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**FONTERRA CO-OPERATIVE GROUP LIMITED (*FONTERRA*) – SUBMISSION ON REVIEW OF THE STATE OF COMPETITION IN THE NEW ZEALAND DAIRY INDUSTRY**

## EXECUTIVE SUMMARY

1 This submission is made in response to Commerce Commission's invitation for views on the state of competition in New Zealand dairy markets and possible changes to the Dairy Industry Restructuring Act (*DIRA*).

### Overview

2 Fonterra supports a staged approach to removing aspects of DIRA.

3 Fonterra recognises that parts of DIRA continue to benefit the industry and New Zealand by contributing to a competitive, efficient dairy sector and public confidence – notably, the milk price regime and the obligations to supply Goodman Fielder and small niche processors with milk.

4 However, in light of significant changes to the dairy industry since 2001, particularly the continuing entry of well resourced competitors, Fonterra believes other parts of DIRA are no longer necessary or efficient. This includes the part of the Raw Milk regulations that requires us to supply milk to larger processors (other than Goodman Fielder) and our obligation to accept all milk. Fonterra is a co-operative and is committed to processing all of the milk produced by its farmer shareholders. But when it comes to new suppliers, Fonterra considers it should have more discretion as to whether, and on what terms, to accept milk from those suppliers.

## DIRA has enabled Fonterra to succeed globally

5 DIRA enabled the creation of Fonterra in 2001. It created a business with greater scale, efficiency and global reach. Since then, Fonterra has successfully expanded its global ingredients and consumer businesses, maintained its position as one of the world's most efficient dairy processors, strengthened its reputation as a globally trusted supplier of dairy nutrition and achieved significant growth in revenue over time (from $12.5b at formation to $22.3b last year). This has benefited New Zealand dairy farmers, communities and the economy as a whole.

6 Fonterra now operates in an increasingly volatile global dairy environment and competitive pressure on Fonterra in New Zealand has intensified. This makes it even more important to make sure the regulatory environment helps Fonterra and the rest of the industry operate as efficiently as possible.

## DIRA was intended to be reviewed as the dairy industry developed

7 DIRA originally included several measures to address Fonterra's size in New Zealand. It was always intended these measures would be transitional – that in time they would not be necessary.

8 Fonterra believes these regulatory measures have played their part (alongside powerful commercial incentives) in fostering a competitive and efficient industry. But in light of so much change in the dairy industry since 2001, the current review is a timely opportunity to improve DIRA.

## The dairy industry has changed significantly

9 In 2001 Fonterra's share of the farm gate milk market was 96%, with the majority of the remainder held between two other New Zealand dairy co-operatives, Westland and Tatua. By 2015, Fonterra's farm gate milk market share had declined to approximately 85%, and considerably less in the South Island (78% according to figures recently released by the Minister for Primary Industries). More than 70% of Fonterra's milk is collected in catchment areas where Fonterra's competitors also collect milk.

10 Today there are numerous large dairy processors in New Zealand, including Westland, Tatua, Open Country Dairy, Oceania, Synlait, Miraka and Gardians (owned by Danone). They are well established and have secured their own milk supply. Yashili and Pureland Dairies will soon commence operations, and others (e.g. He Run) are in planning stages.

11 The profile of these competitors has also changed. There is now a mixture of traditional New Zealand co-operatives, privately owned businesses, as well as large global companies vertically integrated into the New Zealand milk pool.

12 It is not just this competitive environment that has changed since 2001. Both Trading Among Farmers (*TAF*) and the milk price regime (including Commerce Commission oversight) have contributed additional market transparency and efficiency.

## The milk price regime plays an important role

13 Fonterra recognises the milk price regime continues to support market efficiency and public confidence. It is only three years since the milk price manual was built into legislation and the Commerce Commission began its oversight role. Notably, in

its most recent review of the milk price manual, the Commission concluded that it gives Fonterra an incentive to operate efficiently and enables efficient competitors to compete for farmer-suppliers.

## Fonterra should have more discretion when it comes to accepting milk

14 The requirement to accept all milk from a new supplier was intended to incentivise Fonterra to price its shares and farmers' milk efficiently and sustainably – i.e. not too high or too low. Today, an efficient milk price and share price are achieved by the milk price regime, TAF and the presence of many well established competitors. Fonterra believes the requirement to accept all milk no longer provides efficiency benefits over and above the existing market dynamics.

15 Instead, Fonterra ends up being a fallback option for all potential suppliers. They effectively have a free option to take risks with another processor with the costs of this being carried by Fonterra and its farmer shareholders. It means Fonterra must live with additional uncertainty about the volume and location of future milk. Fonterra needs to build capacity for milk that may or may not arrive, and which may or may not stay with Fonterra long-term. This works against Fonterra being able to make the highest returning and most efficient investments in manufacturing capacity.

16 Fonterra is a co-operative and is committed to processing all of the milk produced by its farmer shareholders. The co-operative ethos will also drive towards collection on the same terms. But to help Fonterra and the industry invest and operate efficiently, Fonterra should have more discretion as to whether, and on what terms, to accept milk from new suppliers.

## Fonterra should no longer be required to make milk available to large processors, with the exception of Goodman Fielder

17 Fonterra considers the requirement to supply Goodman Fielder remains important for public confidence in downstream wholesale and retail markets. Fonterra does not regard this as a priority for change at this point. Fonterra also recognises there is still a case for smaller, niche dairy processors who don't have their own milk supply having access to Fonterra milk, even though it is confident satisfactory commercial arrangements could be agreed without the Raw Milk regulations.

18 However, Fonterra firmly believes that it should no longer be obliged to make milk available to larger processors (other than Goodman Fielder), including those looking to establish a foothold in the New Zealand market. Fonterra is now operating in a competitive environment in which competing processors have shown they have the scale and ability to secure their own milk supply (from farms or other processors). There are significant costs to Fonterra and its farmer shareholders as well as a real risk of creating inefficient and excess manufacturing capacity in the industry by continuing to provide this additional, regulatory support for large processors.

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## THE INDUSTRY IS ON A PATHWAY TO DEREGULATION

### Background

19 The Dairy Industry Restructuring Act 2001 (*DIRA*) has always anticipated deregulation over time as dairy markets evolve.[1] Anticipation of the expiry of the provisions that regulate for the purpose of promoting the efficient operation of dairy markets[2] was built into its original structure.[3]

20 And in fact, the markets regulated by DIRA – the farm gate and factory gate markets – have evolved significantly since 2001.

21 This is discussed in more detail below, and in the expert advice from NERA Economic Consulting (*NERA*), which is at Appendix A.[4] In summary:

21.1 For the purposes of the Review, it is not necessary to split the farm gate or factory gate market by geographic region. Although competitive constraints do vary by location, Fonterra's uniform pricing (which it would be likely to retain even in the absence of DIRA) means Fonterra suppliers who do not have a choice of processor benefit from competition from Independent Processors (*IPs*) in other geographic areas.

21.2 There is scope for more confidence about the competitive pressures on Fonterra at the farm gate if the DIRA (or parts of it) were to fall away, compared to when NERA carried out its independent competition analysis in 2010.[5] Both the degree of competition and its sustainability appear to have increased materially. Significantly, in the 2014/15 season IPs collected 22% of all milksolids in the South Island, triggering expiry of the DIRA pro-competition provisions in the South Island by no later than 31 May 2018, unless there is legislative change before then.[6]

21.3 Although the factory gate market remains relatively immature, there is a group of IPs that appears to be sustainable, and capable of constraining Fonterra's ability to raise price above competitive levels. Fonterra acknowledges there may be remaining reservations regarding downstream niche processors and major downstream domestic manufacturers, which do not have their own supply.

