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Miraka Submission to the Commerce Commission:

Consultation Paper – process and approach: Review of the state of competition in the New Zealand dairy industry (12 June 2015)

1.0 Introduction

1.1 The Commission has received submissions to the above Consultation Paper and has invited cross submissions to those submissions. Miraka appreciates the opportunity to provide this cross submission.

1.2 Miraka laid out its views on the Consultation Paper in its submission dated 10 July 2015. Those views are unchanged except as addressed in this submission. Silence on any issue raised by other submitters does not mean Miraka agrees with that submitter.

2.0 Fonterra Submission

2.1 Miraka agrees with Fonterra that submitters should have 8 weeks (Fonterra paragraph 8.1) rather than the Commission's proposed 4 weeks to respond to the Commission's draft report. The Competition Review addresses complex issues of major importance to the industry and the wider economy. A longer period to consider and submit on the report is warranted.

2.2 Miraka is concerned with the implication (Fonterra paragraph 13) that sub-markets within New Zealand might be regulated in different ways. This suggests a complex regulatory environment that could distort or obscure proper market signals. Miraka contends that until or if there is sufficient competition in the national market, the superimposing of a complex regional regime could undermine the DIRA purpose of contestability across the New Zealand wide dairy markets.

2.3 The Miraka submission (paragraph 4.1.4) took a different approach to the possibility of region specific regulation, which would only emerge as part of a move to deregulation. To clarify, where a comprehensive analysis of competition found competition to be generally sufficient it might be appropriate for the regulations to fall away except in those geographies where, for example, farmers still do not have options for selling their milk. This is quite different to a patchwork of differing regulations across the country. The over-riding concern for Miraka (Miraka submission paragraph 4.1.2) is to avoid unnecessary complexity in the regulations or the application of the regulations.

2.4 Fonterra states (paragraph 18.2) that TAF has resulted in a more liquid market for Fonterra shares. Fonterra goes on to say that “units are exchangeable for shares if they [farmers] later return to Fonterra as suppliers”. Fonterra indicates that TAF might therefore address certain objectives of the DIRA, and by implication the entry/exit provisions of the DIRA. TAF as it stands would seem to address Section 71 (e) of the DIRA (entry and exit price for Fonterra members being the same). TAF might also provide an instrument which mitigates financial risks associated with prospective re-entering Fonterra following an exit from Fonterra. Miraka does not however agree that TAF would replace other aspects of the entry/exit regime. TAF does not for example ensure the entry/re-entry requirements of the DIRA. A unit holder is not entitled to become a Fonterra member/supplier simply because they hold units. Rather, units can only be exchanged for shares if the holder of the units is <u>first</u> accepted as, or is already, a Fonterra member. In the absence of the DIRA, there is no reason to assume that a new or returning supplier will be accepted as a member of Fonterra simply because they hold units.

3.0 <u>Federated Farmers Submission</u>

3.1 Federated Farmers holds the view that TAF in itself meets the provisions of the entry/exit regime in the DIRA (FF paragraph 2.1). Federated Farmers thus states more directly what Fonterra seems only to be suggesting. Paragraph 2.4 above explains why the TAF does not meet or assure the entry/exit requirements of the DIRA. While TAF might be useful in <u>facilitating</u> entry, supply variations, and exit from Fonterra, TAF does not and cannot stand in the place of the DIRA entry/exit regulations.

3.2 Federated Farmers seems to consider a secondary market for raw milk is ultimately unnecessary (FF paragraph 4.6.3) and that all processors, large or small, can meet their raw milk requirements in the farm gate market. Miraka does not agree with this and has explained the reasons in paragraph 4.2.4 of its submission.

