In Confidence

Office of the Minister of Agriculture
Chair, Cabinet Economic Development Committee

REVIEW OF THE DAIRY INDUSTRY RESTRUCTURING ACT 2001 AND ITS IMPACT ON THE DAIRY INDUSTRY – POLICY RECOMMENDATIONS

Proposal

1. This paper seeks the Committee's agreement to amendments to Subparts 5 and 5A of Part 2 of the Dairy Industry Restructuring Act 2001 (the DIRA) and the Dairy Industry Restructuring (Raw Milk) Regulations 2012 (the Raw Milk Regulations) arising from review of the DIRA and its impact on the dairy industry.

Executive Summary

2. The DIRA was passed in 2001 to enable the formation of Fonterra to be a strong competitor internationally, and to introduce regulatory safeguards to manage risks arising from Fonterra's dominance domestically.

3. There have been significant changes since 2001. A number of new dairy processors have established facilities in New Zealand, either for export or focussed on the domestic consumer market. The dairy industry remains a cornerstone of the New Zealand economy, in terms of export revenue, employment, and regional impact, but has also imposed some costs in terms of environmental impacts.

4. In order to maintain a high performing, sustainable dairy sector, the DIRA regulatory settings ought to:
   - operate in the long term interests of New Zealand dairy farmers, consumers, and the wider economy (including its economic, social and environmental components);
   - not give rise to any unintended consequences; and
   - remain relevant and fit for purpose.

5. In 2018, the Minister of Agriculture initiated a comprehensive review of the DIRA and its impact on dairy industry performance, involving widespread public consultation and expert independent analysis.

6. The review has found that the DIRA has been effective in meeting its overall purpose, and is still required to manage risks arising from Fonterra's dominance. However, changes are needed to ensure better management of on-farm performance, including matters such as environmental performance, and planning for processing capacity, increased certainty around milk price calculation, removal of unnecessary regulation, protection of consumer interests, and certainty of future regulatory review.

Structure of this paper

7. This paper sets out a broad overview of key themes and issues and makes recommendations relating to the amendment of the DIRA. It is supported by more detailed analysis in Appendices Four to Nine, and Regulatory Impact Assessments at Appendix Ten.

Background

8. The DIRA was passed in 2001 to enable the formation of Fonterra. The intent was to create a large scale dairy company capable of competing effectively in international markets and leading innovation as a “national champion”. However, at the time of its formation, Fonterra controlled 96 percent of all farmers’ milk production in New Zealand. The DIRA therefore included provisions to manage risks arising from such a level of dominance in the absence of competitive pressure.

9. The risks were that Fonterra could:
   - fail to achieve the efficiency and innovative performance for which it was created
   - create barriers to farmers’ milk, and farmland, flowing to their highest value use (for example, to other, more efficient, higher value dairy processors, or to and from alternative land uses)
   - charge excessive wholesale prices for dairy products supplied to the New Zealand consumer markets.

10. The DIRA therefore included a number of measures to manage risks arising from the newly created co-operative company’s dominance in New Zealand dairy markets. Detail on the key elements of the DIRA regulatory regime, their underlying policy rationale, and how the DIRA interacts with Fonterra’s business decisions is provided at Appendix One.

11. The DIRA has been in place for 18 years and there have been substantial changes in the dairy sector. The dairy industry remains a cornerstone of New Zealand’s economy, as well as that of many regions. 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.

12. The industry is facing new challenges and pressures. These include the impacts of climate change; the need to manage dairying, along with other economic activity, within sustainable limits including mitigating environmental impacts; changing trade relationships and market access arrangements; changing consumer demand with a growing demand for high value consumer products and volatility in commodity prices; and the potential effect of alternative proteins and synthetic “milks”.

13. The Government's strategic framework for the economy focusses on three key elements – productivity, sustainability and inclusiveness. Given the contribution of the dairy sector to New Zealand's economy, society, employment and regional economies, it is important that the regulatory regime supports a high-performing, sustainable dairy industry that is aligned with the Government's strategic priorities.

Review process

14. Following Cabinet approval [CAB-18-MIN-0191], the Minister of Agriculture released terms of reference for a comprehensive review of the DIRA and its impact on the dairy industry in May 2018. The terms of reference recognised that the DIRA is only one element (albeit an important one) in influencing dairy industry performance. The terms of reference focused on:
    - whether the DIRA regulatory regime is operating in the long term interests of New Zealand dairy farmers, consumers, and the wider economy (including its economic, social and environmental components);
    - whether, and if so to what extent, the DIRA regulatory regime gives rise to any unintended consequences; and
    - whether the purpose and form of the DIRA regulatory regime remains relevant and fit-for-purpose.

15. MPI carried out the review. As a first step, MPI undertook pre-engagement with key stakeholders and commissioned independent economic analysis to identify issues and possible options.[1] This informed the development of a discussion document, *Review of the DIRA and its Impact on the Dairy Industry,* that Cabinet approved for release as the basis for public consultation in November 2018 [CAB-18-MIN-0528].[2] A summary of the issues covered in the discussion document is provided at Appendix Two.

16. MPI subsequently undertook an extensive public consultation process including 13 public meetings, and 22 one-to-one meetings, with dairy processors and other key stakeholders, such as farmer representatives, Māori landowners and environmental NGOs. To better inform these meetings, MPI published all material derived from its preliminary analysis, including the findings of the independent economic analysis, preliminary input and commentary provided by Fonterra and other dairy processors, and provided an online questionnaire for interested persons who did not wish to write their own formal submission.

17. Recognising the importance of Māori interests in the dairy industry, both as Treaty Partners and as having significant dairy farming interests. MPI engaged with Māori interests and the views expressed are reflected in Appendix Three. The Federation of Māori Authorities, which has 150 member organisations with Commercial Sensitivity also provided a written submission to the review.

[1] Frontier Economics, *2018 DIRA Review: Analysis of Industry Performance,* August 2018, *DIRA Review: Drivers of Industry performance,* August 2018. https://www.mpi.govt.nz/mpisearch#stq=Frontier+Economics&stp=1

[2] https://www.mpi.govt.nz/news-and-resources/consultations/review-of-the-dairy-industry-restructuring-act-2001/

18. MPI received 188 written submissions on the discussion document. Details of the consultation process and a summary of key themes arising from stakeholder meetings and submissions is included in Appendix Three.

Analysis – is the DIRA regulatory regime still required?

19. The review has concluded that the DIRA has been an important factor in enabling competition in dairy markets, and in allowing farmers choice in processors to whom to supply their milk. Competition has developed in the form of eight large processors, producing a mix of commodity and value-added products for export and numerous small processors producing specialty dairy products such as cheeses and yoghurts for the New Zealand domestic consumer market.

20. Fonterra's share of the market for farmers' milk has reduced from 96 percent in 2001 to around 80 percent in 2019. Despite its reduced market share, Fonterra retains significant market power in terms of its national scale, large market share and incumbency advantage.

What are the risks?

21. While, collectively, other processors have 20 percent of the market for farmers' milk, there is a significant difference in scale between Fonterra and other processors. Fonterra is the only processor to have a truly national presence, with Commercial Sensitivity of the market for farmers' milk in most dairying regions, together with large scale processing facilities in all regions. Among the other large processors, Open Country Dairy has the broadest coverage, operating in Auckland, Waikato, Bay of Plenty, Otago and Southland. Most other processors have a single plant in only one region.

22. In the absence of the open entry and exit provisions, Fonterra would have the ability to constrain or foreclose competition by disincentivising and/or restricting dairy farmers' ability to switch to other dairy processors. Fonterra could, for example, require farmers to sign up to exclusive long-term supply contracts, and/or impose restrictions on farmers who might wish to return to Fonterra, thus creating a chilling effect on farmers' willingness to switch their supply. Such restrictions could mean that farmers currently supplying Fonterra may be unwilling or unable to shift their supply to other processing companies that may offer more efficient strategies, performance or price signals.

23. The effect of such conduct could be to either prevent the entry of further competition or constrain the growth of existing competitors, even if those competitors are able to perform better. It is unlikely that this could be effectively dealt with by the Commerce Act. The absence of effective regulatory constraints could have detrimental effects on the overall performance and economic contribution of the dairy industry value (new entrants have typically invested heavily in value added products and have also had access to new overseas distribution channels) and on the performance of Fonterra itself in the absence of competition.

24. The incentives on Fonterra to lock in farmers and leverage its incumbency advantage could also be increased by changes facing the dairy sector. Milk production has plateaued and may well decrease in response to more stringent environmental controls, limits on land and water resources and changing social licence.

Is the DIRA driving Fonterra's business strategy?

25. Fonterra and its farmer-shareholders have argued that the open entry and exit requirements impose costs on the company and constrain its ability to make strategic business decisions. Fonterra has argued that the requirement to accept all applications to become a shareholder in Fonterra and supply milk means that the company cannot control volumes and is therefore forced into a supply-driven commodity-focussed business, with risks around sunk costs in excess capacity.

26. The review found, however, that the DIRA does not drive Fonterra's strategies, investment plans and pricing decisions. Within the broad framework of the open entry and exit requirements, Fonterra has the ability to manage milk supply through its contractual terms of supply, shareholding requirements and dividends policy. The DIRA recognises that Fonterra is free to set its own terms of supply, subject only to a requirement that such terms do not discriminate between farmers in like circumstances.

27. It is therefore open to Fonterra to differentiate prices for farmers' milk (for example, on the basis of milk quality, seasonal variation, distance from processing facilities and other factors). Further comment on Fonterra's options in relation to pricing is provided in Appendix One. Where prices and /or dividends are uniformly high, this will incentivise increased milk production, while limiting ability to rely on retained earnings for future investment.

28. Fonterra's strategy has arguably been more driven by its status as a farmer owned co-operative. Decisions taken by the company as a result of its co-operative status have on occasion been mistakenly assumed to be the result of the DIRA regulatory regime. The DIRA is agnostic as to Fonterra's corporate form or business strategy. These are decisions to be taken by Fonterra and its shareholders.

29. Co-operatives provide benefits to farmers. Collective ownership of processing and related facilities means that farmers can ensure that their milk will be purchased and they will maximise returns for their milk. Risk can be spread across many owners and owners can share in a strong sense of community and mutual support.

