Review of the state of competition in New Zealand’s dairy markets
6 November 2015
Sue Begg, Deputy Chair
Briefing overview

- What the review covers
- Our draft conclusions
- Next steps
- Background
The Minister for Primary Industries requested a report on the state of competition in the New Zealand dairy industry.

The purpose of the review is to:

- provide an assessment on whether the state of competition in the dairy industry is sufficient to justify de-regulation
- advise the Minister on whether the ‘market share thresholds’ in DIRA should be reset; and
- the options (if any) for a pathway to deregulation.

We’re releasing a draft report for consultation.
• Competition is very limited in the factory gate market – this is our key concern
• Some competition has developed in the farm gate market
• The regulations have reduced barriers to entry and constrained Fonterra’s market power
• Costs and benefits of removing regulation are same order of magnitude
• On balance, competition is not yet sufficient to deregulate fully
Summary of draft conclusions (2/2)

Recommendations

• The pathway to deregulation requires the development of the factory gate market. We recommend Ministers consider options that facilitate development of that market.

• Staged approach also mitigates the risk associated with deregulation.

• Reset the ‘market share’ and ‘time limit’ thresholds to trigger a future report on the state of competition.
Questions we looked at in the review

1. What is the **state of competition** with the current DIRA regulations?

2. Is the current **state of competition sufficient** to ensure efficient and contestable markets **without the DIRA regulations**?

3. If the state of competition is insufficient:
   - should the **market share thresholds** be reset?
   - **options** for a transition **pathway to deregulation**
The markets we’ve focused on

Terms of Reference

• Focus on the state of competition and whether we should deregulate:
  • The farm gate market
  • The factory gate market
• Any new information that would change the findings of our 2011 preliminary inquiry into domestic wholesale and retail dairy markets?
Farm gate and factory gate markets

Dairy farmers supplying milk

Farm gate milk market

Raw milk collectors/processors

Milk processors

Downstream markets (retail & wholesale)

Consumers

Factory gate market
Farm gate market

- The market for purchasing raw milk from farmers
- Dairy processors compete with each other to purchase milk from farmers – beneficial to farmers
- DIRA aims to achieve efficient markets via:
  - ‘Open entry and exit’ rules
  - Raw milk regulations
  - Milk price monitoring regime
Factory gate market

- The wholesale market where dairy processors trade raw milk:
  - DIRA milk
  - Non-DIRA milk
- Demand at wholesale level from
  - Emerging dairy processors looking to supplement own supply
  - Food and beverage manufacturers
State of competition with DIRA – farm gate market

Farm gate market

- Concern is possible depression of the farm gate milk price
- Market still highly concentrated
- Significant barriers to entry to these markets
- These issues are addressed by:
  - DIRA regulation
  - Fonterra’s co-operative nature
State of competition with DIRA – factory gate market

Factory gate market

• Regional factory gate markets not characterised by effective competition

• Customers have access to milk under raw milk regulations, so have little incentive to seek supply elsewhere

• Fonterra’s price for non-DIRA milk substantially higher than for DIRA milk
Insufficient competition without DIRA regulations

• We don’t think there is sufficient competition in the farm gate and factory gate markets for them to be more efficient without the regulations.

• We’ve considered:
  o What competition would look like without the DIRA regulations
  o The costs and benefits created by the DIRA regulations
How markets would operate without the regulations

Would Fonterra be likely to:

- Exercise market power against farmer suppliers at the farm gate?
- Exercise market power to increase prices at the factory gate?
- Prevent independent processors from effectively competing?
How markets would operate without the regulations

Farm gate market

- Removing regulations would have not have a big impact on the farm gate market
- Fonterra would still have significant market power, but little or no incentive to use it to the detriment of its shareholder farmers
What competition would look like without DIRA regulations

Factory gate market

• Removing regulations would increase the price of previously-regulated ‘DIRA’ milk

• Increase in factory gate prices has flow-on implications (e.g. increase in the retail price of fresh milk, cheese and yoghurt)

