareholders in Fonterra and supply milk means that Fonterra cannot control volumes and is therefore forced into a supply-driven commodity-focussed business, with risks around sunk costs in excess capacity. MPI's analysis of these issues is outlined in the Appendix.

With the exception of two types of costs/risks (as set out below), MPI considers that the DIRA open entry requirements have not been the primary driver for the above stated outcomes.

2.2 What is the policy problem or opportunity?

Problem 1: unnecessary costs arise from requiring Fonterra to accept milk supply from new dairy conversions

The current regulatory settings impose unnecessary costs on Fonterra.

A key requirement of the DIRA open entry and exit regime is for Fonterra to accept milk supply from all dairy farmers wishing to become shareholders in Fonterra. The DIRA currently does not distinguish between existing and newly converted dairy farmers. Compared to existing dairy farmers, newly converting dairy farmers:

- are better placed to choose which processor they supply, as they do not face any barriers from an existing supply arrangement; and
- create additional forecasting uncertainty of future milk supply for Fonterra, causing it to invest in additional excess capacity.

Although the scale of the problem is likely to be relatively small, given the limited policy rationale for requiring Fonterra to accept supply from new dairy conversions, MPI considers that this requirement represents an unnecessary regulatory impost on Fonterra.

Quantifying the extent of the costs imposed on Fonterra by new conversions is extremely difficult because it cannot be robustly isolated from Fonterra's business-as-usual costs, given Fonterra's existing manufacturing footprint and product mix, highly seasonal variability in milk supply, and Fonterra's business and investment decisions.

In its 2015/16 analysis of the state of competition in the dairy industry, the Commerce Commission concluded that the DIRA open entry and exit provisions do not materially contribute to the milk volume uncertainty that Fonterra manages.

Commercial Sensitivity

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Commercial Sensitivity [redacted]

[redacted]

Problem 2: reputational risk

MPI's analysis also identified that the current drafting of the DIRA open entry requirements creates an unintended consequence. The way the DIRA open entry requirements operate means that Fonterra must accept applications to become shareholders (and accept milk) from new and existing farmer-shareholders who may not meet Fonterra's standards, as set out in Fonterra's terms of supply (including in relation to environmental, climate change, animal welfare, hygiene and health and safety compliance). This creates a reputational risk for Fonterra, its farmer-shareholders and the wider dairy industry, namely that:

- allowing a farmer that would not meet the standards to become a shareholder in the first place sends a message about the types of conduct Fonterra considers acceptable;
- farmer-shareholders whose conduct is unacceptable to Fonterra may have an adverse impact on other shareholding farmers and their reputation, as well as the reputation of Fonterra and the wider dairy industry; and
- dealing with such shareholders requires significant investment of time and effort that Fonterra would prefer to avoid.

Fonterra is using a range of tools available to deal with a farmer-shareholder who fails to comply with its terms of supply. These include financial penalties, requiring a farmer to work with an on-farm consultant, or, in extreme cases, suspending collection of milk. Commercial Sensitivity [redacted]

However, under the current DIRA provisions Fonterra may only take such actions after the farmer is accepted into the co-operative as a shareholder-supplier. Fonterra is not currently in the position to decline an application from new or existing farmers on the basis that the applicant has a record of poor on-farm practice and will likely fail to meet Fonterra's terms of supply.

In addition, there is also a degree of ambiguity as to whether Fonterra could, through its terms of supply, provide positive financial incentives (i.e., pay price premiums) to reward dairy farmers who are performing at or above Fonterra's environmental standards, or provide financial disincentives (i.e., apply price discounts) to dairy farmers whose greenhouse gas emissions performance is at or above Fonterra's determined emissions standards.

Such restriction on Fonterra's discretion does not contribute to the purpose of the DIRA regulatory regime, and represents an unintended consequence, in a form of reputational risk for Fonterra, its farmer-shareholders and the wider dairy industry.

2.3 What do stakeholders think?

MPI's extensive industry consultation process is outlined in the background section of this document. The key industry stakeholders, whose interests are affected by this Regulatory Impact Assessment, include:

- Fonterra as the largest purchaser of farmers' milk in New Zealand;
- existing and future dairy farmers as Fonterra farmer-shareholders and suppliers of milk to Fonterra;
- existing and future dairy farmers supplying independent processors;
- existing and future independent processors as competitors to Fonterra for farmers' milk;
- Federated Farmers as the key industry association representing farming interests; and

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- conservation and environmental stakeholders concerned with the environmental impact of dairying, and animal welfare advocates concerned with animal welfare.

Fonterra's views are reflected above and in the Appendix. Over two-thirds of Fonterra's farmer-shareholders and the Fonterra Shareholders' Council agreed with Fonterra's views. Some Fonterra farmer-shareholders perceived that open entry was undermining Fonterra's co-operative culture by creating an environment where farmer-shareholders were not able to realise the benefits of remaining "loyal". They perceived that "loyal" farmer-shareholders had to bear the costs of Fonterra holding excess processing capacity that resulted from "disloyal" farmer-shareholders leaving the co-operative.

There was very limited engagement from farmers supplying independent processors or those considering converting to dairy in the future. Those who did engage believed that open entry and exit provisions remain important to the dairy industry, particularly in allowing farmers to take up opportunities offered by independent processors.

Established independent processors, while in broad agreement with the costs and risks the DIRA open entry requirements impose on Fonterra, were strongly supportive of retaining open entry and exit provisions. They expressed caution over introducing any amendments that could enable Fonterra to "game" the regime for the purposes of increasing farmers' switching costs, thus foreclosing potential expansion plans by existing, or entry by potential future, independent processors.

Federated Farmers, while noting that some of their members are in favour of the removal of open entry and exit provisions, expressed a concern that their members may not be fully aware of the implications that the removal of open entry could have on their businesses.

Environment Canterbury, Fish and Game, Forest and Bird and Greenpeace expressed concerns that the growth of the dairy industry has led to negative environmental outcomes. These stakeholders contend that the DIRA open entry requirements have been a major driver of dairying expansion, in particular the rise of new conversions in areas that may be considered "environmentally sensitive".

The Royal New Zealand Society for the Prevention of Cruelty to Animals (SPCA) identified a particular concern around the inability of Fonterra to decline an application from a new or existing farmer where that applicant has a record of not meeting animal welfare standards. The SPCA noted that Fonterra has in the past declined milk from existing farmer-shareholders where animal welfare standards have not been met.

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Section 3: Options identification and analysis

3.1 What criteria, in addition to monetary costs and benefits, have been used to assess the likely impacts of the options under consideration?

The options in this Regulatory Impact Assessment have been assessed against the following criteria, which have been given equal weighting:

- *Effectiveness (contribution to policy outcomes sought):* enabling Fonterra to more effectively manage its reputational risk and the costs of building additional processing capacity;
- *Proportionality (the regulatory burden/cost is proportional to the extent of expected benefits):* ensuring that the benefits of enabling Fonterra to more effectively manage its reputational risk and the costs of building additional processing capacity outweigh the negative impact to the overall effectiveness of the DIRA regulatory regime;
- *Regulatory certainty (the regulatory system provides clarity and predictability of outcomes):* ensuring sufficient certainty and predictability of Fonterra's actions for dairy farmers; and
- *Practicality (the implementation risks and unintended consequences are low):* ensuring clarity of legislative provisions and administrative simplicity.

3.2 What options are available to address the problem and how do they perform against the criteria?

Option 1: Repeal the DIRA open entry and non-discrimination requirements

This option would see the DIRA open entry and non-discrimination requirements repealed. Under this option, Fonterra would have the discretion to:

- accept or decline applications by dairy farmers to become shareholders or to increase their existing shareholdings in Fonterra; and
- offer the same or different terms of supply to farmers depending on whether they are new or existing shareholders.

This option would remove the need for Fonterra to manage the costs of open entry. Specifically, Fonterra would no longer need to employ its discretionary tools to send price signals to farmers to attract milk attributes it considers to be of economic value or to discourage production of milk attributes it considers to be of little/no economic value. It could instead impose blunt volume restrictions on new or increasing milk supply.

Under this option, Fonterra would also be able to discriminate between new and existing farmer-shareholders, by offering to buy milk from new farmer-shareholders on less favourable terms. For example, Fonterra, when purchasing New Zealand Dairies Limited (NZDL) when it went into receivership, upon receiving the NZDL farmers' applications, offered to buy milk from the farmers on less favourable terms than other shareholding farmers. The Supreme Court found that the different terms could not be objectively justified. In the absence of the DIRA open entry and non-discrimination requirements, there is an enhanced risk of such asymmetric treatment, which could in turn dissuade farmers from leaving Fonterra in the first place.

Overall, while this option would address the concerns of Fonterra having to hold additional processing capacity and being exposed to reputational risk associated with its suppliers not meeting Fonterra's environmental and other standards, it would significantly weaken the regulatory disciplines on Fonterra's dominance. In particular:

- the removal of farmers' guaranteed ability to supply Fonterra (at all or on terms that are equivalent to Fonterra's existing farmer-shareholders) could have a strong chilling effect on farmers' willingness to exit by switching to supply other dairy processors. This would, in turn, reduce pressure on Fonterra to improve its performance, and prevent other, potentially better performing, dairy processors from entering or expanding their operations; and
- the current DIRA disciplines on Fonterra's benchmark milk price calculation and monitoring provisions and the structural and behavioural obligations around Trading Among Farmers, are designed to provide farmers with transparent information on which to base their switching decisions. Without the DIRA open entry requirements, Fonterra could significantly limit the scope for farmers to act on this transparent information.

This option would also provide less certainty to dairy farmers as to whether Fonterra would or would not accept their milk supply. Fonterra's decisions on whether or not to accept supply would be based on a case-by-case basis and would inherently involve the exercise of discretion. Dairy farmers would not necessarily be able to easily predict the outcome of their application to Fonterra, and therefore know with any degree of certainty whether or not they will be able to supply Fonterra, and if so on what terms.

On the other hand, this option is relatively easy to implement and the risks of unforeseen consequences are low.

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Option 2: Amend the DIRA to allow Fonterra to refuse applications from new and existing farmer-shareholders if their milk supply comes from newly converted dairy farms

Under this option, the DIRA open entry requirements would be amended to provide for a new exception. Fonterra would have the discretion to accept or decline applications from dairy farmers to become shareholders, or to increase their existing shareholdings in Fonterra, when the application was in respect of a new dairy conversion.

'New dairy conversions' would refer to new dairy land that has not been used for dairying in the past five years, and is converted to dairy from, say, the 2020/21 dairy season, onwards. A farm converted to dairy after the 2020/21 implementation date would no longer be considered a new dairy conversion after five years of operation. This would mean that once a farm has been used for dairying for longer than five years (supplying either an independent processor or Fonterra if it had chosen to accept milk from that farm), Fonterra would no longer be able to refuse an application (and milk supply) from that farm.

If Fonterra chose to accept an application from a new or existing farmer-shareholder in respect of a newly converted dairy land, the non-discrimination rule and other DIRA provisions will apply. This will avoid the possibility of creating a class of farmer-shareholders within Fonterra to whom the other provisions of the DIRA open entry and exit did not apply. If Fonterra wanted to accept milk from a newly converted dairy land but on different terms, it could do so by offering the contractual, rather than shareholding, terms of supply.

This option would enable Fonterra to more effectively manage its costs of building new processing capacity, because Fonterra will be able to decline applications from new dairy conversions.

MPI also considers that, in principle, this option would have a minimal negative impact on the overall effectiveness of the DIRA regulatory regime. The primary purpose of the DIRA open entry and exit requirements is to ensure that Fonterra cannot prevent farmers from easily switching processors if they choose to. Compared to existing dairy farmers, newly converted dairy farmers are better placed to choose which processors they supply, as they do not face any barriers from an existing supply arrangement. Commercial Sensitivity [redacted]

In practice, careful drafting of the legislative provisions will be required to minimise the risk of gaming. In addition to developing a tight definition for "new dairy land", it would also be necessary to specify the evidential basis on which Fonterra could decline an application under this exception. As with other DIRA provisions, decisions made by Fonterra in relation to this new exception would be subject to the existing dispute resolution mechanism in the DIRA. An applicant rejected by Fonterra could seek a Commerce Commission determination on Fonterra's decision.

Compared to the status quo, this option would result in less certainty for dairy farmers as to whether Fonterra will or will not accept their milk supply. As with Option 1, Fonterra's decisions on whether or not to accept supply would be based on a case-by-case basis and would inherently involve the exercise of discretion. However, unlike Option 1, this option would provide Fonterra with some bounded rather than open-ended discretion.

Implementation of this option will be challenging, due to drafting complexities and the risk of unintended consequences. It is may also lead to increased enforcement costs incurred by the Commerce Commission, and recovered from Fonterra via a levy. The Commerce Commission estimates the cost of carrying out an investigation at between $60,000 and $300,000, with an indicative timeframe of up to 12 months, depending on complexity. MPI does not consider that the actual number of disputes taken to the Commission would be high, given that Fonterra would need to have good reason (i.e. evidence) to refuse applications to become shareholders (and to supply milk) from new and existing farmer-shareholders.

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This option was not included in the options set that MPI has formally consulted on during this policy development process. However, several stakeholders (including: Fonterra, Westland Milk Products, Danone, Fonterra's Shareholders Council and Federated Farmers) suggested exploring this option, particularly because it was considered, and assessed, in the context of the previous DIRA review, undertaken in 2016. MPI's 2016 Regulatory Impact Assessment, which included the consideration of this option is available at: https://www.mpi.govt.nz/law-and-policy/legal-overviews/regulatory-impact-statements/.

Option 3: Amend the DIRA to allow Fonterra to refuse applications from new and existing farmer-shareholders if their milk supply is unlikely to comply with Fonterra's terms of supply

Under this option, the current DIRA open entry requirements would be amended to provide for another new exception. Fonterra would be able to reject an application to become a shareholder, or an application from an existing shareholder to supply, if Fonterra believed that the applicant was unlikely to comply with its terms of supply. This would avoid a situation where Fonterra had to accept a new shareholder into the co-operative and then had to manage non-compliance with Fonterra's standards, as set out in Fonterra's terms of supply.

Fonterra would continue to be required to not discriminate in its terms of supply between a new entrant and a shareholding farmer in the same circumstances.

To provide further clarity and certainty about the scope of Fonterra's ability to set various performance standards for farmers in its terms of supply, this option would provide for a further amendment. The amendment would set out the types of standards Fonterra could include in its terms of supply, making it explicit, for example, that Fonterra's terms of supply can relate to, and price differentiate on, matters such as environmental (including climate change) impact of the production of milk, health and safety, animal welfare, or hygiene.

This option would enable Fonterra to manage known instances of poor environmental performance, greenhouse gas emissions, animal welfare or product quality issues, to safeguard its and the wider dairy industry's reputation. It would also ensure that Fonterra was operating on a level playing field with other dairy processors and reinforce the good environmental practice that Fonterra could be seeking to promote.

While, in principle, a new exception of this type should have no impact on the overall effectiveness of the DIRA regulatory regime, in practice, careful drafting of the legislative provision will be required to minimise the risk of gaming by Fonterra. The DIRA would therefore need to specify the evidential basis on which Fonterra could decline an application under this exception. Furthermore, decisions made by Fonterra in relation to the new exception would be subject to the existing dispute resolution mechanism in the DIRA. An applicant rejected by Fonterra could seek a Commerce Commission determination on Fonterra's decision.

This option could result in less certainty for dairy farmers as to whether Fonterra would or would not accept their milk supply. As with Option 1, Fonterra's decisions on whether or not to accept supply would be based on a case-by-case basis and would inherently involve the exercise of discretion. However, unlike Option 1, this option would see Fonterra clearly specify its environmental and other standards in its terms of supply, and the DIRA would provide for the standard of evidence that Fonterra would need to have to decline milk under this new exception. These would be available to farmers ahead of their application to Fonterra and could provide a reasonable indication as to the likelihood of their acceptance into Fonterra.

Implementation of this option may lead to increased enforcement costs incurred by the Commerce Commission, and recovered from Fonterra via a levy. The Commerce Commission estimates the cost of carrying out an investigation at between $60,000 and $300,000, with an indicative timeframe of up to 12 months, depending on complexity. MPI does not consider that the number of disputes would be high, given that Fonterra would need to have good reason (i.e. evidence) to refuse milk supply.

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3.3 What other options have been ruled out of scope, or not considered, and why?

MPI did not consider and/or discard any other substantive options to address the problems identified in this Regulatory Impact Assessment.

Frontier Economics, in its report to MPI on potential market failures and remedies, suggested an additional condition to be included in Option 2. The suggestion was to allow Fonterra to refuse milk generated from new conversions, if substantial new (and uneconomic) investments would need to be made in order to accommodate that additional milk supply. MPI considers that a verification process likely to be required to implement the suggested addition to Option 2 would impose disproportionate regulatory compliance costs on Fonterra compared to the extent of additional benefits that would be achieved. This is due to significant difficulties and information asymmetries in isolating the impact of milk supplied from new conversions (as opposed to existing dairy farms) on Fonterra's amount and quality of new capacity investments. For this reason the suggested addition to Option 2 was not considered further.

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Section 4: Impact Analysis

Criterion/Options	No action: Retain existing provisions	Option 1: Repeal the DIRA open entry and non-discrimination requirements	Option 2: Amend the DIRA to provide for an exception to open entry in respect of new dairy conversions	Option 3: Amend the DIRA to provide for an exception to open entry in respect of anticipated non-compliance with Fonterra's terms of supply
Effectiveness - enabling Fonterra to more effectively manage its reputational risk and costs of building additional processing capacity	**0** Imposes unnecessary costs and reputational risks on Fonterra	**++** Removes the need for Fonterra to manage the costs of open entry	**++** Provides Fonterra with an additional tool to manage its costs of additional processing capacity	**++** Provides Fonterra with an additional tool to manage its reputational risk
Proportionality - ensuring that benefits of enabling Fonterra to more effectively manage its reputation risk and costs of building additional processing capacity outweigh the negative impacts to the overall effectiveness of the DIRA regulatory regime	**0** Prevents Fonterra from more effectively managing its costs of building additional processing capacity and reputational risk	**- -** Substantially weakens the effectiveness of the regulatory discipline on Fonterra	**0** Creates no impact on the effectiveness of the regulatory discipline on Fonterra (if well implemented)	**0** Creates no impact on the effectiveness of the regulatory discipline on Fonterra (if well implemented)
Regulatory certainty - ensuring sufficient certainty and predictability of Fonterra's actions for dairy farmers	**0** Provides sufficient certainty and predictability of Fonterra's actions	**- -** Creates significant uncertainty for all dairy farmers	**- / 0** Creates some uncertainty for farmers considering converting to dairy	**-** Creates some uncertainty for all dairy farmers
Practicality - ensuring clarity of legislative provisions and administrative simplicity.	**0** Provides simple and clear-cut legislative provisions	**0** Provides for simple and clear-cut legislative provisions	**-** Relies on complex legal definitions, creates opportunities for gaming by Fonterra, and may give rise to potential disputes	**- / 0** Creates an opportunity for gaming by Fonterra, and may give rise to potential disputes
Overall assessment	**0 - not preferred**	**- - not preferred**	**+ preferred**	**+ preferred**

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Section 5: Conclusions

5.1 What option, or combination of options, is likely best to address the problem, meet the policy objectives and deliver the highest net benefits?

MPI's recommended approach is to amend the DIRA by introducing two new exceptions to Fonterra's obligation to accept milk from new and existing farmer-shareholders (Options 2 and 3).

MPI considers that the proposal to allow Fonterra to refuse milk supply offers from new and existing farmer-shareholders if the milk is produced on newly converted dairy farms would enable Fonterra to more effectively manage its costs of building new processing capacity, while having a minimal impact on the overall effectiveness of the DIRA regulatory regime. MPI also considers that this would not affect the relative efficiency of future land use changes (e.g., potential future dairy conversions) as Fonterra would continue to be incentivised to accept milk supply offers from farms, where it is commercially efficient for it to do so.

Similarly, the proposal to allow Fonterra to refuse milk supply offers from new and existing farmers-shareholders, who are unlikely to comply with Fonterra's terms of supply, would enable Fonterra to more effectively manage its (and the wider industry's) reputational risks, while having no impact on the overall effectiveness of the DIRA regulatory regime.

Both proposed exceptions carry implementation risks associated with complex legal drafting, creating opportunities for gaming by Fonterra and giving rise to potential disputes. The costs of resolving any such disputes will be incurred by the Commerce Commission, and recovered from Fonterra via a levy.

Both exceptions also reduce regulatory certainty for dairy farmers. Fonterra's decisions on whether or not to accept supply, under the proposed arrangements, would be based on a case-by-case basis and would inherently involve the exercise of discretion.

Despite the additional administrative complexity, MPI considers that the proposed new exceptions provide a good balance of reducing costs and unintended consequences of the DIRA open entry requirements for Fonterra, while ensuring minimal impact on the overall effectiveness of the regulatory discipline on Fonterra.

Careful drafting of the legislative provisions will be required to minimise the risk of gaming. In addition to developing a tight definition for "new dairy land", the legislation would also specify the evidential basis on which Fonterra could decline an application under the new exceptions.

Most dairy industry stakeholders were supportive of Option 3, provided that the implementation risks can be effectively managed. MPI did not formally consult on Option 2 during this policy development process. However, several stakeholders (including: Fonterra, Westland Milk Products, Danone, Fonterra's Shareholders Council and Federated Farmers) suggested exploring this option, particularly because it was consulted on during MPI's 2016 DIRA review process (the relevant Regulatory Impact Assessment is available at: https://www.mpi.govt.nz/law-and-policy/legal-overviews/regulatory-impact-statements/. As with Option 3, most stakeholders were supportive of introducing a "new dairy conversions" exception, provided that the implementation risks can be effectively managed.

Fonterra is supportive of the proposed two new exceptions being provided for in the DIRA, as its third preference. With regard to the "new dairy conversions" exception, Fonterra is also seeking an ability to apply discriminatory terms to milk supply that it may choose to accept from a new dairy conversion. MPI considers that this would create a class of farmer-shareholders within Fonterra to whom the other provisions of the DIRA open entry and exit did not apply, impacting more negatively on the effectiveness of the overall DIRA regulatory regime. MPI further considers that, if Fonterra wanted to accept milk from a newly converted dairy land on terms that are different to its standard shareholding terms of supply, it could do so by entering into contractual, rather than shareholding, arrangements with a new conversion. Fonterra's contract, rather than shareholding, milk supply arrangements are not regulated by the DIRA.

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Fonterra's first preference is the full repeal of the DIRA open entry and non-discrimination provisions under Option 1. As outlined above MPI considers that this option would substantially weaken the effectiveness of the regulatory discipline on Fonterra. Fonterra's second preference is the automatic expiry of the DIRA open entry, non-discrimination (and open exit) requirements on a regional basis when Fonterra's market share in a region falls below 75 percent. As outlined in the accompanying Regulatory Impact Assessment #5, MPI considers that this option provides for a very blunt instrument, which does not respond well to complex industry dynamics.