30. The risk, however, is that farmers may prioritise their returns as milk suppliers above those as owners, and seek above all to maximise the short-term price they receive for their milk. Price maximisation is one of Fonterra's stated objectives and is set out in its Constitution. This may result in a relatively short-term business focus. A shorter-term, supplier-driven, focus may incentivise higher levels of milk production, with consequent pressures towards a volume-based business strategy. Farmers may also take a conservative approach to investment, if their priority is that the processor reliably accepts all milk supply in order to meet its own volume-driven strategy.

Proposals

31. The Minister of Agriculture considers that the potential costs and risks of removing the regulatory regime at this time outweigh those of leaving it in place. However, there is scope for improvement to the regulatory regime to remove some unnecessary regulatory impost on Fonterra, support better environmental performance, provide Fonterra with more flexibility to manage some aspects of its operations, and provide increased clarity on aspects of the regime for both Fonterra and other dairy industry stakeholders.

32. The Minister of Agriculture therefore proposes that the DIRA be amended to:

i. Allow Fonterra to decline applications from farmers to become shareholders in, and supply milk to, Fonterra when it is unlikely that the applicant would comply with Fonterra's terms of supply. This would support Fonterra's ability to manage aspects of farmers' on-farm performance more effectively and address reputational risks to Fonterra, and the dairy industry in general, that may arise from poor environmental, or other, on-farm performance.

ii. Clarify in law:

- what Fonterra can include in its terms of supply, for example, environmental, animal welfare, employment matters, and health and safety requirements. This would clarify Fonterra's ability to manage such matters through terms of supply and would support the measure outlined above
- that Fonterra's terms of supply can price differentiate on matters that include but are not limited to, environmental, animal welfare, employment matters, and health and safety requirements. The DIRA already allows Fonterra to price differentiate, and the company does so in some, but not all, circumstances. Consistent with the above clarification on terms of supply, this amendment would make Fonterra's ability to price differentiate across a range of performance issues, such as environmental performance, explicit. This will ensure that Fonterra is able, and encouraged, to reward excellent on-farm performance as part of its business and strategic direction. The Government's expectation that Fonterra and its farmers should fully utilise the flexibility afforded by the proposed exceptions to open entry, including to manage discharges and greenhouse gas emissions, will be clearly signalled through the Explanatory Note to

the Bill, Hansard, media statements and other influencing (rather than regulatory) tools.

iii. Provide Fonterra with discretion to refuse applications from new and existing suppliers to become shareholders in, and supply milk to, Fonterra if their milk is supplied from newly converted dairy farms. This would enable Fonterra to better manage uncertainty of future milk supply that may arise from dairy conversions, and the associated impacts on capacity and investment decisions. Supporting analysis and implementation issues are discussed at Appendix Four.

iv. Allow Fonterra to issue capacity constraint notices for a period of three seasons, rather than one season as now[3]. This would give Fonterra more flexible and realistic timeframes to plan and manage future capacity investment (see Appendix Nine for further detail).

v. Limit Fonterra's discretion with regard to setting a key assumption in calculating the base milk price (i.e. the asset beta assumption, which is the estimate of risk in calculating the cost of financing milk processing operations). This would reduce the risk of Fonterra using its discretion in a way that may impose higher than efficient costs on new and existing dairy processors (including Fonterra). Supporting analysis and implementation issues are discussed at Appendix Five.

vi. Amend the eligibility provisions for independent processors to access regulated milk from Fonterra. An independent processor would not be eligible to purchase regulated milk from Fonterra once it had its own supply of 30 million litres or more in a single season, rather than for three consecutive seasons, as now. Effectively this would mean that Fonterra would no longer be required to supply regulated milk to future large export-focussed dairy processors. Supporting analysis and implementation issues are discussed at Appendix Seven.

vii. Update terms on which Fonterra supplies regulated milk to Goodman Fielder (the only other large scale supplier of fresh milk to the New Zealand domestic consumer market) to:

- increase the amount of regulated milk that Goodman Fielder could buy from Fonterra from 250 to 350 million litres per season to reflect growth in the domestic consumer market;
- increase the regulated price Fonterra can charge Goodman Fielder by 10 cents per kgMS above Fonterra's farmgate milk price to compensate Fonterra for the economic cost of providing milk on the flatter supply basis required by Goodman Fielder; and
- allow Goodman Fielder to purchase raw milk from Fonterra at fixed quarterly prices, in line with terms permitted to other processors supplying the New Zealand domestic consumer market. Supporting analysis and implementation issues are discussed at Appendix Eight.

[3] Where Fonterra does not have sufficient processing capacity to manage the expected increase in the volume of mi k for an upcoming season in a defined geographical area, the DIRA allows Fonterra to limit the volume of mi k that it will accept, for that season only. Fonterra must publish a notice to that effect.

viii. Require further review of whether the DIRA regime should be retained, repealed or amended at intervals of four years following implementation of a previous review. As regulatory review processes can take up to two years, this would effectively result in six-yearly reviews. This would provide regulatory certainty and a clear timeframe within which the dairy industry can plan and operate, while also providing assurance to the industry that the regime can be updated and remain fit for purpose. Supporting analysis and implementation issues are discussed at Appendix Six.

ix. To support the review process with requisite expertise where necessary, empower the Minister of Agriculture, in consultation with the Minister of Commerce and Consumer Affairs, to direct the Commerce Commission to provide input to the review.

33. The Minister of Agriculture also proposes to make some minor and technical amendments to the DIRA in relation to the following matters:

i. Amend the existing regulation-making power in the DIRA to enable future regulations to simplify the process for setting a levy to recover the Commerce Commission's costs of administering the DIRA. The current approach to recover the Commerce Commission's costs from Fonterra is resource intensive and administratively inefficient, as it requires new regulations to be made every financial year to give effect to what is simply a routine administrative process. Supporting analysis and implementation issues are discussed at Appendix Nine.

ii. Provide a new regulation-making power to enable the collection of data regarding the supply of raw milk from sources other than farmers and from Fonterra, as currently regulated. This is to enable MPI to monitor changing market dynamics in the development of processor-to-processor (wholesale) raw milk supply arrangements. Supporting analysis and implementation issues are discussed at Appendix Nine. It is also proposed to make the necessary regulations pursuant to this new power, through the DIRA Bill.

iii. With regard to the base milk price, clarify the original policy intent that Fonterra can pay a farmgate milk price that is different from the calculated benchmark price. This would clarify Fonterra's legal obligations and avoid any unintended consequences arising from Fonterra's current interpretation of the Act. Supporting analysis and implementation issues are discussed at Appendix Nine.

Conclusion

34. The Minister of Agriculture considers that the amendments proposed above will collectively meet the objectives of the terms of reference. It is proposed to include these amendments in a DIRA Bill included in the 2019 Legislation Programme with a category 2.

35. While the proposed regulatory amendments address a range of separate issues, they are intended to be implemented as a package. Together they aim to ensure that the DIRA operates in the long term interests of New Zealand dairy farmers, consumers, and the wider economy, and that the regulatory regime will support a sustainable dairy industry and remain fit for purpose.

36. The regulatory proposals discussed in this paper were identified as the preferred approach after weighing a range of possible options. Details of other options that were identified, consulted on and considered by MPI are set out in the Regulatory Impact Assessments attached as Appendix Ten.

Consultation

37. The following departments were consulted: the Treasury, Ministry of Business, Innovation and Employment, Ministry of Foreign Affairs and Trade, Te Puni Kokiri, Te Arawhiti, Ministry for the Environment, Ministry of Justice, the Commerce Commission. The Department of the Prime Minister and Cabinet has been informed. Details of industry consultation are set out in the body of this paper and in Appendix Three.

Financial Implications

38. The recommendations in this paper regarding periodic reviews of the DIRA will have financial implications for the Government in the future. These are estimated at around $1 million per review. The cost of the current review was funded from MPI's existing baselines.

39. The recommendation to allow Fonterra to decline applications from dairy farmers who are unlikely to comply with Fonterra's terms of supply or whose milk is supplied from newly converted dairy farms, may increase the scope for potential disputes between Fonterra and dairy farmers.

40. Consistent with the existing dispute resolution provisions in the DIRA, the costs of resolving any such disputes would be incurred by the Commerce Commission under funding appropriated for the Commission's operations. These costs are subsequently 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, however, consider that the number of disputes that would actually come before the Commerce Commission will be high, given that Fonterra would need to have good reason (i.e. evidence) that the applicant could not meet the terms of supply.

Legislative Implications

41. The recommendations in this paper involve amendments to Subpart 5 and 5A of Part 2 of the DIRA and the Dairy Industry Restructuring (Raw Milk) Regulations 2012. A DIRA Bill has been included in the Legislation Programme for 2018/19 with a priority 2.

Impact Analysis

42. The Regulatory Impact Assessments are attached as Appendix Ten.

43. A quality assurance panel with representatives from the Regulatory Quality Team at the Treasury and the Ministry for Primary Industries has reviewed the Regulatory Impact Assessments (RIAs) accompanying this Cabinet paper that have been produced by the Ministry for Primary Industries and dated May 2019.

RIA 1 – Obligation to Accept all Milk from New and Existing Farmer-Shareholders

44. The panel considers that the RIA on the 'Obligation to Accept all Milk from New and Existing Farmer-Shareholders' meets the quality assurance criteria. 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 RIA 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.

RIA 2 - Obligation to Calculate a Benchmark Milk Price

45. While presented in a complex manner, the panel considers that the RIA on the 'Obligation to Calculate a Benchmark Milk Price' meets the quality assurance criteria. 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.

RIA 3 – Obligation to Sell up to 50 million litres of Raw Milk to Independent Processors

46. The panel considers that the RIA on the 'Obligation to Sell up to 50 million litres of Raw Milk to Independent Processors' meets the quality assurance criteria. 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.

RIA 4 – Obligation to Sell up to 250 litres of Raw Milk to Goodman Fielder

47. The panel considers that the RIA on the 'Obligation to Sell up to 250 litres of Raw Milk to Goodman Fielder' meets the quality assurance criteria. 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.

RIA 5 – DIRA Review and Expiry Provisions

48. The panel considers that the RIA on the 'DIRA Review and Expiry Provisions' meets the quality assurance criteria. 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.