3.3 Federated Farmers seeks a number of changes to the supply of regulated milk including that regulated milk should not be available to any processor (be it new entrant, existing processor or a processor requiring only small milk volume) in a region “where competition has been deemed to be sufficient” (FF paragraph 4.9.3). This is perhaps an example of the region specific regulations that Fonterra is contemplating (see paragraph 2.2 above). Miraka does not agree with Federated Farmers. From a farmer perspective, competition in the farm gate market might be perceived to be achieved where farmers have options for selling milk (i.e.

competition in regional markets). The objective of the DIRA is however wider, and equally important is the emergence in the market of processors that can compete effectively between each other and with Fonterra. The proper scope for that market is the the national market. Denying access to regulated milk as proposed by Federated Farmers would dilute the effectiveness of regulated milk in encouraging the emergence of sufficient competition in the nationwide market.

3.3 Federated Farmers supports the continued use of the Milk Price Manual and presumably supports the ongoing regulation of the Base Milk Price under Subpart 5A of Part 2 of the DIRA. Federated Farmers is however misinformed in its view (FF section 9) that the milk price manual:

- determines the value of milk "if it were to be produced simply into a commodity product"
- that the dividend Fonterra pays is a measure of "what value is added to that milk in added-value processing, marketing and customers relations"
- that the milk price manual "gives assurance that the milk price will not subsidise the dividend or vice versa".

3.4 As submitted by Miraka (Miraka submission section 4.2.5), and contrary to the Federated Farmers view, the Milk Price Manual necessarily results in a subsidy from the Fonterra added value business to the milk price. A milk price determined in the way Federated Farmers describes would provide greater transparency of Fonterra performance and would result in a more efficient allocation of investment across the entire value chain of the New Zealand dairy markets (including on farm). Miraka has submitted that the Base Milk Price regulations should be changed (Miraka submission section 4.2.5). Those changes are consistent with the way Federated Farmers (and possibly many others) believe the milk price is calculated today.

4.0 Tatua Submission

4.1 Tatua is critical of a bias towards deregulation in the review process outlined by the Commission (for example at Tatua paragraph 7.3). While the ultimate deregulation of the markets might be an appropriate objective, Miraka agrees that the review of competition itself should not presuppose deregulation. This bias has for example limited the scope of the review by excluding consideration of new regulatory responses which might more effectively or efficiently meet the objective of the DIRA (contestable markets).

4.2 Tatua also points out that the Commission's intention to assess how the market would behave in the absence of regulation requires an extensive analysis across many possible scenarios (paragraph 5.1). Given there is no experience of deregulated farm and factory gate milk markets in New Zealand, this analysis will necessarily be hypothetical. Both the bias towards deregulation, and the challenges of assessing the counterfactual deregulated market are pointedly illustrated in paragraph 13.3 of the Consultation Paper. At paragraph 13.3, the Commission notes it is required to determine, in the absence of the regulations, whether "the current state of competition is sufficient to ensure the efficient and contestable operation of these markets". Not only is this a hypothetical analysis, it would seem an impossible task. The "current state of competition" has emerged within the context of the current regulations, so it would seem not possible to determine that current state of competition in the absence of the regulations. In any event, Miraka supports Tatua's request that the Commission explain how the hypothetical analysis will be carried out (Tatua paragraph 5.3).

4.3 Miraka also points out that determining whether competition is sufficient requires an analysis of the markets as they currently operate. The hypothetical analysis of how the markets might operate in the absence of regulation is less concerned with the state of competition in the markets than it is with the efficacy of the regulatory framework. Miraka submits that the review needs to place greater emphasis on assessing the markets as they currently operate. In determining that competition is not sufficient (if that is the case), the review should then focus on how the regulations (or new regulations) might change to ensure the markets are sufficiently competitive.

Talley's Submission

The Talley's submission notes (paragraph 7) that there are regional variations in competition in the farm gate market, and that Fonterra holds "regional monopolies" in some cases. Fonterra can use tactical pricing to increase prices in areas where it faces competition. This again reflects Fonterra market power, with Fonterra in effect subsidising those tactical prices either from the other areas where its suppliers are captive, or from its value add business activities. Talley's submits that such tactical pricing should not be permitted while Fonterra's regional monopolies persist (Talley's paragraph 8). Miraka supports this position.

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