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[1] The review of the state of competition in dairy markets (*Review*) is considering, in particular, Subparts 5 and 5A of Part 2 of DIRA and the provisions of the Dairy Industry Restructuring (Raw Milk) Regulations 2012 (*Raw Milk regulations*), (together, *DIRA's pro-competition provisions*).

[2] Part 2, subpart 5. The purpose of this subpart is set out in section 70.

[3] Section 149.

[4] NERA, *Assessment of Competition in Raw Milk Markets and Costs and Benefits of the DIRA provisions* (17 August 2015) (*NERA advice*).

[5] NERA, *An Assessment of the DIRA Triggers – Ministry of Agriculture and Forestry* (30 March 2010) (*2010 NERA advice*).

[6] Nathan Guy press release, *Independent dairy processors collecting more milk*, (13 August 2015); see DIRA, sections 147, 148B, 148A,148(4) to (8) and 149.

22 The regulatory and other constraints on Fonterra have also evolved considerably since 2001. Most significantly:[7]

22.1 A farm gate milk price regime has been included in DIRA. This safeguards the provision of a robust, efficient and transparent milk price, which is subject to oversight by an independent milk price panel and the Commerce Commission (*Commission*).

22.2 The Trading Among Farmers (*TAF*) scheme has been introduced, which facilitates entry to and exit from Fonterra by providing a market for farmers' shares that delivers well-discovered prices.

## Staged deregulation

23 As part of the Review, the Commission must address options for a transition pathway to deregulation,[8] and accordingly has sought the views of stakeholders on this important issue. In short, in Fonterra's view there is real merit in considering a "pathway to deregulation" that involves a staged removal of DIRA provisions.

24 Based on the NERA advice and its own market experience, Fonterra submits that the current trajectory represents consistent progress towards sustainable and effective competition in both the farm gate and factory gate markets.

25 In this environment it is appropriate to reassess the costs and benefits of DIRA's pro-competition provisions. Although overall DIRA's pro-competition provisions may have benefited the contestability of dairy markets, aspects that were necessary 14 years ago may now be unnecessary and working against efficiency (for example by incentivising inefficient entry). In this regard:

25.1 Given the development of competition, the sustainability of major competitors, the milk price regime and developments in Fonterra's own institutional arrangements, the Review should examine whether some regulation is redundant, or has its purpose served by competition or other regulatory developments, and in the interests of efficiency should be removed or changed now (noting that in the absence of DIRA Fonterra would remain subject to competition regulation, and in particular the Commerce Act 1986 (*Commerce Act*)).

25.2 Other regulation may for now continue to serve a justifiable purpose. The NERA advice suggests that sustainable competition has increased materially since 2010 but is not yet at the point where full deregulation can be recommended. Fonterra understands this view and agrees there are some key features of DIRA that should be retained for now, but revisited again in time.

26 This staged approach to deregulation is discussed in the context of the farm gate and factory gate markets, below.

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[7] In addition to these developments, in 2012 changes were made to the Raw Milk regulations which require Fonterra to supply raw milk to IPs). These have focused the Raw Milk regulations more closely on IPs' access to raw milk to facilitate entry to the farm gate market, and to provide support for competition in domestic dairy products.

[8] Ministry for Primary Industries, *Terms of Reference for a Report on the state of competition in the New Zealand dairy industry* (3 June 2015).

## ASSESSMENT OF COMPETITION

### Scope of submission

27 The Commission has sought views on the markets upon which it intends to focus, and the relative extent of that focus.[9] In this regard, and as noted in its previous submission,[10] Fonterra agrees with the position set out in the Commission's process and approach consultation paper,[11] that the scope of the Review's terms of reference does not extend to detailed analysis of markets other than farm gate and factory gate markets, which are the only markets covered by DIRA's pro-competition provisions.[12]

28 Fonterra acknowledges that the Commission has sought views on the state of competition in downstream markets and how deregulation may potentially impact on downstream markets.[13] In this submission Fonterra addresses downstream markets to the extent they are relevant to evaluating competition in the farm gate and factory gate markets, and DIRA's pro-competition provisions.

### Assessment of competition in the farm gate market

#### *Facts on the farm gate market*

29 The factual picture of the farm gate market is explained in detail in the NERA advice. In summary, the key factual features of the market are:

29.1 The volume of milk collected nationally has increased from approximately 1.35 billion kgMS to approximately 1.6 billion kgMS annually since 2010, while Fonterra's national share has declined from 89% to approximately 85%.[14]

29.2 IPs have tended particularly to target, and been successful in obtaining, market share in the South Island:[15]

(a) Fonterra's market share in the South Island has declined from approximately 88% to approximately 78% since 2010. Importantly, and as noted above, Fonterra's market share is now below the statutory threshold for triggering deregulation.[16]

(b) Fonterra's market share in the North Island has declined to approximately 91%.[17]

29.3 Fonterra's decreasing market share is attributable to the rise of IPs such as Westland Milk Products (*Westland*), Synlait and Open Country Dairy (*Open*

[9] Commerce Commission, *Consultation on substantive issues – review of competition in the dairy industry* (20 July 2015), paragraph 11.

[10] Fonterra, *Submission on review of the state of competition in the New Zealand dairy industry – process and approach* (10 July 2015), paragraphs 11 and 12.

[11] Commerce Commission *Review of the state of competition in the New Zealand dairy industry: consultation paper – process and approach* (12 June 2015)

[12] Ibid, paragraph 40.

[13] Commerce Commission, above n 9, paragraph 11.

[14] NERA advice, above n 4, [3.3.1], Figure 2.

[15] Ibid, [3.3.1], Figures 3 & 4.

[16] DIRA, section 147; Nathan Guy press release, above n 8.

[17] Nathan Guy press release, above n 8.

*Country*). With the exception of New Zealand Dairies Limited (*NZDL*) (which went into receivership and whose manufacturing assets were subsequently purchased by Fonterra) and Tatua Co-operative Dairy Company Limited (*Tatua*, which does not accept new supply) the market share of IPs has increased since 2010.[18]

29.4 IPs have been successful in contracting farms close to their plants, and can often offer higher farm gate prices where transport costs are lower than Fonterra's national average. IPs generally have significantly higher shares relative to their national shares in their collection zones. For example, Fonterra estimates that:[19]

(a) Westland has a share of supply of approximately 95% of milksolids collected within its Hokitika collection zone, with an overall market share of approximately 3.5%;

(b) Synlait has a share of supply of approximately 20% of dairy farms operating within 75km of its processing plant, with an overall market share of approximately 2.5%; and

(c) Tatua has a share of supply of approximately 34% of dairy farms operating within a 12km radius of its processing plant, with an overall market share of just under 1%.

29.5 Fonterra considers that IPs will continue to expand capacity.[20] Many are now well-established and stable, and some are backed by large global players.

29.6 A hurdle Fonterra faces in attracting new conversions is the requirement to invest additional capital in shares. Fonterra also experiences some loss of market share as a result of suppliers switching from Fonterra to an IP, often due to the ability to free up invested capital. Exiting suppliers also often cite their right freely to return to Fonterra as a factor in their decision to exit.[21]

29.7 Fonterra is still experiencing growth in total milk collected (despite the decreasing number of shareholders), as farm sizes and productivity increase. The average volume of milksolids produced per cow has increased from approximately 340 kgMS in 2010 to approximately 390 kgMS, and the average hectare now produces approximately 1,150 kgMS (in comparison to approximately 970 kgMS in 2010). Farms in the South Island are generally larger and more productive,[22] which may contribute to the South Island having been a particular target for IPs (see paragraph 29.2 above).