Human Rights, Gender Implications, Disability Perspective

49. Not applicable.

Publicity

50. The Minister of Agriculture proposes to issue a media statement on the outcome of the review and amendments once agreed by Cabinet.

Proactive Release

51. Following Cabinet consideration, the Minister of Agriculture intends to release this paper, with certain redactions in line with the Official Information Act 1982, via the MPI website. MPI will also publish all submissions received in response to the review on its website, subject to any necessary redactions in accordance with the Official Information Act 1982.

Recommendations

The Minister of Agriculture recommends that the Committee:

1. **Note** that the Dairy Industry Restructuring Act 2001 regulates Fonterra to manage risks to the dairy industry, farmers and consumers arising from Fonterra's dominance in the market for farmers' milk

2. **Note** that the key regulatory tools for managing Fonterra's dominance risk are the open entry and exit provisions that allow farmers to switch their milk supply between Fonterra and other dairy processors in response to price signals and Fonterra's performance

3. **Note** that the Ministry for Primary Industries has carried out a review of the Dairy Industry Restructuring Act 2001 and its impact on the dairy industry, informed by extensive consultation with stakeholders and independent economic analysis

4. **Note** that the overall conclusions arising from the review are that the DIRA:
    - 4.1 has been effective in achieving its core regulatory objective of managing Fonterra's dominance
    - 4.2 is still required to manage ongoing risks arising from Fonterra's dominance and incentive to use its incumbency advantage to lock farmers in or out of the co-operative as a strategy to deter farmers from switching to other dairy processors
    - 4.3 has resulted in some unintended consequences, in preventing Fonterra from effectively managing some aspects of its farmer-shareholders' on-farm performance and planning investment in capacity
    - 4.4 requires some strengthening of requirements around the calculation of the base milk price to improve the certainty and reliability of the calculation
    - 4.5 requires updating of terms of access to regulated milk for Goodman Fielder and large export-focussed processors

5. **Agree** to the following amendments to the Dairy Industry Restructuring Act 2001:

Open entry and exit

- 5.1 **provide** a limited exception to the open entry and exit requirements to allow Fonterra, subject to the existing non-discrimination provision, to either decline an application to become a shareholding farmer, or to increase supply from an existing shareholding farmer, where it is evident that the applicant could not meet Fonterra's terms of supply
- 5.2 **clarify** that Fonterra's terms of supply can relate to, and price differentiate on the basis of, various on-farm performance matters that include, but are not limited to animal welfare, food safety, health and safety, employment conditions, environmental, climate change and other sustainability standards, subject to the existing non-discrimination provision

5.3 **provide** a limited exception to the open entry and exit requirements to allow Fonterra, subject to the existing non-discrimination provision, to decline an application to become a shareholding farmer, or to increase supply from an existing shareholding farmer, when the application is in respect of a new dairy conversion

5.4 **provide** a definition of 'new dairy conversion' that includes dairy farming established on land that had not been used for dairying in the five years prior to an application to Fonterra to become a shareholding farmer, or to increase supply from an existing shareholding farmer

5.5 **provide** a transitional arrangement to disapply the exception referred to in recommendation 5.3 to dairying conversions that are currently underway

Base milk price calculation

5.6 **limit** Fonterra's discretion in setting its assumption on the estimate of risk (measured by asset beta) by requiring consistency with dairy and other commodity processors when estimating the cost of financing milk processing operations in its base milk price calculation

Future review provisions

5.7 **provide** that the Minister should carry out reviews of whether the DIRA regulatory regime should be retained, repealed or amended, at intervals of no less than four years and no more than six years from presentation to the House of a report on the previous review

5.8 **provide** that the Minister of Agriculture, in consultation with the Minister of Commerce and Consumer Affairs, can direct the Commerce Commission to provide input to a review, as provided under recommendation 5.7

Minor and technical changes

<u>Fonterra Levy</u>

5.9 **amend** the existing regulation-making power in the DIRA to enable future regulations to be made that simplify the process for setting a levy to recover the Commerce Commission's costs of administering the DIRA

<u>Capacity constraint notices</u>

5.10 **provide** that Fonterra can issue a capacity constraint notice in a region for a period of three seasons, rather than one, as now

<u>Monitoring</u>

5.11 **add** a regulation-making power to require Fonterra and independent processors to provide information to the Ministry for Primary Industries to support the monitoring of dairy markets (such as the wholesale (processor-to-processor) market)

<u>Base milk price</u>

5.12 **clarify** that Fonterra can pay a farmgate milk price that differs from the base milk price calculated and monitored under Subpart 5A of Part 2 of the DIRA

6. **Agree** to the following amendments to the Dairy Industry Restructuring (Raw Milk) Regulations 2012:

Access to regulated milk by dairy processors other than Goodman Fielder

6.1 **provide** that Fonterra will no longer be required to sell up to 50 million litres of raw milk per season to an independent processor once that independent processor has obtained 30 million litres of its own supply of raw milk in a season (whether from farmers or through a wholesale process)

6.2 **provide** transitional arrangements for independent processors who have not yet exhausted the three-year own-supply entitlement as set out in current regulations

Access to regulated milk by Goodman Fielder

6.3 **update** the terms on which Goodman Fielder can purchase regulated milk from Fonterra to:

6.3.1 **increase** the total maximum volume that Goodman Fielder can purchase from Fonterra in a season from 250 to 350 million litres to recognise changing demand and growth in the domestic consumer market

6.3.2 **amend** the regulated price from Fonterra's farmgate milk price per kgMS to Fonterra's farmgate milk price plus 10 cents per kgMS to compensate Fonterra for the economic cost of providing milk to Goodman Fielder

6.3.3 **allow** Goodman Fielder to purchase raw milk from Fonterra at fixed quarterly prices in line with other processors supplying the domestic consumer market

Monitoring

6.4 **subject** to recommendation 5.11, require processors to keep records and enable MPI to collect information on the supply of raw milk other than that supplied by Fonterra or direct from farmers to processors, i.e. raw milk that is subject to wholesale (processor to processor) trade

7. **Invite** the Minister of Agriculture to issue drafting instructions to the Parliamentary Counsel office to give effect to recommendations 5 and 6 above.

8. Authorise the Minister of Agriculture to make secondary design and policy decisions in relation to any minor and technical drafting matters required to ensure consistency with recommendations 5 and 6 above.

Authorised for lodgement
Hon Damien O'Connor
Minister of Agriculture

Appendix One: CONTEXT: THE PURPOSE OF THE DIRA AND FONTERRA'S STRATEGY

The purpose of the DIRA

1. In 2001 the DIRA was passed to enable the formation of Fonterra through the merger of two large dairy co-operatives and the New Zealand Dairy Board (a statutory body). The DIRA enabled the creation of a single, vertically-integrated, farmer-owned, dairy co-operative company. The aim was to provide for sufficient economies of scale and scope in collection, processing and marketing of New Zealand dairy products to compete effectively in international dairy markets and generate impetus for strategic change and innovation in the New Zealand dairy industry.

2. At the time of its formation, Fonterra controlled 96 percent of all farmers' milk production in New Zealand. The DIRA therefore included provisions to manage risks arising from such a level of dominance in the absence of competitive pressure. The risks were that Fonterra could:
    - fail to achieve the efficiency and innovative performance for which it was created
    - create barriers to farmers' milk, and farmland, flowing to their highest value use (for example, to other, more efficient, higher value dairy processors, or to and from alternative land uses)
    - charge excessive wholesale prices for dairy products supplied to the New Zealand consumer markets.

DIRA risk mitigation tools

3. The key risk mitigation tools in the DIRA are:
    - **Open entry and exit requirements:** every farmer in New Zealand has the right to become a shareholder in Fonterra and supply milk, can freely exit to supply another dairy processor, and can choose to return to Fonterra. This enables farmers to respond to Fonterra's performance by switching their milk supply from and to Fonterra, thus exposing Fonterra to actual or potential competitive pressure and facilitating the development of competition.
    - **Fonterra's base milk price calculation and Trading Among Farmers (TAF):** Fonterra is free to set its price for farmers' milk supply but must do so in reference to a transparent base (benchmark) milk price that it calculates, and the Commerce Commission monitors, in accordance with pricing principles, governance and information disclosure requirements set out in the DIRA. The DIRA also contains TAF-related provisions to ensure that the prevailing market price for Fonterra shares transparently reflects Fonterra's financial performance. These requirements aim to inform farmers' decisions about where to direct their milk supply and share capital.

- **Access to raw milk from Fonterra:** the Raw Milk Regulations require Fonterra to make up to five percent of its annual milk collection available for purchase by other dairy processors at a regulated or agreed price. There are two aims: to provide new dairy processors with an entrance pathway into the market for farmers' milk and to enable dairy processors to offer New Zealand consumers product choice. Individual dairy processors can purchase up to 50 million litres of raw milk per annum from Fonterra. Eligibility ceases when an independent processor has obtained its own raw milk supply of 30 million litres or more per season for three consecutive seasons. Goodman Fielder is entitled to purchase up to 250 million litres of raw milk per annum from Fonterra, on regulated or agreed terms. This is to ensure that there is at least one large-scale competitor to Fonterra in the domestic consumer market for staple consumer dairy products, such as fresh milk.

4. While the DIRA provides an enabling framework for the dairy industry's resources (milk production, farmland, capital) to flow to their highest value uses, it does not prescribe what the highest value use should be, or how dairy farmers and processors (including Fonterra) should structure or size their commercial operations, what investments they should make or what dairy products they should produce.

Fonterra's strategy and the DIRA

5. The open entry and exit provisions of the DIRA have been perceived by Fonterra and its farmer-shareholders as imposing costs and risks on the company. Fonterra and its shareholders have argued that the requirement to accept all applications to become a shareholder in Fonterra, and to supply milk means that Fonterra faces uncontrollable volumes of milk that drive it towards a supply-focussed, commodity business. This in turn is perceived as forcing Fonterra to invest in excess capacity with a risk of being locked into lower value production and the possibility of stranded assets if market share declines.

6. The DIRA created a framework that aimed to ensure that the dairy industry's resources (milk production and farm land) could flow to their highest value use, despite Fonterra's dominance and its associated ability and incentive to create barriers to such industry dynamic. The DIRA does not prescribe what that highest value use should be, or how dairy farmers and processors (including Fonterra) should structure or size their commercial operations, what investments they should make, or what dairy products they should produce.

