

Terms of Reference for a report on the state of competition in the New Zealand dairy industry

Purpose

The Dairy Industry Restructuring Act 2001 (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 or
- in the event that they have not been met by 1 June 2015, as soon as practicable after that date.

The report must provide an assessment of the state of competition in the dairy industry and advise the Minister as to whether the market share thresholds should be reset, and options for a pathway to deregulation (if any).

Context

The creation of Fonterra resulted in a lessening of competition in the New Zealand dairy industry. As a result, DIRA imposed regulatory requirements on Fonterra to promote contestability and efficiency in New Zealand dairy markets. Specifically, s4(f) of DIRA stipulates the purpose of the DIRA regulatory requirements is to “promote the efficient operation of dairy markets in New Zealand by regulating the activities of Fonterra to ensure New Zealand markets for dairy goods and services are contestable”.

The DIRA regulatory requirements are aimed at the following two dairy markets:

- The market for milk at the farm gate, which is a market for the purchase of raw milk from farmers. Dairy processors compete with each other to purchase raw milk from farmers and this rivalry is beneficial to dairy farmers.
- The factory gate milk market, which is a wholesale market where dairy processors trade raw milk among themselves prior to processing. There is demand at the wholesale level for unprocessed raw milk, from:
 - dairy processors who are in the early stages of their operations looking to supplement their own inputs of raw milk to improve the capacity utilisation of their processing plants; and
 - food and beverage manufacturers, which require unprocessed raw milk as an input for their manufacturing processes.

To ensure the contestability of the farm gate milk market, the DIRA contains 'open entry and exit' provisions, as well as the farm gate milk price monitoring regime (as set out in Subparts 5 and 5A of Part 2 of DIRA). The requirement for Fonterra to on-sell a small proportion of its raw milk to other dairy processors (as specified in the Dairy Industry Restructuring (Raw Milk) Regulations of 2012 (DIRA Raw Milk Regulations) further promotes the contestability of the farm gate milk market by providing newly established dairy processors with temporary access to wholesale raw milk supply. The DIRA Raw Milk Regulations also provide access to wholesale raw milk for food and beverage manufacturers that choose not to have access to their own farm gate milk supply.

Critically, the DIRA regulatory requirements were designed to be transitional in nature. The regulatory regime is designed to expire if and when the New Zealand dairy markets are considered to be sufficiently competitive, so that industry-specific regulation is no longer required over and above the normal application of general competition law.

The process to expire these requirements begins when independent processors have collected 20% or more of milk solids in either the North or the South Island of New Zealand in a dairy season. If this market share threshold is not met by 1 June 2015, the DIRA sets out a process to ascertain the state of competition in the New Zealand dairy industry (pursuant to section 148A).

The first step in the process requires a report to be produced on the state of competition in the New Zealand dairy industry. This document sets out the requirements for that report.

Objectives and scope

The provider of the report (the provider) must ascertain:

- (i) the state of competition that exists in the New Zealand dairy industry; and
- (ii) if the provider determines that the state of competition in the New Zealand dairy industry or any specified New Zealand dairy market or markets is insufficient,—
 - (A) whether either or both of the market share thresholds specified in section 147 should be reset; and
 - (B) the options for a transition pathway to deregulation (if any) and whether a particular option or a set of options (if any) should be pursued.

In addressing the objectives above, the report should address the following questions:

- What is the state of competition that exists in the relevant New Zealand dairy markets, in particular, in the farm gate and factory gate markets? In relation to the wholesale and retail dairy markets, is there any new information that would alter the conclusions reached in the Commerce Commission's preliminary inquiry into domestic milk markets in 2011 under Part 4 of the Commerce Act?

- Is the current state of competition in the relevant New Zealand dairy markets sufficient to ensure the efficient and contestable operation of these markets in the absence of the provisions of Subparts 5 and 5A of Part 2 of the DIRA and/or the provisions of the DIRA Raw Milk Regulations? In particular, would Fonterra (given its market shares, nationwide collection and processing networks, and ownership and capital structure arrangements) be likely to have both the ability and the incentives to exercise market power against competitors, suppliers or purchasers in one or more of the relevant New Zealand dairy markets (in the North and/or the South Island), in the absence of the provisions of Subparts 5 and 5A of Part 2 of the DIRA and/or the provisions of the DIRA Raw Milk Regulations?
- If the research determines that the current state of competition in the relevant New Zealand dairy markets is insufficient in one or more of the relevant New Zealand dairy markets, so far as the available information allows the provider of the report to reach a conclusion:
 - i. Should either or both of the market share thresholds specified in s147 of the DIRA be reset (and, if so, to what new level(s))?
 - ii. Are there other expiry triggers that should be provided for, either in addition to or in place of the market share thresholds?
 - iii. What options, if any, are there for a transition pathway to deregulation?
 - iv. Are there any options (or sets of options) for a transition pathway to deregulation that should be pursued?

Stakeholder consultation

The provider of the report must consult at least once with the following on each of Questions 1-3 above before providing its final report:

- New Zealand dairy farmers through the following representative groups:
 - DairyNZ
 - Federated Farmers
- Fonterra
- Independent dairy processors.

The method of consultation may include:

- Providing a draft report for written submissions;
- Facilitating a workshop, following which participants may provide written submissions.

The provider of the report may seek further information from, and conduct any interviews with, submitters, government departments or other people as it thinks necessary or useful for the preparation of the report.

The provider of the report may invite submissions on any of the Questions from any other person but is not required to do so.

Confidentiality and privacy

The provider must maintain confidentiality over all commercial information collected in relation to the report.

The provider must also comply with the Privacy Act 1990 in respect of any personal information obtained during the preparation of the report.

Timeframe

The Minister for Primary Industries will formally request the report as soon as practicable after 1 June 2015. The final report must be provided to the Minister for Primary Industries by 1 March 2016.