5.2 Summary table of costs and benefits of the preferred approach

Affected parties	Comment	Impact	Evidence certainty
Additional costs of proposed approach, compared to taking no action			
Regulated parties: • Fonterra	**Monetised costs:** • **No direct costs**: - the proposals seek to remove unnecessary costs and risk currently imposed on Fonterra. • **Indirect costs:** - greater scope for disputes that could be taken to the Commerce Commission for adjudication, the costs of which are recovered from Fonterra via a levy.	**Low** \$60,000 - \$300,000 per dispute, depending on complexity. The actual number of disputes taken to the Commission is not expected to be high, as Fonterra would need to have a good reason (i.e., evidence) to decline an application.	**Medium**
	Non-monetised costs: • Additional management time and effort to make discretionary decisions within set legal parameters	**Low** Making discretionary decisions is a core management expertise.	**High**
Other affected parties: • Newly converting and existing dairy farmers	**Monetised costs:** • **Not available** – the costs will depend on Fonterra's commercial decisions, which will be made on a case by case basis.		
	Non-monetised costs: • Increased uncertainty for new and existing dairy farmers over Fonterra's acceptance of their milk supply.	**Low** May deter some farmers from applying to become shareholders in, and supplying milk to Fonterra.	**Medium**
Other affected parties: • Independent processors	**Monetised costs:** • **Not available** – the costs will depend on Fonterra's discretionary decisions and compliance with set legal parameters.		

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	Non-monetised costs: • Greater scope for gaming by Fonterra, which may deter some farmer-switching to independent processors	**Low** Additional scope for gaming will be managed by tight legal definitions.	**Low**
Regulator: • Commerce Commission	**Monetised costs:** • Greater scope for additional disputes being taken to the Commission for adjudication	**Medium** $60,000 - $300,000 per dispute, depending on complexity.	**Medium**
	Non-monetised costs: • Resources diverted away from the Commission's other activities	**Low** Additional resources are likely to be employed rather than existing resources being re-prioritised.	**Medium**
Total monetised costs	as per above	**Low - Medium** $60,000 - $300,000 per dispute, depending on complexity.	**Medium**
Total non-monetised costs	as per above	**Low**	**Medium**

Affected parties	Comment	Impact	Evidence certainty
Expected benefits of proposed approach, compared to taking no action			
Regulated parties: • Fonterra	**Monetised benefits:** • Potential savings from not having to build additional processing capacity.	**Low** Commercial Sensitivity	**Low**
	Non-monetised benefits: • Ability to more effectively manage its (and the wider industry's) reputational risk	**High** Global consumers are increasingly seeking assurance about NZ-wide on-farm performance.	**High**
Other affected parties: • New and existing dairy farmers	**Monetised benefits:** • Not applicable		
	Non-monetised benefits:	**High**	**High**

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	• Reduced reputational risk for the dairy industry	Global consumers are increasingly seeking assurance about NZ-wide on-farm performance.	
Other affected parties: • Independent processors	**Monetised benefits:** • Not applicable		
	Non-monetised benefits: • Reduced reputational risk for the dairy industry	**High** Global consumers are increasingly seeking assurance about NZ-wide on-farm performance.	**High**
Total monetised benefits	as per above	**Low** Commercial Sensitivity	**Low**
Total non-monetised benefits	as per above	**High**	**High**

5.3 Is the preferred approach compatible with the Government's 'Expectations for the design of regulatory systems'?

MPI's preferred combination of options is aligned with the guidance provided in *Government Expectations for Good Regulatory Practice* (April 2017).

Section 6: Implementation and operation

6. 1 How will the new arrangements be implemented?

A legislative amendment is required to introduce the proposed two new exceptions to Fonterra's obligation to accept milk from new and existing farmer-shareholders. It is expected that the Dairy Industry Restructuring Amendment Bill will be introduced and progressed through the Parliamentary processes in 2019, with enactment expected to take place in early 2020.

Transitional arrangements will be required to provide both Fonterra and dairy farmers with sufficient time to adjust their operations. It is expected that the proposed new exceptions will come into effect at the start of the dairy season following the season in which the legislative amendment is passed. That is, if the legislative amendment is passed in early 2020, the new conversions exception will come into effect from 1 June 2021.

As with the existing exceptions, it will be up to Fonterra to consider applications from farmers and determine, in the first instance, whether or not they fall within the scope of the legislative exceptions. As part of this process, Fonterra would need to develop, and may choose to consult its farmer-shareholders on, an internal company policy on how it intends to exercise its discretion under the proposed new exceptions to its obligation to accept milk from new and existing farmer-shareholders.

The Commerce Commission will continue to operate in its current role of being the enforcement agency for any disputes that may arise in relation to all DIRA provisions, including the two new exceptions proposed in this Regulatory Impact Assessment.

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6.2 What are the implementation risks?

The key implementation risk with the proposed new exceptions is the legal drafting challenge to ensure that the scope of the legal definitions is tight enough to minimise the risk of gaming by Fonterra.

This risk will be mitigated by MPI working closely with the Parliamentary Counsel Office to achieve as precise and clear definitions as possible. MPI will be testing draft definitions with other government agencies and in particular the Commerce Commission as the enforcement agency. Finally, other stakeholders and affected parties, including Fonterra, will provide further testing during the Select Committee process.

In addition, the legislation would specify the evidential basis on which Fonterra could decline an application under the proposed new exceptions.

The existing non-discrimination provisions will continue to apply to safeguard against potential gaming by Fonterra.

The Commerce Commission will continue to operate in its current role of being the enforcement agency for disputes arising in relation to all DIRA provisions, including the two new exceptions proposed in this Regulatory Impact Assessment.

These mitigation strategies are expected to ensure that the proposed new exceptions to open entry are workable and the risk of unintended consequences is minimised.

Section 7: Monitoring, evaluation and review

7. 1 How will the impact of the new arrangements be monitored?

The Government, through the Commerce Commission, will have access to information related to complaints or disputes arising from Fonterra's application of the new arrangements. The number of, and the costs associated with, these complains or disputes will be reviewed on an annual basis through the Fonterra Levy setting process. This annual levy setting process provides an opportunity to consider the effectiveness of the proposed arrangements.

Fonterra is best placed to collect information and monitor the impact of the proposed new exceptions on its business. It is also incentivised to bring any issues with workability of the new arrangements to the Government's attention, as it does now in regard to the existing DIRA provisions.

7.2 When and how will the new arrangements be reviewed?

The accompanying proposal to introduce a statutory requirement for periodic reviews of the DIRA regulatory regime (as per Regulatory Impact Assessment #5) provides an opportunity to evaluate and review the effectiveness and other impacts of the entire DIRA regulatory regime, including the proposals in this Regulatory Impact Assessment. The proposal is for the next review to take place during the 2024/25 dairy season, following standard regulatory review processes.

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Coversheet #2: Obligation to calculate a benchmark milk price

Advising agencies	*Ministry for Primary Industries*
Decision sought	*Approval to amend the Dairy Industry Restructuring Act 2001 to introduce an additional mandatory assumption to underpin Fonterra's benchmark price calculation. This amendment will reduce Fonterra's discretion and improve the certainty and robustness of Fonterra's benchmark price calculation.*
Proposing Ministers	*Hon Damien O'Connor, Minister of Agriculture*

Summary: Problem and Proposed Approach

What problem or opportunity does this proposal seek to address? Why is government intervention required?

There is an opportunity to improve the certainty and robustness of Fonterra's benchmark price calculation.

The benchmark price is a key input into the price Fonterra pays dairy farmers for milk. Fonterra's price is, in turn, a key industry metric that drives both Fonterra's and other dairy processors' profitability and performance.

The DIRA provides for a methodology to calculate the benchmark price but leaves Fonterra with a wide discretion to decide on the key assumptions, and other inputs, that underpin the calculation. While this ensures that the regulatory compliance costs and risk of regulatory error are low, and the benchmark price can respond quickly to changing market dynamics, it also creates a degree of uncertainty and, given Fonterra's inherent incentives to maximise the price, raises questions about the robustness of Fonterra's assumptions. The DIRA relies on a light-handed qualitative monitoring regime by the Commerce Commission (the Commission) to identify potential issues with Fonterra's discretionary decisions.

The Commission has to date been satisfied with all but one of Fonterra's assumptions. In 2017/18, the Commission identified that Fonterra's approach to estimating risk in calculating the cost of financing milk processing operations (measured by asset beta) results in a too low risk estimate. This leads to a higher benchmark price, and could impose higher than efficient costs on, and lead to reduced profitability of, new and existing dairy processors (including Fonterra itself).

The Commission's extensive consideration of Fonterra's asset beta assumption provides an opportunity to reduce Fonterra discretion and improve the certainty and robustness of Fonterra's benchmark price calculation, which in turn affects Fonterra's and other dairy processors' profitability and performance.

How will government intervention work to bring about the desired change? How is this the best option?

MPI recommends amending the DIRA to embed the Commission's approach to setting the asset beta assumption as a mandatory requirement for Fonterra to rely on in its benchmark price calculation. This would reduce the risk of Fonterra using its discretion in a way that imposes higher than efficient costs on new and existing dairy processors (including Fonterra).

The proposed amendment addresses the specific issue identified by the monitoring regime, without introducing significant regulatory compliance costs, risks of regulatory error, or reducing the much needed flexibility to ensure that the benchmark price calculation can respond to future changes in industry dynamic.

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Summary Impacts: Benefits and costs

Who are the main expected beneficiaries and what is the nature of the expected benefit?

Improved certainty and robustness of the benchmark price calculation would benefit dairy farmers and processors in New Zealand. The benchmark price is intended to be used by Fonterra (and can be used by other dairy processors) as a reference point for setting the farmgate milk price. Its main purpose is to provide dairy farmers with a robust benchmark against which to assess Fonterra's (and other dairy processors') farmgate milk price offers. The more certain and reliable the benchmark price is, the more informed and transparent the assessment of Fonterra's and other dairy processors' farmgate milk price offers are likely to be.

The benchmark price is also a key driver of Fonterra's and other dairy processors' profitability and performance. The proposed approach would reduce Fonterra's discretionary ability to calculate a benchmark price that may impose higher than efficient costs on new and existing dairy processors (including Fonterra). This could improve dairy processors' (including Fonterra's) profitability and provide higher returns to their shareholders (including dairy farmers as shareholders in Fonterra). The magnitude of these impacts cannot however be quantified, as it would depend on the level of the chosen asset beta assumption, which is not proposed to be prescribed in legislation.

Where do the costs fall?

The proposed amendment would impose a one-off regulatory compliance cost on Fonterra for having to correct its calculation. MPI considers that the cost will be minimal.

The potential of the proposed correction to improve dairy processors' (including Fonterra's) profitability could come at a cost of reduced revenues for dairy farmers, as milk suppliers. The magnitude of these impacts cannot however be quantified, as it will depend on the level of the chosen asset beta assumption, which is not proposed to be prescribed in legislation. Given the Commerce Commission's extensive consideration of the issue, MPI considers that the risk of regulatory error in the proposed correction is low.

What are the likely risks and unintended impacts, how significant are they and how will they be minimised or mitigated?

Given the very targeted scope of the proposed amendment, no significant implementation risks or unintended impacts are foreseen.

The challenge of legislative drafting will be mitigated by MPI working closely with the Parliamentary Counsel Office to achieve as precise and clear provisions as possible. MPI will be testing draft provisions with other government agencies and in particular the Commerce Commission as the monitoring agency. Finally, other stakeholders and affected parties, including Fonterra and independent dairy processors, will provide further testing during the Select Committee process.

Identify any significant incompatibility with the Government's 'Expectations for the design of regulatory systems'.

MPI's proposed approach is aligned with the guidance provided in Government Expectations for Good Regulatory Practice (April 2017).

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Evidence certainty and quality assurance

Agency rating of evidence certainty

MPI considers there is an adequate evidence base for the proposed amendments.

Concerns about Fonterra's asset beta assumption in the benchmark price calculation have been highlighted by the Commission's monitoring of Fonterra's assumptions, inputs and processes that underpin the calculation. In reaching its conclusion, the Commission considered all the evidence available, commissioned additional expert advice, considered submissions and cross-submissions from Fonterra and other dairy processors, and applied its judgment to weigh all the information and evidence. MPI considers that this provides sufficient confidence in the analysis, conclusions, and the evidential basis for the proposed amendment.

MPI's policy development process commenced in May 2018, following the Government's release of the terms of reference for the review of the Dairy Industry Restructuring Act 2001 and its impact on the dairy industry. MPI engaged with a large and diverse group of key industry stakeholders to help clarify concerns, establish facts and build evidence to inform preliminary analysis of issues and options for potential legislative amendments. MPI completed 28 engagement meetings and received written input from 12 organisations. MPI have also commissioned two reports from an independent economic consultancy, Frontier Economics, on the performance of New Zealand dairy industry and its underlying drivers. The industry input and consultancy reports can be found at http://www.mpi.govt.nz/dira-review.

In November 2018, a discussion document, outlining issues and options for change, was approved for public consultation by Cabinet [CAB-18-MIN-0528 refers]. Comprehensive consultation was conducted for 14 weeks, closing on 8 February 2019. It involved 13 town hall meetings (attended by 401 dairy farmers), 22 face-to-face industry meetings and workshops, and was supported by extensive communications to the sector via traditional and social media.

The final proposals take account of stakeholder feedback.

Quality Assurance Reviewing Agency:
The Regulatory Impact Assessment has been reviewed by a quality assurance panel with representatives from the Regulatory Quality Team at the Treasury and the Ministry for Primary Industries.
Quality Assurance Assessment:
While presented in a complex manner, the panel considers that the Regulatory Impact Assessment meets the quality assurance criteria.
Reviewer Comments and Recommendations:
There are risks and costs associated with the proposed amendment to Fonterra's benchmark price calculation, but they are likely to be small relative to the benefits. This view is supported by the Commerce Commission's extensive consideration of the issue.

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Impact Statement #2: Obligation to calculate a benchmark milk price

Section 1: General information

Purpose

The Ministry for Primary Industries is solely responsible for the analysis and advice set out in this Regulatory Impact Statement, except as otherwise explicitly indicated. This analysis and advice has been produced for the purpose of informing key policy decisions to be taken by Cabinet.

Key Limitations or Constraints on Analysis

Scope

The policy development process that underpins the recommendations in this Regulatory Impact Assessment is focused on the changes to the current DIRA regulatory regime. While MPI's policy review of the DIRA and its impact on the dairy industry required broader contextual consideration of the dairy industry's performance and its underlying drivers, the scope for regulatory changes is limited to the current DIRA regime. As a result, the proposed regulatory changes take account of, but do not seek to directly affect the dairy industry's performance arising from (among other things):

- Fonterra's ownership model and business strategy;
- trade and market access rules; and
- environmental regulation.

The options considered in this Regulatory Impact Assessment were developed in the context of the DIRA's objective of promoting contestable (rather than competitive) market outcomes. The DIRA promotes the efficient operation of New Zealand dairy markets through ensuring that entry by dairy processors is not precluded (subject to a particular level of efficiency of entrants), while also ensuring that Fonterra is incentivised to be more productively efficient even if efficient entry has not occurred. This is different from promoting actual new entry to increase competition for farmers' milk. The contestability standard relies on the threat of entry, rather than the actual entry, to moderate Fonterra's behaviours. As a result, options designed to increase actual new entry by dairy processors were not considered.

Assumptions

The proposed legislative amendment could be unnecessary should Fonterra decide to voluntarily adopt the Commerce Commission's approach. What Fonterra may or may not do voluntarily is unclear at this stage. The proposed amendment is an opportunity to ensure that Fonterra does correct its approach and reduce Fonterra's discretion to change its approach in the future.

Responsible Manager

Emma Taylor

Director of Agriculture, Marine and Plant Policy,

Policy and Trade Branch

Ministry for Primary Industries

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Section 2: Problem definition and objectives

2.1 What is the context within which action is proposed?

The price Fonterra pays dairy farmers for milk (Fonterra's farmgate milk price) is a key industry metric that drives both Fonterra's and independent processors' profitability.

Fonterra's dominance means that Fonterra's farmgate milk price effectively sets the market price that all dairy processors in New Zealand have to match or better to attract and maintain milk supply from farmers. If Fonterra's farmgate milk price is "too high" it could incentivise inefficiently high milk production volumes by farmers, impose higher costs on existing dairy processors (including Fonterra), and act as a barrier to entry for more efficient competitors. If Fonterra's farmgate milk price is "too low" it could incentivise inefficiently low milk production volumes by farmers, reduce incentives for existing dairy processors (including Fonterra) to improve cost efficiencies in processing, and encourage entry by less efficient competitors.

The DIRA does not regulate the price Fonterra pays farmers for milk. When the regulatory regime was designed, there was a deliberate policy choice to avoid direct price regulation. Price regulation imposes significant regulatory costs and carries risks of distorting business and investment decisions, due to asymmetric information available to the regulator. Instead, through the open entry and exit requirements, the DIRA aims to incentivise Fonterra to pay an efficient (not "too high" and not "too low") farmgate milk price.[2]

To supplement (rather than supplant) the discipline imposed by the open entry and exit requirements (as the alternative to direct price regulation), and to promote the transparency of Fonterra's farmgate milk price-setting processes, the DIRA requires Fonterra to calculate and publish a base milk price (benchmark price). The benchmark price is intended to be used by Fonterra (and can be used by other dairy processors) as a reference point for setting the farmgate milk price. Its main purpose is to provide dairy farmers with a robust benchmark against which to assess Fonterra's farmgate milk price.

In the absence of a competitive market, the benchmark price can only be determined using an administrative methodology. Given the key role the benchmark price plays in Fonterra's (and other dairy processors') farmgate milk pricing decisions, its calculation needs to be based on a robust methodology and credible assumptions and inputs.

The methodology for deriving the benchmark price is set out in the DIRA and reflects the aim of the DIRA to ensure contestability of (rather than actual competition for) farmers' milk. That is, the methodology aims to ensure that the benchmark price is:

- high enough to incentivise Fonterra to strive to improve cost efficiencies, even in the absence of actual competition ("efficiency component"); but
- low enough to be practically feasible for an efficient competitor to enter and compete for farmers' milk ("contestability component").[3]

The DIRA provides for some mandatory assumptions to underpin Fonterra's benchmark price calculation, but generally allows Fonterra to exercise wide discretion in making what are very technical and necessarily subjective input decisions.

Fonterra's exercise of discretion is monitored and publicly commented on by the Commerce Commission. To avoid the risk of regulatory error arising from asymmetric information, the Commerce Commission's findings are not binding on Fonterra's benchmark price calculation. Instead, they are designed to provide an informed public commentary by a credible and independent expert, with access to commercially sensitive information, to promote transparency of Fonterra's necessarily subjective assumptions that underpin the benchmark price calculation. The potential for

[2] If Fonterra's farmgate milk price were "too high" it would receive more milk than would be economical for it to process. If Fonterra's farmgate milk price were "too low" it would risk losing supply and having its assets stranded.

[3] The DIRA promotes the efficient operation of New Zealand dairy markets through ensuring that entry by dairy processors is not precluded, subject to a particular level of efficiency of entrants. This is different to promoting actual new entry to ensure increased competition. The contestability standard relies on the threat of entry, rather than the actual entry, to moderate Fonterra's behaviours.

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adverse Commerce Commission findings may provide an additional incentive for Fonterra to adopt robust assumptions for its benchmark price calculation.

In line with this transparency objective, the DIRA also contains some governance and high-level information disclosure requirements. These include a requirement for Fonterra to maintain an internal committee of the Fonterra Board (the milk price panel) to oversee the benchmark price calculation and make recommendations to the Fonterra Board on the benchmark price. The DIRA requires the majority of panel members, including the Chair, to be independent of any supplier relationship with Fonterra. Fonterra is also required to publish its milk price manual, the milk price panel's recommendations to the Fonterra Board, and the Fonterra Board's reasons for deviating from the milk price panel's recommendations.

2.2 What is the policy problem or opportunity?

There is an opportunity to improve robustness of a key assumption underpinning Fonterra's benchmark price calculation, without imposing additional regulatory compliance costs or creating risks of regulatory error.

While Fonterra generally has a wide discretion to determine the key assumptions that underpin its benchmark price calculation, some assumptions are prescribed in the DIRA and must be used by Fonterra. The purpose of the mandatory assumptions is to set boundaries within which Fonterra must calculate the benchmark price, thus providing a degree of certainty and robustness of the benchmark price calculation outcomes.

The current mandatory assumptions primarily support the "efficiency component" of the benchmark price calculation. There are no such mandatory assumptions underpinning the "contestability component". The lack of "contestability" assumptions reflects the inherent difficulties in anticipating what industry practices and technologies may be practically feasible in the future. Providing Fonterra with unbounded discretion allows for the benchmark price to respond to changing market dynamics. However, it also creates a degree of uncertainty and may limit the robustness of the benchmark price.

Since the introduction of the benchmark price provisions in 2012, the Commerce Commission (the Commission) has conducted numerous reviews and worked through and assessed a large volume of submissions and expert opinions on each of the assumptions, inputs and processes that underpin Fonterra's benchmark price calculation. The Commission has to date been satisfied with all but one of Fonterra's key "contestability" assumptions.[4]

In its most recent 2017/18 review, the Commission concluded that, while Fonterra's benchmark price is "largely consistent" with both the efficiency and contestability components of the calculation, Fonterra's estimate of risk in calculating the cost of financing milk processing operations (measured by asset beta) is too low, and therefore unlikely to be "practically feasible". Fonterra's current asset beta assumption relies on the electricity distribution businesses as the proxy for estimating the asset beta in the benchmark price calculation and leads to a higher benchmark price. The Commission concluded that other dairy and commodity processors are better comparators for the purposes of the benchmark price calculation. Fonterra's current approach leads to a higher benchmark price, and could impose higher than efficient costs on, and reduced profitability of, new and existing dairy processors (including Fonterra itself).

Estimating asset beta with reliability and confidence is inherently difficult, and there are differing views between dairy processors and the various experts on the most appropriate approach and level of asset beta. In reaching its conclusion, the Commission considered all the evidence available, commissioned additional expert advice, considered submissions and cross-submissions from Fonterra and other dairy processors, and applied its judgment to weigh all the information and evidence.

[4] The Commerce Commission is currently subject to judicial review proceedings, filed by Open Country Dairy, in respect of the Commission's review of Fonterra's 2017/18 base milk price calculation.

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Given the Commission's extensive consideration of the issue, MPI considers that the risk of regulatory error, in this particular instance, is low. This, in turn, provides an opportunity to embed a more robust assumption in legislation, thus limiting Fonterra's ability to impose higher than efficient costs on new and existing dairy processors (including Fonterra).

2.3 What do stakeholders think?

MPI's extensive industry consultation process is outlined in the background section of this document. The key industry stakeholders, whose interests are affected by this Regulatory Impact Assessment, include:

- Fonterra as the largest purchaser of farmers' milk in New Zealand;
- Fonterra farmers as suppliers of milk to, and shareholders of, Fonterra;
- farmers supplying independent processors;
- independent processors as competitors to Fonterra for farmers' milk; and
- industry associations representing farmers' interests.

Fonterra and its farmer-shareholders (84 percent of those who commented on this provision) were strongly supportive of the existing DIRA provisions for the benchmark price calculation. Fonterra considered that the existing calculation works well, and provides its farmer-shareholders with the necessary degree of transparency. Fonterra farmer-shareholders believe that the benchmark price calculation provides sufficient transparency and accountability, and allows them to exert pressure on Fonterra's management with regard to performance.

There was very limited engagement from farmers supplying independent processors. Those who did engage considered that the current benchmark price calculation is an adequate transparency mechanism that informs their consideration of the independent processors' farmgate milk price offers.

Most independent processors (including Open Country Dairy, Synlait, Miraka, Westland, Mataura Valley Milk, and Danone) expressed significant concerns with the DIRA provisions for the benchmark price calculation. They contend that the methodology for calculating the benchmark price is flawed and should be based on a competition rather than a contestability standard; the process of calculating the base milk price lacks transparency; and that Fonterra is able to manipulate the benchmark price to its advantage. These stakeholders perceive the relevant DIRA provisions as ineffective in constraining Fonterra's ability and incentive to calculate a benchmark price that is "too high", and that this results in reduced profitability of both Fonterra and other dairy processors.