[18] NERA advice, above n 4, [3.3.1], Figure 6.

[19] Fonterra estimates.

[20] NERA advice, above n 4, [3.3.2].

[21] Ibid, [3.3.4].

[22] Fonterra.

### *Competition analysis of the farm gate market*

30 NERA has considered the facts of the farm gate market and provided expert advice on the sufficiency and sustainability of competition in this market. In summary:

30.1 For the purposes of the Review, it is not necessary to split either farm gate or factory gate markets by geographic region. Although competitive constraints do vary by location, Fonterra's uniform pricing (which it would be likely to retain even in the absence of DIRA) mean Fonterra suppliers who do not have a choice of processor benefit from competition from IPs in other geographic areas.[23]

30.2 Fonterra's high market shares (nationally, and particularly in the North Island) understate the competitive impact of IPs, which also has effects beyond the IPs' catchment zones.[24]

30.3 Several IPs have demonstrated growth, sustainability and confidence, and investment continues to take place. Fonterra considers it likely that these IPs would be sustainable without DIRA.[25]

30.4 There is scope for more confidence about the competitive pressures on Fonterra if DIRA (or parts of it) fell away, compared to the situation in 2010. There are sufficient constraints and institutions to justify considering the costs and benefits of removing or altering the DIRA's pro-competition provisions. DIRA principally aims to enable entry, and there has been plenty of entry, so it is legitimate to consider whether the relevant provisions are still needed.[26]

31 In the competitive environment outlined above, the role of key aspects of the regulations in the farm gate market should be assessed, and pathways to deregulation considered.

## Assessment of competition in the factory gate market

### *Facts on the factory gate market*

32 The factual picture of the factory gate market is explained in detail in the NERA advice. Fonterra notes that it does not have the same degree of visibility over the operation of the factory gate market as the farm gate market, in particular because supply relationships between IPs may not be disclosed.

33 The following paragraphs summarise the key factual features of the market described in the NERA advice and based on Fonterra's market experience and observations:

33.1 IPs have sufficient capacity to switch milk into the domestic factory gate market in the event of a price rise in the factory gate market.

[23] NERA advice, above n 4, [3.2].

[24] Ibid, [3.6].

[25] Ibid.

[26] Ibid.

33.2 The Raw Milk regulations[27] are being used by IPs, including Goodman Fielder New Zealand Limited (*Goodman Fielder*). Since the advent of the Raw Milk regulations there have been:[28]

(a) 44 customers whose maximum take was less than 10 million litres per season; and

(b) 21 customers whose maximum take was greater than 10 million litres per season.

33.3 The amount of milk taken by larger IPs (excluding Goodman Fielder) each season has tapered off to approximately 100 million litres, following a peak of approximately 300 million litres in 2011. Fonterra considers that this is likely due to the introduction of regulation 6(2), which specifies how much IPs may request in a given month[29] and, potentially, in anticipation of the obligation to supply ceasing for IPs whose own supply of raw milk was 30 million litres or more for three consecutive seasons (provided for in new regulation 6(3)).

33.4 There is also evidence of trading between IPs without reliance on regulated milk:[30]

(a) Westland has traded raw milk, cream retentate and permeate with other processors;

(b) Fonterra has observed Miraka and Open Country tankers taking raw milk to Tatua's factory, suggesting that trading is taking place between these IPs; and

(c) Fonterra understands Yashili, which has not yet commenced to operate, has been in discussions with Open Country (as well as Fonterra) for the supply of raw milk.

### *Competition analysis of the factory gate market*

34 NERA has considered the facts of the factory gate market and provided expert advice on the sufficiency and sustainability of competition in this market (see Appendix A). Again, Fonterra notes that there may well be additional factory gate market activity that Fonterra cannot observe and which is consequently not accounted for in this analysis. That aside, in summary:

34.1 As set out above, for the purposes of the Review, it is not necessary to split the factory gate market by geographic region. [31]

34.2 Although the factory gate market appears still to be relatively immature, IPs appear to be capable of constraining Fonterra's ability to raise price above competitive levels.[32]

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[27] See above n 7.

[28] NERA advice, above n 4, [5.2.1].

[29] Ibid, [5.2.1], Figure 19.

[30] Ibid, [4.3].

[31] Ibid, [3.2].

[32] Ibid, [4.3].

34.3 The ability of competitors to supply at the factory gate has reached a point where the structure of the regulatory requirements on Fonterra can be reconsidered. NERA suggests that both the regulatory obligation to supply raw milk and the regulated price be reviewed.[33]

35 In the competitive environment outlined above, there is a strong mandate to assess the role of key aspects of DIRA's pro-competition provisions in the factory gate market, and pathways to deregulation.

[33] Ibid, [5.2.3].

## ASSESSMENT OF REGULATIONS

36 Based on the approach to deregulation set out above,[34] the following sections contain an analysis of those of DIRA's pro-competition provisions that in Fonterra's view continue to have a valuable role in their current form. Fonterra goes on to address the components of DIRA's pro-competition provisions that could be reviewed with a view to their refinement or removal.

### Pro-competition provisions that continue to have a valuable role

#### *Milk Price regime*

37 The level of the farm gate milk price that Fonterra pays its farmers was not originally regulated by DIRA. Until 2008, the milk price and share dividend were combined as one payout. In October 2008 Fonterra shareholders voted to adopt the Milk Price Manual and associated processes, with separate milk price and dividend payments coming into effect in the 2009/10 season.

38 The price setting regime was generally considered to be satisfactory, and effective in establishing a price that would arise in a competitive market. In its 2012 "dry run" review of Fonterra's farm gate milk price (which aimed to show how the new milk price monitoring regime – described below – would work in practice), the Commission noted:[35]

> Considering the key issues in aggregate, the base milk price would meet section 150A(2) and therefore provide for contestability in the market for the purchase of milk from farmers.
>
> …
>
> On balance, we consider that Fonterra has set the base milk price so as to provide an incentive for Fonterra to operate more efficiently.

39 And:[36]

> More significantly, our review of Fonterra's analysis to support recent business cases for large milk processing investment also supports the view that Fonterra's base milk price provides for contestability in the market for the purchase of milk from farmers. Fonterra's analysis shows that recent powder investments were expected to be NPV positive when assessed against the base milk price. If Fonterra expects to recover all of its costs from new investment under its current base milk price settings, other efficient processors too would be able to potentially compete for farmers' raw milk.

40 This was endorsed by the fact that the Dairy Industry Restructuring Amendment Act 2012 (*2012 DIRA Amendment*) effectively enshrined Fonterra's existing practice in relation to the setting of the milk price. The most significant change brought about by the 2012 DIRA Amendment was the addition of regulatory oversight. The key components of regulation of the milk price (*Milk Price regime*) are:

40.1 *Milk Price Manual* – The 2012 DIRA Amendment required Fonterra to establish, maintain and make publicly available a Milk Price Manual, which

[34] See from paragraph 19.

[35] Commerce Commission, *Final report: Report on the dry run review of Fonterra's farm gate milk price* (27 August 2012), [69.2] and [73].