7. The chief way in which the DIRA intervenes in the industry dynamics is by incentivising Fonterra to use price signals as the means of managing the volume of its milk supply. The DIRA open entry and exit requirements deliberately ensure that Fonterra cannot directly control the volume of its milk supply simply by refusing to accept supply or preventing its existing suppliers from switching to other dairy processors or land uses.

8. Instead, the DIRA gives Fonterra the ability to control its milk supply volumes through the price it pays farmers for their milk, and through the cost of farmers' shareholding in Fonterra. The intent is that Fonterra is incentivised to set its milk price and cost of shareholding in a way that produces an optimal volume of milk to run its existing processing capacity (i.e. its sunk investment) while directing further investment to higher value use/product lines. Higher prices for farmers' milk and a lower cost of shareholding tend to incentivise increased milk production. If Fonterra sets a milk price that is "too high" and the cost of shareholding in Fonterra that is "too low" it risks incentivising farmers to produce excessive volumes of milk.

9. Fonterra has a number of tools by which it can manage price and milk volumes. These include:
   - farmgate milk price
   - terms of supply
   - shareholding requirements
   - dividend policy.

10. **Farmgate milk price**: the DIRA does not prescribe what price Fonterra, or other processors, should pay for farmers' milk. Fonterra is free to set the price in accordance with its business strategy. As outlined above, the open entry and exit provisions are intended to incentivise Fonterra to set an efficient price. The alternative regulatory approach would be to impose direct price control on the company, with an expert body, such as the Commerce Commission, determining the price. When the DIRA was introduced there was a deliberate policy decision against price regulation, as this carries risks of distorting business and investment decisions. There would also be costs for the Commission to build and run an independent pricing model, as well as risks of regulatory error and slower response time to changes in industry dynamic. A price regulation approach could also require a formal information disclosure regime to be imposed on Fonterra, with associated compliance costs on Fonterra.

11. **Terms of supply**: The DIRA allows for Fonterra to set its own terms of supply subject to the non-discrimination rule. MPI understands that Fonterra's current terms of supply differentiate the price it pays individual farmers on the basis of:
    - milk composition (e.g. milk with higher protein or milk solids attracts a premium)
    - seasonal variation (farmers who are able to supply milk outside of peak season receive a premium for that milk)
    - speciality milk (winter milk, organic milk, and colostrum is paid a premium).

12. Fonterra can also price differentiate on the basis of farmers' distance from a processing facility. The company choses not to exercise this right, as its Constitution (established and maintained by its shareholders) preludes it.

13. **Shareholding requirements:** the DIRA does not require Fonterra to take any particular corporate form. Fonterra has a co-operative structure because this is what its farmer-shareholders prefer. As a consequence of Fonterra's co-operative structure, its shareholders are required to purchase and hold a certain number of shares per kilogram of milk solids (kgMS) supplied to Fonterra. The price of Fonterra shares is established on a trading platform, known as Trading Among Farmers. Fonterra requires farmers to buy and sell its shares on this trading platform at the prevailing market prices. The DIRA requires Fonterra to ensure liquidity in the market for Fonterra shares and transparency of Fonterra's share price discovery process. The number of Fonterra shares that farmers must purchase and hold per kgMS is determined by Fonterra, at its complete discretion.

14. Where the number of shares that must be held per kgMS is high, the cost to farmers of supplying milk to Fonterra is high. Fonterra can influence farmers' overall profitability of supplying milk to Fonterra by increasing or decreasing the numbers of shares it requires its suppliers to hold per kgMS. It appears that since 2013 Fonterra has undertaken a number of initiatives that have made it cheaper for farmers to supply more milk to Fonterra. These include:
    - issuing bonus shares that provided farmers with one additional share for every 40 already held, free of charge. This increased the total shares on issue by 2.5 percent meaning that an estimated 95 percent of farmers needed not share up to grow their milk volumes that year.
    - the development of special growth supply contracts. Such contracts give farmers more time and options to buy shares to match their production. Under such contracts farmers could be required to purchase only 10 percent of the required number of shares upfront, with no further purchases needing to be made until the fourth season.
    - the introduction of MyMilk that assists Fonterra in maintaining and growing its milk supply in more competitive regions by allowing farmers to supply milk for five years without having to share-up.

15. **Dividends policy**: Fonterra can also influence its milk supply volumes through its dividends policy. Fonterra suppliers receive two income streams from Fonterra: a milk price as suppliers of milk, and a dividend on their shares in Fonterra. Since Fonterra's shareholding requirements are linked to the volume of farmers' milk supply, higher dividends could be incentivising higher milk production volumes.

Appendix Two: Summary of Issues Covered in Consultations

Appendix Three: Public Consultations

Summary of Submissions

1. Public consultation ran from 2 November 2018 to 8 February 2019. During this time MPI held 13 public meetings throughout New Zealand. A total of 401 people attended the public meetings, primarily Fonterra farmer-shareholders.

2. At the same time, MPI held 22 one-to-one meetings with dairy processors and other key stakeholders, such as representatives of farmers, Māori landowners and environmental lobby groups.

3. MPI received 188 written submissions on the discussion document entitled: *Review of the DIRA and its Impact on the Dairy Industry*. The submissions comprised:
   - 160 submissions from individuals (mainly Fonterra farmer-shareholders); and
   - 28 submissions from organisations (including: 11 dairy processors, five environmental groups, five farmer representative groups, two central and local government organisations, one Māori representative group, one food and grocery business, and three other organisations).

4. The key themes arising from the consultation process are briefly summarised below.

<u>Performance of the dairy industry</u>

Drivers of industry growth

5. The majority of independent processors and industry groups agreed with MPI's analysis that the growth of the dairy industry was primarily related to, and influenced by, the growth in international demand for dairy products, rising international prices, and the relatively poor returns on alternative land uses.

6. Fonterra farmer-shareholders were divided on the drivers of industry growth. Some agreed with the analysis that the growth of the dairy industry was related to international markets and the relatively poor return on alternative land uses. However, there were a number of farmer-shareholders, and environmental stakeholders who believed that the open entry provisions of the DIRA had driven unsustainable growth by encouraging new dairy conversions in areas that may be considered environmentally marginal or unsustainable.

7. MPI's analysis concluded that the DIRA had enabled the industry's growth but had not been its primary driver. Instead, the growth of the dairy industry was more directly related to, and influenced by, strong international demand, high prices for dairy products and less profitable returns from alternative land uses.

Impact of DIRA on Fonterra's business strategy

8. Fonterra and Fonterra farmer-shareholders expressed concerns about the perceived unintended consequences of the DIRA open entry requirements on Fonterra's business strategy. Open entry was perceived as driving a volume-based dairy industry because these submitters considered that Fonterra is unable to control the amount of milk it receives from its farmer-shareholders, and is therefore forced to invest in supply-driven commodity processing assets, rather than in demand-driven production of higher value dairy products.

9. Independent processors strongly disagreed that DIRA has impacted Fonterra's business strategy. They considered that, like most other commercial entities, Fonterra's strategy is driven by total shareholder value and maximising returns.

10. MPI's analysis concluded that, on the whole, Fonterra can and does influence its milk supply volumes through various price signals it sends to farmers. The degree to which Fonterra may choose to rely on price signals to influence its milk supply volumes depends on Fonterra's strategic and commercial decisions, and the expectation in its Constitution that Fonterra will maximise the milk price to supplier-shareholders. The DIRA does constrain Fonterra's ability to control its milk supply through volume restrictions. However, this is an intended (rather than an unintended) consequence of the DIRA regulatory regime aimed at ensuring that Fonterra, as a dominant company, does not create barriers to farmer switching.

11. MPI's analysis highlighted a slight degree of ambiguity about the intended policy distinction between the base milk price and Fonterra's farmgate milk price. MPI is also aware that the two terms have been referred to and used interchangeably by the industry. Both the legal provisions and the industry's interpretation appear to reflect an assumption, as opposed to a requirement, that the farmgate milk price Fonterra pays farmers for milk would equal the benchmark price that Fonterra calculates, and the Commerce Commission monitors, under the DIRA provisions. This is contrary to the original policy intent, and therefore warrants a clarification.

Environmental impacts of the dairy industry

12. There was a clear divide amongst Fonterra farmer-shareholders as to the extent to which the DIRA had driven negative environmental outcomes. However, there was a general agreement that the DIRA was not the appropriate means of addressing environmental concerns, and that these are best dealt with through other avenues.

13. Fonterra, Environment Canterbury, Fish and Game, Forest and Bird, Greenpeace and a number of individual submitters considered that the DIRA open entry requirements have contributed to negative environmental outcomes. Their concern was that open entry provides farmers with a guaranteed buyer (Fonterra) for all the milk they choose to produce. They believed this had 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.

14. Independent processors considered that environmental impacts were not driven by the DIRA, but were instead driven by on-farm practices and decisions taken at regional council level. These stakeholders considered that environmental issues should be addressed through avenues such as the Resource Management Act 1991 rather than the DIRA.

15. MPI's analysis concluded that, on the whole, the DIRA has not been responsible for negative environmental impacts. However, the DIRA has created an unintended consequence, by constraining Fonterra's ability to manage the overall environmental and other on-farm performance of its existing and entering farmer-shareholders through its terms of supply. Such outcomes do not contribute to the purpose of the DIRA regulatory regime, and may compromise Fonterra's ability to manage its own and industry-wide reputational risks. They therefore warrant amendment.

Open entry and exit requirements

16. Fonterra farmer-shareholders called for the repeal of open entry and exit provisions. They believed that under the current regime independent processors selectively procure supply, while Fonterra is forced to collect from fringe areas, which imposes unreasonable costs on the co-operative.

17. Fonterra farmer-shareholders also considered that open entry and exit provisions force Fonterra to carry excess processing capacity. They believed that open entry and exit provisions undermine the co-operative principle, as they allow disloyal farmer-shareholders to leave at no risk, which remaining farmer-shareholders have to bear.

18. Fonterra and the Fonterra Shareholders' Council also called for the repeal of open entry and exit provisions. This was underpinned by the argument that open entry and exit requirements had driven Fonterra to invest in commodity processing, at the expense of value-add processing, while also forcing Fonterra to carry excess processing capacity. A secondary argument presented by Fonterra was that open entry had driven the rapid expansion of the dairy industry, leading to negative environmental impacts.