Some independent processors (particularly Open Country Dairy and Synlait) have expressed additional concerns about their inability to access some of the more detailed assumptions and inputs in Fonterra's benchmark price calculation, making it difficult for independent processors to accurately forecast where the market price for milk will land. These concerns arise from the relatively high-level nature of Fonterra's public disclosure of its assumptions and is associated with the dairy industry's self-imposed ex-post pricing system. MPI understands that Fonterra aims to improve its public disclosure, but is naturally constrained by commercial sensitivity of some of its assumptions, particularly those that reflect Fonterra's actual performance.

Two independent processors, Tatua and Organic Dairy Hub view the current benchmark milk price calculation provisions as sufficient for their intended purpose. Tatua stated that the cost of producing the benchmark price forecast must be balanced with the reality that it is only one indicator of future performance. Tatua also noted that, while Fonterra's size means that most (if not all) independent processors chose to reference their milk price to Fonterra's calculated benchmark price, there is no requirement for this practice.

Federated Farmers submitted that a light-handed approach to the benchmark price calculation remains appropriate, particularly as Fonterra's market dominance continues to decline.

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On a separate but related matter, Fonterra expressed a view that the DIRA provisions prevent Fonterra from paying a farmgate milk price that deviates from the calculated benchmark price. Fonterra's interpretation of the DIRA provisions is contrary to the original policy intent and results in Fonterra's inability to proactively and strategically manage its milk supply volumes through prices that reflect Fonterra's desired strategic direction. Notably, Fonterra is not seeking an ability to deviate from the benchmark price for commercial or strategic reasons. Rather, Fonterra submits that the misalignment between its milk supply volumes and the co-operative's desired strategic direction is best addressed by repealing open entry. As outlined in the accompanying *Regulatory Impact Assessment #1: Obligation to accept all milk from new and existing farmer-shareholders*, this would be undesirable. Instead, MPI considers that any doubt over the intended policy distinction between the benchmark price and Fonterra's farmgate milk price should be removed, and will recommend a technical "avoidance of doubt" provision, explicitly providing for Fonterra to pay a farmgate milk price that is different from the calculated benchmark price, to be included in the upcoming legislative amendment.

Section 3: Options identification and analysis

3.1 What criteria, in addition to monetary costs and benefits, have been used to assess the likely impacts of the options under consideration?

The options in this Regulatory Impact Assessment have been assessed against the following criteria, which have been given equal weighting:

- *Effectiveness (contribution to policy outcomes sought):* improving certainty and robustness of the assumptions underpinning the benchmark price calculation;
- *Proportionality (the regulatory burden/cost is proportional to the extent of expected benefits):* ensuring that the benefits of improved certainty and reliability of the assumptions underpinning the benchmark price calculation outweigh the associated regulatory compliance costs and risk of regulatory error; and
- *Durability (the regulatory system is able to evolve in a timely manner in response to changing circumstances):* maintaining sufficient flexibility for the benchmark price calculations to respond to changes in industry dynamics over time.

3.2 What options are available to address the problem and how do they perform against the assessment criteria?

Option 1: Amend the DIRA to reduce Fonterra's discretion in setting a key assumption (asset beta) underpinning the benchmark price calculation

Under this option, the DIRA would be amended to require Fonterra to adopt the Commerce Commission's approach to setting the asset beta assumption in its benchmark price calculation. The DIRA would require Fonterra to rely on the estimate of risk (measured by asset beta) consistent with dairy and other commodity processors when estimating the cost of financing milk processing operations.

MPI's consultation document originally envisaged a wider scope for this option. This original scope included additional legislative guidance on the types of assumptions, inputs and processes that Fonterra must rely on in its base milk price calculation, to ensure that the calculation was consistent with the notion of "practical feasibility". MPI envisaged that the guidance would codify the Commerce Commission's conclusions from its monitoring experience to date.

However, consultation has confirmed that codifying all of the Commission's conclusions on specific technical issues into statutory principles is extremely difficult and could lead to unintended consequences. Given that the Commission is satisfied with all, but one, of Fonterra's assumptions, MPI considers that the risks of unintended consequences created by the original option would outweigh its expected benefits. The scope of this option was therefore narrowed to address the one key issue identified by the Commission as unlikely to be practically feasible.

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Embedding the Commerce Commission's approach to asset beta as a mandatory assumption in the DIRA, would go some way towards improving certainty and robustness of the benchmark price calculation, in the absence of Fonterra's willingness to alter its approach voluntarily. It would not significantly reduce the flexibility of the overall benchmark price calculation to respond to changes in industry dynamics in the future.

This option would impose a one-off minimal regulatory compliance cost on Fonterra of having to correct its calculation. The potential of this correction to improve dairy processors' (including Fonterra's) profitability could come at a cost of reduced revenues for dairy farmers, as milk suppliers. The magnitude of these impacts cannot be quantified, as it will depend on the level of the chosen asset beta assumption.

Given the Commission's extensive consideration of the issue, MPI considers that the risk of regulatory error, in this particular instance, is low.

Option 2: Amend the DIRA to give the Commerce Commission statutory power to set the key assumptions underpinning the benchmark price calculation

Under this option, it would be up to the Commerce Commission, rather than Fonterra, to determine the rules, requirements and processes for the key assumptions, inputs and processes that underpin the benchmark price calculation. This option could go as far as requiring the Commission to select the appropriate metrics (thus setting the benchmark price) or it could allow Fonterra to select the metrics, in accordance with the Commission's rules, requirements and processes and subject to information disclosure requirements. The current methodology for the benchmark price calculation, which relies on the costs of a hypothetically efficient processor, would continue to apply.

This option would provide significantly higher levels of certainty and stability for calculating the key assumptions underpinning the benchmark price. This is due to the Commission's independence and extensive regulatory expertise in determining such rules, requirements and processes (referred to as 'input methodologies') that it currently applies to natural monopoly businesses regulated under Part 4 of the Commerce Act.

However, the regulatory compliance costs and risks of regulatory error would also be significantly higher under this option. There would be initial set up costs of developing 'input methodologies' for the benchmark milk price. Given the significant differences between currently regulated natural monopolies (e.g., energy networks and airports) and the dairy sector, it is unlikely that only minor modifications to the Part 4 regime would produce a fit-for-purpose regime for the benchmark milk price calculation. There would also be ongoing costs faced by the Commission, in administering the regime, and Fonterra in complying with the information disclosure requirements that would need to underpin the Commission's administration of the regime. Commercial Sensitivity [redacted] The Commission's past experience of monitoring Fonterra's assumptions, inputs and processes may offer some lessons for the creation of 'input methodologies' for the dairy sector thus lowering the initial set-up costs.

A possible risk with an information disclosure regime is the potential for the release of commercially sensitive information that may place Fonterra at a competitive disadvantage. Natural monopoly businesses by their nature face no material competition. Hence, publication of, and consultation on, commercial information on those businesses would not put them at a competitive disadvantage. By contrast, Fonterra does face competition from other dairy processors in New Zealand and overseas. Ensuring that any information disclosure does not undermine Fonterra's ability to compete, is likely to make the Commission's task of administering the regime more complex and potentially less effective.

Changing the Commission's role from reviewing and commenting on to determining the key assumptions underpinning the benchmark price would create risks of regulatory error, due to asymmetric information available to the Commission, and likely lead to a slower response to changes in industry dynamic. Reviewing the rules, requirements and processes for the key

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assumptions is likely to be a significant undertaking for the Commission. The Commission's 'input methodologies' for energy networks and airports are currently reviewed at seven-yearly intervals.

Critically, although in principle, Fonterra and other dairy processors could pay a farmgate milk price that is different from the benchmark price (as they can now), in practice there will be a risk that the benchmark price set under this option would become the default farmgate milk price for the dairy industry. If this risk were to eventuate, this option would supplant the incentive-based disciplines of the DIRA open entry and exit provisions and become a default form of direct price regulation.

Given that the Commerce Commission has to date been satisfied with all but one of Fonterra's assumptions, MPI's judgement is that the benefits of improved certainty of the benchmark price calculation would be outweighed by disproportionate regulatory costs and risks of regulatory error.

This option was strongly favoured by many independent dairy processors and strongly opposed by Fonterra and its farmer-shareholders.

3.3 What other options have been ruled out of scope, or not considered, and why?

The options considered in this Regulatory Impact Assessment were developed in the context of the DIRA's objective of promoting contestable, rather than competitive, market outcomes. Options aiming to increase actual new entry by dairy processors have therefore not been considered. Such options included amending the methodology for calculating the benchmark price to reflect Fonterra's actual costs, rather than estimating the costs of a hypothetically efficient processor.

During MPI's consultation process, Miraka and Synlait proposed an option that would provide the Commerce Commission with statutory powers to substitute a metric for any assumption, input or processes adopted by Fonterra that the Commission does not agree with. The rationale for this option was that Fonterra did not take account of the Commission's views (for example in relation to the asset beta). This option was not considered because it had similar characteristics and risks to Option 2, and Option 1 better addressed the underlying concern.

Additional options that have been proposed by industry stakeholders but have not been considered further were:

- requiring Fonterra to formally attest that the benchmark price calculation meets the legislative purpose each time it is adjusted. MPI considers this practice is already in place as Fonterra makes a similar attestation in its 'Reasons paper' to the Commerce Commission, which the Commission then makes publicly available;
- making external appointments to Fonterra's milk price panel and making the panel's minutes publically available. MPI considers that this would create issues of confidentiality and commercial sensitivity, potentially placing Fonterra at a competitive disadvantage; and
- requiring Fonterra to publish detailed information and data that underpins the assumptions for the benchmark price calculation, every time Fonterra reports on its farmgate milk price. Any such information disclosure would need to avoid requiring Fonterra to release commercially sensitive information that could place Fonterra at a competitive disadvantage. MPI understands that the rationale for this proposal is to make it easier for independent processors to accurately forecast where the market price for milk will land. MPI considers that this objective, although outside the scope and purpose of the DIRA benchmark price calculation provisions, warrants further consideration. The timeframes for preparing this Regulatory Impact Assessment have not allowed for sufficient consideration of, and industry consultation on, this issue. Given that the DIRA already contains regulation-making powers that could be used to impose obligations on Fonterra to publish information about its business (including prices and its components, as well as information and methodologies used to calculate those prices), MPI would consider this issue at a later date, subject to its future work programme and the Minister's regulatory priorities.

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Section 4: Impact Analysis

Criterion/Options	No action: Fonterra retains wide discretion to decide on key assumptions for the benchmark price calculation	Option 2: Amend DIRA to reduce Fonterra's discretion on a key assumption (asset beta) for the benchmark price calculation	Option 3: Amend DIRA to give Commerce Commission statutory powers to set the key assumptions and inputs for the benchmark price calculation
Effectiveness - improving certainty and robustness of the benchmark price calculation	0 Presents an opportunity to improve certainty and robustness of the assumptions underpinning the benchmark price calculation	+ Improves certainty and robustness of a key assumption underpinning the benchmark price calculation	++ Significantly improves certainty of the assumptions underpinning the benchmark price calculation
Proportionality – ensuring that the benefits of improved certainty and robustness of the benchmark price calculation outweigh the associated regulatory compliance costs and risk of regulatory error	0 Provides for low regulatory compliance costs and does not create risk of regulatory error	0 / + Imposes minimal additional regulatory compliance costs and the risks of regulatory error are low	-- Significantly increases regulatory compliance costs and creates risks of regulatory error
Durability – maintaining sufficient flexibility for the benchmark price to respond to changes in industry dynamics over time	0 Maintains sufficient flexibility to respond to changes in industry dynamics over time	0 / - Marginally reduces flexibility to respond to changes in industry dynamics over time	- Reduces flexibility to respond to changes in industry dynamics
Overall assessment	**0 not preferred**	**+ preferred**	**- not preferred**

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Section 5: Conclusions

5.1 What option, or combination of options, is likely best to address the problem, meet the policy objectives and deliver the highest net benefits?

MPI recommends amending the DIRA to require Fonterra to adopt the Commerce Commission's approach to setting the asset beta assumption in its benchmark price calculation. The DIRA would require Fonterra to rely on the estimate of risk (measured by asset beta) consistent with dairy and other commodity processors when estimating the cost of financing milk processing operations.

The proposed amendment would improve the certainty and robustness of the benchmark price calculation by addressing the specific issue highlighted through the Commerce Commission's monitoring regime. The improvement would be achieved without introducing significant regulatory compliance costs, risks of regulatory error or the much needed flexibility to ensure that the benchmark price calculation can respond to future changes in industry dynamic.

There would be a one-off regulatory compliance cost on Fonterra of having to correct its calculation. MPI considers that the cost will be minimal.

The potential of the proposed correction to improve dairy processors' (including Fonterra's) profitability could come at a cost of reduced revenues for dairy farmers, as milk suppliers. The magnitude of these impacts cannot be quantified, as it will depend on the level of the chosen asset beta assumption. Given the Commerce Commission's extensive consideration of the issue, the risk of regulatory error in the proposed correction is low.

Fonterra and its farmer-shareholders strongly oppose any changes to the status quo. They consider that the existing provisions work well. MPI considers that there is an opportunity for the existing provisions to be improved with minimal additional regulatory compliance costs and scope for regulatory error.

Key independent processors (particularly Open Country Dairy and Miraka) considered that the benchmark calculation provisions require a fundamental overhaul. These stakeholders strongly supported a modified version of Option 2, where the benchmark price would be set independently of Fonterra and according to a methodology that encouraged competition. These proposals could not be accommodated because they would in effect replace the incentive-based disciplines of the DIRA open entry and exit provisions with a form of direct price regulation, with the associated regulatory compliance costs and risk of regulatory error.

Tatua considered that the current benchmark milk price calculation provisions are sufficient for their intended purpose. Tatua submitted that the cost of producing the benchmark price must be balanced with the reality that it is only one indicator of future performance. It also noted that while Fonterra's size means that most (if not all) independent processors chose to reference their milk price to Fonterra's calculated benchmark price, there is no requirement for this practice.

5.2 Summary table of costs and benefits of the preferred approach

Affected parties	Comment	Impact	Evidence certainty
Additional costs of proposed approach, compared to taking no action			
Regulated parties: • Fonterra	**Monetised costs:** • **Not applicable** – the proposal limits Fonterra's discretion, thus reducing the scope and cost of the Commerce Commission's assessment of Fonterra's discretionary decisions.		

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	Non-monetised costs: • Minimal additional compliance cost of a one-off adjustment to Fonterra's Manual and the calculation of the benchmark price. • Minimal scope for regulatory error.	**None - Low** Fonterra's Manual is already subject to a continuous improvement process. The proposal is based on extensive analysis and consultation undertaken by the Commission.	**High**
Other affected parties: • Dairy farmers as suppliers of milk	**Monetised costs:** • **Not available** - the costs will depend on Fonterra's chosen level of the asset beta assumption, which is not proposed to be prescribed in legislation.		
	Non-monetised costs: • Depending on Fonterra's chosen level of the asset beta, the proposal may lead to reduced revenues for dairy farmers as milk suppliers.	**Low – Medium** Size of the impact would depend on Fonterra's chosen level of the asset beta assumption, which is not proposed to be prescribed in legislation.	**Medium**
Other affected parties: • Independent processors	**Monetised costs:** • **Not applicable** - the proposal limits Fonterra's discretion and scope for potentially imposing higher than efficient costs on the processing sector.		
	Non-monetised costs: • **Not applicable**		
Regulator: • Commerce Commission	**Monetised costs:** • **Not applicable** – the proposal limits Fonterra's discretion, thus reducing the scope and cost of the Commerce Commission's assessment of Fonterra's discretionary decisions.		
	Non-monetised costs: • **Not applicable**		
Total monetised costs	as per above	**Not available -** the costs will depend on Fonterra's chosen level of the asset beta assumption, which is not proposed to be prescribed in legislation.	
Total non-monetised costs	as per above	**Low**	**Medium**

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Affected parties	Comment	Impact	Evidence certainty
Expected benefits of proposed approach, compared to taking no action			
All dairy farmers and processors in NZ	**Non-monetised benefits:** • Improved certainty and robustness of the benchmark price would enable more informed assessment of Fonterra's and other processors' farmgate milk price offers.	**Low – Medium** The proposal targets a key assumption underpinning the benchmark price calculation.	**Medium**
Regulated party: • Fonterra	**Monetised benefits:** • Extent of increased earnings and improved profitability for Fonterra will depend on its chosen level of the asset beta assumption, which is not proposed to be prescribed in legislation.	**Low – Medium** Size of the impact would depend on Fonterra's chosen level of the asset beta assumption, which is not proposed to be prescribed in legislation.	**Medium**
	Non-monetised benefits: • Improved certainty and predictability of a key assumption underpinning the benchmark price calculation.	**Low – Medium** The proposal targets a key assumption underpinning the benchmark price calculation.	**Medium**
Other affected parties: • Independent processors	**Monetised benefits:** • Extent of increased earnings and improved profitability for independent processors will depend on Fonterra's chosen level of the asset beta assumption, which is not proposed to be prescribed in legislation.	**Low – Medium** Size of the impact would depend on Fonterra's chosen level of the asset beta assumption, which is not proposed to be prescribed in legislation.	**Medium**
	Non-monetised benefits: • Improved certainty and predictability of a key assumption underpinning the benchmark price calculation.	**Low – Medium** The proposal targets a key assumption underpinning the benchmark price calculation.	**Medium**
Total monetised benefits	as per above	**Low – Medium**	**Medium**
Total non-monetised benefits	as per above	**Low – Medium**	**Medium**

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5.3 Is the preferred approach compatible with the Government's 'Expectations for the design of regulatory systems'?

MPI's preferred option is aligned with the guidance provided in *Government Expectations for Good Regulatory Practice* (April 2017).

Section 6: Implementation and operation

6. 1 How will the new arrangements be implemented?

A legislative amendment is required to implement MPI's recommendations in this Regulatory Impact Assessment. It is expected that the Dairy Industry Restructuring Amendment Bill will be introduced and progressed through the Parliamentary processes in 2019, with enactment expected to take place in early 2020.

Transitional arrangements will be required to provide Fonterra with sufficient time to adjust its operations, including amending its milk price manual. It is expected that the proposed amendments will come into effect at the start of the dairy season following the season in which the legislative amendment is passed. That is, if the legislative amendment is passed in early 2020, the new provisions will come into effect from 1 June 2021.

The Commerce Commission will continue to operate in its current role of undertaking monitoring of Fonterra's benchmark price calculation.

6.2 What are the implementation risks?

Given the very targeted scope of the proposed amendments, no significant implementation risks are foreseen.

The challenge of legislative drafting will be mitigated by MPI working closely with the Parliamentary Counsel Office to achieve as precise and clear provisions as possible. MPI will be testing draft provisions with other government agencies and in particular the Commerce Commission as the monitoring agency. Finally, other stakeholders and affected parties, including Fonterra and independent dairy processors, will provide further testing during the Select Committee process.

Section 7: Monitoring, evaluation and review

7. 1 How will the impact of the new arrangements be monitored?

The Commerce Commission's bi-annual monitoring of, and public reporting on, Fonterra's assumptions, inputs and processes that underpin the benchmark price calculation provides for an ongoing monitoring of Fonterra's practices.

7.2 When and how will the new arrangements be reviewed?

The accompanying proposal to introduce a statutory requirement for periodic reviews of the DIRA regulatory regime (as per Regulatory Impact Assessment #5) provides an opportunity to review the effectiveness and other impacts of the recommendations in this Regulatory Impact Assessment. The proposal is for the next review to take place during the 2024/25 dairy season, following standard regulatory review processes.

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Coversheet #3: Obligation to sell up to 50 million litres of raw milk to independent processors

Advising agencies	*Ministry for Primary Industries*
Decision sought	*Approval to amend the Dairy Industry Restructuring (Raw Milk) Regulations 2012 to change the eligibility criteria for access to regulated milk from Fonterra. This will remove unnecessary regulation and ensure that the DIRA regime remains fit-for-purpose.*
Proposing Ministers	*Hon Damien O'Connor, Minister of Agriculture*

Summary: Problem and Proposed Approach

What problem or opportunity does this proposal seek to address? Why is government intervention required?

The current eligibility provisions of the Dairy Industry Restructuring (Raw Milk) Regulations 2012 (the Regulations) are no longer fit-for-purpose, which in turn presents a regulatory stewardship issue.

The Regulations require Fonterra to sell up to 50 million litres per season of raw milk collected from farmers to any eligible dairy processor in New Zealand, on agreed or regulated terms. Eligibility ceases when an independent processor has its own supply of 30 million litres of farmers milk per season for three consecutive seasons.

A key policy rationale for the Regulations was to provide new dairy processors, who are in the process of establishing their own milk supply from farmers, with an "entrance pathway" into the market for farmers' milk. The Regulations were designed to help manage the risk that farmers might not wish to commit supply to an unknown new processor, and the new processors might not be able to obtain investment capital without certainty of milk supply (referred to as the initial "catch 22" problem). Since the Regulations were introduced, a number of large dairy processors have entered, established viable operations and proved their credibility and viability with farmers. This demonstration effect means that farmer and investor confidence no longer appears to be a significant constraint on new dairy processors entering the market for farmers' milk. MPI therefore considers that the existing government intervention is no longer needed.

How will government intervention work to bring about the desired change? How is this the best option?

MPI proposes to amend the eligibility provisions in the Regulations. The amendment would exclude dairy processors with their own supply of 30 million litres of raw milk per season from being able to purchase regulated milk from Fonterra.

The proposed amendment will reduce an existing government intervention, recognising that certain dairy processors no longer require the support of the Regulations to access milk supply.

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Summary Impacts: Benefits and costs

Who are the main expected beneficiaries and what is the nature of the expected benefit?

Fonterra is the main beneficiary of this proposal, as it will be relieved of its obligation to sell a limited quantity of raw milk collected from farmers to large dairy processors, on agreed or regulated terms.

The proposed approach would ensure that the DIRA regulatory regime remains fit-for-purpose.

Where do the costs fall?

The proposed regulatory amendment does not impose new costs, as it removes unnecessary regulation, the rationale for which can no longer be justified.

Future large dairy processors will face the opportunity cost of foregone convenience of being able to access regulated milk from Fonterra.

What are the likely risks and unintended impacts, how significant are they and how will they be minimised or mitigated?

There is a small risk that, in absence of access to milk from Fonterra, further investment in large dairy processing facilities might be constrained. MPI considers that the risk is small and unlikely to eventuate, because of the existing demonstration effect (as stated above) and the fact that access to regulated milk appears to have been helpful, rather than critical for newly establishing large dairy processors. A large dairy processing plant is generally capable of processing over 200 million litres per season. It is therefore not sustainable for a large dairy processor to rely on regulated milk, and those who have entered the market have moved very quickly to obtain their own supply from farmers. MPI considers that investment decisions of this scale would not be made on the basis of access to a limited and short-term supply of regulated milk.

Transitional arrangements would be included to address the interests of remaining eligible large dairy processors, or any new facility in the planning stages.

There is also a small risk that higher value dairy products and new business models could be developed in the future, where smaller volumes of milk supply could support what would otherwise be considered a large dairy operation. Attempting to anticipate and regulate for this risk would add significant administrative complexity and could lead to other potential unintended consequences. Instead, MPI is proposing to keep a close watching brief, so that any future amendments, if required to address unintended consequences, could be made in a timely manner.

Identify any significant incompatibility with the Government's 'Expectations for the design of regulatory systems'.

MPI's proposed approach is aligned with the guidance provided in Government Expectations for Good Regulatory Practice (April 2017).

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Evidence certainty and quality assurance

Agency rating of evidence certainty

MPI considers there is an adequate evidence base for the proposed amendments. The scope of the problem is definable and limited. The proposed regulatory change is based on the assumption, and evidence of past industry practice, that dairy processors with large scale processing facilities achieve large scale supply rapidly and do not require ongoing regulatory support. Based on this evidence, no significant risks with the proposed amendment or its implementation are foreseen.