[36] Ibid, [82].

sets out how the farm gate milk price is calculated. The methodology for calculating the farm gate milk price must be consistent with certain principles.[37] A Milk Price Manual has been used by Fonterra for this purpose since August 2008, and Fonterra voluntarily made it public in 2011. Fonterra met its obligations under the 2012 DIRA Amendment using its pre-existing Milk Price Manual, with only minor amendments.[38] The Milk Price Manual may only be amended or replaced with approval of at least 75% of the Fonterra board, including at least a majority of Fonterra's independent directors.[39]

40.2 *Milk price* – The methodology for setting the farm gate milk price, which as noted above is largely in line with the methodology Fonterra applied prior to the 2012 DIRA Amendment, seeks to calculate the price that an efficient processor of Fonterra's scale could sustainably pay for the milk collected by Fonterra in New Zealand.[40] The farm gate milk price is set by reference to "Reference Commodity Products". In other words, the Milk Price regime assumes that Fonterra will use raw milk as an input into certain commodity dairy products (for example whole and skim milk powder). The list of Reference Commodity Products, which forms part of the Milk Price Manual, may only be amended or replaced with approval of at least 75% of the Fonterra board, including at least a majority of Fonterra's independent directors.[41] The farm gate milk price is based on:[42]

(a) notional revenue, calculated assuming Fonterra's entire volume of milk is processed and sold as Reference Commodity Products, primarily on the Global Dairy Trade auction platform; minus

(b) the notional manufacturing costs of an efficient competitor (including capital costs), and overhead, collection and other costs derived from Fonterra's actual costs.

40.3 *Independent Milk Price Panel* – The 2012 DIRA Amendment requires the establishment of a Milk Price Panel, which oversees the calculation of the milk price.[43] This essentially aligns with the arrangements Fonterra had already put in place or had intended to adopt upon the launch of TAF. The Milk Price Panel must at all times include a majority of members who are independent from Fonterra, including the chair.[44] Among other activities, the Milk Price Panel:[45]

(a) oversees the governance of the milk price and the Milk Price Manual, including undertaking reviews;

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[37] DIRA, sections 150F and 150C.

[38] Commerce Commission, *Review of Fonterra's 2012/13 Milk Price Manual: Final Report* (14 December 2012), [3.7].

[39] Fonterra Co-operative Group Limited, *Fonterra Shareholders' Market Rules* (24 August 2012), [3.3.5(b)].

[40] See also the purpose statement in DIRA, section 150A.

[41] *Fonterra Shareholders' Market Rules*, above n 39, [3.3.5(b)].

[42] Fonterra, *Farmgate Milk Price Manual – Part A: Overview* (1 August 2015), [4.1].

[43] DIRA, section 150D.

[44] Constitution of Fonterra Co-operative Group Limited (*Fonterra's constitution*), clause 10.3(c)(ii) and (iv).

[45] DIRA, section 150D and Fonterra's constitution, above n 44, clause 10.3(a).

(b) supervises the calculation of the milk price and makes recommendations on it to the Fonterra board;

(c) makes recommendations to the Fonterra board relating to the Milk Price Manual, including recommendations that it should or should not be amended; and

(d) provides assurances to the Fonterra board that the Milk Price Panel is not aware that the milk price has been calculated incorrectly or that the Milk Price Manual ought to be changed.

40.4 If Fonterra sets a farm gate milk price other than in accordance with a recommendation by the Milk Price Panel (including where Fonterra receives no recommendation), certain disclosures are required.[46]

40.5 *Commission oversight* – The 2012 DIRA Amendment provided for the Commission to review and report on the extent to which the Milk Price Manual[47] and the milk price[48] are consistent with specific principles of DIRA. Regulatory oversight was of course not part of the milk price regime prior to the 2012 DIRA Amendment. The Commission must publish its final reports on the Milk Price Manual by 15 December each season and on the milk price by 15 September following the season to which the review relates. The Commission's timing enables its views to be known before Fonterra's annual results for the relevant season are finalised and announced.

41 In addition, Fonterra has a working group known as the Milk Price Group. Its head is independent of Fonterra's management and reports directly to the chair of the Milk Price Panel.[49] Among other things, the Milk Price Group ensures that the farm gate milk price is calculated in accordance with the Milk Price Manual, considers amendments to the Milk Price Manual and ensures amendments are consistent with the Milk Price Principles in Fonterra's constitution.[50]

42 Finally, under the Fonterra Shareholders' Market Rules, Fonterra is prohibited from making a decision to pay an aggregate amount for milk in excess of the amount calculated under the Milk Price Manual unless that decision is approved by at least 75% of the Fonterra board, including at least a majority of Fonterra's independent directors.[51]

43 Fonterra expects that in the absence of these aspects of DIRA's pro-competition provisions its conduct would be largely unaltered. This is borne out by:

43.1 Its method of arriving at a farm gate milk price prior to the enshrinement of the Milk Price regime which, as described above, was generally consistent with the Milk Price regime.

[46] DIRA, section 150N.

[47] Ibid, section 150H.

[48] Ibid, section 150O.

[49] *Farmgate Milk Price Manual – Part A: Overview*, above n 42, [5.3] and [5.4].

[50] Ibid, [5.4].

[51] *Fonterra Shareholders' Market Rules*, above n 39, [3.3.5(a)].

43.2 Fonterra's constitution, which incorporates elements of the Milk Price regime. For example, Fonterra's constitution requires Fonterra to determine the farm gate milk price on the basis of the methodology set out in the Milk Price Manual.[52] Fonterra must set the methodology and policies in the Milk Price Manual with reference to Fonterra's milk price principles.[53] Fonterra's constitution also provides for the establishment of the Milk Price Panel to supervise the calculation of the milk price.[54]

43.3 The structure of Fonterra as a co-operative body, which largely eliminates the prospect of exercising market power against farmers.[55] The Commission has observed in the past that principles of fairness and equality to all shareholders are entrenched in Fonterra, due to the overlap of supply and ownership. The Commission has noted that this structure constrains Fonterra's commercial ability and incentive to discriminate against particular shareholder suppliers.[56]

43.4 The imperative generated by TAF to operate transparently (discussed below at paragraph 50), providing comfort to investors under the TAF structure that Fonterra is not favouring its suppliers over them.

43.5 Fonterra's internal co-operative principles,[57] which provide that "financial benefits and obligations that arise from cornerstone activities are allocated to supplying shareholders in proportion to their total milk solids supplied."[58]

43.6 Strong commercial incentives to act prudently in evolving its milk pricing arrangements. Changes to reflect, for example, the location of farms, may result in significant value shifts among shareholders and could hamper Fonterra's ability to locate sites optimally (since this would affect the regional pattern of farm gate pricing). In general, the economies of scale of building large plants more than offset incremental costs of drawing milk from a wider catchment.

44 Given Fonterra's conduct would be unlikely to change significantly in the absence of the Milk Price regime, and there are costs arising out of the Milk Price regime that would otherwise be avoided (particularly the cost of Commission oversight), it could be argued that the farm gate market would operate more efficiently without the Milk Price regime.

45 Nevertheless, Fonterra acknowledges that the Milk Price regime could be said to facilitate entry and exit by safeguarding the level at which the milk price is set, as well as ensuring a high degree of transparency and a level of public confidence. For example, it avoids concerns that Fonterra may, if faced with competitive

[52] Fonterra's constitution, above n 44, clause 10.2.

[53] Ibid. The milk price principles are set out at Annexure 1 to Fonterra's constitution.

[54] Ibid, clause 10.3.

[55] NERA advice, above n 4, [2.1].

[56] *Fonterra Limited and New Zealand Dairies Limited (in receivership)* [2012] NZCC 21, [26]-[27] and [81]-[88]. Some time ago (between 2007 and 2009), Fonterra engaged in "tactical pricing" in a limited way – by offering some farmers in specific areas who were considering leaving (or were at risk of leaving) a bespoke contract, which was non-shareholding. As observed by the Commission these tactics were not favoured by shareholders (ibid, [26]).

[57] Fonterra's constitution, above n 44, clause 16.1(a) provides that the Shareholders' Council's functions include working with the board to develop Fonterra's Co-operative Philosophy.