• Some portion of likely price increase reflects Fonterra’s market power
Restricting competition
• We have considered Fonterra’s ability to restrict competition in the absence of regulation
• It is unlikely Fonterra would:
  o Raise prices at the farm gate in order to exclude competitors
  o Commit farmer suppliers to longer term exclusive contracts to shut out competing processors
  o Raise prices at the factory gate in order to exclude downstream competitors

What competition would look like without DIRA regulations
On balance, we found competition is not sufficient to warrant deregulation at this point

- Cannot conclude that markets would be more efficient without regulations
- Static efficiency costs and benefits in the same order of magnitude
Efficiency would not be enhanced by removing DIRA regulations

• Benefits of the regulations:
  
  o Facilitate independents being able to source milk from farmers – these are the potential entrants to the factory gate market
  
  o Reduce Fonterra’s ability to exercise market power at the factory gate and prevent consequential impacts on the retail market (i.e. the price of fresh milk, yoghurt and cheese)

• Costs of the regulations
  
  o Costs to Fonterra of maintaining excess capacity
  
  o No evidence that the regulations have incentivised inefficient dairy conversions
  
  o However, raw milk regulations may be impeding development of factory gate market
Draft recommendations

- The pathway to deregulation requires the development of the factory gate market. We recommend Ministers consider options that facilitate development of that market.

- Staged approach also mitigates the risk associated with deregulation.

- Competition review when non-Fonterra market share of 30% is achieved in either North Island or South Island, or if threshold not met in five years.

- Recommended thresholds not a magic number.
Options for transition pathways to deregulation

• The factory gate market is our key concern
• A **staged approach** is the most appropriate transition pathway to deregulation
• Pathways to a functioning factory gate market potentially offer the biggest benefits:
  1) Changes to the raw milk regulations
• Later, consider the other regulations
  2) Base milk price disclosure and monitoring rules
  3) Open entry and exit provisions
## Review steps

<table>
<thead>
<tr>
<th>Indicative date</th>
<th>Process step</th>
</tr>
</thead>
<tbody>
<tr>
<td>2 June 2015</td>
<td>Review requested by Minister</td>
</tr>
<tr>
<td>6 November 2015</td>
<td>Draft report published</td>
</tr>
<tr>
<td>4 December 2015</td>
<td>Submissions due on draft report</td>
</tr>
<tr>
<td>18 December 2015</td>
<td>Cross-submissions due</td>
</tr>
<tr>
<td>29 February 2016</td>
<td>Final report published</td>
</tr>
</tbody>
</table>
Questions?
Contact us

Call: 0800 943 600
Write: PO Box 2351, Wellington 6140
Attn: Alex Sim
Email: Alex Sim, Chief Adviser
regulation.branch@comcom.govt.nz
Website: comcom.govt.nz
Background

- Trigger for the review
- DIRA regulations
- Consultation process
DIRA requires the Minister of Primary Industries, in consultation with the Minister of Commerce, to request a report on the state of competition in the New Zealand dairy industry:

- When **market share thresholds** are met;
- If the market share thresholds haven’t been met by **1 June 2015**, as soon as practicable after that date.
- The review was triggered by the 1 June 2015 time limit.
Enacted when Fonterra was created in 2001 because Fonterra’s creation lessened competition in NZ dairy markets

Key elements are:
- Open entry into and exit from Fonterra
- Raw milk regulations (obligations to collect and supply)
- Milk price monitoring regime

Intended to be transitional
Consultation process

• We are releasing a draft report for consultation on our draft findings
• We have already consulted with interested parties via:
  • A process and approach paper
  • A consultation paper on substantive issues
  • Opportunities for cross-submissions
• Engagement with Fonterra, farmers and independent processors (IPs)
Next steps

- Consultation period for the next 6 weeks
- Final report to be published 29 February 2016
- Within 90 days of receiving our report, DIRA requires Minister to give notice of whether the Minister:

  “...intends to promote the enactment of legislation that resets either or both of the market share thresholds specified in s 147 or to promote the adoption of measures that provide a transition pathway to deregulation, or to promote both.” – s 148(3) DIRA