MPI's policy development process commenced in May 2018, following the Government's release of the terms of reference for the review of the Dairy Industry Restructuring Act 2001 and its impact on the dairy industry. MPI engaged with a large and diverse group of key industry stakeholders to help clarify concerns, establish facts and build evidence to inform preliminary analysis of issues and options for potential legislative amendments. MPI completed 28 engagement meetings and received written input from 12 organisations. MPI have also commissioned two reports from an independent economic consultancy, Frontier Economics, on the performance of New Zealand dairy industry and its underlying drivers. The industry input and consultancy reports can be found at http://www.mpi.govt.nz/dira-review.

In November 2018, a discussion document, outlining issues and options for change, was approved for public consultation by Cabinet [CAB-18-MIN-0528 refers]. Comprehensive consultation was conducted for 14 weeks, closing on 8 February 2019. It involved 13 town hall meetings (attended by 401 dairy farmers), 22 face-to-face industry meetings and workshops, and was supported by extensive communications to the sector via traditional and social media.

The final proposals take account of stakeholder feedback.

Quality Assurance Reviewing Agency:
The Regulatory Impact Assessment has been reviewed by a quality assurance panel with representatives from the Regulatory Quality Team at the Treasury and the Ministry for Primary Industries.
Quality Assurance Assessment:
The panel considers that the Regulatory Impact Assessment meets the quality assurance criteria.
Reviewer Comments and Recommendations:
The proposed change is essentially addressing a regulatory stewardship issue by removing regulation relating to the eligibility criteria for access to regulated milk from Fonterra that is no longer needed. The proposed regulatory change is based on evidence of past industry practice, focussing mainly on existing processors and it is less clear what this means for new dairy processors.

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Impact Statement #3: Obligation to sell up to 50 million litres of raw milk to independent dairy processors

Section 1: General information

Purpose

The Ministry for Primary Industries is solely responsible for the analysis and advice set out in this Regulatory Impact Statement, except as otherwise explicitly indicated. This analysis and advice has been produced for the purpose of informing key policy decisions to be taken by Cabinet.

Key Limitations or Constraints on Analysis

There are no significant constraints on analysis. The scope of the problem is definable and limited. The proposed regulatory change is based on the assumption, and evidence of past industry practice, that dairy processors with large scale processing facilities achieve large scale supply rapidly, and therefore do not require ongoing regulatory support. Based on this evidence, no significant risks with the proposed amendment or its implementation are foreseen.

There is a small risk that, in the absence of access to milk supplied at regulated prices from Fonterra, further investment in large dairy processing facilities might be constrained. MPI considers that this small risk is unlikely to eventuate, because of the existing demonstration effect and the fact that access to regulated milk appears to have been helpful, rather than critical, for newly establishing large dairy processors. A large dairy processing plant is generally capable of processing over 200 million litres per season. It is therefore not sustainable for a large dairy processor to rely on regulated milk, and those who have entered the market have moved very quickly to obtain their own supply from farmers. MPI considers that investment decisions of this scale would not be made on the basis of access to a limited and short-term supply of regulated milk.

There is also a small risk that higher value dairy products and new business models could be developed in the future where smaller volumes of milk supply could support what would otherwise be considered a large dairy operation. Attempting to anticipate and regulate for this risk would add significant administrative complexity and could lead to potential other unintended consequences. Instead, MPI is proposing to keep a close watching brief so that any future amendments, if required to address unintended consequences, could be made in a timely manner.

Responsible Manager

Emma Taylor
Director of Agriculture, Marine and Plant Policy,
Policy and Trade Branch
Ministry for Primary Industries

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Section 2: Problem definition and objectives

2.1 What is the context within which action is proposed?

The Regulations require Fonterra to sell up to 50 million litres per season of raw milk collected from farmers to any eligible dairy processor in New Zealand, on agreed or regulated terms. Eligibility ceases when an independent processor has its own supply of 30 million litres of farmers milk per season for three consecutive seasons.

The total amount of raw milk that Fonterra is required to sell to all eligible dairy processors in a season is capped at 5 percent of Fonterra's total milk collection in a season. It is currently set in the Regulations at 600 million litres per season (representing approximately 3.5 percent of Fonterra's total milk collection in 2017/18).

Commercial Sensitivity [redacted]

2.2 What is the policy problem or opportunity?

The current eligibility provisions for access to regulated milk from Fonterra present a regulatory stewardship issue. Regulatory stewardship requires that regulations are reviewed to ensure that they remain fit-for-purpose. The provisions include large dairy processors, whose market entry is no longer dependent on access to regulated milk. This means that the Regulations are currently not fit-for-purpose.

A key policy rationale for the Regulations was to provide new dairy processors, who are in the process of establishing their own milk supply from farmers, with an "entrance pathway" into the market for farmers' milk. The Regulations were designed to help manage the risk that farmers might not wish to commit supply to an unknown new processor, and the new processors might not be able to obtain investment capital without certainty of milk supply (referred to as the initial "catch 22 problem).

The Regulations provided for the entering dairy processors to access small volumes of raw milk from Fonterra, on agreed or regulated terms, to help establish their operations, while ensuring that significantly-sized dairy processors could not rely on the Regulations beyond their initial establishment phase. As 50 million litres per season is insufficient to sustain the operations of a large processing plant (starting at around 200 million litres processing capacity) post-establishment, large dairy processors have an incentive to source their own supply from farmers as quickly as possible.

Since the Regulations have been in force, a number of large dairy processors have entered and, with the exception of one (NZDL), all have established viable operations and proved their credibility and viability with farmers.

Commercial Sensitivity [redacted]

These large dairy processors have secured investors and reliable supply of raw milk from their own farmer suppliers Commercial Sensitivity [redacted]

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[5] The Regulations also provide access of up to 250 million litres per season for Goodman Fielder, which is Fonterra's only competitor of scale in the consumer market for fresh milk and other staple dairy goods. Issues associated with Goodman Fielder's access to regulated milk are considered in the accompanying Regulatory Impact Assessment #4: Obligation to sell up to 250 million litres of raw mi k to Goodman Fielder.

Commercial Sensitivity. This demonstration effect means that farmer and investor confidence no longer appears to be a significant constraint on new dairy processors entering the market for farmers' milk.

Therefore, MPI considers that the current eligibility provisions provide an unnecessary regulatory support to large dairy processors, which can no longer be justified.

This unnecessary regulatory support also comes at a potential (small) opportunity cost to Fonterra and its farmer-shareholders. Unless Fonterra reaches a commercial agreement on price, the Regulations require that the limited quantities of regulated milk be sold at Fonterra's average farmgate milk price for the particular season plus Fonterra's average transport costs. Depending on Fonterra's opportunity cost for the on-sold quantities of raw milk (which is extremely difficult to quantify) the Regulations may create a potential (small) subsidy which is met by Fonterra and its farmer-shareholders.

2.3 Are there any constraints on the scope for decision making?

The Regulations do not distinguish between large or small processors, nor the use to which dairy processors put regulated milk. However, aside from facilitating entry by larger processors as described above, the Regulations have also benefitted smaller dairy food and beverage manufacturers supplying the domestic consumer market. This enabled small companies, who may not be able to obtain their own supply of raw milk, to offer diverse product choice and specialty consumer products including cheeses, yoghurts, ice cream and organic fresh milk. Access provisions as they relate to these smaller dairy processors are outside the scope of this Regulatory Impact Assessment.

In addition, the Regulations provide access of up to 250 million litres per season for Goodman Fielder, which is Fonterra's only competitor of scale in the New Zealand consumer market for fresh milk and other staple dairy goods. Issues associated with Goodman Fielder's access to regulated milk are outside the scope of this Regulatory Impact Assessment. These are instead considered in the accompanying Regulatory Impact Assessment #4: Obligation to sell up to 250 million litres of raw milk to Goodman Fielder.

During the public consultation process, Fonterra raised a number of issues that relate to the nature of regulated terms, which eligible dairy processors can rely on for access to raw milk from Fonterra. These relate to regulated milk use by eligible dairy processors, forecasting rules and certain other minor matters. The timeframes for preparing this Regulatory Impact Assessment have not allowed for the consideration of, and industry consultation on, these issues. Given that these issues are of secondary importance, they will be considered at a later date, depending on MPI's future work programme and the Minister's regulatory priorities.

2.4 What do stakeholders think?

MPI's extensive industry consultation process is outlined in the background section of this document. The key industry stakeholders, whose interests are affected by this Regulatory Impact Assessment, include:

- Fonterra as the regulated party required to sell regulated milk to eligible dairy processors;
- Fonterra farmers as suppliers of milk to, and shareholders of, Fonterra; and
- large export-focused independent processors as potential purchasers of regulated milk from Fonterra.

Fonterra and the majority of its farmer-shareholders (75 percent of those who commented on this provision) consider that large export-focused dairy processors should no longer be eligible to purchase regulated milk from Fonterra. Farmer-shareholders expressed a strong concern that by regulating Fonterra to supply regulated milk to other processors, Fonterra is being hampered in its efforts to move more into value-add production, which is in turn impacting Fonterra's ability to gain the maximum value for its milk products.

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Large established dairy processors, by and large, noted that the Regulations have been helpful in supporting investor confidence in the early stages of establishing a new processing operation. They did not, however, express any strong opposition to the above stated problem definition.

Mataura Valley Milk, cautioned against the self-interests of the now well established large dairy processors in making it more difficult for the potential future entrants to enter and compete with them for farmers' milk. Similarly, Miraka noted that removing access to regulatory milk for new entrants could have a significant impact on new entrants financed by New Zealand-backed rather than foreign sources of investment capital. Similar to the views of Mataura Valley Milk and Miraka, the Federation of Māori Authorities (FOMA) hold some concerns about the impact on future entrants, with a particular lens on the possible impact on Māori interests. As noted above, however, it appears unlikely that investors would commit to a large processing facility on the basis of access to a small quantity of regulated milk.

Fresha Valley, a domestically-focused supplier, considers that there needs to be some mechanism for operators solely focussed on the domestic market to purchase milk outside their own supply base.

Section 3: Options identification and analysis

3.1 What criteria, in addition to monetary costs and benefits, have been used to assess the likely impacts of the options under consideration?

The options in this Regulatory Impact Assessment have been assessed against the following criteria, which have been given equal weighting:

- *Effectiveness (contribution to policy outcomes sought):* removing unnecessary regulation, which can no longer be justified;
- *Proportionality (the regulatory risk is proportional to the extent of expected benefits):* ensuring that the benefits of excluding large export focused processors from accessing regulated milk from Fonterra outweigh the risk of preventing smaller processors from operating or growing;
- *Regulatory certainty (the regulatory system provides clarity and predictability of outcomes):* ensuring that regulatory provisions are sufficiently clear and outcomes are predictable; and
- *Practicality (the implementation risks and unintended consequences are low):* ensuring that regulatory provisions are simple to administer, and risk of perverse incentives (e.g., incentivising a deliberate business strategy involving an otherwise unnecessary reliance on the Regulation on an ongoing basis) and unintended consequences is low.

3.2 What options are available to address the problem and how do they perform against the assessment criteria?

Option 1: Amend the eligibility provisions in the Regulations to exclude dairy processors that source 30 million litres or more of own supply in one season

Under this option, the Regulations would be amended so that Fonterra would no longer be required to sell regulated milk to any dairy processor once that processor has sourced its own milk supply (from farmers or other processors) of 30 million litres or more in one season. This differs from the status quo, where a processor must have 30 million litres of own supply (from farmers) for three consecutive seasons before eligibility ceases. Under this option, newly establishing large dairy processors would be eligible to purchase raw milk from Fonterra under the Regulations for no more than one season, if at all (depending on their level of own supply at the outset of their operations).

By extending the own supply rule to include milk sourced from other processors (rather than just farmers) this option recognises and caters to the more developed industry landscape and the possibilities for various contractual arrangements for milk supply to emerge, compared to when the original own supply rule was introduced.

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The own supply rule is well understood by the industry, it is relatively easy to verify compliance and it is simple to administer. A modified version of this rule would provide dairy processors with regulatory certainty and predictability of their eligibility for regulated milk from Fonterra.

The proposed 30 million litres threshold also serves as a workable proxy for large export-focused dairy processors. The threshold provides a clear distinction between dairy processors who are in the business of processing large volumes of milk (most likely for export) and those who service small niche product markets (most likely for domestic consumers). The 30 million litre threshold is proposed on the basis of existing industry experience and practice, whereby large dairy processors require significantly higher volumes of own supply than 30 million litres of raw milk to operate their processing plants efficiently. As the total of 80 million litres of raw milk per season (30 million of own supply and 50 million of regulated milk from Fonterra) is insufficient to sustain the operations of a large dairy processing plant (starting at around 200 million litres processing capacity), large export-focused dairy processors have an incentive to source their own supply as quickly as possible. They would have little incentive to source less than 30 million litre of own supply just to be able to access regulated milk from Fonterra.

However, there is a small risk that higher value dairy products and new business models could be developed in the future, where processing of 80 million litres of raw milk or less per season could be sufficient to run what could otherwise be considered a large export-focused dairy operation. The existing industry experience and practice suggests that this is unlikely. Commercial Sensitivity [redacted] It is, however, possible that new dairy products and business models may develop in the future. Attempting to anticipate and regulate for them ahead of time would add significant administrative complexity and could lead to potential other unintended consequences.

Option 2: Amend the eligibility provisions in the Regulations to exclude dairy processors with a set level of processing capacity and a set percentage of exported production volumes

Under this option, the Regulations would be amended to provide specific criteria for determining what would constitute a "large export focused' processor. The definition would capture a processor with the capacity to process more than a set volume of raw milk in a season, and exporting more than a set percentage of its production by volume.

Setting the thresholds for processing capacity and exports requires a careful judgement on what types of business models are sought to be excluded. Setting a high threshold (e.g. more than 150 million litres of processing capacity, exporting more than 80 percent of production volumes) would capture most if not all dairy processors who are most likely to have already been captured by the proposed amendment of the own supply rule in Option 1. Setting a low threshold (e.g. more than 30 million litres of processing capacity, exporting more than 20 percent of production volumes) could constrain the potential for some smaller processors to operate and grow. Smaller processors may choose to focus on the small domestic consumer market before pursuing growth opportunities in export markets.

MPI has previously considered that setting the thresholds at more than 100 million litres of processing capacity, exporting more than 50 percent of production volumes could provide a reasonable trade-off.[6] At that time, this option was identified as the main mechanism for excluding large dairy processors from accessing regulated milk from Fonterra, as no amendments to the own supply rule (as per Option 1) were contemplated.

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[6] MPI's 2016 Regulatory Impact Assessment, which included the consideration of this option is available at: https://www.mpi.govt.nz/law-and-policy/legal-overviews/regulatory-impact-statements/

Compared to Option 1, this option is more administratively complex, as it would be harder to verify compliance with the new criteria. This is likely to provide dairy processors with a lesser degree of regulatory certainty. Furthermore, as Fonterra would continue to be the body that assesses dairy processors' eligibility for regulated milk in the first instance, this option would require dairy processors to reveal a greater amount of company-specific and potentially commercially sensitive information to Fonterra.

This option could also operate in combination with Option 1. It would then be relied on to mitigate the small risk of new dairy products and business models developing in the future, where processing of 80 million litres of raw milk or less per season could be sufficient to run what could otherwise be considered a large export-focused dairy operation. However, the added complexity associated with this option and its potential to prevent some smaller processors from growing is likely to outweigh the benefits of mitigating the risk created by Option 1.

3.3 What other options have been ruled out of scope, or not considered, and why?

MPI did not consider the option of raising the price for regulated milk as a means of compensating Fonterra for the potential (small) opportunity cost of having to sell raw milk to other dairy processors at cost. Other than being difficult to quantify Fonterra's opportunity cost with any degree of certainty, this option would not address the problem as identified. Providing regulatory support, which can no longer be justified, even if at a higher price, is inconsistent with *Government Expectations for Good Regulatory Practice* (April 2017). This option was therefore not considered.

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Section 4: Impact Analysis

Criterion/Options	No action: large dairy processors can access regulated milk for 3 seasons	Option 1: Amend the own supply rule to exclude large dairy processors with own supply from accessing regulated milk	Option 2: Introduce new criteria defining large export focused processors
Effectiveness - removing unnecessary regulation, which can no longer be justified.	0 Perpetuates unnecessary regulation	++ Removes unnecessary regulation	++ Removes unnecessary regulation
Proportionality - ensuring that the benefits of excluding large export focused processors outweigh the risk of preventing smaller processors from operating or growing.	0 Does not exclude large export focused processors from accessing regulated milk	++ Excludes all known large export focused business models, while providing sufficient room for smaller processors to operate or grow	+/0 Excludes all known and unknown future large export focused business models, but provides less room for smaller processors to operate or grow
Regulatory certainty - ensuring that regulatory provisions are sufficiently clear and outcomes are predictable.	0 Provides for clear regulatory provisions and predictable outcomes	+ Builds on the existing eligibility provisions that are clear and well understood by the industry	- - Introduces new eligibility provisions that are more complex with outcomes depending on multiple factors which may vary overtime.
Practicality - ensuring that regulatory provisions are simple to administer, and risk of perverse incentives (e.g. incentivising a deliberate business strategy involving an otherwise unnecessary reliance on the Regulation on an ongoing basis) and unintended consequences is low.	0 Provides for simple administration of the provisions	++ Administratively simple, with a low risk of perverse incentives and unintended consequences	- - Administratively complex, with a high risk of perverse incentives and unintended consequences
Overall assessment	**0 - not preferred**	**++ preferred**	**- not preferred**

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Section 5: Conclusions

5.1 What option, or combination of options, is likely best to address the problem, meet the policy objectives and deliver the highest net benefits?

MPI's recommended approach is to amend the eligibility provisions in the Regulations to exclude dairy processors that source 30 million litres or more of own supply (from farmers or other processors) in one season (Option 1).

This option would remove unnecessary regulatory provisions that were designed to address a policy problem that no longer exists. It would therefore ensure that the DIRA regulatory regime remains fit-for-purpose.

The proposed amendments build on the existing eligibility provisions that are well understood by the industry and are easy to administer. This would provide dairy processors and Fonterra with regulatory certainty and predictability of outcomes.

MPI is confident of both the assumptions and past industry experience/evidence supporting this recommendation. There is a small risk that new business models could be developed in the future, while unnecessarily relying on the Regulations. MPI considers that this is unlikely. However, close monitoring of the industry developments by MPI will ensure that if such risk eventuates, regulatory changes could be made in a timely manner. Attempting to anticipate and regulate for this risk ahead of time (as per Option 2) would add significant administrative complexity, and could lead to potential other unintended consequences. The addition of Option 2 is therefore not recommended.

Fonterra considers that both Options 1 and 2 should be implemented. For Option 2, Fonterra recommends adopting the low thresholds of more than 30 million litres of processing capacity, exporting more than 20 percent of production volumes. MPI considers that such thresholds create the risk of constraining the potential for some smaller processors to operate or grow, while providing a very limited benefit over and above Option 1.

Existing large export focused dairy processors, by and large, supported MPI's recommended approach. The majority of Fonterra's farmer-shareholders also supported MPI's recommended approach. Small domestically-focused dairy processors did not engage on this issue, as their eligibility for regulated milk from Fonterra remains unaffected under MPI's recommended approach.

5.2 Summary table of costs and benefits of the preferred approach

Affected parties	Comment	Impact	Evidence certainty
Additional costs of proposed approach, compared to taking no action			
Regulated parties: • Fonterra	**Monetised costs:** • **Not applicable** – the proposal seeks to remove unnecessary regulation on Fonterra.		
	Non-monetised costs: • **Not applicable**		
Other affected parties: • Future large independent processors	**Monetised costs:** • **Not available** – the opportunity cost of not being able to purchase regulated milk from Fonterra will depend on future large independent processors' business models, sources and costs of capital and other business and commercial factors.		
	Non-monetised costs:	**Low**	**High**

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	• Foregone convenience of being able to purchase regulated milk from Fonterra for three seasons, rather than having to source higher volumes of farmers' milk supply earlier on.	There are strong existing incentives for processors to secure higher volumes of farmers' milk supply early on.	
Other affected parties: • Existing independent processors	**Monetised costs:** • Provision of additional information to Fonterra to demonstrate eligibility and to MPI for market monitoring purposes.	**None – Low** Minor addition to existing information provisions requirements.	**High**
	Non-monetised costs: • **Not applicable**		
Regulatory agencies: • MPI • Commerce Commission	**Monetised costs:** • Collection of additional market information • Potential for additional disputes taken to the Commission for adjudication	**None – Low** Minor addition to existing information gathering and market analysis functions. Minor amendments to existing rules are unlikely to increase number of disputes.	**High**
	Non-monetised costs: • **Not applicable**		
Total monetised costs	as per above	**None - Low**	**High**
Total non-monetised costs	as per above	**Not applicable**	

Affected parties	**Comment**	**Impact**	**Evidence certainty**
Expected benefits of proposed approach, compared to taking no action			
Regulated parties: • Fonterra	**Monetised benefits:** • Fonterra will be relieved of its regulatory obligation to sell a limited quantity of raw milk, potentially at a (small, if any) opportunity cost that is difficult to quantify.	**None - Low** Saving of a (small, if any) opportunity cost for Fonterra.	**High**
	Non-monetised benefits: • **Not applicable**		

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Other affected parties: • Future large independent processors • Existing independent processors	**Monetised benefits:** • **Not applicable**		
	Non-monetised benefits: • **Not applicable**		
Regulatory agencies: • MPI	**Monetised benefits:** • **Not applicable**		
	Non-monetised benefits: • Ensuring that the DIRA regime remains fit-for-purpose	**High** The proposal removes unnecessary regulation.	**High**
Total monetised benefits	as per above	**None - Low**	**High**
Total non-monetised benefits	as per above	**High**	**High**

5.3 Is the preferred approach compatible with the Government's 'Expectations for the design of regulatory systems'?

MPI's preferred combination of options is aligned with the guidance provided in *Government Expectations for Good Regulatory Practice* (April 2017).

Section 6: Implementation and operation

6. 1 How will the new arrangements be implemented?

A regulatory amendment is required to change the eligibility provisions. It is expected that the Dairy Industry Restructuring (Raw Milk) Amendment Regulations will be considered by Cabinet in August/September 2019 and progressed through the standard Order in Council process before the end of 2019. The amended Regulations would then come into force from 1 June 2020.

Transitional arrangements would be included to "grandparent" the current eligibility provisions for dairy processors who had started, or were about to start, utilising the existing entrance pathway provisions. These processors would continue to have access to regulated milk until they had (as now) obtained their own supply of 30 million litres for three consecutive seasons.

MPI will communicate the changes to all affected parties as soon as Cabinet decisions are made. This will provide all industry stakeholders with sufficient time to adjust their operations, if needed.

As with the existing eligibility provisions, it will be up to Fonterra to consider and assess eligibility applications from dairy processors, in the first instance. The Commerce Commission will continue to operate in its current role of being the enforcement agency for disputes arising in relation to all DIRA provisions, including in relation to changes proposed in this Regulatory Impact Assessment.

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6.2 What are the implementation risks?

Dairy processors who are currently eligible for regulated milk have sought assurances that their existing entitlement will not be affected. MPI proposes to protect existing dairy processors' entitlement by including "grandparenting" provisions in the Regulations. MPI anticipates that this will extend to at least one dairy processor (Mataura Valley Milk) and possibly two (Mataura Valley Milk and Yashili) relying on access to regulated milk for two to three seasons respectively.