[58] Fonterra, Co-operative Philosophy, Co-operative Principle 5.

pressure, be incentivised to pay farmers a higher than efficient milk price in order to encourage entry to, and discourage exit from, Fonterra in the short to medium term. In its reviews to date, the Commission has concluded that the Milk Price Manual has been generally consistent with the s150A purpose. That is, the Milk Price Manual incentivises Fonterra to operate efficiently (i.e. drive cost efficiencies) while providing contestability in the market for the purchase of milk from farmers.[59]

46 Fonterra acknowledges that certain stakeholders seek changes to the Milk Price regime, and in particular the methodology used to determine its level.[60] However, the evidence and analysis above suggest that the farm gate milk price that results from the application of the Milk Price regime is robust and performing the role intended.

47 **Fonterra recognises the Milk Price regime continues to support market efficiency, transparency and public confidence, and does not seek its removal, or any changes, at this time.**

## *Trading Among Farmers (TAF)*

48 TAF was not contemplated in the original DIRA pro-competition provisions; Fonterra shareholders voted in favour of its introduction in June 2010. Relevant aspects of the 2012 DIRA Amendment were implemented in order to enable TAF (rather than specifically for a pro-competitive purpose).[61] Nevertheless one of the core objectives of TAF is to preserve open entry and exit for Fonterra's supplier shareholders by providing a stable, deep and liquid market for their shares that delivers well-discovered prices for those shares.[62]

49 TAF comprises a number of inter-related arrangements that establish:[63]

49.1 A Fonterra Shareholders' Market, which is a private market on which farmer shareholders are able to trade Fonterra shares with one another (an appointed market maker also trades shares).

49.2 The Fonterra Shareholders' Fund. External investors are able to buy units in the Fonterra Shareholders' Fund, through which these investors may enjoy certain economic rights of Fonterra shares. The Fonterra Shareholders' Fund supplements liquidity in the Fonterra Shareholders' Market because units can effectively be "exchanged" for Fonterra shares by farmer shareholders, Fonterra and the market maker and vice versa.

50 TAF is interdependent with, and complementary to, the Milk Price regime. Under TAF, external unit-holders as well as farmer shareholders receive dividends. The

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[59] Commerce Commission, *Review of Fonterra's 2014/15 Milk Price Manual: Final report* (15 December 2014), [2.2]; Commerce Commission, *Review of Fonterra's 2013/14 Milk Price Manual: Final report* (16 December 2013), [2.1]; *Review of Fonterra's 2012/13 Milk Price Manual: Final report*, above n 38, [3.7].

[60] See, for example, Open Country, *Submission on the Commerce Commission's Consultation Paper – Review of the State of Competition in the New Zealand Dairy Industry* (10 July 2015), pages 4-5.

[61] See DIRA, sections 109A to 109N.

[62] See, for example, Fonterra Co-operative Group Limited, *Submission of Fonterra Co-operative Group Limited on MAF Discussion Paper No. 2012/01: Dairy Industry Restructuring Amendment Bill 2012* (24 February 2012), page 2; explanatory note to Dairy Industry Restructuring Amendment Bill 2012.

[63] The documentation constituting the TAF scheme includes Fonterra's constitution (see above n 44), and resulting Board policies, the Fonterra Shareholders' Market Rules (see above n 39), the structure and constitution of the Fonterra Farmer Custodian, the structure of the Fonterra Farmer Custodian Trust, the terms of the Custody Trust, the Unit Trust Deed for the Fonterra Shareholders Fund, the Authorised Fund Contract between Fonterra and the Fund, and the Registered Volume Provider Agreement.

amount paid is directly impacted by the efficiency of the milk price. TAF strengthens incentives upon Fonterra to determine an efficient milk price, as external investors' interests are solely focused on dividend payments (as opposed to farmer shareholders, who are incentivised to maximise the milk price). Scrutiny by external investors encourages Fonterra to be transparent in its milk price-setting process.

51 In practice, TAF also achieves its objective of facilitating entry to and exit from Fonterra for farmers by providing liquidity and good price discovery. Fonterra's exiting shareholders are able to sell all of their shares, or sell down their shares over three seasons[64] (as well as retaining an ongoing ability to participate in the Shareholders' Fund) which further facilitates switching.[65]

52 **Fonterra considers that enabling TAF has contributed additional market transparency and efficiency.**

## Pro-competition provisions that could be reviewed

### *Obligation to accept supply*

53 One of the principles intended to be promoted by DIRA's pro-competition provisions is that Fonterra "must accept applications by new entrants and shareholding farmers to supply it with milk, as shareholding farmers".[66]

54 Fonterra is required to accept an application to become a shareholding farmer that is made by a new entrant in an application period, and an application to increase the volume of milk supplied as a shareholding farmer to Fonterra that is made by an existing shareholding farmer in an application period.[67] An application period must span the dates 15 December until 28 February the following year, at a minimum.[68] This gives Fonterra a limited period of time before seasonal milk collection commences (which then escalates quickly to peak milk supply). By contrast, IPs have no obligation to accept supply.

55 Fonterra may publish a capacity constraint notice in respect of a specified geographic area in circumstances where it reasonably expects processing the expected increase in the volume of milk supplied to it from that area in the next season cannot reasonably be managed. The notice may not apply to more than one season.[69] In those circumstances, Fonterra may defer, for only up to the period of the notice, the commencement of supply pursuant to applications in the specified area.[70] Fonterra has not published a capacity constraint notice to date. Since it does not allow Fonterra to decline to accept new supply altogether, and the maximum deferral period of 12 months is too short a period to build a new plant, Fonterra considers that the capacity constraint notice provisions in practice do not limit the obligation. Thus it does not assist Fonterra to manage its capacity investments.

[64] Fonterra's constitution, above n 44, clause 3.10(d) –(f).

[65] Farmers may exchange units in the Fund for shares when they join or return as a farmer shareholder.

[66] DIRA, section 71(b).

[67] Ibid, section 73.

[68] Ibid, section 75. In practice, application periods have spanned the period 15 December until the last day of February (28 or 29 February) the following year.

[69] Ibid, section 86.

[70] Ibid, section 87.

56 The obligation to accept supply is subject to only very confined exceptions:

56.1 Fonterra may reject an application by a new entrant or shareholding farmer on the basis of minimal supply (amounting to less than 10,000 kgMS in a season).[71] In practice, Fonterra has not had cause to reject an application under this exception, but considers it useful in that accepting minimal supply could potentially result in inefficiency, with no meaningful countervailing benefit for competition.

56.2 Fonterra may reject an application by a new entrant on the basis of transport costs (*transport exception*).[72] Specifically, the transport exception is triggered where the cost of transporting the milk of the new entrant exceeds the highest cost of transporting another shareholding farmer's milk to the same factory. In practice the transport exception is difficult to apply.[73] It has not allowed Fonterra to control its transport costs; practicalities of calculating whether the transport exception applies have resulted in incremental expansion of the area of New Zealand from which Fonterra must accept supply, and Fonterra expects this to continue. In particular:

(a) The key components of the calculation are complex and uncertain. They include:

(i) Distance and time, comprising driving to the farm (factoring in collection of milk from more than one farm on a route, and that the farms from which milk is collected alter daily depending on volumes collected) waiting while milk is pumped, and driving to the factory.

(ii) Estimated milk volumes, which change daily for each farm.

(b) Furthermore, in many instances new milk may be routinely transported to more than one factory, which means more than one calculation must be made.

Thus in practice the calculation is an estimate; given that, Fonterra incorporates a margin of error to ensure it complies with the exception, which reduces the effect of the exception and results in incremental expansion of collection areas.