19. All environmental stakeholders who submitted (Fish and Game, Forest and Bird, Greenpeace, and Environment Canterbury) supported repealing open entry, based on their view that open entry it is a key driver in the growth of the dairy industry, which consequentially has driven negative environmental impacts.

20. Independent processors were strongly supportive of retaining the current open entry and exit provisions and expressed caution over introducing any amendments that could enable Fonterra to "game" the regime for the purposes of increasing farmers' switching costs. Independent processors were particularly concerned with the risk of Fonterra seeking to lock in suppliers given the likely plateau of milk supply in the coming seasons.

21. MPI concluded that, on the whole, the DIRA open entry requirements needed to be retained, but identified opportunities to reduce the costs imposed on Fonterra. Such costs include, for example, reputational risk from suppliers who cannot meet Fonterra's terms of supply, including environmental performance, and the need to better manage capacity in relation to supply from new dairy conversions.

Base milk price calculation

22. Fonterra farmer-shareholders supported retaining the existing base milk price calculation and monitoring regime. They believed the regime provides sufficient transparency and accountability, puts pressure on Fonterra management to perform, and, gives farmers a true value for their milk. There was also a concern that without regulatory support for a base milk price calculation, dairy farmers would be reduced to price takers.

23. Fonterra, Fonterra Shareholders' Council, and Federated Farmers all supported retaining the existing base milk price provisions, maintaining that they work well and provide Fonterra's farmer-shareholders with the necessary transparency around Fonterra's milk price setting processes. Tatua was also in support of retaining the base milk price provisions, stating the need to consider the costs of any changes with any associated benefits.

24. A number of independent processors were extremely critical of the existing base milk price provisions, contending that the process of calculating the benchmark price lacks transparency and that Fonterra is able to manipulate it in a manner that imposes unfair costs on independent processors. They indicated a strong preference for giving the Commerce Commission (or an independent body) statutory power to set the base milk price for the industry.

25. MPI's analysis concluded that, on the whole, the current base milk price calculation and monitoring provisions were operating as intended, but identified an opportunity to improve the certainty and reliability of the base milk price calculation.

Access to regulated milk for large dairy processors (except Goodman Fielder)

26. Fonterra farmer-shareholders considered that large dairy processors should be excluded from accessing regulated milk. Their views were based on the belief that there is little rationale for Fonterra to be supplying large dairy processors, which then compete with Fonterra in overseas markets.

27. Excluding large dairy processors from accessing regulated milk from Fonterra was also supported by Fonterra, Fonterra Shareholders' Council, Federated Farmers, and Fresha Valley Processors. Similar to the farmer-shareholder submissions, these stakeholders emphasised the need to exclude large export-focused processors from accessing regulated milk from Fonterra.

28. Danone, Westland and Mataura Valley Milk supported continuation of the current access provisions, on the basis that they supported innovation and further diversification in the industry.

29. MPI's analysis concluded that large dairy processors are not necessarily Fonterra's closest competitors in export markets, and it appears that the entry of other processors likely provided a net gain in New Zealand exports. However, MPI considered that access to regulated milk was no longer necessary to secure farmer and investor confidence to enter the market for farmers' milk. Left unchanged, the current eligibility provisions would provide an unnecessary regulatory support to large dairy processors.

<u>Access to regulated milk for Goodman Fielder</u>

30. A number of Fonterra farmer-shareholders supported removing Goodman Fielder's entitlement to access regulated milk from Fonterra. This was on the basis that Goodman Fielder has had time to source its own supply.

31. The majority of independent processors, as well as Fonterra, were supportive of retaining the status quo for Goodman Fielder's access to regulated milk. It was noted that New Zealand is a small market and removing the current provisions would create large risks to the New Zealand consumer welfare. Fonterra's support of the status quo was on the basis of changes being made to both the price of regulated milk and the conditions on which milk is taken by Goodman Fielder.

32. Goodman Fielder submitted that developing its own supply was cost-prohibitive. It would require Goodman Fielder to significantly transform its business model. Goodman Fielder believed it should not be expected to transform its domestic consumer business to effectively replicate its predecessor (i.e. pre-DIRA) which had its own farm supply, ingredients business and domestic marketing and sales business. Instead, Goodman Fielder considered that its regulatory entitlement (in an enhanced form) should continue.

33. Goodman Fielder further submitted that to continue to operate as a viable large-scale competitor to Fonterra, 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. Goodman Fielder believes that Fonterra's own domestic consumer business receives preferential treatment from its parent company, which significantly disadvantages other competitors in the domestic consumer market.

34. MPI's analysis concluded that, in the absence of foreseeable alternative market solutions, there is a need for a continued fit-for-purpose 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.

DIRA review and expiry provisions

35. A number of Fonterra farmer-shareholders (around 25% of those who submitted on this issue) disagreed with all options regarding review and expiry, calling for an immediate removal of the DIRA provisions (except for those relating to the base milk price calculation and monitoring). They believed that there was no longer any need for the DIRA provisions, on the basis of the growing number of dairy processors in New Zealand and the maturity of the industry structure since 2001. These stakeholders were concerned with the DIRA provisions' perceived hindrance of Fonterra's ability to operate domestically and in international markets.

36. The majority of Fonterra farmer-shareholders supported either periodic reviews or automatic expiry from a nominated date or when a set market share threshold has been reached.

37. Federated Farmers, Federation of Māori Authorities and a significant proportion of the independent processors supported periodic reviews as the means of striking a balance between the costs of undertaking reviews and ensuring that Fonterra is not regulated for longer than necessary. Fonterra and the Fonterra Shareholders' Council also preferred this option, but on the condition that Fonterra's preferred changes (particularly on repealing open entry and exit provisions) are implemented and there is a clear path to de-regulation.

38. MPI's analysis concluded that lack of review and/or expiry provisions create a risk of Fonterra being regulated for longer than necessary. Providing for periodic reviews in legislation would address this risk.

Appendix Four: Open Entry and Exit

- The open entry and exit provisions of the DIRA are still required in light of Fonterra's continuing dominance in the dairy sector. While a number of large processors have entered the market, they do not provide sufficient competitive constraint on Fonterra.
- While open entry and exit should be retained as a general rule, there are two improvements that could be made by giving Fonterra some discretion to:
  - Decline shareholder applications and milk supply to allow Fonterra to better manage farmers' environmental performance and reputational risk, subject to the existing non-discrimination rule.
  - Decline shareholder applications and milk supply from new dairy conversions to enable Fonterra better to manage planning and investment in capacity, subject to the existing non-discrimination rule.

1. Open entry and exit is the main DIRA regulatory tool for managing Fonterra's dominance. It allows farmers to switch supply between Fonterra and other dairy processors in response to price signals and their judgement of Fonterra's current and future performance, so that farmers' milk is directed to its highest value use.

Stakeholders' views

2. There was a sharp division between the views of Fonterra and its existing shareholders, and other dairy processors as to the necessity for open entry and exit to remain in place.

3. Fonterra and its shareholders considered that the open entry and exit provisions should be repealed.

4. Other dairy processors consider that the open entry and exit provisions continue to be the most essential part of the DIRA regime. They consider that Fonterra could foreclose competition by locking farmers' milk supply in or out of the co-operative, through long-term contracts or a threat to refuse to accept returning farmer-shareholders.

Comment

<u>The continuing need for open entry and exit</u>

5. Fonterra has argued in the past that the requirement to accept all milk from new shareholders has driven it to over-invest in commodity processing. However, Fonterra's business strategy has (until recently) been volume-driven with a stated aim of growing volumes of milk production, and maximising milk prices to its farmer-shareholders. MPI's analysis suggests that this pricing approach has not been driven by the DIRA, but primarily by a response to global dairy prices, Fonterra's ownership structure and its chosen business strategy. Milk price maximisation is enshrined in Fonterra's Constitution.

6. Commercial Sensitivity Utilisation is also impacted by the seasonality of milk supply.

7. The Minister of Agriculture considers that there would be significant risk in removing the open entry and exit provisions, thus enabling Fonterra to create barriers to farmer switching. Farmers' ability to switch supply will continue to be an essential element in incentivising performance across the dairy industry. The risk of Fonterra seeking to lock in suppliers is now exacerbated as milk supply is likely to plateau in future seasons and possibly decline in response to environmental and land limits.

8. Despite a reduction in Fonterra's share of the market for farmers' milk, from 96 percent in 2001 to around 80 percent now, both collectively and individually the other "large" processors that have entered the market are on a significantly smaller scale. Commercial Sensitivity Fonterra's scale and incumbency advantages continue to create a risk to be managed.

9. In the absence of the open entry and exit provisions, Fonterra's ability to create barriers to farmer switching would be constrained only by the general provisions of section 36 of the Commerce Act 1986. The DIRA sets out what the regulated party must do or not do, in order to constrain potential abuse of a dominant position, and the requirements are relatively clear-cut and relatively easy to enforce. In contrast, the Commerce Act is a generic regime, and the parties can take action in the courts, or through the Commerce Commission, only after alleged anti-competitive conduct has occurred. The boundaries between what conduct is anti or pro-competitive are not always clear up front. This makes the outcome less certain and enforcement much more costly and complex.

10. 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. Given the significance of the dairy industry to the New Zealand economy, the Minister of Agriculture considers that there is sufficient risk of negative impacts to merit retention of the open entry and exit regime.

Proposals

11. The Minister of Agriculture therefore recommends that the DIRA open entry and exit provisions remain in place. Two exceptions to the open entry requirements are proposed, to give Fonterra discretion to accept or reject milk in the following specific circumstances:

- where it is evident that an applicant seeking to become a Fonterra shareholder /supplier would be unable to comply with Fonterra's terms of supply; and
- where the applicant's milk comes from a newly converted dairy farm .

12. These are discussed in turn below.

Inability to comply with Fonterra's terms of supply

13. MPI's discussion paper noted that the open entry and exit provisions appeared to have had an unintended consequence, in constraining Fonterra's ability to manage the overall environmental and other on-farm performance of its existing and entering farmer-shareholders.