The proposed regulatory change is based on the assumption, and evidence of past industry practice, that dairy processors with large scale processing facilities achieve large scale supply rapidly and do not require ongoing regulatory support. Based on this evidence, no significant risks with the proposed amendment or its implementation are foreseen.

Section 7: Monitoring, evaluation and review

7. 1 How will the impact of the new arrangements be monitored?

The Regulations already provide for MPI to collect data from Fonterra regarding its supply of regulated milk to other dairy processors. This tracks which dairy processors purchase regulated milk, and in what quantities, each season. The Regulations also provide for MPI to keep track of the volumes of raw milk sourced by individual dairy processors from farmers. MPI collects and analyses this information on an annual basis.

Given the proposal to expand the own supply rule to raw milk sourced from other processors, the accompanying Dairy Industry Restructuring Amendment Bill will also contain a new regulation making power enabling MPI to expand its existing annual information gathering surveys. This information is currently collected on a voluntary basis, resulting in some inconsistencies and data quality issues.

In addition, the Commerce Commission will continue to operate in its current role of being the enforcement agency for disputes arising in relation to all DIRA provisions, including the application of the proposed amendment to the own supply rule. The Government, through the Commerce Commission, will have access to information related to complaints or disputes arising from the proposed new arrangements. The number of, and the costs associated with, these complains or disputes will be reviewed on an annual basis through the Fonterra Levy setting process. This annual review process provides an opportunity to consider the effectiveness of the new arrangements.

These information sources will enable MPI to closely monitor the type of business models that source regulated milk from Fonterra, and should the need arise, recommend regulatory change in response to any unintended consequences in a timely manner.

7.2 When and how will the new arrangements be reviewed?

The accompanying proposal to introduce a statutory requirement for periodic reviews of the DIRA regulatory regime (as per Regulatory Impact Assessment #5: DIRA review and expiry provisions) provides an opportunity to review the effectiveness and other impacts of the proposals in this Regulatory Impact Assessment. The proposal is for the next scheduled review to take place during the 2024/25 dairy season, following standard regulatory review processes.

Fonterra and other dairy processors are incentivised to bring any issues with workability of the new arrangements to the Government's attention, as they do now in regard to the existing DIRA provisions.

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Coversheet #4: Obligation to sell up to 250 million litres of raw milk to Goodman Fielder

Advising agencies	*Ministry for Primary Industries*
Decision sought	*Approval to amend the Dairy Industry Restructuring (Raw Milk) Regulations 2012 to ensure that regulated terms, as they apply to Goodman Fielder, are fit-for-purpose.*
Proposing Ministers	*Hon Damien O'Connor, Minister of Agriculture*

Summary: Problem and Proposed Approach

What problem or opportunity does this proposal seek to address? Why is government intervention required?

Some of the Goodman Fielder-related provisions in the Dairy Industry Restructuring (Raw Milk) Regulations 2012 (the Regulations) are no longer current.

The Regulations provide assistance for Goodman Fielder to ensure that New Zealand consumers of staple dairy products are served by a competitive domestic consumer market, where that there is at least one viable large-scale competitor to Fonterra.

Specifically, the Regulations allow Goodman Fielder to purchase up to 250 million litres of raw milk per annum from Fonterra, on agreed or regulated terms. Goodman Fielder has, to date, been purchasing regulated milk from Fonterra on commercially agreed terms. Commercial Sensitivity [redacted] The current regulated terms, if relied on, could reduce Goodman Fielder's ability to operate as an effective large-scale competitor in the domestic consumer market.

On the other hand, the Regulations create long-term regulatory dependency by Goodman Fielder. Guaranteed access to regulated milk acts as a strong disincentive for Goodman Fielder to transform its business model and/or secure alternative supply arrangements.

MPI considers that, in the absence of foreseeable alternative market solutions, there is a need for a continued fit-for-purpose and up to date regulatory backstop for Goodman Fielder. This is to ensure that New Zealand consumers of staple dairy products continue to be served by a competitive domestic consumer market.

How will government intervention work to bring about the desired change? How is this the best option?

MPI proposes to update key regulated terms on which Goodman Fielder can access raw milk from Fonterra by:

- increasing the volume of regulated milk that Goodman Fielder can access from Fonterra from 250 to 350 million litres per season;
- enabling Goodman Fielder to purchase raw milk from Fonterra at fixed quarterly prices; and
- increasing Goodman Fielder's regulated price to include a margin for seasonal adjustment of $0.10 per kg MS.

The proposed changes would support Goodman Fielder's continued presence as an effective large-scale competitor in the domestic consumer market, on fit-for-purpose and up to date regulated terms, without imposing unreasonable regulatory burden and costs on Fonterra.

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Summary Impacts: Benefits and costs

Who are the main expected beneficiaries and what is the nature of the expected benefit?

The main beneficiaries of the proposed amendments are the New Zealand consumers of staple dairy products. The amendments would provide the domestic consumer market with confidence in the security of Goodman Fielder's position as a viable large-scale domestic competitor to Fonterra Brands. The Commerce Commission had estimated that, in the absence of regulatory assistance for Goodman Fielder, New Zealand consumers would likely face an average 6.25 percent increase in the retail price of fresh milk. This was then estimated to translate to a consumer welfare loss in the range of $51.9 million to $92.4 million per annum.

Goodman Fielder is the direct beneficiary of the proposed amendments. The amendments would provide Goodman Fielder with a continued regulatory backstop on more reasonable, fit-for-purpose and up to date regulated terms.

Fonterra is also a beneficiary of this proposal. Continuous presence of a viable large-scale competitor assures New Zealand consumers of competitive market outcomes, and reduces the risk of potential consumer backlash against Fonterra. The proposed pricing adjustment would also ensure that Fonterra would be compensated for its costs on a more reasonable basis.

Where do the costs fall?

The costs associated with the proposed amendments will fall on Fonterra and Goodman Fielder. Under the proposed approach, Goodman Fielder may choose to purchase greater volumes of regulated milk from Fonterra, possibly at fixed quarterly prices, but at a higher overall price payable to Fonterra. MPI considers that the new net costs on Fonterra and Goodman Fielder would be small or neutral.

What are the likely risks and unintended impacts, how significant are they and how will they be minimised or mitigated?

The proposed amendments could encourage further regulatory dependency by Goodman Fielder.

To address this, MPI considered and consulted on a further amendment to the Regulations that would have gradually reduced Goodman Fielder's eligibility for regulated milk. Such a gradual phase-out of the regulatory backstop might have provided Goodman Fielder with stronger incentives to secure alternative sources of raw milk supply and reduce its regulatory dependency over time. However, such amendment could have equally reduced Goodman Fielder's ability to operate as an effective large-scale competitor. In the absence of alternative market solutions, this would present a high risk of depriving Goodman Fielder of a reliable raw milk supply, with consequent detriment to New Zealand consumer welfare. For these reasons, this amendment is not recommended. Instead, MPI will continue to keep a close watching brief of the developments in the domestic consumer market, so that any changes to the Regulations, if and when required, could be made in a timely manner.

Given Synlait's recent (limited) entry into the South Island domestic fresh milk processing market, MPI does not consider that continued regulatory assistance for Goodman Fielder would prevent alternative market arrangements from emerging.

Identify any significant incompatibility with the Government's 'Expectations for the design of regulatory systems'.

MPI's proposed approach is aligned with the guidance provided in Government Expectations for Good Regulatory Practice (April 2017).

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Evidence certainty and quality assurance

Agency rating of evidence certainty

MPI considers there is an adequate evidence base for the proposed amendments. The scope of the problem is definable and limited to Goodman Fielder. The proposed amendments are based on the assumptions and evidence of past industry practice and market developments.

MPI's policy development process commenced in May 2018, following the Government's release of the terms of reference for the review of the Dairy Industry Restructuring Act 2001 and its impact on the dairy industry. MPI engaged with a large and diverse group of key industry stakeholders to help clarify concerns, establish facts and build evidence to inform preliminary analysis of issues and options for potential legislative amendments. MPI completed 28 engagement meetings and received written input from 12 organisations. MPI have also commissioned two reports from an independent economic consultancy, Frontier Economics, on the performance of New Zealand dairy industry and its underlying drivers. The industry input and consultancy reports can be found at http://www.mpi.govt.nz/dira-review.

In November 2018, a discussion document, outlining issues and options for change, was approved for public consultation by Cabinet [CAB-18-MIN-0528 refers]. Comprehensive consultation was conducted for 14 weeks, closing on 8 February 2019. It involved 13 town hall meetings (attended by 401 dairy farmers), 22 face-to-face industry meetings and workshops, and was supported by extensive communications to the sector via traditional and social media.

The final proposals take account of stakeholder feedback.

Quality Assurance Reviewing Agency:
The Regulatory Impact Assessment has been reviewed by a quality assurance panel with representatives from the Regulatory Quality Team at the Treasury and the Ministry for Primary Industries.
Quality Assurance Assessment:
The panel considers that the Regulatory Impact Assessment meets the quality assurance criteria.
Reviewer Comments and Recommendations:
It is an overly complex presentation of what is essentially a regulatory stewardship issue arising because the regulated terms on which Goodman Fielder can access raw milk from Fonterra are no longer current.

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Impact Statement #4: Obligation to sell up to 250 million litres of raw milk to Goodman Fielder

Section 1: General information

Purpose

The Ministry for Primary Industries is solely responsible for the analysis and advice set out in this Regulatory Impact Statement, except as otherwise explicitly indicated. This analysis and advice has been produced for the purpose of informing key policy decisions to be taken by Cabinet.

Key Limitations or Constraints on Analysis

There are no significant constraints on analysis. The scope of the problem is definable and limited to Goodman Fielder. The proposed amendments are based on the assumptions and evidence of past industry practice and market developments.

Commercial Sensitivity

[redacted]

During MPI's consultation process, Fonterra suggested a series of further minor changes to the Regulations in relation to regulated milk use by eligible dairy processors, forecasting rules and certain other matters. The timeframes for preparing this Regulatory Impact Assessment have not allowed for the consideration of, and industry consultation on, Fonterra's proposed changes. Given that the proposed changes are not essential and represent only some fine-tuning of the regulatory regime, they will be considered at a later date, depending MPI's future work programme and the Minister's regulatory priorities.

Responsible Manager

Emma Taylor
Director of Agriculture, Marine and Plant Policy,
Policy and Trade Branch
Ministry for Primary Industries

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Section 2: Problem definition and objectives

2.1 What is the context within which action is proposed?

The Regulations were designed to provide assistance for Goodman Fielder to ensure that New Zealand consumers of staple dairy products are served by a competitive domestic consumer market, where there is at least one viable large-scale competitor to Fonterra.

The rationale goes back to the formation of Fonterra, which presented a significant risk to New Zealand consumers of staple dairy products (e.g., basic fresh milk, butter, table cheese). Without some form of government intervention, Fonterra's domestic consumer business (Fonterra Brands) would have been the only large-scale supplier of staple dairy products to New Zealand consumers. This would have given Fonterra Brands the ability to charge excessive wholesale prices and/or restrict the quantity and variety of dairy products available in New Zealand.

To manage this risk, Fonterra was required to divest 50 percent of its domestic consumer business, thus creating a competitor of comparable size. Since the newly-formed competitor (now Goodman Fielder) did not have its own milk supply, this was provided for under a long-term commercial contract with Fonterra, backed by the provisions of the Regulations. The Regulations require Fonterra to sell up to 250 million litres of raw milk per annum to Goodman Fielder, on agreed or regulated terms.[7]

The required divestment and regulatory assurance of on-going milk supply have guaranteed the immediate and ongoing presence of at least one large-scale competitor to Fonterra Brands in the domestic consumer market. This has in turn ensured that, despite Fonterra's creation, the New Zealand consumers of staple dairy products continued to be served by a competitive domestic consumer market. It was expected that, over time, Goodman Fielder would develop its own supply of raw milk independent of Fonterra.

To date, Fonterra Brands and Goodman Fielder remain the only two large-scale suppliers of staple dairy products (and particularly fresh milk) to New Zealand consumers. Goodman Fielder has not developed its own supply and remains almost entirely reliant on Fonterra for its raw milk requirements. Commercial Sensitivity [redacted] Exceptions to this are Westland Milk selling premium butter products on the New Zealand market and Synlait, which is starting to toll process[8] fresh consumer milk products for Foodstuffs South Island's private label brand this year.

While the Regulations ensure that there is at least one viable large-scale competitor to Fonterra in the domestic consumer market, they also create long-term regulatory dependency on the part of Goodman Fielder Commercial Sensitivity [redacted]

Addressing regulatory dependency requires careful balancing of the principles of good regulatory practice and the interests of New Zealand consumers. The Commerce Commission, in its 2016 review of the state of competition in the dairy industry, estimated that in the absence of regulatory

[7] The Regulations also enable smaller processors supplying the domestic consumer market to purchase up to 50 million litres of raw milk each season from Fonterra, on agreed or regulated terms. This enables small dairy food and beverage companies producing mostly premium or niche consumer products to offer diverse product choice and specialty goods to New Zealand consumers (e.g., premium cheeses, yoghurts, ice cream and organic dairy products).

Commercial Sensitivity [redacted]

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assistance for Goodman Fielder, New Zealand consumers would likely face an average of 6.25 percent increase in the retail price of fresh milk. This was then estimated to translate to a consumer welfare loss in the range of $51.9 million to $92.4 million per annum.

Commercial Sensitivity [redacted]

2.2 What is the policy problem or opportunity?

The continued presence of Goodman Fielder as a viable large-scale competitor to Fonterra Brands depends on Goodman Fielder having access to sufficient volume of raw milk on terms that are fit-for-purpose and up to date.

The current regulated terms that apply to Goodman Fielder were put in place in 2002 and have not been reviewed since. Key regulated terms are no longer current or fit-for-purpose. For example, the regulated terms do not take account of pricing implications of Goodman Fielder's demand curve for raw milk or the increase in the overall level of demand in the domestic consumer market since 2002. If relied on, the current regulated terms could reduce Goodman Fielder's ability to operate as an effective large-scale competitor in the domestic consumer market.

2.3 Are there any constraints on the scope for decision making?

Commercial Sensitivity [redacted]

[redacted]

2.4 What do stakeholders think?

MPI's extensive industry consultation process is outlined in the background section of this document. The key industry stakeholders, whose interests are affected by this Regulatory Impact Assessment, include:

- Goodman Fielder as the purchaser of regulated milk from Fonterra;
- Fonterra as the regulated party required to sell regulated milk to Goodman Fielder;
- Fonterra farmers as suppliers of milk to, and shareholders of, Fonterra;
- Independent processors as potential competitors to Fonterra and Goodman Fielder in the wholesale supply of domestic dairy products
- Supermarkets and other retail outlet as wholesale purchasers of dairy products in New Zealand; and
- New Zealand public as consumers of staple dairy products.

Commercial Sensitivity [redacted]

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Equally, Goodman Fielder does not consider that sourcing its raw milk requirements from other large established dairy processors can be viable, on terms that would be acceptable to Goodman Fielder.

Instead, Goodman Fielder considers that its regulatory entitlement (in an enhanced form) should continue. Goodman Fielder further submits that to continue to operate as a viable large-scale competitor to Fonterra Brands, it requires access to greater volumes of regulated milk from Fonterra, at the same price as Fonterra Brands, to ensure that the two businesses can compete on equal terms.

Fonterra supports the continuation of a regulatory backstop provided to Goodman Fielder, or an equivalent large-scale competitor in the domestic consumer market, to ensure there is a competitor of scale in the domestic consumer market. Commercial Sensitivity [redacted]

Fonterra's farmer-shareholders were divided in their views on the regulated milk supply for Goodman Fielder. While the majority recognised the important role that Goodman Fielder plays in the domestic consumer market, a significant proportion (almost 50 percent of those who commented on this provision) submitted that there has been an adequate time period for Goodman Fielder to establish its own supply and action should now be taken to remove regulatory dependence.

Large independent processors considered that having effective competition in the domestic consumer market was important and that, at this stage, there was unlikely to be a major entry into the market (beyond Synlait's limited entry in the South Island). However, some believed that Goodman Fielder's regulatory dependence was a problem and, as such, would prefer to see a clear pathway to end the regulated milk supply for Goodman Fielder.

Foodstuffs NZ submitted that effective competition in the domestic consumer market requires at least two potential suppliers to the retail sector, each having sufficient scale to be able to supply fresh milk products to consumers on a competitive basis. Foodstuffs NZ noted that Fonterra Brands and Goodman Fielder have, up until recently, been the only two companies with scale to tender for Foodstuffs' private label contracts. Foodstuffs' private label milk is the price leader and holds the largest market share of their retail market for fresh milk. Foodstuffs NZ were concerned that, in the absence of competition, Fonterra may seek to supply only its own branded products, thus reducing consumer choice and impacting on prices. While Synlait's entry into domestic milk processing in the South Island will enhance competition in the South Island, Synlait does not operate in the North Island, where Goodman Fielder is the only competitor to Fonterra Brands.

MPI had tried but was unable to generate engagement from the New Zealand Consumer Institute, or any other organisation representing New Zealand consumer interests.

Section 3: Options identification and analysis

3.1 What criteria, in addition to monetary costs and benefits, have been used to assess the likely impacts of the options under consideration?

The options in this Regulatory Impact Assessment have been assessed against the following criteria, which have been given equal weighting:

- *Effectiveness (contribution to policy outcomes sought):* ensuring that New Zealand consumers of staple dairy products continue to be served by a competitive domestic consumer market, where there is at least one viable large-scale competitor to Fonterra operating in the market at all times;
- *Proportionality (the regulatory cost is proportional to the extent of expected benefits):* ensuring that regulatory assistance for Goodman Fielder is provided on terms that allow Goodman Fielder to compete effectively and does not impose unreasonable costs on Fonterra;
- *Regulatory certainty (the regulatory system provides clarity and predictability of outcomes):* ensuring that regulatory provisions are sufficiently clear and outcomes are predictable over time; and

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- *Practicality (the implementation risks and unintended consequences are low):* ensuring that regulatory assistance for Goodman Fielder does not encourage further regulatory dependency by Goodman Fielder and/or prevent alternative market solutions from emerging.

3.2 What options are available to address the problem and how do they perform against the assessment criteria?

Option 1: Amend the Regulations to update key regulated terms on which Goodman Fielder can access raw milk from Fonterra

Under this option the Regulations would be amended to update key regulated terms on which Goodman Fielder can access raw milk from Fonterra, as follows:

- The volume of regulated milk that Goodman Fielder could access from Fonterra would increase from 250 to 350 million litres per season. Commercial Sensitivity [redacted]
- Goodman Fielder would have the option of purchasing regulated milk from Fonterra at fixed quarterly prices. The Regulations were amended in 2012 to allow other dairy processors without own supply to purchase milk from Fonterra at fixed quarterly prices. This was provided as a means of managing the price uncertainty associated with the dairy industry's ex-post pricing system. That amendment was not at the time extended to Goodman Fielder because of its commercial contract with Fonterra. This amendment would align Goodman Fielder's payment terms with other dairy processors without own supply.
- The regulated price for Goodman Fielder would increase to include a margin for seasonal adjustment. Goodman Fielder requires raw milk on a "flat" rather than seasonal curve in order to supply fresh milk all-year-round to the New Zealand consumer market. Under the current Regulations, the price Goodman Fielder would be required to pay for the "flattening" of the seasonal curve is set to reflect Fonterra's average milk price as it relates to the seasonal milk curve. This average price does not take into account the economic cost to Fonterra of selling raw milk to Goodman Fielder in the "shoulder" months of the season when it is more scarce and more valuable. To reflect the value of raw milk and to compensate Fonterra for the cost, the regulated price for Goodman Fielder would include a margin of $0.10 per kg of milk solids (kgMS) above Fonterra's average farmgate milk price.

This option would provide Goodman Fielder with more reasonable and fit-for-purpose regulatory terms of access to Fonterra's milk. It would therefore support Goodman Fielder's continued presence as an effective large-scale competitor in the domestic consumer market.

While this option would provide regulatory certainty for Goodman Fielder, it could encourage further regulatory dependency by Goodman Fielder. The updated regulated terms could provide Goodman Fielder with a reduced incentive to obtain its own supply.

The costs associated with this option would fall on Fonterra. Under this option Fonterra could be required to supply increased volumes of regulated milk to Goodman Fielder, potentially at fixed quarterly prices, but at a higher overall price. MPI considers that the additional net costs on Fonterra would small or neutral.

Option 2: Amend the Regulations to provide for Goodman Fielder's regulated terms to mirror the terms on which Fonterra supplies its own New Zealand consumer business

Under this option, the Regulations, as they apply to Goodman Fielder, would be amended to provide for the regulated terms to mirror the terms on which Fonterra supplies its own domestic consumer business, Fonterra Brands.

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MPI's consultation document presented this option as applying to all dairy processors supplying the domestic consumer market. Following consultation, the scope of this option has been narrowed down to apply to Goodman Fielder only, because MPI did not identify any significant issues with other domestically-focused processors accessing milk from Fonterra, on existing agreed or regulated terms.

This option would remove any competitive cost advantage Fonterra Brands may have over Goodman Fielder arising from its parent company's large scale and vertically integrated business model. Subsequently, Goodman Fielder would not be disadvantaged by not having its own (equally or more efficient) sources of raw milk supply, and could compete with Fonterra Brands on equal raw milk supply terms. Any competitive advantage Fonterra Brands would have over Goodman Fielder, and vice versa, would then be based only on the companies' relative product offerings, distribution channels and pricing strategies.

This option would significantly improve Goodman Fielder's ability to operate as a viable large-scale competitor in the domestic consumer market and provide regulatory certainty and predictability of outcomes over time.

Its implementation would require Fonterra to account for its domestic consumer business in a way that clearly separates it from Fonterra's other business units. This would be a significant and somewhat costly change for Fonterra. This type of regulatory intervention is usually considered in cases where significant competition and market efficiency issues are identified.

MPI's analysis of the domestic consumer market found that this is unlikely to be the case. Supply of domestic consumer products is constrained by the small market size and the underlying imbalance between the year-round demand from consumers and seasonal supply of milk from farmers. A dairy processor focused solely on New Zealand consumer markets inherently faces significant difficulties and higher costs in managing its raw milk requirements compared to a dairy processor with an export-focused arm. This suggests that the domestic consumer market could be efficiently served by companies that had both domestic and export focused dairy processing assets or if there were high levels of cooperation between stand-alone producers of domestic consumer products and dairy exporters.

MPI has not identified significant barriers to these types of market solutions from developing. However, this option would reduce the need for such market solutions to develop. Under this option there would be no incentive for Goodman Fielder to transform its business model, negotiate commercial arrangements with Fonterra or other large export-focused processors, and/or try to obtain its own supply from farmers. This would embed Goodman Fielder's regulatory dependency. It would also impose a disproportionate and administratively costly regulatory burden on Fonterra.

3.3 What other options have been ruled out of scope, or not considered, and why?

MPI has consulted on two additional options but has not considered them further. These options were to:

- Amend the Regulations to gradually reduce Goodman Fielder's eligibility to access regulated milk over time. This option was identified as a potential means of reducing Goodman Fielder's regulatory dependency. A gradual phase-out of regulatory assistance would provide Goodman Fielder with greater incentives to secure alternative sources of raw milk supply and reduce its regulatory dependency over time. However, such amendment could equally reduce Goodman Fielder's ability to operate as an effective large-scale competitor. MPI considered that, in the absence of foreseeable alternative market solutions, this option presented a high risk of reducing Goodman Fielder's ability to operate as a viable large-scale competitor, with the consequent impacts on New Zealand consumer welfare. This option was therefore not considered further.
- Amend the Regulations to remove limits on the amount of regulated milk available to dairy processors, without their own supply, who are serving the domestic consumer market. Consultation on this option was premised on the assumption that expansion by domestically-focused dairy processors could be hindered by the existing limits on the amount of regulated

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milk they can access. MPI's consultation process did not find any significant issues with domestically-focused dairy processors (other than Goodman Fielder) growing their operations within their existing regulated caps. Instead, MPI found that smaller dairy processors' growth was more likely to be constrained by the need to invest substantial amounts of additional capital, which may not be sustainable given the small size of the domestic market. This option was therefore not considered further.