57 As set out above, limits and exceptions to the obligation to accept supply play only a very small role, and the obligation to accept supply is almost absolute. Significant inefficiencies arise out of the absolute nature of the obligation, including:

57.1 *Managing capacity* – In an environment of increased competition, farmers typically face a choice of processors to which they may offer new supply. Similarly, farmers currently supplying processors other than Fonterra may choose to switch to supplying Fonterra. Fonterra must assume it would need to accept all such supply, whereas in practice such supply might be offered to another processor, in whole or part. This creates inefficiencies in managing capacity utilisation in existing plants.

[71] Ibid, section 94.

[72] Ibid, section 95.

[73] Ibid, section 95.

57.2 *Investing in new capacity* – More acutely, the obligation to accept supply drives Fonterra to invest in new capacity that would ensure it is able to accept all potential new supply. This creates inefficiency by distorting the priority Fonterra would place on investing in new processing capacity, compared with other investments. This works against Fonterra being able to make the highest returning and most efficient investments in manufacturing capacity.[74] To the extent it alters the capacity mix that Fonterra would otherwise maintain under its commercial strategy, it could be regarded as driving inefficient investment.

57.3 *Disadvantages compared with other processors* – In contrast, IPs are able to compete to secure new supply, and to retain existing supply, in a manner that suits their commercial strategy.

58 In the absence of the obligation to accept supply, Fonterra considers that its conduct would not differ markedly. In particular:

58.1 Fonterra would not be in a position to decline to accept applications by existing farmer shareholders to increase supply from existing farms.[75] Fonterra considers this to be fundamental to its institutional form, and thus that its co-operative structure would constrain it from declining such applications. In the 2010 NERA advice, NERA acknowledged that Fonterra is partially "constrained by the overall co-operative desire to treat suppliers equally".[76] Fonterra considers that a key benefit to shareholders of its co-operative form is the ability to grow and that this is intrinsic to the value it offers to farmer shareholders.

58.2 In most cases, Fonterra will face a strong commercial imperative to accept applications for new supply. As set out in the NERA advice, Fonterra would have an incentive to accept milk provided the incremental revenue from that milk exceeds the incremental cost.[77]

58.3 In a small number of cases, Fonterra may choose to decline applications by new entrants for commercial reasons. This may occur, for example, where it would not be efficient from a capacity management perspective (such as because it would not be efficient to build new capacity in a particular area and transport costs mean it would not be efficient to utilise existing capacity). As noted above, the current transport exception is insufficiently effective to deal with this situation.

58.4 Alternatively, in some cases Fonterra may wish to accept supply, but based on altered terms, for example a fixed period of commitment to supply Fonterra. This may also have implications for the non-discrimination rule, the right to withdraw and the 160km rule.[78]

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[74] See NERA advice, above n 4, [5.3.2].

[75] Fonterra notes that, in any event, it is rare for a farmer shareholder to apply to increase supply. Typically, in practice, farmer shareholders increase their supply without making a formal application.

[76] 2010 NERA advice, page 17.

[77] NERA advice, above n 4, [5.3.2].

[78] The non-discrimination rule is addressed below from paragraph 63, and the right to withdraw and the 160km rule are addressed below from paragraph 67.

59 It should also be noted that inefficiency is created by farmers' right to return to Fonterra. Fonterra is effectively granting a "free option" to farmers to take a risk on an IP, with the costs of them exercising this being carried by Fonterra and its farmer shareholders. These costs arise in particular out of the uncertainty over the volume and location of raw milk that it is required to accept.[79] Fonterra needs to have capacity to process that milk, which may or may not arrive (and may or may not remain with Fonterra). Thus the option contributes to the inefficiencies outlined above at paragraph 57.

60 Thus, it can be concluded that without the obligation to accept supply (or with discretion to accept new supply on different terms), Fonterra's conduct would result in an increase in the efficiency of managing and planning processing capacity and logistics.

61 Giving Fonterra discretion in accepting supply would not be likely to result in significant change to the status quo that would materially increase barriers to entry or expansion for IPs, and such discretion would likely be exercised in a way that increases efficiency. Discretion would likely give better effect to an objective to ensure any farmer wishing to join Fonterra must be accepted *if capacity is available*, than the current obligation with its unused capacity constraint notice regime. Furthermore, to the extent the original purpose of the obligation to accept supply was to ensure an appropriate price point for the value of its shares to facilitate switching, as set out in the preceding sections this purpose is fulfilled by the process of setting the milk price (which is buttressed by the fact that the Milk Price regime is enshrined in DIRA) and TAF.

62 **Fonterra is a co-operative and is committed to processing all of the milk produced by its farmer shareholders. But when it comes to new suppliers, Fonterra considers it should have more discretion as to whether, and on what terms, to accept milk from those suppliers.**

### *Non-discrimination rule*

63 Fonterra must ensure that the terms of supply for a new entrant are the same as those for a farmer shareholder in the same circumstances, or differ from the terms for a farmer shareholder only to reflect the different circumstances (*non-discrimination rule*).[80]

[79] Ibid.

[80] DIRA, section 106.

64 As set out in the foregoing section, this has particular relevance, and gives rise to particular inefficiencies, in the context of the obligation to accept supply.[81] For instance, in that context it constrains Fonterra from managing supply and volume uncertainty by requiring a longer period of supply commitment, or to pay for supply or impose charges (e.g. based on transport costs) that reflect the true value of that additional supply. In the absence of the non-discrimination rule, Fonterra considers that its conduct would differ to only a small extent, and then only in respect of new supply. Specifically:

64.1 Fonterra would be constrained from discriminating among existing farmer shareholders in a way that would contravene the non-discrimination rule by:

(a) Its contracts with existing farmer shareholders. For farmer shareholders, supply terms are contained in Fonterra's constitution, the Farmers' Handbook, standard form "share up over time" contracts (if applicable) and any policies set by the board. These terms are not supplier-specific.

(b) The co-operative structure of Fonterra, which places significant constraining power in the hands of farmer shareholders. Fonterra is constrained by the views of farmer shareholders.[82]

(c) Fonterra's co-operative principles and more broadly its institutional form as a co-operative.[83]

64.2 In relation to new supply that the non-discrimination rule renders inefficient to accept, Fonterra would have a discretion to pay for supply at a price that reflects its incremental value to Fonterra.

65 As described in the preceding section, Fonterra considers that the freedom to impose charges to reflect the true value of new supply would not materially raise barriers to entry or expansion.

66 **Fonterra submits that it should be granted discretion regarding the non-discrimination rule, in particular as it relates to the obligation to accept supply.**

## *Right to withdraw and 160km rule*

67 A farmer shareholder who wishes to cease or reduce the supply of milk as a farmer shareholder may give a notice of withdrawal (or volume reduction); the right to withdraw is subject to the terms governing the relationship between Fonterra and the farmer shareholder (*right to withdraw*).[84]

68 Fonterra may offer new entrants and existing shareholders supply contracts with terms greater than one year subject to ensuring that, at all times, 33% or more of milksolids produced within a 160km radius of any point in New Zealand is either:

68.1 supplied to IPs; or

[81] See paragraph 58.4 above. See also NERA advice, above n 4, [5.3.2].

[82] See paragraph 43.3 above.

[83] See paragraph 43.5 above.

[84] DIRA, section 97.

68.2 supplied to Fonterra on contracts that expire or are terminable by the supplier at the end of the current season (without penalty) and on expiry or termination end all the supplier's obligations to supply milk to Fonterra (*160km rule*).