14. Fonterra must accept all applications to become a shareholder (and accept milk) from entering farmers and existing shareholders wishing to increase their milk supply. This means that Fonterra must accept farmers even if they may not meet Fonterra's standards, as set out in its terms of supply (including in relation to environmental, climate change, animal welfare, employment practices, hygiene, and health and safety compliance). MPI considers that the DIRA open entry requirements create a reputational risk for the company, and for the wider dairy industry.

15. There also appears to be some drafting ambiguity in the DIRA over what Fonterra is able to include in its terms of supply and whether it can in fact set requirements for matters such as the environmental performance of its farmers.

16. MPI consulted on an option that would allow Fonterra to refuse an application to become a shareholder, or from an existing shareholder wishing to increase milk supply, where it was clear that the applicant would not be able to meet Fonterra's terms of supply (including environmental, animal welfare, health and safety, employment practices, quality or other standards applied by Fonterra to its shareholder-suppliers).

17. This proposal received a mixed reaction:
    17.1. Fonterra and some other stakeholders considered that this was a helpful measure.
    17.2. Some stakeholders expressed concern that allowing Fonterra to decline a shareholder application could provide scope for gaming the open entry and exit requirements.

18. The Minister of Agriculture considers that this risk can be managed by careful drafting and notes that Fonterra will continue to be bound by the non-discrimination provisions of the DIRA. The non-discrimination provisions require that Fonterra must extend like terms and conditions to farmer-shareholders in like circumstances.

19. The Minister of Agriculture therefore proposes that the DIRA open entry and exit provisions be amended to allow Fonterra to decline an application to become a farmer-shareholder, or an existing shareholder to increase their supply, where it is evident that the applicant would be unlikely to comply with Fonterra's terms of supply. In practice, this would give Fonterra discretion to refuse applications from farmers whose record of on-farm performance involved consistent non-compliance with local environmental standards, animal welfare or other regulatory requirements, as well as Fonterra's own standards.

20. As noted above, Fonterra's discretion to decline an application would be constrained by the existing non-discrimination provisions in the DIRA. In addition, appeal provisions would apply. The DIRA already provides an appeal process to the Commerce Commission which offers a relatively quick and simple approach for dealing with disputes.

21. The Minister of Agriculture also proposes that the DIRA be amended to clarify that Fonterra's terms of supply can relate to, and price differentiate on the basis of, various on-farm performance matters. These matters could include environmental, climate change and other sustainability standards, animal welfare, health and safety, employment conditions, and food safety, subject to the non-discrimination provisions.

22. The intent is to ensure that Fonterra is able to set terms of supply on an equal footing with other processors which have the ability to set standards for their suppliers, and to reward farmers for excellent on-farm performance.

23. The Minister of Agriculture notes that these amendments are permissive not mandatory – that is, they give Fonterra discretion to make judgments about suppliers' performance, and how to reward that performance, consistent with the company's business and strategic direction. The Minister notes further that expectations as to the exercise of this provision will be set out in the explanatory note to the proposed DIRA Bill and in any media statements regarding the regulatory regime.

24. In making these recommendations, the Minister of Agriculture notes that the Resource Management Act, not the DIRA, is the statute that manages environmental matters. The above amendments to the DIRA are intended to enable Fonterra to better manage the performance of its farmers, consistent with the overarching requirements of the RMA.

25. The Ministry for the Environment is currently progressing policy work on its Essential Freshwater work programme. This programme has the objectives of stopping further degradation and loss of New Zealand's freshwater resources; reversing past damage; and addressing water allocation issues.

<u>New conversions</u>

26. Fonterra has argued that the DIRA open entry requirements impose costs on the co-operative. These costs arise from the need for Fonterra to invest in additional excess processing capacity to provide a buffer to accommodate new milk supply.

27. It is difficult to isolate the effect of the DIRA open entry requirements on capacity from other factors that drive Fonterra's milk volume uncertainty. For example, uncertainty around milk supply, and therefore pressure on capacity, can arise from seasonal variations in milk production and incentives to increase production in response to international trading conditions.

28. However, it appears that where there are costs associated with open entry, these mostly arise from the uncertainty of future supply from new dairy conversions. The Minister of Agriculture therefore proposes that the DIRA be amended to allow Fonterra discretion to accept or decline applications by dairy farmers to become shareholders, or to increase their existing shareholdings in Fonterra, when the application is in respect of a new dairy conversion.

29. Providing this exception to the open entry and exit requirements would enable Fonterra to manage the costs of building new processing capacity more effectively, without undermining the overall intent and effectiveness of the DIRA regulatory regime.

30. The primary purpose of the DIRA open entry and exit requirements is to ensure that Fonterra cannot prevent farmers from 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 barriers from an existing supply arrangement. This suggests that the potential costs of requiring Fonterra to continue to accept milk from new dairy conversions outweigh the benefits.

31. Commercial Sensitivity [redacted]

32. The key elements of the proposed amendment would include:

- A carefully drafted definition of “new dairy conversion” to minimise the risk of gaming and avoid unintended consequences (such as preventing an existing dairy farmer from making a relatively limited extension to an existing farm).
- Definition of a point at which a dairy farm is no longer considered a “new conversion”: e.g. after five years of operation.
- Continued application of the non-discrimination rule. If Fonterra chose to accept an application from a new or existing farmer-shareholder in respect of a newly converted dairy farm, the non-discrimination rule and other DIRA provisions would apply. This would 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.
- Recourse to the Commerce Commission, using existing appeal provisions, in the event that an applicant wished to challenge Fonterra’s decision to decline an application.

Appendix Five: Base Milk Price Calculation

- The base milk price is a benchmark against which Fonterra's actual pricing of farmers' milk, and consequently its efficiency, can be assessed.
- However, it has come to be regarded as the default farmgate milk price for the industry.
- Other processors lack confidence in the methodology and assumptions by which the base milk price is calculated.
- If the benchmark price calculation is not reliable and robust, there is a risk of higher costs being imposed on processors (including Fonterra), as well as a risk of gaming by Fonterra.
- There is scope to improve the robustness of the calculation by embedding the Commerce Commission's findings on the asset beta, to limit the discretion that Fonterra can exercise over this key aspect of the benchmark price calculation.

1. The DIRA does not regulate the price that Fonterra, or any other processor, pays farmers for their milk. However, because Fonterra remains the largest processor of milk in New Zealand, and the largest purchaser of farmers' milk, the price that Fonterra pays tends to act as a default price that other processors match or better in seeking milk supply from farmers.

2. Fonterra sets its milk price in reference to a base milk price that it calculates in accordance with its Milk Price Manual. This base milk price calculation provides a benchmark and a reference point against which Fonterra then sets its actual milk price for the season. Prior to the 2008/09 season Fonterra undertook its base milk calculation as a matter of business practice without regulatory intervention.

3. In 2012, to promote increased transparency, the DIRA was amended to:
   - set out the purpose, principles and processes to underpin Fonterra's base milk price, and
   - provide for the Commerce Commission to monitor Fonterra's methodology and calculation of this benchmark price.

4. The DIRA allows 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. The key purpose of these DIRA provisions was to promote greater transparency of, and confidence in, Fonterra's business practice of setting its milk prices.

Stakeholder views

5. The DIRA provisions governing Fonterra's base milk price calculation were extensively debated in consultations with stakeholders. Fonterra and its shareholders strongly support the existing base milk price regulatory regime and consider that it should remain unchanged.

6. Other large scale dairy processors are extremely critical both of aspects of Fonterra's current methodology and of the regulatory regime itself. They have stated that they do not have confidence in a number of key assumptions and inputs that Fonterra relies on in its calculation and that Fonterra is able to inflate the milk price in a manner that imposes costs on other processors. They considered that the Commerce Commission should be empowered to direct Fonterra on key aspects of its price setting methodology. In January 2019 Open Country Dairy sought a judicial review of the Commerce Commission's interpretation of aspects of the Subpart 5 of the DIRA and decisions in respect of the base milk price calculation.

Comment

7. The purpose of the base milk price regulatory regime is not to set the milk price, but to provide a theoretical benchmark against which farmers can assess the price that Fonterra actually pays. This enables farmers to assess whether Fonterra is achieving the maximum feasible efficiency (which is then translated into the price that farmers receive). Because Fonterra is dominant in the market for farmers' milk, the price that is paid by Fonterra becomes the price that other processors must match or better to attract and retain farmers' milk supply.

8. While Fonterra can deviate from the benchmark price, the company has rarely done so. It is therefore important that the calculation is as reliable and robust as possible. If the benchmark price is set inefficiently high, this will impose costs on processors, including Fonterra. If the process and assumptions for setting the benchmark price are insufficiently robust and transparent, there is also a risk that Fonterra could game the calculation, with the flow-on effect of imposing costs on competitors.

9. The Minister of Agriculture considers that there is scope to improve the current process but does not accept the view expressed by some independent processors that the Commerce Commission should have statutory powers to direct Fonterra on price.

10. This approach would substantially alter the focus and nature of the regulatory regime. 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. Instead of price control, the DIRA relies on the open entry and exit requirements to incentivise Fonterra to pay an efficient (not "too high" and not "too low") farmgate milk price. The benchmark price setting measures are therefore an added (but not primary tool) to support efficiency and transparency as explained above.

Proposal

11. The Minister of Agriculture proposes to amend the DIRA to limit Fonterra's discretion with regard to setting a key assumption in calculating the benchmark milk price.

12. The Commerce Commission, which monitors Fonterra's milk price calculation has generally been satisfied with the assumptions, inputs and processes that underpin the calculation, with one exception. This concerns Fonterra's estimate of risk in calculating the cost of financing milk processing operations (measured by asset beta), which the Commission considers is too low. The Commerce Commission therefore considers that Fonterra's approach to setting the asset beta assumption does not meet the DIRA requirement that the assumptions underlying the calculation must be "practically feasible" for an efficient dairy processor.

13. 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 contribute to reduced profitability of, new and existing dairy processors (including Fonterra itself).

14. The Minister of Agriculture therefore proposes that the Commission's approach to the asset beta assumption be specifically referenced in the DIRA as a mandatory assumption which Fonterra must take into account in calculating its benchmark milk price.

15. This will improve the reliability of one of the key assumptions underlying the calculation, while avoiding additional compliance costs and the risk of regulatory error. The DIRA generally allows relatively wide discretion to Fonterra to determine key assumptions underlying the benchmark price calculation. While this proposal will limit some discretion, it is important to retain sufficient flexibility in the calculation to take account of future market and industry dynamics. The proposal therefore aims for a balance of increased reliability without undue cost and constraint.