In addition, Fonterra suggested a series of further minor changes to the Regulations in relation to regulated milk use by eligible dairy processors, forecasting rules and certain other matters. The timeframes for preparing this Regulatory Impact Assessment have not allowed for the consideration of, and industry consultation on, Fonterra's proposed changes. Given that these proposed changes are not essential and represent only some fine-tuning of the regulatory regime, they will be considered at a later date, depending MPI's future work programme and the Minister's regulatory priorities.

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Section 4: Impact Analysis

Criterion/Options	No action: retain existing regulated terms for Goodman Fielder	Option 1: Update existing regulated terms for Goodman Fielder to ensure they are fit-for-purpose	Option 2: Align existing regulated terms for Goodman Fielder with those of Fonterra Brands
Effectiveness - ensuring there is at least one viable large-scale competitor to Fonterra operating in the domestic consumer market at all times	**0** Could undermine Goodman Fielder's effective presence in the domestic consumer market	**+** Supports Goodman Fielder's continued presence as an effective large-scale competitor	**++** Significantly improves Goodman Fielder's position as an effective large-scale competitor
Proportionality - ensuring regulatory assistance for Goodman Fielder is provided on terms that allow Goodman Fielder to compete effectively and does not impose unreasonable costs on Fonterra	**0** Does not provide Goodman Fielder with a fit-for-purpose regulatory backstop	**+** Allows Goodman Fielder to compete on terms that are fit-for-purpose **0** Does not impose unreasonable costs on Fonterra	**++** Allows Goodman Fielder to compete on equal terms with Fonterra Brands **- -** Imposes disproportionate and costly regulatory burden on Fonterra
Regulatory certainty - ensuring regulatory provisions are sufficiently clear and outcomes are predictable.	**0** Provides for clear provisions and predictable outcomes	**+** Builds on existing provisions that are clear and well understood	**+** Relies on new but clear regulatory provisions
Practicality - ensuring regulatory assistance for Goodman Fielder does not encourage further regulatory dependency by Goodman Fielder and/or prevent alternative market solutions from emerging.	**0** Encourages regulatory dependency by Goodman Fielder **0** Unlikely to prevent alternative market solutions from emerging	**- -** Could encourage further regulatory dependency by Goodman Fielder **0** Unlikely to prevent alternative market solutions from emerging	**- -** Embeds regulatory dependency by Goodman Fielder **- -** Could prevent alternative market solutions from emerging
Overall assessment	**0 - not preferred**	**+ preferred**	**- not preferred**

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Section 5: Conclusions

5.1 What option, or combination of options, is likely best to address the problem, meet the policy objectives and deliver the highest net benefits?

MPI's recommended approach is to amend the Regulations to update key regulated terms on which Goodman Fielder can access raw milk from Fonterra by:

- increasing the volume of regulated milk that Goodman Fielder can access from Fonterra from 250 to 350 million litres per season;
- enabling Goodman Fielder to purchase raw milk from Fonterra at fixed quarterly prices; and
- increasing Goodman Fielder's regulated price to include a margin for seasonal adjustment of $0.10 per kgMS.

These amendments would provide Goodman Fielder with more reasonable, current and fit-for-purpose regulatory terms of access to Fonterra's milk, thus supporting Goodman Fielder's continued operation as an effective large-scale competitor in the domestic consumer market. The amendments would also not impose unreasonable costs on Fonterra. Although Goodman Fielder may choose to purchase greater volumes of regulated milk from Fonterra, possibly at fixed quarterly prices, it would be required to pay higher overall price. MPI considers that the new net costs on Fonterra and Goodman Fielder would be therefore be small or neutral.

The proposed amendments build on the existing regulatory provisions and would provide Goodman Fielder, and the wider domestic consumer market, with regulatory certainty and confidence in the security of Goodman Fielder's position as a viable large-scale domestic competitor.

The proposed amendments could, however, encourage further regulatory dependency by Goodman Fielder. To address this, MPI considered and consulted on a further amendment to the Regulations that would have gradually reduced Goodman Fielder's eligibility for regulated milk. Such gradual phase-out of regulatory assistance might provide Goodman Fielder with greater incentives to secure alternative sources of raw milk supply and reduce its regulatory dependency over time. However, the amendment could equally reduce Goodman Fielder's ability to operate as an effective large-scale competitor. In the absence of foreseeable alternative market solutions emerging, this amendment presents a high risk of depriving Goodman Fielder of a reliable raw milk supply, with consequent detriment to New Zealand consumer welfare. For these reasons, this amendment is not recommended.

Instead, MPI will continue to keep a close watching brief on the developments in the domestic consumer market so that any changes to the Regulations, if and when required, could be made in a timely manner. Given Synlait's recent (limited) entry into the South Island domestic fresh milk processing market, MPI does not consider that continued regulatory assistance for Goodman Fielder would prevent alternative market arrangements from emerging.

Goodman Fielder supported the proposed amendments (as its second preference) and submitted that there are no significant costs for Goodman Fielder arising from these proposals.

Fonterra acknowledged the importance of Goodman Fielder as a viable large-scale competitor in the domestic consumer market and was supportive of ongoing access to regulated milk for Goodman Fielder. However:

- Fonterra did not support the proposal to increase the total amount of regulated milk provided to Goodman Fielder to 350 million litres of raw milk per season. Fonterra considers that Goodman Fielder could secure additional volumes through alternative market solutions. MPI believes that, in the absence of foreseeable alterative market solutions, increased volumes of regulated milk would ensure that Goodman Fielder continued to operate as an effective competitor in the domestic consumer market.

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- Fonterra also did not support the proposal to enable Goodman Fielder to purchase regulated milk at fixed quarterly prices. Fonterra believes that, unlike smaller processors, Goodman Fielder is large and sophisticated enough to manage the ex-post price. MPI considers that as long as Goodman Fielder is not sourcing its milk from farmers, it is just as challenging for it to manage the price uncertainty associated with the industry's ex-post raw milk pricing practices as it is for smaller processors.
- Fonterra did support the proposal to increase the regulated price for Goodman Fielder to include a margin for seasonal adjustment, but submitted that the margin should set at \$0.12 kgMS rather than \$0.10 kgMS. Fonterra considered that a higher margin was required to cover the additional cost of flat supply (of slightly more than \$0.10 kgMS) and make a contribution towards Fonterra's milk sourcing operation. MPI considers that providing Goodman Fielder with regulated milk does not impact on the cost of Fonterra's milk sourcing operationsCommercial Sensitivity

Large dairy processors considered that Goodman Fielder plays a key role as a competitor of scale in the domestic consumer market. However, some believed that Goodman Fielder's regulatory dependence was a problem, and as such would prefer to see a clear pathway to end the regulated milk supply for Goodman Fielder.

Fonterra's farmer-shareholders were divided in their views on the regulated milk supply for Goodman Fielder. While the majority recognised the important role that Goodman Fielder plays in the domestic consumer market, a significant proportion submitted that there has been an adequate time period for Goodman Fielder to establish own supply and action should now be taken to reduce regulatory dependence.

As outlined above, MPI considers that, in the absence of foreseeable alternative market solutions emerging, reducing Goodman Fielder's access to regulated milk presents a high risk to New Zealand consumer welfare. For this reason, it has not been possible to accommodate these stakeholder concerns.

5.2 Summary table of costs and benefits of the preferred approach

Affected parties	Comment	Impact	Evidence certainty
Additional costs of proposed approach, compared to taking no action			
Regulated parties: • Fonterra	**Monetised costs:** • Fonterra may have to supply small additional volumes of regulated milk to Goodman Fielder, potentially at fixed quarterly prices, but at a higher overall price.	**None – Low** Given the small additional volumes of regulated milk involved, the net cost impact is likely to be small or neutral.	**Medium**
	Non-monetised costs: • **Not applicable**		
Other affected parties: • Goodman Fielder	**Monetised costs:** • Goodman Fielder may choose to purchase small additional volumes of regulated milk from Fonterra, at fixed quarterly prices,	**None – Low** Given the small additional volumes of regulated milk involved, the net cost impact is likely to be small or neutral.	**Medium**

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	but at a higher overall price.		
	Non-monetised costs: • Potentially reduced incentive to transform Goodman Fielder's business model.	**None – Low** Other significant factors will drive or prevent Goodman Fielder's business transformation.	**High**
Other affected parties: • Independent processors as suppliers of domestic dairy products	**Monetised costs:** • Not applicable		
	Non-monetised costs: • Goodman Fielder's ongoing presence in the domestic consumer market may reduce incentives for others to enter.	**None – Low** Other factors have more significant impact on dairy processors' entry decisions.	**High**
Other affected parties: • Retail outlets • New Zealand consumers of dairy products	**Monetised costs:** • **Not applicable** – the proposals are designed to ensure that retail outlets and consumers of dairy products in NZ do not face additional costs.		
	Non-monetised costs: • **Not applicable** - the proposals are designed to ensure that retail outlets and consumers of dairy products in NZ remain unaffected		
Total monetised costs	as per above	**None - Low**	**Medium**
Total non-monetised costs	as per above	**None - Low**	**High**

Affected parties	Comment	Impact	Evidence certainty
Expected benefits of proposed approach, compared to taking no action			
Regulated parties: • Fonterra	**Monetised benefits:** • Ability to charge Goodman Fielder a higher overall price for greater volumes of regulated milky, potentially purchased at fixed quarterly prices.	**None – Low** Given the small additional volumes of regulated milk involved, the net benefit impact is likely to be small or neutral.	**Medium**
	Non-monetised benefits: • Continued presence of a viable large-scale competitor, providing assurance to consumers of	**Medium** Maintaining consumer confidence in competitive market outcomes.	**High**

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	competitive market outcomes and reducing the risk of potential consumer backlash against Fonterra.		
Other affected parties: • Goodman Fielder	**Monetised benefits:** • Ability to purchase greater volumes of regulated milk from Fonterra, potentially at fixed quarterly prices but at a higher overall price.	**None – Low** Given the small additional volumes of regulated milk involved, the net benefit impact is likely to be small or neutral.	**Medium**
	Non-monetised benefits: • Increased certainty of raw milk supply.	**Low - Medium** Secure access to sufficient volumes of milk supply.	**High**
Other affected parties: • Independent processors	**Monetised benefits:** • **Not applicable**		
	Non-monetised benefits: • **Not applicable**		
Other affected parties: • Retail outlets • New Zealand consumers of staple dairy products	**Monetised benefits:** • **Not applicable** – the proposals are designed to ensure that retail outlets and consumers of dairy products in NZ retain existing benefits of competition.		
	Non-monetised benefits: • Confidence in the ongoing competitiveness of the domestic consumer market	**High** Maintaining consumer confidence in competitive market outcomes.	**High**
Total monetised benefits	as per above	**None-Low**	**High**
Total non-monetised benefits	as per above	**Medium**	**High**

5.3 Is the preferred approach compatible with the Government's 'Expectations for the design of regulatory systems'?

MPI's preferred combination of options is aligned with the guidance provided in *Government Expectations for Good Regulatory Practice* (April 2017).

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Section 6: Implementation and operation

6. 1 How will the new arrangements be implemented?

A regulatory amendment is required to update the regulated terms as they apply to Goodman Fielder. It is expected that the Dairy Industry Restructuring (Raw Milk) Amendment Regulations will be considered by Cabinet in June 2019 and progressed through the standard Order in Council process before the end of 2019. The amended Regulations are expected to come into force from 1 June 2020.

MPI does not consider that any transitional arrangements are required at this stage. MPI will communicate the changes to Goodman Fielder, Fonterra and other interested parties as soon as Cabinet decisions are made. This will provide all stakeholders with sufficient time to adjust their operations, if needed.

As with the existing regulatory provisions, it will be up to Fonterra to interpret and apply the amendments to the Regulations, in the first instance. The Commerce Commission will continue to operate in its current role of being the enforcement agency for disputes arising in relation to all DIRA provisions, including in relation to changes proposed in this Regulatory Impact Assessment.

6.2 What are the implementation risks?

The key risk with the proposed amendments is that they could encourage further regulatory dependency by Goodman Fielder. To mitigate this risk, MPI will keep a close watching brief of the developments in the domestic consumer market and recommend changes to the Regulations, if and when alternative market solutions emerge.

Given Synlait's recent (limited) entry into the South Island domestic fresh milk processing market, MPI does not consider that continued regulatory assistance for Goodman Fielder would prevent alternative market arrangements from emerging.

Section 7: Monitoring, evaluation and review

7. 1 How will the impact of the new arrangements be monitored?

The Regulations already provide for MPI to collect data from Fonterra regarding its supply of regulated milk to other dairy processors. This tracks the volumes of regulated milk Goodman Fielder purchased in each season. The Regulations also provide for MPI to keep track of the volumes of raw milk sourced by dairy processors from farmers. MPI collects and analyses this information on annual basis.

The proposed the Dairy Industry Restructuring Amendment Bill, which will give effect to proposals in the accompanying Regulatory Impact Assessments, will also contain a new regulation-making power that will allow MPI to expand its existing information gathering to other sources of milk supply (i.e., from other processors). This information is currently collected on a voluntary basis, resulting in some inconsistencies and data quality issues. The new provision will enable MPI to monitor Goodman Fielder's quantities of potential alternative milk supply arrangements. If Goodman Fielder were to secure alternative milk supply arrangements or if another processor were to start supplying domestic consumer dairy products at scale, this would indicate that the regulatory backstop for Goodman Fielder was no longer required.

In addition, the Commerce Commission will continue to operate in its current role as the enforcement agency for disputes arising in relation to all DIRA provisions, including the application of the proposed amendments in this Regulatory Impact Assessment. The Government, through the Commerce Commission, will have access to information related to complaints or disputes arising from the proposed new arrangements. The number of, and the costs associated with, these complains or disputes will be reviewed on an annual basis through the Fonterra Levy setting process. This annual review process provides an opportunity to consider the effectiveness of the new arrangements.

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These information sources will enable MPI to closely monitor the effectiveness of the proposed changes, and, should the need arise, recommend regulatory change in response to any unintended consequences in a timely manner.

7.2 When and how will the new arrangements be reviewed?

The accompanying proposal to introduce a statutory requirement for periodic reviews of the DIRA regulatory regime (as per Regulatory Impact Assessment #5: DIRA review and expiry provisions) provides an opportunity to review the effectiveness and other impacts of the proposals in this Regulatory Impact Assessment. The proposal is for the next scheduled review to take place during the 2024/25 dairy season, following standard regulatory review processes.

Goodman Fielder, Fonterra and other interested parties are incentivised to bring any issues with workability of the new arrangements to the Government's attention, as they do now in regard to the existing DIRA provisions.

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Coversheet #5: DIRA review and expiry provisions

Advising agencies	*Ministry for Primary Industries*
Decision sought	*Approval to amend the Dairy Industry Restructuring Act 2001 to introduce a statutory requirement for six-yearly periodic reviews of whether the DIRA should retained, repealed or amended. This will ensure that future regulatory review processes are undertaken in a timely manner.*
Proposing Ministers	*Hon Damien O'Connor, Minister of Agriculture*

Summary: Problem and Proposed Approach

What problem or opportunity does this proposal seek to address? Why is government intervention required?

The DIRA does not currently contain any review or expiry provisions. This creates a risk of Fonterra being regulated for longer than necessary.

When the DIRA was originally passed, the assumption was that over time Fonterra's dominant position, and therefore market power, could be eroded. The original DIRA, therefore, contained automatic expiry provisions. In February 2018, the expiry provisions were repealed to prevent the upcoming expiry in the South Island and to enable a policy review to take place in a stable regulatory environment.

MPI's policy review concluded that the DIRA regulatory regime, on the whole, was a cost-effective way of managing Fonterra's dominance and that was still needed at this stage. However, the lack of a statutory requirement for a review creates a risk that Fonterra could be regulated for longer than necessary.

How will government intervention work to bring about the desired change? How is this the best option?

MPI's recommended approach is to introduce a statutory requirement for six-yearly periodic reviews of whether the DIRA should retained, repealed or amended. Having the review provisions embedded in law will reduce the risk of a future review being deferred by other government priorities, thus reducing the risk of Fonterra being regulated for longer than necessary.

Undertaking a review at regular time-bound intervals, rather than linking it to a set market share threshold, will avoid the risk of creating an expectation and a false sense of regulatory certainty amongst industry stakeholders that the DIRA would be definitely repealed.

Summary Impacts: Benefits and costs

Who are the main expected beneficiaries and what is the nature of the expected benefit?

Fonterra, as the regulated party, is the main beneficiary of the proposed approach. The key benefit of this option is that it provides Fonterra and the wider industry with certainty that the need for the DIRA regulatory regime will be reviewed in a timely manner. It also provides the dairy industry with a clear time horizon over which the regulatory regime can be expected to remain unchanged and a predictable point in the future when a regulatory review process will take place.

Where do the costs fall?

The costs of undertaking and engaging on regular reviews fall on the Government, Fonterra and other industry participants, respectively. These costs have been estimated to be around $3 million per review, but are likely to be unavoidable under all options considered in this Regulatory Impact Assessment, including the status quo.

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Although significant, these costs would be incurred to avoid the regulatory risks/costs of regulating Fonterra for longer than necessary.

What are the likely risks and unintended impacts, how significant are they and how will they be minimised or mitigated?

The timing for periodic reviews would be relatively inflexible. Reviews would need to be undertaken regardless of whether there had been significant changes to the industry's competitive landscape since the last review. At the same time, if there were some rapid industry changes, periodic reviews may not be able to respond to them in a timely manner.

A shorter period in between reviews (e.g., three years following the implementation of the previous review's recommendations) and MPI's active monitoring of changes in industry dynamics (potentially resulting in a recommendation to initiate an earlier review) would mitigate these risks.

Identify any significant incompatibility with the Government's 'Expectations for the design of regulatory systems'.

MPI's proposed approach is aligned with the guidance provided in Government Expectations for Good Regulatory Practice (April 2017).

Evidence certainty and quality assurance

Agency rating of evidence certainty

MPI considers there is an adequate evidence base for the proposed amendment.

The proposal to introduce a statutory requirement for a six-yearly periodic review reduces the risk of Fonterra being regulated for longer than necessary. The proposal is part of the wider package of regulatory changes aimed at modifying the current DIRA provisions to ensure that they do not create unintended consequences and remain fit-for-purpose.

MPI's policy development process commenced in May 2018, following the Government's release of the terms of reference for the review of the Dairy Industry Restructuring Act 2001 and its impact on the dairy industry. MPI engaged with a large and diverse group of key industry stakeholders to help clarify concerns, establish facts and build evidence to inform preliminary analysis of issues and options for potential legislative amendments. MPI completed 28 engagement meetings and received written input from 12 organisations. MPI have also commissioned two reports from an independent economic consultancy, Frontier Economics, on the performance of New Zealand dairy industry and its underlying drivers. The industry input and consultancy reports can be found at http://www.mpi.govt.nz/dira-review.

In November 2018, a discussion document, outlining issues and options for change, was approved for public consultation by Cabinet [CAB-18-MIN-0528 refers]. Comprehensive consultation was conducted for 14 weeks, closing on 8 February 2019. It involved 13 town hall meetings (attended by 401 dairy farmers), 22 face-to-face industry meetings and workshops, and was supported by extensive communications to the sector via traditional and social media.

The final proposal takes account of stakeholder feedback.

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Quality Assurance Reviewing Agency:
The Regulatory Impact Assessment has been reviewed by a quality assurance panel with representatives from the Regulatory Quality Team at the Treasury and the Ministry for Primary Industries.
Quality Assurance Assessment:
The panel considers that the Regulatory Impact Assessment meets the quality assurance criteria.
Reviewer Comments and Recommendations:
The problem definition is clear and a range of options around expiry and review provisions has been outlined. A sound case has been made for regular reviews by MPI to balance the risk of Fonterra being regulated for longer than necessary and the risk of regulation being removed too early. A six yearly review cycle would help to balance the regulatory outcomes sought and the cost of the reviews, with out-of-cycle reviews if required.

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Impact Statement #5: DIRA review and expiry provisions

Section 1: General information

Purpose

The Ministry for Primary Industries is solely responsible for the analysis and advice set out in this Regulatory Impact Statement, except as otherwise explicitly indicated. This analysis and advice has been produced for the purpose of informing key policy decisions to be taken by Cabinet.

Key Limitations or Constraints on Analysis

Scope

The policy development process that underpins the recommendations in this Regulatory Impact Assessment is focused on the changes to the current DIRA regulatory regime.

While MPI's policy review of the DIRA and its impact on the dairy industry required a contextual consideration of the dairy industry's performance and its underlying drivers, the scope for regulatory changes is limited to the current DIRA regime. As a result, the proposed regulatory changes take account of, but do not seek to directly affect the dairy industry's performance arising from (among other things):

- Fonterra's ownership model and business strategy;
- trade and market access rules; and
- environmental regulation.

Assumptions

The analysis underpinning the proposal to introduce a statutory requirement for a six-yearly periodic review is based on MPI's assessment of the risk associated with a government-initiated regulatory review process in the future.

Government-initiated reviews are dependent on policy and regulatory priorities at the time. While this is no different from most regulatory regimes, there is a risk that the DIRA regulatory regime may continue to apply for longer than necessary. If a future review were to be initiated in a timely manner, the proposed statutorily-required review would not be needed.

Responsible Manager

Emma Taylor
Director of Agriculture, Marine and Plant Policy,
Policy and Trade Branch
Ministry for Primary Industries

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Section 2: Problem definition and objectives

2.1 What is the policy problem or opportunity?

The DIRA does not currently contain any review or expiry provisions. This creates a risk of Fonterra being regulated for longer than necessary.

When the DIRA was originally passed, the assumption was that over time Fonterra's dominant position, and therefore market power, in the market for farmers' milk could be eroded. If and when Fonterra was no longer dominant, active competition for farmers' milk, rather than regulation, would become the means of ensuring that farmers' milk supply flowed to its highest value use. In the absence of the DIRA, the management of any risks of anti-competitive behaviour among competing firms would rely solely on the provisions of the Commerce Act 1986.

The original DIRA contained automatic expiry provisions based on [the then] set market share thresholds. In 2011, these expiry provisions were amended to provide for a review of the state of competition to be undertaken prior to the new automatic expiry provisions taking effect. In February 2018, the DIRA review and expiry provisions were repealed to prevent the upcoming expiry of the DIRA in the South Island and to enable a policy review to take place in a stable regulatory environment.

MPI undertook a comprehensive analysis and review of the dairy industry performance and the overall fitness-for-purpose review of the DIRA regime and found that despite the changes in the dairy industry structure and Fonterra's reduced market share, Fonterra is still dominant and the overall DIRA regime provides an effective means of managing this dominance (Appendix refers). Although the review has identified a number of regulatory provisions that would benefit from modification (as outlined and analysed in the accompanying Coversheets and Regulatory Impact Assessments), the review concluded that at this stage Fonterra is still dominant and the DIRA is providing a cost-effective means of managing this dominance.

Under the current DIRA provisions, the regulatory regime will remain in place indefinitely. The Government would need to take a positive action to decide to undertake a further review. Although the Government of the day can initiate a regulatory review at any time, this is dependent on other regulatory review and policy priorities, which may affect the timeliness of the necessary regulatory change processes. While this is no different from most regulatory regimes that are permanent features on the New Zealand statute book, with any legislative review subject to government priorities, the outcome may not be consistent with good regulatory practice.