69 Separately, Fonterra's constitution provides that the aggregate amount of milksolids obtained from shareholders in a season on contract supply cannot exceed 15% of the total milksolids supplied by shareholders in the preceding 12 months.[85]

70 The right to withdraw, in combination with the 160km rule (and Fonterra's constitution), in practice allows Fonterra some flexibility in its supply contracts. In particular, Fonterra has been able to develop and make offers to present more, and more attractive, options to suppliers and meet competition. In addition, longer supply term commitments allow Fonterra some certainty to support its capacity and other investment decisions.

71 In particular, Fonterra has offered suppliers options to "share up" (in other words, purchase sufficient Fonterra shares to support their volume of milksolids supply) over longer periods, including three, 6 or 10 years. These offers entail some degree of commitment to supplying Fonterra for the share up period.

72 Fonterra has also developed its MyMilk offer in order to meet competition in the South Island. Specifically, in introducing the MyMilk offer, Fonterra sought to attract valuable new milk, provide a stepping stone for potential new co-operative members, match some of the value propositions of IPs, and secure additional supply from farmers who support a strong New Zealand-owned co-operative but are at the stage in their business where sharing up is not within their reach. The key features of this offer are:

72.1 Farmers supply MyMilk, which is a Fonterra subsidiary, which in turn supplies Fonterra but holds no shares.

72.2 Supply to MyMilk is on an annual basis (suppliers may leave at the end of any season, with notice given prior to 31 December), and supply is at a price set at the end of the season. The maximum level of the price is equivalent to the farm gate milk price, and the minimum is the lower of the farm gate milk price and 15 cents below the Fonterra contract milk price (less any contract fee). The Fonterra contract milk price is the price that applies to contracted, rather than share-backed, supply, and is currently equivalent to the farm gate milk price.

72.3 Participation in MyMilk is limited to a maximum of 5 years (after which its suppliers must find an alternative processor or commence to supply Fonterra in the ordinary way) and MyMilk is initially limited to 5% of Fonterra's total supply. These limits were placed on the MyMilk offer in recognition of Fonterra's co-operative structure and in particular that suppliers to Fonterra should hold shares in proportion to the milk they supply.

72.4 Although suppliers may exit at the end of any season, MyMilk commits to accept the supply for the full 5-year period.

[85] Fonterra's constitution, above n 44, clause 3.22.

72.5 As noted in a previous submission on the Review, Fonterra does not (and has no desire to) use MyMilk as a tool to secure long term milk supply. As noted above, suppliers may leave at the end of any season.[86]

73 Despite the degree of flexibility evidenced above, without the right to withdraw and the 160km rule, Fonterra would have greater ability to present a range of offers to existing and potential suppliers as well as make more efficient planning decisions.

74 **Although it considers the right to withdraw and 160km rule result in inefficiencies, Fonterra considers it currently manages to compete satisfactorily within their constraints. These provisions may need to be examined in the context of granting discretion regarding whether and on what terms to accept supply.**

### *Raw Milk regulations*

75 The key provisions regulating conduct in the factory gate market are the Raw Milk regulations.[87] Fonterra submits that some aspects of the Raw Milk regulations could be considered for removal immediately, while other aspects continue to play a useful role and are important for public confidence in the downstream dairy markets.

76 The principal aspects of the Raw Milk regulations, which require Fonterra to supply raw milk to IPs and others, are the following:

76.1 Fonterra must make up to 795 million litres of milk available to IPs.[88] Additionally:

(a) Maximum supply to Goodman Fielder is limited to 250 million litres per season (and subject to monthly limits and forecasting and other requirements).

(b) Supply to each IP is limited to 50 million litres per season (and subject to certain maximum monthly limits and forecasting and other requirements).

76.2 Fonterra is not required to supply raw milk to an IP from the season beginning 1 June 2016 if the IP's own supply of raw milk in each of the three consecutive previous seasons was 30 million litres or more.[89]

76.3 The price for raw milk can be agreed between Fonterra and the IP (or Goodman Fielder); otherwise, it defaults to a price comprising the farm gate milk price, plus the reasonable cost of transporting the raw milk to the processor and, in the case of winter and organic milk, the additional cost of procuring and supplying that milk.[90] Alternatively, new IPs or those whose own supply of raw milk in the previous season was less than 30 million litres can choose to obtain raw milk at a "fixed quarterly price", which is formulated

[86] Fonterra Co-operative Group Limited, *Cross-submission on review of the state of competition in the New Zealand dairy industry – process and approach* (24 July 2015), paragraph 4.

[87] It should be noted that provisions that support the entry to and exit from Fonterra by suppliers (discussed above) also support the ability of IPs to obtain their own supply at a farm gate level.

[88] Raw Milk regulations, above n 7, regulation 5.

[89] Ibid, regulation 6(3).

[90] Ibid, regulation 20.

by the same methodology as the default milk price, except that instead of the actual farm gate milk price, it is based on the most recent quarterly published forecast of the farm gate milk price.[91]

77 As noted above, the Raw Milk regulations also cover a wide range of detail in relation to forecasting and other requirements; to the extent relevant, these are addressed in more detail below.

### *Obligation to supply*

78 The role of the Raw Milk regulations in facilitating contestability has been achieved with the advent of IPs that have secured their own supply and present a sustainable competitive force in the farm gate market.

79 Furthermore, as set out in the NERA advice, the majority of entrants have entered on the basis of a combination of regulated raw milk and direct supply,[92] which calls into question whether the "catch 22" set out in the 2010 NERA advice has significance in this context.[93] Given there is now a strong history of sustainable entry and self-supply by IPs, suppliers can be expected to be willing to offer to supply entrant IPs, even in their early stages.

80 Moreover, it remains open to all IPs to secure factory gate supply on commercial terms from Fonterra and, increasingly, other IPs. Without the Raw Milk regulations, Fonterra (and other IPs) could be expected to engage in such arrangements, to the extent they were compensated for their opportunity cost in doing so (and these arrangements would be subject to the Commerce Act).[94] In this respect, the market could be expected to be more efficient in the absence of the Raw Milk regulations.

81 Against this background, there is little justification for mandating the supply of regulated milk to sustainable IPs, particularly where they have little or no participation in domestic downstream markets.

82 Nevertheless, Fonterra considers it could be argued that the Raw Milk regulations have some ongoing legitimate role. Specifically, without the Raw Milk regulations, the factory gate market may not yet be sufficiently developed to allow niche suppliers to secure their own supply from the farm gate or factory gate markets on terms that would facilitate their entry and sustainable participation in downstream markets.[95]

83 Fonterra also acknowledges the comfort that stakeholders take from the fact that there is regulated raw milk supply to a key downstream competitor, Goodman Fielder, safeguarding a level of downstream domestic competition. NERA articulates the potential concern around this issue as follows, "to the degree that Fonterra still has market power in the upstream markets, it might have the incentive and ability to raise its downstream rivals' costs (in the absence of DIRA)".[96]

[91] Ibid, regulations 19 and 24.

[92] NERA advice, above n 4, [5.2.2].

[93] In the 2010 NERA advice, NERA described barriers to entry into the farm gate market as resulting from a "catch 22" whereby investors in independent processing plants are reluctant to invest without a secured supply of milk, and farmers (who have sunk assets and a perishable output) are reluctant to contract with processing plants until they are established in the market. See 2010 NERA advice, 4.1.1.2.

[94] NERA advice, above n 4, [5.2.2].

[95] See further NERA advice, above n 4, [5.2.2].

[96] Ibid.

Retaining regulated raw milk supply to Goodman Fielder and niche competitors, which do not have their own supply, protects the current level of competition in downstream markets. There is no evidence to suggest downstream markets require additional intervention.[97]

84 In this context, the task is to identify a deregulation pathway that resolves the current situation of supplying major competitors but recognises the concerns regarding the position of some customers.