Appendix Six: Future Review Provisions

- The DIRA currently has no review or expiry provisions. This means that the regulatory regime could remain in place permanently.
- It is desirable to include some regulatory provision for review, to provide regular opportunity to update the regulatory regime, remove unnecessary regulation and take account of changing circumstances in New Zealand dairy markets.
- Prior to the last amendment, a review was triggered by market share thresholds. These are not, however considered to provide a reliable indicator on which to base review decisions.
- It is therefore proposed to introduce a requirement to review the DIRA at intervals of four years after the findings of a previous review have been implemented. This will provide certainty for stakeholders over timeframes applying to the regulatory regime, to assist in planning and investment decisions. Given that regulatory review processes can take up to two years, this would effectively provide for six-yearly review intervals.

1. MPI also consulted stakeholders on options for future review and possible expiry provisions for the DIRA. When the DIRA was originally enacted, the need for the DIRA was seen as contingent on Fonterra retaining a dominant position in the market. The assumption was that if Fonterra's dominance was eroded, competition between processors for farmers' milk would replace the need for regulation. At that point the management of any risks arising from strategic market conduct would rely on the general provisions of the Commerce Act 1986.

2. Automatic review and expiry provisions were therefore included in the DIRA, that were triggered when Fonterra's share of farmers' milk fell to a certain market share threshold in either the North Island, South island or both.

3. The review and expiry process was triggered when Fonterra's market share fell below 80 percent in the South Island. In February 2018 these provisions were repealed to prevent the expiry of the DIRA in the South Island and to enable the current review to take place in a stable regulatory environment.

4. In its current form, the DIRA has no provision for any further review or possible expiry or repeal of the DIRA provisions. This means that the provisions that regulate Fonterra would remain in place permanently, unless the Government took another decision in the future to undertake a further review.

Stakeholder views

5. Fonterra has argued that there is substantial competition in most regions and its market share, even at a national level, means that the continuation of the open entry and exit provisions is unnecessary. Fonterra farmer-shareholders considered that, as the triggers in the original DIRA had been met, further reviews and retention of the regulatory regime constituted a shifting of the goal posts.

6. Other processors have argued that Fonterra remains dominant in the market for farmers' milk, and could foreclose competition in the absence of the DIRA constraints, particularly open entry and exit.

Comment

7. While Fonterra's market share has fallen since 2001, the Minister of Agriculture notes that the company retains some 80 percent of the farmgate milk supply. The Minister of Agriculture considers that there are still risks arising from Fonterra's dominance. The Minister of Agriculture therefore proposes that the DIRA regulatory regime should remain in place, with a statutory provision for periodic reviews, to be initiated every four years following implementation of a previous review.

8. Given the time involved in consultation and implementation, this would mean that in effect future review processes would generally take place within a six year period. This would allow for the effects of the regulatory regime to be assessed to ensure that the regime remains fit for purpose. It would also allow a sufficiently long period between reviews to provide certainty for farmers and processors to plan and take business and investment decisions.

9. Other options were canvassed in consultations, such as using a prescribed market share threshold for triggering a review. The Minister of Agriculture does not consider that reviews should be triggered by a prescribed market share. Experience to date with reliance on a market share indicates that it is too arbitrary and does not of itself provide a sound basis for making regulatory decisions. Nor does the Minister of Agriculture consider that an automatic expiry should be provided as this would create a risk that the DIRA provisions could lapse regardless of a continuing need for some form of regulation to remain in place.

Appendix Seven: Access to Regulated Milk for Large Dairy Processors

- The Raw Milk Regulations have usefully provided access to a limited quantity of raw milk for large dairy processors in the start-up phase of their operations, and for smaller processors servicing the domestic market.
- Large processors have acknowledged that this has been helpful in building confidence in the viability of a new plant for both investors and farmers.
- It does not appear necessary to continue providing this initial support to large processors. It is therefore proposed that eligibility for regulated milk will cease when a processor has its own supply of 30 million litres for one season, rather than three as now.

1. Currently, under the Raw Milk Regulations, dairy processors are entitled to purchase up to 50 million litres of raw milk from Fonterra each season, at regulated or agreed prices. Eligibility ceases when a processor has obtained 30 million litres of its own supply for three continuous seasons.

2. This provision is now mostly used by smaller processors (e.g. specialty cheese and yoghurt manufacturers servicing the New Zealand consumer market), whose scale of operations makes it difficult to obtain milk directly from farmers.

3. Commercial Sensitivity [redacted]

4. The key policy consideration is whether this regulatory measure is still required to enable new large scale processors to establish in New Zealand. The original basis for this measure was that a new processor might face difficulty getting supply without a functioning dairy facility in place, but could also face difficulty obtaining investment capital in the absence of reliable milk supply.

5. Large processors which are not reliant on debt financing are less likely to face barriers with access to investment finance than New Zealand-owned processors. New Zealand's reciprocal international trade obligations, however, require non-discrimination between New Zealand and overseas-owned investors. Any regulatory assistance measure must therefore be available to overseas-owned companies on the same basis as New Zealanders.

Stakeholder views

6. Fonterra and its shareholders support continued availability of regulated milk for smaller processors who are supplying products to New Zealand consumers. However, they strongly oppose the continuation of this measure to large scale processors who are primarily focussed on export. They consider this provides a subsidy to processors that compete directly with Fonterra in export markets.

7. Processors other than Fonterra consider that the provision of an initial supply of raw milk was very helpful in enabling them to establish operations in New Zealand. Miraka and Mataura Valley Milk considered that they would not have been able to establish at all without this provision and noted that sourcing investment capital within New Zealand would be very difficult without a guaranteed initial supply of milk. While most large processors rapidly developed their own farmer supply and are no longer eligible for regulated milk, they commented that the absence of this provision could make it more difficult for any further large dairy processing to be established.

Comment

8. MPI's analysis and consultation suggests that other processors do not in fact compete directly with Fonterra overseas. Their product lines tend to differ from those of Fonterra and most large processors that have entered the New Zealand dairy sector since 2001 already had supply chains to overseas markets in place. Arguably this has grown the market for New Zealand dairy products.

9. While the Raw Milk Regulations impose a potential opportunity cost on Fonterra, in requiring the company to supply milk to processors at regulated prices, in practice this cost is not substantial or open-ended. The DIRA imposes a limit on the total amount of raw milk that Fonterra is required to supply in a season at no more than five percent of Fonterra's total milk collection. The total amount is currently capped in the Raw Milk Regulations at 600 million litres per season.

10. Commercial Sensitivity [redacted]

11. The provision of regulated milk has provided a helpful entrance pathway for new processors establishing in New Zealand. The question is whether it needs to be retained for the benefit of larger operations. It is considered that this measure is no longer essential to support investment in new large scale dairy processing facilities. Since 2001, eight large processors have successfully established viable ongoing operations in New Zealand. The demonstration effect and farmer experience with these companies should be sufficient to engender confidence in any future investment decisions.

Proposals

12. The Minister of Agriculture therefore proposes that the eligibility provisions in the Raw Milk Regulations should be amended to exclude large dairy processors. Specifically the amendments would provide that:
    - A dairy processor would cease to be eligible to purchase raw milk from Fonterra at regulated prices once that processor had obtained its own supply (whether from farmers or another processor) of 30 million litres or more of raw milk in a season (rather than, as now, allowing access to regulated milk to continue for three seasons).
    - A transitional arrangement would be included to "grandparent" the current eligibility provisions for dairy processors who are currently eligible and have started, or are about to start, purchasing regulated milk from Fonterra. In practice, there are two large processors (Mataura and Yashili) to which this transitional provision would apply.
    - Processors who source less than 30 million litres of own supply in a season would continue to have access (as now) of up to 50 million litres of regulated milk from Fonterra per season, on agreed or regulated terms. In practice, this means that smaller processors, who generally focus on the domestic consumer market, will continue to be able to obtain regulated milk from Fonterra.

13. The amendments outlined above would not make specific reference to "export-focussed" processors, as proposed by Fonterra and Fonterra's Shareholder Council, and as was the case in a similar proposal following the 2015 review of the state of competition in dairy markets. This concept is complex in terms of drafting legal definitions, and could constrain the potential for some processors to grow. For example, smaller processors tend to be focussed initially on the New Zealand domestic consumer market. That market is small, and if such processors wish to grow (and generate export revenue for the benefit of the New Zealand economy) they must eventually turn to export markets.

14. The Minister of Agriculture considers that the effect of the amendments outlined above will in any event ensure that any future regulated milk is directly targeted at those who require it in the very early start-up stage or for the purpose of servicing the domestic consumer market.

Appendix Eight: Access to Regulated Milk for Goodman Fielder

- Goodman Fielder is the only large-scale competitor to Fonterra supplying staple dairy products (fresh milk, butter and table cheese) to the domestic consumer market.
- The company is reliant on Fonterra for its raw milk supply. The DIRA provides assurance of supply, for the benefit of New Zealand consumers, in requiring Fonterra to provide up to 250 millions of raw milk per season at a regulated or negotiated price.
- While this regulatory dependency is undesirable, there is a high risk that, for a number of reasons, Goodman Fielder may not be able source its own supply and the small size of the domestic consumer market may limit the scope for alternative large scale competition.
- To ensure that New Zealand consumers continue to have choice and access to basic dairy staples it is proposed to maintain the current regulatory backstop, with some updating to recognise changes in the consumer market, and some pricing anomalies imposed on Fonterra.

1. The creation of Fonterra in 2001 meant that Fonterra was the only large-scale supplier of staple dairy products (fresh milk, butter and table cheese) to New Zealand consumers. There was a risk that Fonterra might therefore have been able to charge excessive wholesale prices and/or restrict the quantity and variety of dairy products available to New Zealand consumers.

2. 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. The contract ends in 2021 and, despite ongoing negotiations, the parties have yet to conclude a new agreement.

3. As a fall-back, the Raw Milk Regulations provide for Goodman Fielder to purchase up to 250 million litres of raw milk per annum from Fonterra on regulated terms. The assumption in 2001 was that over time Goodman Fielder would develop its own supply of raw milk. This has not eventuated. There are a number of factors which have influenced Goodman Fielder's ongoing reliance on Fonterra as a supplier of milk.