The lack of a statutory requirement for a review or expiry of the DIRA creates a risk that the DIRA regulatory regime could remain in place for longer than necessary.

2.2 Are there any constraints on the scope for decision making or interdependencies with other issues?

MPI is not aware of any constraints on the scope for decision-making.

This issue is part of a wider package of issues and regulatory proposals designed to modify Fonterra's obligations under the DIRA regulatory regime. While addressing each of the issues individually would provide for improvements over the status quo, they are more likely to be effective if implemented jointly.

2.3 What do stakeholders think?

MPI's extensive industry consultation process is outlined in the background section of this document. The key industry stakeholders, whose interests are affected by this Regulatory Impact Assessment, include:

- Fonterra as the regulated party;
- Fonterra farmer-shareholders as suppliers of milk to, and shareholders of, Fonterra;
- farmers supplying independent processors;
- independent processors as competitors to Fonterra for farmers' milk; and

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- Federated Farmers as the key industry association representing farming interests.

Fonterra considers that having no review or expiry provisions in the DIRA heightens the risk of regulation remaining in place unnecessarily.

Almost half of Fonterra farmer-shareholders who provided submissions to the review did not submit on this particular issue. Those that did submit, held similar views as Fonterra on the risks associated with no review or expiry provisions. About twenty five percent of those who submitted considered that the DIRA should be repealed now.

Independent processors generally recognised that there was a need to strike a balance between the costs of the regular review processes, and ensuring that regulations do not remain in place for longer than necessary.

Federated Farmers was also concerned to ensure that there was a balance between regulator reviews, certainty for the industry and unnecessary regulation.

Section 3: Options identification and analysis

3.1 What criteria, in addition to monetary costs and benefits, have been used to assess the likely impacts of the options under consideration?

The options in this Regulatory Impact Assessment have been assessed against the following criteria, which have been given equal weighting:

- *Effectiveness (contribution to policy outcomes sought):* ensuring timeliness of regulatory review processes to reduce the risk of either regulating Fonterra for longer than necessary or removing regulation too early.
- *Regulatory certainty (the regulatory system provides clarity and predictability of outcomes):* ensuring sufficient certainty and predictability of Fonterra's legal obligations over time.
- *Durability (the regulatory system is able to evolve in a timely manner in response to changing circumstances):* maintaining sufficient flexibility to respond to potentially rapid changes in industry dynamics.
- *Proportionality (the regulatory burden/cost is proportional to the extent of expected benefits):* ensuring that the regulatory cost of undertaking and engaging on future regulatory review processes does not outweigh the benefits that the proposed change is expected to deliver.

3.2 What options are available to address the problem and how do they perform against the assessment criteria?

Option 1: Amend the DIRA to require periodic reviews of whether the DIRA should be retained, repealed or amended

This option would amend the DIRA to require a review to be carried out at regular time-bound intervals. The review would not trigger an automatic DIRA expiry process.

This option would reduce the risk of Fonterra being regulated for longer than necessary. A statutory requirement to undertake a periodic review would ensure that the DIRA review could not be deferred by other government priorities.

This option would give the industry certainty over timing of potential regulatory change processes. The option provides the industry with a clear time horizon over which the regulatory regime can be expected to remain unchanged and a predictable point in the future when a regulatory review process will take place. It would not however provide greater certainty of regulatory outcomes for the industry.

The costs to the industry of having to engage on regular reviews and the cost to the Government of undertaking the reviews could be significant. While MPI does not have exact figures of the costs to the industry of having to engage on the current DIRA review, we estimate the direct costs to be in the order of $2 million. This is based on the assumption (and past experience) that key industry participants would rely on the support of external

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competition and regulatory law and economics experts. The direct cost to the Government of undertaking the review is estimated at around $1 million, which also includes sourcing external expertise in competition and regulatory economics. The impacts could be mitigated, to some extent, by ensuring that the intervals between reviews (assuming the first did not result in complete repeal) were designed and planned for with the industry's business cycles and the Government's budget decisions and timeframes in mind.

However, the timing for review would be inflexible. Reviews would need to be undertaken regardless of whether there had been significant changes to the industry's competitive landscape since the last review. At the same time, if there were some rapid industry changes, a periodic review may not be able to respond to them in a timely manner.

A shorter period in between reviews and active monitoring of changes in industry dynamics (resulting in a recommendation to initiate an earlier review) would mitigate this drawback. On the other hand, providing for more frequent reviews would increase the overall cost of undertaking reviews and reduce regulatory certainty for the dairy industry.

MPI originally consulted on this option, with reviews being conducted on a five-yearly periodic basis. Most stakeholders agreed with the proposed frequency of the review provisions. Fonterra suggested adopting a three-yearly review period following the recommendations of the previous review being implemented. Given that it would normally take about two years for a policy review to undertaken and its recommendations to be implemented, Fonterra's suggested approach would effectively result in five-yearly intervals between the reviews being initiated, providing the dairy industry with three years of stable regulatory environment in between the reviews. MPI considers that a longer period of stable regulatory environment is required, but agrees that the time taken to undertake the review and implement its recommendations needs to be taken into account in determining the frequency of periodic reviews. A more balanced outcome could be achieved by providing for six-yearly periodic reviews in legislation, thus effectively allowing for four years of stable regulatory environment in between the reviews.

Option 2: Amend the DIRA to require review of whether the DIRA should be retained, repealed or amended to be undertaken when a set market share threshold has been reached

This option would amend the DIRA to require a review to be carried out when a certain market share threshold had been reached. The review would not trigger an automatic DIRA expiry process.

The advantage of using a market share threshold as a trigger for review is that it points to the changing competition dynamics in the industry. Unlike a periodic review, a review triggered by a market share threshold would ensure that a review was triggered only when significant industry change had taken place.

However, identifying an appropriate market share threshold for a trigger point is extremely difficult. Market share thresholds are highly imperfect proxies of competition. At different times and circumstances a firm holding 40 percent of market share may be able to exercise market power. In other times and circumstances, a firm with a market share as high as 70 percent may still be subjected to substantial competitive pressure from its much smaller rival(s) and/or the bargaining power of its customers. Determining whether there is "sufficient" competition in a market is driven by many different factors. A market share threshold alone cannot determine whether there is "sufficient" competition (so that regulation can be removed or amended). It simply identifies a point in time when a full competition analysis may be warranted.

Linking the next review to a market share threshold will likely create an expectation and a false sense of regulatory certainty amongst industry stakeholders that the chosen market share threshold represents the point at which a future Government will be expected to allow the DIRA to be repealed, which would be contrary to the policy intent.

The costs to the industry and the Government would be the same as under Option 1.

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Options 1 and 2 are not mutually exclusive and could be implemented in combination, if judged necessary and desirable.

Option 3: Amend the DIRA to provide for its automatic expiry from a nominated date or when a set market share threshold has been reached

This option would not provide for any further review of the DIRA regulatory regime. It provides for the outright repeal of the entire DIRA regulatory regime on a nominated date in the future or at a certain level of Fonterra's market share (e.g. 70 or 75 percent in either, each or both North and South Islands, or a region).

Under this option, the chosen trigger for expiry would necessarily need to be conservative to counter the risk of the DIRA regulatory regime being repealed too early. It may then result in the DIRA continuing to apply when it is no longer necessary. Critically, this option provides for a very blunt instrument which does not respond to complex industry dynamics. Under this option, the expiry could occur regardless of whether Fonterra's market power had changed.

While this option may appear to provide greater regulatory certainty, relative to Options 1 and 2 above, its actual effect on regulatory certainty is unclear. This is because a future Government may decide that it would be imprudent to allow the DIRA regulatory regime to expire, without subjecting it to a policy review process prior to expiry. This was the case in 2010, when the DIRA's original expiry provisions were set to be reached. The Government of the day had then instigated a review, which eventually led to the introduction of the statutorily-required review and expiry process.

The cost to the industry and the Government of undertaking future reviews may or may not be avoided under this option.

Some stakeholders, primarily Fonterra's farmer-shareholders, favoured this option over Options 1 and 2, because they considered that this option would give them greater regulatory certainty. As outlined above, MPI is concerned that this option would give industry stakeholders a false sense of certainty over future regulatory outcomes.

3.3 What other options have been ruled out of scope, or not considered, and why?

During MPI's consultation process, Fonterra proposed an additional option for a regional phase-out of the DIRA open entry and exit provisions. Under this option, the DIRA open entry and exit provisions would stop applying in regions where Fonterra's market share dropped below 75 percent of milk production in that region.

This option would create significant additional layer of regulatory complexity, while having essentially the same characteristics as Option 3, applied at a different level of the geographic market definition. This option was therefore not considered.

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Section 4: Impact Analysis

Criterion/Options	No action: no statutory requirement for review or expiry	Option 1: Amend the DIRA to introduce a statutory requirement for periodic reviews	Option 2: Amend the DIRA to introduce a statutory requirement for a review, triggered by a set market share threshold being reached	Option 3: Amend the DIRA to introduce an automatic expiry of the regime from a nominated date or a set market share threshold
Effectiveness - ensuring timeliness of regulatory review processes to reduce the risk of either regulating Fonterra for longer than necessary or removing regulation too early	0 Creates the risk of Fonterra being regulated for longer than necessary	++ Reduces the risk of regulating Fonterra for longer than necessary. Not having automatic expiry provisions ensures that regulation is not removed too early.	++ Reduces the risk of regulating Fonterra for longer than necessary. Not having automatic expiry provisions ensures that regulation is not removed too early.	- Increases the risk of Fonterra being regulated for longer than necessary and the risk of removing regulation too early.
Regulatory certainty - ensuring certainty and predictability of Fonterra's legal obligations over time	0 Signals that the regulatory regime may remain in place indefinitely	+ Provides a certain horizon over which the regulatory regime can be expected to remain unchanged. Provides limited certainty of outcomes of regulatory review processes.	- Provides an uncertain time horizon over which the regulatory regime can be expected to remain unchanged. Creates strong expectations that DIRA will be repealed, and signals potentially false certainty of regulatory outcomes.	- Could be perceived as providing regulatory certainty, but a future Govt cannot be prevented from initiating review prior to automatic expiry. Creates very strong expectations that DIRA will be repealed, and provides potentially false certainty of regulatory outcome.
Durability – maintaining sufficient flexibility to respond to potentially rapid changes in industry dynamics	0 Provides sufficient flexibility to initiate review in response to rapid changes	- Could be inflexible in times of rapid industry change, thus requires close monitoring of market dynamics.	0 Could be indicative of the extent of changes in industry structure, but not necessarily market dynamics.	- Unrelated to changing market dynamics.
Proportionality - ensuring that the cost of undertaking and engaging on future regulatory processes does not outweigh the benefits	0 Regulatory review processes, although resource intensive for both Government and the industry, are necessary to ensure that regulation does not apply for longer than necessary.	0 Regulatory review processes, although resource intensive for both Government and the industry, are necessary to ensure that regulation does not apply for longer than necessary.	0 Regulatory review processes, although resource intensive for both Government and the industry, are necessary to ensure that regulation does not apply for longer than necessary.	- Avoiding the cost of future regulatory review processes creates a high risk of regulation being removed too early.
Overall assessment	**0 - not preferred**	**++ most preferred**	**+ less preferred**	**- - not preferred**

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Section 5: Conclusions

5.1 What option, or combination of options, is likely best to address the problem, meet the policy objectives and deliver the highest net benefits?

MPI's recommends amending the DIRA to require a legislative review of whether the DIRA should be retained, repealed or amended to be carried out at six-yearly intervals (Option 1). Given that it normally takes about two years to undertake a review and implement its recommendations, this would give the dairy industry around four years of regulatory certainty in between reviews. The review provisions would not trigger an automatic DIRA expiry process.

MPI considers that this option provides an optimal balance between the risk of Fonterra being regulated for longer than necessary and the risk of regulation being removed too early. A statutory requirement for periodic reviews would ensure that the consideration of whether the industry dynamics have changed sufficiently to justify repealing or amending the DIRA regulatory regime could not be deferred by other Government priorities.

To mitigate the risk of relative inflexibility arising from statutorily-determined review intervals, MPI will undertake active monitoring of potential changes in industry dynamics, so that if rapid industry change takes place in between set reviews, MPI will be in the position to recommend an out-of-cycle review. Unless rapid industry change takes place, the proposed approach provides the industry with a clear time horizon over which the regulatory regime can be expected to remain unchanged, hence providing certainty over timing of potential regulatory change processes.

The option would not provide greater certainty of regulatory outcomes for the industry, but neither would other options.

All dairy industry stakeholders were supportive of the need to have a statutory requirement for a review or an outright expiry of the DIRA regulatory regime to ensure that the regime does not continue to apply when it is no longer necessary.

Fonterra, as the main affected party, is supportive of periodic reviews to be undertaken every three years after any changes from a previous review have come into effect (provided that Fonterra's other suggested modifications to the DIRA requirements are implemented). MPI considers that a slightly longer period of regulatory stability (of four rather than three years) would provide a better balance for the outcomes sought.

Most Fonterra farmer-shareholders who participated in consultation, and the Fonterra Shareholders' Council, were supportive of periodic reviews, on the condition that there is also a clear path to de-regulation. The proposed approach does not provide for a clear path to de-regulation, as provided for in Option 2. MPI does not recommend combining Options 1 and 2, although it would be possible to do so. The key reason for this is the main drawback of Option 2. Linking the next review to a market share threshold will likely create an expectation and a false sense of regulatory certainty amongst industry stakeholders that the chosen market share threshold represents the point at which a future Government will be expected to allow the DIRA to be repealed, which would be contrary to the policy intent.

Most independent processors and other stakeholders were strongly supportive of periodic reviews. The period of time between each review was identified as an issue that needs to be closely considered, particularly given the costs imposed on all stakeholders in taking part in regular reviews. MPI considers that the proposed six-yearly review intervals provide for an optimal balance of regulatory outcomes sought.

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5.2 Summary table of costs and benefits of the preferred approach

Affected parties	Comment	Impact	Evidence certainty
Additional costs of proposed approach, compared to taking no action			
Regulated parties: • Fonterra	**Monetised costs:** • Engagement in periodic regulatory review processes	**Medium** Commercial Sensitivity external consultancy support is sought	**Medium - High**
	Non-monetised costs: • Limited certainty of future regulatory environment	**Medium** May impact future investment decisions	**High**
Other affected parties: • Dairy farmers • Independent processors • Industry good bodies	**Monetised costs:** • Engagement in periodic regulatory review processes	Commercial Sensitivity	**Medium**
	Non-monetised costs: • Limited certainty of regulatory outcomes	**Medium** May impact future investment decisions	**High**
Regulatory agencies: • MPI • Commerce Commission	**Monetised costs:** • Undertaking periodic regulatory review processes	**Medium** ~$1 million per review, incurred either by MPI or MPI/Commerce Commission combined, assuming external expertise is sought	**High**
	Non-monetised costs: • Government resources diverted from other uses		
Total monetised costs	as per above	**Medium** ~$3 million per review	**Medium - High**
Total non-monetised costs	as per above	**Medium**	**High**

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Affected parties	Comment	Impact	Evidence certainty
Expected benefits of proposed approach, compared to taking no action			
Regulated parties: • Fonterra	**Monetised benefits:** • **Not applicable**		
	Non-monetised benefits: • Improved timeliness and certainty of future regulatory review processes • Reduced risk of being regulated for longer than necessary	**High** Provides clear timeline over which regulatory change is unlikely to take place	**High**
Other affected parties: • Dairy farmers • Independent processors • Industry good bodies	**Monetised benefits:** • Not applicable		
	Non-monetised benefits: • Improved timeliness and certainty of future regulatory review processes	**High** Provides clear timeline over which regulatory change is unlikely to take place	**High**
Regulatory agencies: • MPI • Commerce Commission	**Monetised benefits:** • Not applicable		
	Non-monetised benefits: • Greater certainty and predictability of future work programmes and ability to budget and plan for them	**High** Provides clear timeline over which planning can take place	**High**
Total monetised benefits	as per above	**Not applicable**	
Total non-monetised benefits	as per above	**High**	**High**

5.3 Is the preferred option compatible with the Government's 'Expectations for the design of regulatory systems'?

MPI's preferred option is aligned with the guidance provided in *Government Expectations for Good Regulatory Practice* (April 2017).

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Section 6: Implementation and operation

6. 1 How will the new arrangements work in practice?

A legislative amendment is required to introduce a statutory requirement for periodic reviews. It is expected that the Dairy Industry Restructuring Amendment Bill will be introduced and progressed through the Parliamentary processes in 2019, with enactment expected to take place in early 2020. The next review would therefore be expected to be undertaken during the 2024/25 dairy season.

The DIRA regulatory regime will continue to apply (in its modified form as per the recommendations in the accompanying Regulatory Impact Assessments) until the next review is undertaken and its recommendations are given effect to.

The Commerce Commission will continue to operate in its current role of being the enforcement agency for disputes arising in relation to all DIRA provisions.

No transitional arrangements are anticipated to be required, at this stage.

MPI will communicate the changes to all affected parties as soon as Cabinet decisions are made. This will provide all industry stakeholders with sufficient time to adjust their operations, if needed.

6.2 What are the implementation risks?

There is a risk that the legislative change process will take longer than expected due to other priorities and business in the House. If the enactment of the proposed three-yearly review provisions is delayed, the time period between the current and the next substantive review would be extended beyond the currently envisaged five-yearly intervals. This will increase the risk of the DIRA regulatory regime potentially applying for longer than necessary.

This risk will be mitigated by MPI closely monitoring the progress of the upcoming Dairy Industry Restructuring Amendment Bill through the House, and recommending drafting changes (if necessary) to ensure that regardless of when the upcoming Bill is passed, the next DIRA review is undertaken during the 2024/25 dairy season, ie, six years since the commencement of the current review.

Section 7: Monitoring, evaluation and review

7. 1 How will the impact of the new arrangements be monitored?

MPI's consistently collects information (including under existing information disclosure requirements of the DIRA) about the changing dynamics in the dairy industry and its markets. This enables MPI to closely monitor the developments in the dairy industry and ensures that any significant changes are not overlooked.

Industry stakeholders, including Fonterra, are also well incentivised to bring any significant shifts in the industry dynamics to MPI's and Government's attention.

Through its ongoing monitoring and stakeholder relations roles, MPI is well placed to identify the need for, and recommend, an earlier review of the DIRA regulatory regime, should it be required.

7.2 When and how will the new arrangements be reviewed?

The proposed introduction of a statutory requirement for a review will ensure that a comprehensive evaluation of the need for the DIRA regulatory regime is undertaken in a timely manner. The next review is intended to cover a comprehensive set of issues, including the effectiveness, efficiency and fitness-for-purpose of the overall DIRA regulatory regime and its individual parts.

The next review will also provide an opportunity to consider whether the currently proposed periodic review provisions are working as intended.

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Appendix

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Summary analysis of the DIRA and its impact on the dairy industry performance

MPI's review of the DIRA regulatory regime and its impact on the dairy industry performance has focused on the following key questions:

- Has the DIRA been effective at managing Fonterra's dominance in the market for farmers' milk, and is it still needed?
- Does the DIRA encourage potentially inefficient industry growth?
- Does the DIRA influence Fonterra's strategy?
- Does the DIRA impact on the industry's environmental performance?
- Does the DIRA incentivise inefficient entry by large dairy processors?

Has the DIRA been effective at managing Fonterra's dominance in the market for farmers' milk, and is it still needed?

The DIRA regulatory regime was designed to ensure that the dairy industry's resources (milk production and land) can flow to their highest value use, despite Fonterra's dominance and its associated ability and incentives to create barriers to this.

In 2001, Fonterra accounted for 96 percent of the national market for farmers' milk. Although the total volume of milk produced since 2001 has increased by around 60 percent, Fonterra's national market share fell to around 81 percent in 2018. Over the last five years, independent processors have grown their milk volumes by about 10 percent per annum on average.

Despite this market entry, Fonterra remains the only processor with truly national coverage, with [redacted] of the farmers' milk market in most dairying regions. Of the existing independent processors, one (Open Country Dairy) has the broadest coverage, operating in Auckland, Waikato, Bay of Plenty, Otago and Southland. The regions with the greatest number of processors are Canterbury, Auckland, Waikato and Bay of Plenty.

The current industry structure raises the question of whether the DIRA is still needed. The following factors are relevant to the consideration of this question:

- the extent to which Fonterra still holds market power;
- the effectiveness of the Commerce Act alone to manage Fonterra's market power; and
- the potential market failures that could arise in the absence of the DIRA regulatory regime and the effectiveness of the alternative remedies that might be required to address them.

The extent to which Fonterra still holds market power

MPI's analysis of regulatory precedent and economic literature suggests that at a market share of over 70 percent a firm could have the ability to exercise market power, especially if competition was relatively weak and barriers to entry were material. Some economic analysis also suggests that effective competition would require at least two independent processors competing with Fonterra in each regional market, whereas one rival could be sufficient if entry and expansion barriers were not material.[9]

Fonterra's national market share has reduced from 96 percent in 2001 to around 81 percent in 2018. At a regional level, the extent of competition varies depending on whether or not Fonterra faces competition in its collection areas. It appears that apart from three regions in New Zealand (Northland, Wairarapa and Marlborough Sounds), there is at least one independent processor

[9] NERA (2010) *An Assessment of the DIRA Triggers.* Available at http://www.mpi.govt.nz/dira-review.

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competing with Fonterra for farmers' milk, each of whom have now had sufficient time to establish their operations.

The key issue is whether, in the absence of the DIRA regulatory provisions, Fonterra would have the ability and incentive to create barriers to farmers switching to other processors, thus frustrating expansion of its existing rivals or preventing new processors from establishing.

Fonterra, and its farmer-shareholders, do not consider that it has the ability or incentive to use its position to frustrate entry by new processors, or exercise market powers against farmers. Fonterra considers that in an environment of low to flat milk growth, and with significant capital already invested in processing facilities, it would have limited interest in turning away milk. Fonterra also submitted that in a large number of regions there is already significant competitive pressure from independent processors, which acts as a competitive constraint on its behaviour.

Large independent processors almost unanimously hold the view that Fonterra is still dominant in the market for farmers' milk. Even in regions where competition is established, Fonterra's dominance nationally is believed to have an impact on its competitors, and they have limited ability to put pressure on Fonterra. There was also a concern that in the future, when the national milk pool is expected to diminish, there will be a greater incentive for Fonterra to exhibit behaviours that suppress farmgate competition.

MPI's analysis suggests that the risk of Fonterra creating barriers to farmers switching to other processors is significant. This is particularly so given that milk supply appears to have reached its limits, which, in turn, is likely to lead to more intense competition for farmers' milk. In particular:

- Statistics NZ figures show that dairy cow numbers decreased by 3.1 percent in the 2017/18 season and cow numbers are forecast to fall further.
- The availability of land for further conversions is constrained and Commercial Sensitivity Regional councils are required to have water quality objectives and limits on discharge and abstraction volumes in place by 2025.
- Regional councils are introducing measures such as caps on nutrient discharges, requirements to demonstrate good farming practice and controls on land use intensification.
- Commercial Sensitivity

In this context, farmers' ability to switch their supply to alternative processors and/or land uses is critical to ensuring that milk production and land use can flow to their highest value uses.

Fonterra and other dairy processors have invested heavily in processing capacity over the last decade. They face strong incentives to retain their current suppliers to avoid asset stranding and plant closures. While all dairy processors will have strong incentives to secure and lock in farmers' milk supply, Fonterra, given its current size, has both the incentives and ability to construct barriers to farmer-switching to an extent that would be detrimental for the entire dairy industry and the wider economy.