85 **Fonterra submits that the requirement to supply Goodman Fielder remains important for public confidence in downstream wholesale and retail markets and there is still a case for smaller, niche IPs that do not have their own milk supply having access to Fonterra raw milk. However, Fonterra considers it should no longer be obliged to make raw milk available to larger IPs (other than Goodman Fielder), including those looking to establish a foothold in the New Zealand market.**

### *Regulated price for supply*

86 As noted above,[98] the Milk Price regime has a role in the factory gate market in that it forms the basis for the price at which raw milk must be supplied under the Raw Milk regulations.

87 NERA advises that the price for supply under the Raw Milk regulations, which is likely to be lower than Fonterra's opportunity cost, creates cost for Fonterra, particularly in the context of supply to larger IPs. The regulated milk price may result in Fonterra shareholders subsidising entry, which could in turn lead to inefficient entry.[99] A milk price below opportunity cost could also limit the incentives for IPs to trade raw milk, thus working against IPs entering the factory gate market.[100] In a context of markets that are already, and are increasingly, contestable, this is particularly undesirable and unnecessary.

88 However, to the extent there remains an ongoing justification for particular types of supply under the Raw Milk regulations, the regulated price may be considered warranted for those smaller, niche suppliers and for Goodman Fielder (which do not have their own supply). NERA indicates that the costs associated with requiring Fonterra to supply IPs at the regulated price, while still material, might in the case of Goodman Fielder be mitigated by the greater volume certainty it entails, and in the case of supply to niche players, due to the lower overall volumes for which they account.[101]

89 **Fonterra notes the inefficiency generated by the price regime governing factory gate milk prices and that the price should reflect Fonterra's opportunity cost.**

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[97] See Commerce Commission, *Milk Markets: consideration of whether to initiate a Commerce Act Part 4 inquiry into milk prices* (August 2011).

[98] See paragraph 76.1 above.

[99] NERA advice, above n 4, [5.2.2].

[100] Ibid, [4.2].

[101] Ibid, [5.2.2].

*Other regulated terms of supply*

90 The Raw Milk regulations allow IPs to vary the estimates of the quantity of raw milk they intend to purchase by a wide range and up until very close to the time they receive the supply, creating significant cost for Fonterra and unnecessary inefficiencies. NERA acknowledges this, indicating that such issues might lead to potential plant overbuild or other inefficient operating decisions, particularly at peak. IPs effectively have a free option to vary the milk they take from Fonterra at peak such that Fonterra bears the risk of forecasting peak supply.[102]

91 In particular:

91.1 Tolerances in relation to IPs' estimates of the quantity of raw milk they anticipate purchasing should be reduced, as they have a significant combined effect.[103] Fonterra is able to cope with these during "shoulder" months but faces significant costs arising out of coping with excess milk during "peak" months (in particular, administrative costs and capacity constraints). Accordingly, Fonterra submits that narrower tolerances should apply at least during peak months.

91.2 Currently, IPs must give 18 months' notice of requiring winter milk supply above 20,000 litres per day.[104] Fonterra submits that a longer notice period should be required. A period of 18 months is insufficient for Fonterra to source new supply and for successful applicant farmers to alter calving patterns in order to supply milk in June and July (changing calving patterns itself takes at least 18 months).

91.3 There is currently a large tolerance for winter milk supply quantity estimates,[105] which Fonterra considers should be removed. Fonterra must contract winter milk from its suppliers at a premium. If IPs do not purchase the winter milk they have forecast to purchase Fonterra must nevertheless pay the premium to suppliers. Although Fonterra is able to process the milk it does not recover the winter milk premium. For the same reason, Fonterra submits that the take or pay prohibition[106] should not apply to (at least) winter milk.

92 Fonterra also notes that winter months are currently excluded from the months that are subject to maximum monthly limits (the "October rule"). The premium for winter milk reflects the cost to Fonterra of sourcing that milk. But there is no rationale for IPs to purchase unlimited quantities of winter milk simply because they pay the additional costs.[107]

93 Separately, Fonterra submits there is an ambiguity in the drafting of the Raw Milk regulations. Specifically, it could be argued they allow IPs to forego their supply of

[102] NERA advice, above n 4, [5.2.2].

[103] Raw Milk regulations, above n 7, regulations 10(3), 21(1) and 21(2).

[104] Ibid, regulation 11(2)(a).

[105] Ibid, regulation 11(3).

[106] Ibid, regulation 21(5).

[107] Ibid, regulation 6.

milk under the Raw Milk regulations for a season, which would allow them to re-start the three-year supply period and circumvent the Raw Milk regulations.[108]

94 **Fonterra notes inefficiencies and ambiguity created by particular aspects of the Raw Milk regulations and seeks their amendment.**

### *20% rule*

95 Farmer shareholders are entitled to allocate to IPs up to 20% of their weekly production throughout the season (without exiting Fonterra) (*20% rule*).[109]

96 In practice the 20% rule has not been, and is still not, widely used. Fonterra acknowledges Karikaas' submission that it does collect milk under the 20% rule from a single supplier (as well as, during winter, sourcing milk from Fonterra)[110] but submits that this is an exception, and that in any event Karikaas could replace that supply with supply through the factory gate market (as to which, see from paragraph 75 above).

97 As such, it can be concluded that IPs do not rely on it as a means of attracting supply. Accordingly, in the absence of the 20% rule, it would make little difference in the market were Fonterra to prevent farmer shareholders from offering a proportion of their production to IPs without exiting. In particular, in the absence of the 20% rule, IPs' ability to win supply would be affected to only a very small extent.

98 Fonterra does not consider the 20% rule to be of material significance, and it is not a priority for change. Nevertheless, given changes are being considered Fonterra submits that the 20% rule appears to be a redundant feature of the DIRA.

99 In the 2010 NERA advice, NERA noted the lack of use of the 20% rule, but indicated that "an issue to consider… is whether the 20% rule might become more important under Fonterra's proposed capital restructuring"[111]. Since 2010, use of the 20% rule has not increased, and the increase in competition and its sustainability have continued regardless. Furthermore, Fonterra does not foresee the 20% becoming more widely used in the future. Removal of unnecessary regulation would be competitively neutral, and would decrease the cost of regulation; thus, it would increase efficiency in the current environment.

100 **Fonterra submits that, while not a priority for change, the 20% rule appears to be redundant and of little importance in the farm gate market.**

### *Sale of milk vats*

101 Fonterra must sell a milk vat situated on the farm of a withdrawing farmer shareholder to the farmer shareholder or an IP that has agreed to buy the milk

[108] Regulation 6(3) provides for the limit on supply to IPs whose own supply in the prior three seasons was greater than 30 million litres, "as specified in the returns provided" to Fonterra under regulation 18(2). However, under regulation 18(2) an IP is only required to provide Fonterra with a return if it requires supply in the current season. If the IP wishes to purchase milk in a subsequent season, it will not have submitted a return and yet might have had more than 30 million litres of its own supply in the three preceding seasons.

[109] DIRA, section 108.

[110] Karikaas Natural Dairy Products Ltd, *Submission on the dairy competition review consultation paper* (12 June 2015), pages 1 to 2.

[111] 2010 NERA advice, page 19.

vat.[112] The provisions governing the requirement to sell milk vats are used frequently, and disputes arise only rarely.

102 **The requirement for Fonterra to sell milk vats is in use, and Fonterra does not consider material inefficiency arises out of it. Accordingly, Fonterra is not seeking its immediate removal.**

**Andrew Cordner**
**Group General Counsel**

[112] DIRA, section 109.

# APPENDIX A: NERA ADVICE