Stakeholder views

4. Commercial Sensitivity

5. Goodman Fielder has also stressed that it requires a consistent year round volume of milk supply, on a "flat" curve in order to maintain a consistent volume of fresh milk production for the consumer market. New Zealand's milk production follows a seasonal peak. This means that Goodman Fielder cannot readily obtain the necessary quantities of winter milk wholesale from other processors (who have their own milk supply). While other processors may be willing to supply their surplus milk during the peak season they have little incentive to sell the winter milk which they require to sustain their own operations.

6. Goodman Fielder also considers that it is constrained in its ability to obtain raw milk direct from farmers. To establish the necessary quantities and flat curve, it would have to recruit farmers who are currently supplying other processors, and establish collection and transport infrastructure. Goodman Fielder considers that it could not match the efficiencies of Fonterra in this regard. This would mean higher costs for consumer products, which would impact on its position as a competitor to Fonterra in the domestic consumer market.

7. To manage the excess peak supply that would necessarily be generated in order to obtain the required levels of winter milk, Goodman Fielder considers that it would also have to develop an associated commodity-focussed business. Aside from the level of capital investment required, neither of Goodman Fielder's existing processing sites would accommodate this type of expansion.

8. Commercial Sensitivity [redacted] Fonterra farmer-shareholders had mixed views. Some stated that they were prepared to continue to ensure supply to Goodman Fielder for the benefit of consumers. Some considered that Goodman Fielder should by now have established its own supply.

9. Foodstuffs has noted the importance of a large scale competitor to Fonterra. A particular concern is the ability of Foodstuffs to obtain dairy products under its private label. Private label products account for the majority of sales in basic dairy products and retail at a comparatively lower price. There is a concern that in the absence of competition, Fonterra would seek to supply only its own branded products, thus reducing consumer choice and impacting on prices.

Comment

10. Commercial Sensitivity [redacted]

11. The domestic consumer market is well served by small scale producers of products such as yoghurt and specialty cheese. However, essential basic products, and particularly fresh milk, are largely dependent on Fonterra and Goodman Fielder. There are smaller processors that provide these products locally (Green Valley Dairy, Fresha Valley, Oakland Dairy) but they have limited geographical reach.

12. Since 2001, there has been little interest shown by larger dairy processors in servicing the domestic consumer market for fresh milk, butter and table cheese. The domestic market is small and processors that have supplied these products have generally done so for the purposes of establishing brand credibility in overseas markets. Westland has a limited presence in providing some premium butter, and Synlait plans to start toll processing fresh consumer milk products on behalf of Foodstuffs South Island's private label brand from 2019. Neither currently provide competition of scale to Fonterra in the basic dairy products consumer market.

13. It is questionable that these, or other large processors, will over time grow their share of the domestic consumer market to match that of Fonterra in the supply of consumer basics, and particularly fresh milk.

14. Commercial Sensitivity

15. Commercial Sensitivity

16. The Minister of Agriculture therefore proposes that the Raw Milk Regulations be amended to update the regulatory provisions. Essentially this would maintain the current regulatory backstop for Goodman Fielder, while taking account of growth in the domestic consumer market, and addressing some existing pricing anomalies.

17. Specifically, the Minister of Agriculture proposes to amend the Raw Milk Regulations to update the terms on which Goodman Fielder could source regulated raw milk supply from Fonterra to:

i. Increase in the total amount of regulated milk that Goodman Fielder could buy, from 250 to 350 million litres per season. This equates to half of the current consumer market demand (300 million litres), with some scope for further growth.

ii. Increase in the regulated price of 10 cents per kgMS above Fonterra's farmgate milk price. This would compensate Fonterra for the economic cost of providing milk on a flatter supply basis rather than aligned with the seasonal curve that peaks in October.

iii. Allow Goodman Fielder to purchase raw milk from Fonterra at fixed quarterly prices. The regulations were amended in 2012 to allow other dairy processors without their own supply to purchase milk from Fonterra at fixed quarterly prices. This was provided for 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 contractual terms. However, if Goodman Fielder were to rely on the regulated terms, its payment terms could be aligned with other processors supplying the domestic consumer markets.

18. The above proposals involve some price adjustment for regulated milk, which would be a cost to Goodman Fielder. This is not expected to translate into increased costs to New Zealand consumers. Goodman Fielder has the option of negotiating a contract with Fonterra, rather than relying on the regulatory backstop. Further, the price of milk to consumers is not directly governed by the price for raw milk. Costs at retail are highly subject to the influence of retailers, and particularly supermarkets.

Appendix Nine: Technical Amendments

1. There are some housekeeping matters that need to be included in the DIRA Bill. These are technical and operational matters to support the administration of the regulatory regime and are not controversial. They include amendments to the DIRA to:
   - amend the regulation-making power regarding the setting of the levy that Fonterra must pay to meet certain Commerce Commission costs involved in administering the DIRA regime, so that the regulations governing the process can be simplified;
   - provide a new regulation-making power to allow MPI to collect data on the sale of raw milk that is subject to wholesale (factory gate) trade (i.e. sold by one processor to another), in addition to its current powers to collect such data on farmgate milk supply;
   - better align current provisions around capacity constraint notices with requirements for planning and managing new processing capacity; and
   - to clarify original policy intent of the DIRA that Fonterra can deviate from the calculated benchmark price.

Amend existing regulation-making power for Fonterra levy-setting processes

2. The Commerce Commission has a number of functions and responsibilities under the DIRA. Fonterra is required to bear most of the costs of enforcing the DIRA. This was a trade off in 2001. The DIRA conferred benefits in enabling the company's formation and imposed a relatively light regulatory regime. Fonterra in turn was to meet the costs of the Commerce Commission's oversight, namely:
   - investigating complaints and making determinations;
   - enforcing Subpart 5 and 5A of Part 2 the DIRA;
   - enforcing determinations in the High Court; and
   - conducting Fonterra's base milk price monitoring under Subpart 5A.

3. The current approach to recover the Commerce Commission's costs from Fonterra is resource intensive, time consuming and administratively inefficient. It requires new regulations to be made in each financial year to give effect to what is simply a routine administrative process. Aside from its inherent inefficiency, the process is not aligned with best practice relating to other levy setting processes aimed at recovering the Commerce Commission's costs from other regulated parties.

4. The Minister of Agriculture therefore proposes to amend the existing regulation-making power in the DIRA to enable future regulations to simplify the process relating to setting the levy. Approval to amend the levy regulations themselves will be the subject of separate advice, once the regulation-making power has been amended.

New regulation-making power to collect milk-related data

5. The Raw Milk Regulations provide for MPI to collect data from Fonterra regarding its supply of regulated milk to other dairy processors, including to Goodman Fielder. The Regulations also provide for MPI to track the volumes of raw milk sourced by other dairy processors from farmers, including both own supply arrangements and the purchase of raw milk under other regulatory provisions such as the 20 percent rule. MPI collects and analyses this information on annual basis.

6. This information helps to inform policy advice by enabling MPI to determine the extent to which processors rely on regulated supply, changes in the level of demand for regulated supply, and, more broadly, the total volumes of raw milk purchased in a season.

7. A new regulation-making power is proposed, to allow MPI to expand its existing information gathering to cover other sources of milk supply. At present the regulations cover only raw milk that is supplied by Fonterra or direct from farmers to processors. The intention is to enable MPI also to collect data on raw milk that is subject to wholesale (factory gate) trade (i.e. sold by one processor to another).

8. This information is currently collected on a voluntary basis, resulting in some inconsistencies and data quality issues. The new regulation-making power would enable MPI to monitor the development of alternative supply arrangements, including, for example, opportunities for Goodman Fielder to obtain raw milk supply outside of its reliance on regulated supply.

9. The new regulation-making power would essentially mirror existing provisions in the DIRA, that currently require independent processors to provide periodic returns of milk solids expected to be collected from dairy farmers and as well as periodic forecasts. The new power would refer to whole supply rather than milk supplied by farmers.

Capacity constraint notices

10. A technical amendment is required to DIRA provisions relating to capacity constraint notices to ensure that the provisions can work as intended.

11. The DIRA allows Fonterra to publish a capacity constraint notice for a specified geographical area if it could not reasonably manage to process the expected increase in the volume of milk to be supplied in the next season. The notice applies only for one season.

12. This provision recognises that there may be circumstances where the volume of milk production in the forthcoming season is more than Fonterra's existing capacity can handle. It is intended to give Fonterra some time to manage its capacity requirements by temporarily constraining the volume it will accept.

13. The one year constraint period works in one-off short-term situation where Fonterra simply needs some "breathing space", for example, where there is an unusually high level of milk production because of highly favourable weather and pasture growth (i.e. an unusually "good" season resulting from growing conditions). However, it is not responsive to situation where there may be a significant ongoing increase in production that will require increased processing capacity over the longer term.

14. The Minister of Agriculture therefore proposes an amendment to the DIRA to change the one year period to three years. This is better aligned with circumstances where increased capacity may need to be commissioned. This generally requires a period of three years to commission new plant.

Clarification of Fonterra's ability to depart from the base milk price

15. Fonterra has expressed a view that the DIRA (along with company law, Fonterra's constitution, and the Commerce Act 1986) prevents Fonterra from paying a farmgate milk price that deviates from the calculated benchmark price. Fonterra has argued that this constrains its ability to proactively and strategically manage its milk supply volumes through prices that reflect Fonterra's desired strategic direction.

16. MPI's analysis of the relevant DIRA provisions suggests that there may be a slight degree of ambiguity about the intended policy distinction between the benchmark price and Fonterra's farmgate milk price. MPI is also aware that the two terms have been referred to and used interchangeably by the industry.

17. Both the legal provisions and the industry's interpretation appear to reflect an assumption, as opposed to a requirement, that the farmgate milk price Fonterra pays farmers for milk would equal the benchmark price that Fonterra calculates, and the Commerce Commission monitors, under the DIRA provisions. This is contrary to the original policy intent.

18. The Minister of Agriculture therefore proposes to amend the DIRA to make clear the original policy intent that Fonterra's farmgate milk price (the price actually paid to farmers) can be different from the benchmark milk price calculated by Fonterra.

Appendix Ten: REGULATORY IMPACT STATEMENTS