In the absence of the DIRA open entry and exit requirements, there is a significant risk that Fonterra would have both the ability and incentive to disincentivise and/or restrict farmers' ability to switch to other dairy processors, even if they were dissatisfied with Fonterra's performance. Specifically Fonterra could require farmers to sign up to exclusive long-term supply contracts, and/or impose restrictions on returning farmers' supply, including as a means of creating a chilling effect on existing farmers' willingness to switch their supply.

Such restrictions could result in dairy farmers making their decisions on whom to supply not based on dairy processors' strategies, performance or price signals but based on Fonterra's entry and exit policies, which may or may not be underpinned by commercial and strategic drivers.

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A key concern is that farmer-politics rather than commercial value of farmers' milk may become a key underpinning of Fonterra's policy on entry and exit. Fonterra's actions in *Fonterra Co-operative Group Limited v McIntyre and Williamson Partnership and others [2017] NZSC 197*, demonstrate this risk, where Fonterra sought to impose restrictions on new farmers' supply as a disciplinary action against those considering switching to another processor. The Supreme Court noted that Fonterra's motivations in imposing a five cents per kgMS discount on ex-NZDL suppliers' milk was not driven by the financial viability of the transaction or the commercial value of that milk to Fonterra; instead, it was intended to be and to be seen as a "penalty" for the respondents who had previously left the co-operative and so could not expect just to "waltz back in".

The effectiveness of the Commerce Act alone to manage Fonterra's market power

In the absence of the DIRA, actions by Fonterra that may be anti-competitive would only be constrained by the general provisions of section 36 of the Commerce Act 1986. The Commerce Act has a range of tools to prohibit a firm with a substantial degree of market power from taking advantage of it (i.e. acting anti-competitively).

The key differences between the DIRA and the Commerce Act are that the DIRA is designed to deter Fonterra from engaging in a strategic anti-competitive behaviour, and its provisions are relatively clear-cut and are relatively easy to enforce. In contrast, the Commerce Act is a generic regime, which means that the boundaries between what conduct is prohibited, and what is not, are not always clear up front. This can make enforcement much more costly and complex. In some cases, if parties engage in conduct which is later deemed to be a breach of the Commerce Act, the effects may be irreversible.

The Government has signalled its intention to amend section 36 of the Commerce Act. This is on the basis that the current section 36 has the potential to under-capture anti-competitive behaviour, is costly and complex to enforce, and may lack predictability of outcomes.

In Fonterra's view, section 36 provides a real constraint on market power, and is backed by a significant body of regulatory and judicial guidance. Fonterra states that it applies Commerce Act analysis in addition to the restrictions under section 107 of the DIRA when making decisions whether to contract supply for more than one season. It is Fonterra's expectation that the review of section 36 will lead to a tightening of the provision regarding companies with a substantial degree of market power.

MPI considers that, while a reform of section 36 would aim to improve the deterrence of anti-competitive behaviour by firms with substantial market power, it is still unlikely to offer the upfront predictability and ease of enforcement of the DIRA.

The potential market failures and remedies, in the absence of the DIRA regulatory regime

MPI commissioned Frontier Economics to identify potential market failures or sources of inefficiency that could arise in the absence of the DIRA regulatory regime, and consider potential remedies to the identified market failures. The full report is available at www.mpi.govt.nz/dira-review.

In summary, the report concluded that:

- Fonterra enjoys an incumbency advantage over potential new entrants, due to the sunk costs and economies of scale in processing. This is likely to be the largest impediment to the off-farm dairy sector becoming more competitive, but there is no straightforward way of addressing this issue. While an access regime for Fonterra's processing capacity could be introduced, its main drawback is a significant risk that the access price could be set too high or too low, deterring efficient entry by processors or encouraging inefficient entry by processors. An access regime would introduce significant complexity, increasing regulatory uncertainty and the risk of mispricing access services. Another approach would be to require Fonterra to divest some of its assets. However, this would be a very costly, complex and intrusive form of intervention, which could perversely deter Fonterra from making efficient investments in future.

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- Fonterra may have an incentive to use its incumbency advantage to lock farmers in or out. An effective way of addressing such conduct would be to retain the existing open entry and exit provisions, and the non-discrimination rule. These provisions undoubtedly reduce switching barriers. Fonterra has argued that open entry and exit provisions impose significant costs and inefficiencies on the sector by encouraging over-capacity, incentivising investments in low-value processing and raising Fonterra's stranding risk. Fonterra's own data suggest that these claimed costs and inefficiencies are overstated. Although the evidence does not suggest widespread inefficiency, Fonterra's concern that open entry and exit may compel it to make inefficient investments in new capacity, particularly to accommodate new conversions, is reasonable. However, any action by Fonterra to refuse milk from returning farmers, or to apply discriminatory price or non-price terms to such farmers, is very likely to be a strategy to deter farmers from switching to other processors. Such conduct is therefore likely to have an anticompetitive effect and should therefore be prevented by regulation.
- Fonterra may set an inefficiently high price for farmers' milk, which may have the effect of foreclosing entry or expansion by independent processors. General competition law may be effective in preventing blatant predatory pricing by Fonterra. However, the Commerce Act may not prevent all instances in which Fonterra prices in a manner that makes entry or expansion by rival processors difficult. One potential approach could be to require an independent regulator (rather than Fonterra) to set the farmgate milk price by estimating hypothetical efficient costs. The main drawback of this option is the scope for regulatory error (misestimation of notionally efficient costs) when setting the farmgate milk price. This could result in allocative, productive and dynamic inefficiencies. The scope for regulatory error would be reduced if the farmgate milk price was set based on Fonterra's actual costs. However, in order to implement this approach, it would be necessary to have a sound understanding of Fonterra's actual costs. This would need to be supported by a formal information disclosure regime, with its associated regulatory compliance costs.
- Fonterra's farmer-shareholders may have insufficient information to monitor Fonterra's performance. An information disclosure regime that provides targeted and independent information on Fonterra's performance to its owners may help reduce this information access problem. However, individual farmer-shareholders may not be sufficiently motivated to act on better information, even if it were available. Even if some owners were motivated to act, Fonterra's scale, co-operative structure and governance arrangements may make it difficult for individual farmers to influence the company's overall direction.

On balance, MPI considers that the potential for Fonterra to create barriers to farmer switching and the difficulties involved in deterring potential anti-competitive behaviour under the Commerce Act suggest that the DIRA is still needed at this stage.

Does the DIRA encourage potentially inefficient industry growth?

MPI's analysis suggests that the DIRA has enabled the industry's growth but has not been its primary driver. Instead, the growth of the dairy industry is more directly related to, and is influenced by, the growth in international demand for dairy products and rising international prices, including for commodities such as milk powders. This external demand created incentives for increased dairy activity and investment in new processing facilities. New Zealand already had a well-established and efficient dairy industry that was well placed to take advantage of expanding overseas market opportunities. The relative profitability of alternative land uses and financial institutions' willingness to lend capital for dairy conversations have also played a role in the expansion of the dairy industry.

Within the context of the above drivers, the DIRA has provided a regulatory environment conducive to industry growth. In the absence of the DIRA it is possible that New Zealand may have been less well placed to respond to growing international market opportunities. Specifically, the DIRA:

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- *Enabled the creation of Fonterra.* This provided New Zealand with a dairy company of sufficient scope and scale and an opportunity to compete at scale against other international dairy companies.
- *Enabled the entry of other dairy processors* in New Zealand, through the open entry and exit provisions, which allowed processors to compete with Fonterra for farmers' milk supply. The DIRA also enabled new dairy processors to access raw milk from Fonterra, on agreed or regulated terms, during their initial establishment phase.

At the same time the following factors have helped drive growth in the dairy industry:

- New Zealand established a free trade agreement with China in 2008.
  The economies of China and other Asian countries grew rapidly. Increasing consumer affluence meant increasing demand for dairy products.
- Global demand for dairy products saw steadily rising prices from 2006/07 to 2013/14.
- New Zealand has a highly regarded food safety regime that has more stringent standards than those in many of the countries that experienced significant growth in dairy demand, particularly in Asia. This is likely to have provided New Zealand dairy products with a competitive advantage relative to locally-produced dairy products in those high growth markets.
- The growth in demand for dairy products in South East Asia gave rise to investment in the New Zealand dairy industry by Chinese and other South East Asian interests. New Zealand already had a well established reputation for safety and quality. Commercial Sensitivity [redacted]
- While New Zealand's Overseas Investment Act 2005 imposed constraints on the purchase of sensitive land (including farmland), the weighting of decision-making criteria under the Act for much of the period under review focussed relatively strongly on economic benefit.

Increased global demand has resulted in higher milk prices being paid to New Zealand dairy farmers. In particular, Fonterra's price for farmers' milk is based on a bundle of commodities. If commodity prices are high, the milk prices received by farmers follow. This may have incentivised farmers to expand milk production over time.

It is unclear what the extent of growth in economic benefit would have been had the DIRA regulatory regime not been in place - that is, if Fonterra's dominance had not been constrained by legislation. Economic and export growth could not have occurred in the absence of overseas demand from new markets and New Zealand was well placed to capitalise on that demand growth.

A majority of independent processors and industry associations agree that the growth of the dairy industry is more directly related to, and is influenced by, the growth in international demand for dairy products, and rising international prices, including for commodities such as milk powders.

Fonterra's farmer-shareholders are more divided on this issue. A number agree with the analysis that the growth of the dairy industry is related to international markets. Others consider the open entry provisions of the DIRA have driven unsustainable growth by encouraging new conversions in areas that may be considered "marginal" or "unsustainable". The same view is held by a number of environmental stakeholders.

If the DIRA had not been in place, it is conceivable that Fonterra may have attempted to act strategically to frustrate entry by new processors (e.g., by locking farmers into long-term contracts or imposing restrictions on new milk as a means of creating a chilling effect on farmers considering switching their supply to other processors). If successful, such attempts (albeit somewhat constrained by the application of section 36 of the Commerce Act and potential enforcement actions by the Commerce Commission) may have limited the dairy industry's ability to increase the supply of milk to meet the increased demand from export markets.

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Does the DIRA influence Fonterra's strategy?

Fonterra and a number of other industry stakeholders, including Fonterra's farmer-shareholders, have expressed concerns about potential unintended consequences of the DIRA open entry requirements. Open entry is perceived as driving a volume-based dairy industry because Fonterra is unable to control the amount of milk it receives from farmers and is therefore forced to invest in the supply-driven commodity processing assets, rather than in demand-driven production of higher value-added dairy products.

Independent processors do hold the same concerns regarding the impact of DIRA on Fonterra's business strategy. They are of the belief that like most other commercial entities, Fonterra's strategy is driven by total shareholder value, social responsibility and environmental sustainability.

MPI's analysis indicates that New Zealand dairy farmers' milk production decisions are sensitive to price. Although MPI recognises that the price-volume relationship is not linear, can be subject to time lags, and also impacted by multiple other factors, when the price paid to farmers for milk is high, production volumes tend to increase. Similarly, when price falls, production tends to decrease.

This effect was seen in 2013/14 when global demand for commodity dairy products fell, along with global commodity prices, and New Zealand farmers produced lower milk supply volumes. Fonterra noted that the 2013/14 fall in milk production enabled the company to stop investing in commodity processing assets and instead allowed it to shift its investment focus on to the higher value-add processing assets. This effect occurred as a reaction to global prices for commodity products.

The policy issue, however, is whether there is anything in the DIRA that prevents Fonterra from adjusting its milk price *proactively*, that is, taking a strategic decision to pay farmers less over multiple seasons as a means of signalling to its existing and potential new shareholder-suppliers that it is wishing to pursue a business strategy based on lower milk volumes and/or a focus on investing in demand-driven value-added processing assets.

All dairy processors (including Fonterra) are free to set their own milk price. Independent processors tend to set their prices for milk with reference to Fonterra's. Given Fonterra's dominance, Fonterra's milk price tends to be the default price in the market for farmers' milk in New Zealand.

Fonterra sets its milk price in reference to a base milk price it calculates in accordance with its Milk Price Manual. The base milk price calculation provides a benchmark of the value of farmers' milk in global dairy markets during the particular season, based on the assumption that milk is processed only into commodities. The calculation of the base (benchmark) price is based on the revenues and costs of a notionally efficient processor of Fonterra's size and scale, processing all its milk supply into a bundle of profitable commodity products, and selling them in global dairy markets in the particular season.[10]

The policy intent of the DIRA base milk price provisions is *not* to regulate the price Fonterra pays farmers for milk. The DIRA sets out the purpose, principles and processes to underpin Fonterra's base milk price calculation, and provides for the Commerce Commission to monitor Fonterra's methodology and calculation of the base milk price against the statutory purpose and principles. The DIRA allows and specifically provides for Fonterra to set a milk price that is different from the calculated base (benchmark) milk price. Fonterra is required to publicly disclose its reasons for deviating from the calculated base (benchmark) milk price.

Instances when Fonterra may have commercial and strategic reasons to deviate from the calculated base (benchmark) milk price include:

- *Fonterra may not be able to afford to pay the calculated base (benchmark) milk price.* Since the calculation of the base (benchmark) milk price relies on the revenues and costs of a notionally efficient processor, there may be times when Fonterra's actual performance differs significantly

[10] Information on Fonterra's Mi k Price Manual and the notionally efficient processor construct is available on Fonterra's website at https://www.fonterra.com/content/dam/fonterra-public-website/phase-2/new-zealand/pdfs-docs-infographics/pdfs-and-documents/milk-prices/pdf-f18-milk-price-manual-final-1-august-2017.pdf and the Commerce Commission's website at https://comcom.govt.nz/regulated-industries/dairy/milk-price-manual-and-calculation.

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from that of the notionally efficient processor. In the 2013/14 season, Fonterra chose to pay $0.53 per kgMS less than the calculated base (benchmark) price. In the 2017/18 season, Fonterra has also chosen to pay $0.05 per kgMS less than the calculated base (benchmark) milk price.

- *Fonterra may be facing intense competition for its milk supply.* At times of scarce milk supply, Fonterra (as well as other dairy processors) may place a higher value on security of supply and pay above the base (benchmark) milk price. This would reflect the willingness of Fonterra's shareholders (similar to the shareholders of other dairy processors) to sacrifice some of the shareholder return in the short term to maintain supply and ensure the company's long-term viability. So long as Fonterra does not engage in strategic behaviour that would prevent, restrict, deter or eliminate competition for farmers' milk (e.g., through predatory pricing), Fonterra has the same right to compete for farmers' milk as any other processor. Engaging in strategic behaviour that would prevent, restrict, deter or eliminate competition for farmers' milk may breach section 36 of the Commerce Act 1986.
- *Fonterra may want to reduce its milk supply volumes and secure funding to pursue a value-added strategy.* A value-added, consumer-driven, business strategy may require Fonterra to focus on developing demand in a new product market and aligning its milk supply volumes and funding sources accordingly. This may require Fonterra to hold back some of the money that an efficient commodity-only dairy processor would have paid to farmers for their milk, in the short term, in exchange for future returns on investment into such activities as research and development of new products and markets, marketing/brand development, capital investment into higher value-add processing assets, etc.

MPI acknowledges that adjusting the milk price to manage the volumes of milk Fonterra receives presents a significant management challenge for a large co-operative company, with a significant existing investment in highly efficient commodity processing assets, a highly seasonal milk supply, and a highly diffused and relatively risk-averse supplier-shareholder base.

When global commodity prices are high, farmers could expect to receive high prices for their milk supply. In the short term, therefore, there may be a strong incentive for Fonterra to continue to produce commodity products and sell them for the high prices the global commodity markets are willing to pay. The issue for the company is how to convince farmers to trade off the short-term attraction of high commodity prices against investment into higher value-added products, which could produce higher and less volatile returns in the long term, but would require much higher levels of capital investment and risk-taking by shareholders.

Production of higher value-added dairy products requires less seasonal milk supply volumes, relatively higher capital investment, extensive management expertise and capability in identifying the right product mix, as well as extensive marketing and branding efforts to create and secure consumer demand for such products. In contrast, production of commodity products offers a practical solution to the need to process a large volume of perishable milk at the peak of the season. Commodity products also have the advantages of requiring a relatively lower cost per litre of additional capacity installed capital investment and a relatively higher level of certainty of having matching demand, compared to most value-add products.

MPI understands from Fonterra that its co-operative structure requires conservative risk management and strong fiscal discipline, resulting in a bias towards manufacturing capacity that relies on lower capital investment per litre of capacity and higher certainty of demand.

At times when global commodity prices are high the difference between the risk-adjusted rates of return on commodity and value-added production may be small. When global commodity prices are low such difference could be significant.

A key strategic management challenge for Fonterra and its farmer-shareholders is to determine the company's long-term strategic goals and invest into an optimal mix of production assets to enable it to achieve those goals, having made short/medium-term price (and therefore volume) trade-offs, if any, as required by the company's strategy. This would require identifying an optimal balance

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between incentivising production of “just enough” milk supply volumes to run Fonterra’s existing commodity processing plants (to minimise potential asset stranding problems) but “not so much” that it would preclude Fonterra from directing further investment to higher value product lines.

Does the DIRA impact on the industry’s environmental performance?

Some stakeholders consider that the DIRA’s open entry requirements have contributed to these negative environmental outcomes. The concern is that open entry provides farmers with a guaranteed buyer (Fonterra) for all and as much milk as they choose to produce. This has resulted in overproduction of milk and expansion of dairying to a level where in some areas this activity has now exceeded its sustainable environmental limits.

Dairying has indeed expanded and its environmental impacts have been, in some cases, negative. However, the question is to what extent has the DIRA been responsible for these outcomes.

MPI’s analysis indicates that the main driver for the growth of the dairy industry appears to be the incentives created by growing international demand for dairy products and associated high prices for commodities. It also appears that, notwithstanding the DIRA open entry requirements which did provide a suitable environment for expansion, Fonterra can and does influence farmers’ milk supply decisions through its price signals to align with its chosen strategic direction. It also appears that Fonterra has been encouraging milk supply growth, which may suggest that it was consistent with Fonterra’s chosen business strategy.

Critically, water and other resource-uses in New Zealand are regulated. The Resource Management Act 1991 (the RMA) empowers local communities to make decisions on how their environment is managed through regional and district plans. Accordingly, regional and local authorities play a critical role in determining what land use and economic activity, including dairying, can be established and under what conditions, to ensure that they are environmentally sustainable.

The Ministry for the Environment is currently progressing policy work on its Essential Freshwater work programme. This programme has three objectives: stopping further degradation and loss of our freshwater resources; reversing past damage; and addressing water allocation issues. The work programme intends to deliver on these objectives through:

- targeted action and investment in at-risk catchments;
- amendments to the National Policy Statement for Freshwater Management;
- a new National Environmental Standard for Freshwater Management; and
- wide engagement in developing options for allocating water resources, starting with allocation of discharges to water in 2019.

Dairy processors have also introduced programmes to support and recognise their farmer-suppliers who are taking measures to minimise the impact of their milk production on the environment. For example:

- **Fonterra** provides support to its farmer-suppliers with advice, tools and systems to help meet environmental limits set by councils and local communities. Fonterra has a network of Sustainable Dairy Advisers, who provide advice to farmer-suppliers through Tiaki (Fonterra’s Sustainable Dairying Programme). While no milk premiums are paid to farmer-suppliers who are signed up to Tiaki, those that meet and exceed expected standards are eligible for discounted advisory services and products. Additionally, farmer-suppliers that do not meet Fonterra’s minimum conditions of supply could be subject to a charge for the visit of a Fonterra representative, or suspension of milk collection.
- **Synlait** runs its Lead With Pride programme, which recognises and financially rewards farmer-suppliers who achieve best practice standards. In the environmental sphere, Synlait’s farmer-suppliers are expected to achieve excellence in water and effluent management, soil quality, biodiversity, emissions and energy management. Farmer-

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suppliers that meet the standards of best practice or leading practice receive premium payments for their milk.

- **Miraka** has its Te Ara Miraka Farming Excellence programme that aims to improve efficiency and produce high quality milk, improving profitability for farmer-suppliers and Miraka, with a lower environmental footprint. All Miraka's farmer-suppliers are encouraged to be proactive in the management of their farm environment in order to minimise any negative impact. The Te Ara Miraka Farming Excellence programme gives farmers the potential to earn a premium on their raw milk by meeting 31 standards, including 13 mandatory ones.

Does the DIRA incentivise inefficient entry by large export-focused dairy processors?

The DIRA has a number of provisions that may influence large (and therefore by definition export-focused) dairy processors' decisions to enter and compete with Fonterra for farmers' milk. These include:

- the open entry and exit requirements, which enable large dairy processors to attract milk supply from farmers who are supplying Fonterra;
- Fonterra's base milk price calculation and the Commerce Commission's monitoring, which provide for a transparent benchmark price for large dairy processors to rely on when setting their prices for farmers' milk; and
- the Raw Milk Regulations, which enable large dairy processors to purchase up to 50 million litres of raw milk per season from Fonterra, on agreed or regulated terms, for up to three seasons, while they are establishing their own supply from farmers.

The following questions are relevant to the analysis of the extent to which the DIRA may influence large dairy processors' strategies and entry decisions:

- Does the DIRA incentivise inefficient entry by large dairy processors?
- Does the DIRA undermine Fonterra's competitive advantage offshore?

Does the DIRA incentivise inefficient entry by large export-focused dairy processors?

Some stakeholders are concerned that the DIRA open entry and exit requirements could be encouraging farmers to take a risk in supplying a new processor on the basis that Fonterra must always take them back. The concern is that the ease of farmer switching could lead to investment in excess processing capacity that may create a downward spiral of low-margin competition, inability to move up the value chain and, ultimately, factory closures. A further concern is that providing large export-focused dairy processors with access to regulated milk from Fonterra further reinforces the perceived incentives for inefficient entry created by the DIRA open entry and exit provisions.

MPI's analysis indicates that there are significant disciplines and constraints on new investment. The establishment of a large processing plant involves significant amounts of capital, long term investment, and the need to generate sufficient returns to recoup and sustain that investment. Large dairy processors also have to pay a highly competitive milk price to secure sufficient milk supply volumes, including for regulated milk. It seems unlikely that just because farmers are able to switch their supply, large dairy processors would be making such substantial and long term investments in the absence of a solid business case for such investments.

Furthermore, access to 50 million litres of raw milk from Fonterra at the initial stages of a new processor's operations is unlikely to be sufficient to sustain the operation of a large processing plant, nor be sufficient to drive investment strategies.

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Does the DIRA undermine Fonterra's competitive advantage offshore?

Fonterra's shareholders have expressed concern that allowing large dairy processors (who are typically backed by foreign capital and large global businesses), to purchase regulated milk from Fonterra, effectively at cost, undermines Fonterra's competitive advantage in export markets where those processors then compete with Fonterra for global customers.

MPI's analysis suggests that more often than not large dairy processors would not necessarily be Fonterra's closest competitors in export markets. It appears that the entry of other processors likely provides a net gain in New Zealand exports. Several established large dairy processors have direct links to foreign distribution channels through partnership or foreign ownership arrangements. This is arguably providing access to markets through distribution channels that may not have otherwise been available to New Zealand.

MPI considers that while the DIRA makes it possible for large export-focused dairy processors to attract milk supply, it is highly unlikely to be incentivising entry by inefficient dairy processors or undermining Fonterra's competitive advantage in export markets.

Large independent processors tend to agree that the DIRA has assisted their entry, through both the open entry and regulated milk provisions. These stakeholders believe that this entry has been beneficial to the industry and New Zealand as whole, through the diversification of production and access to new markets. They also hold the view that Fonterra's competitive advantage has not been undermined by their entry.

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