SUBMISSION

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FEDERATED FARMERS OF NEW ZEALAND

To:	Commerce Commission
Submission on:	Review of the state of competition in the New Zealand dairy industry Consultation paper – process and approach
From:	Federated Farmers of New Zealand
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1. EXECUTIVE SUMMARY

1.1. Federated Farmers submits that while competition is present at the farm gate and the factory gate, having the industry supported by good legislation will continue to allow a strong, New Zealand dairy industry (see paragraphs 3.16 – 3.17, sections 7, 8 and 10).

1.2. Federated Farmers supports retaining the Dairy Industry Restructuring Act (the DIRA), regardless of the amount of competition present in the industry (see sections 7 and 10).

1.3. Federated Farmers submits that the DIRA and its regulations will need to be amended if it is to be kept long term (see sections 10 and 6).

1.4. Federated Farmers submits that there is competition at the farm gate in many areas of New Zealand, that farmers can switch processors if required, and the reasons for switching are to realise capital, for philosophical reasons or because of a dispute (see section 3).

1.5. Fonterra is seen as the dairy processor of last resort, often to the detriment of its shareholders and public opinion, who see Fonterra supporting dairy farming in marginal areas (see section 5).

1.6. Federated Farmers submits there is little competition at the farm gate regarding price as all processors peg their milk price to Fonterra's. What makes not belonging to Fonterra attractive for some is that they do not have to buy shares, allowing them to spend capital to buy land, cows, improve the farm, retire debt or on recreation (see paragraphs 3.12 – 3.15).

1.7. Others see co-operative values and belonging to a co-operative as the most important aspect of their business.

1.8. Federated Farmers submits that competition at the farm gate could be increased by amending the Raw Milk Regulations (see section 4).

1.9. The Federation is unsure whether a deregulated dairy industry would alter New Zealand's trade position (see section 11).

2. THE DAIRY INDUSTRY POST TAF AND THE 2012 AMENDMENT OF THE DIRA

2.1. The amended DIRA now allows for Trading Among Farmers (TAF). While the open entry and exit clauses for farmers remain in the legislation, TAF overrides those provisions.

2.2. TAF was voted into Fonterra after considerable consultation and discussion with farmers over two years. It surpassed the 75 percent vote threshold in favour of the proposal. Further amendments to the proposal were voted on later in 2012, where 66.45 percent voted in favour. TAF is now part of the farmer's everyday business.

2.3. The fundamental change to the co-op was not done effortlessly by the co-operative's shareholders (the farmers). For some it was a step too far, leading them to believe it would lead to the demise of Fonterra as a co-op. As a result some left Fonterra and now supply another processor.

2.4. The many who remain have been able to enter and exit the co-op and to grow or decrease their milk production, all by trading shares. Fonterra has tweaked the system to manage this new tool, as expected with any new process. Farmers are learning how to manage their shares. In essence it is doing what it was set up to do – manage redemption risk while allowing farmer shareholders to enter and exit the co-op.

2.5. While it is expected that TAF will remain an integral part of Fonterra, Federated Farmers wishes to comment on the open entry and exit clauses that sit inside the DIRA.

2.6. In its submission to the Ministry of Agriculture and Forestry in 2011 (Review of the Raw Milk Regulations, Discussion Paper No: 2011/09) Federated Farmers submitted against the proposal to legislate Fonterra to provide a share priced at the 'fair value', should TAF not proceed. The arguments are set out in paragraphs 2.26 - 2.36 of that submission.

2.7. Federated Farmers has not changed its position on this. Given that competition has increased, the method of calculating the share should revert back to the 2001, original legislation, where Fonterra could set its share price (annually) as it saw fit. Why should it be treated any differently from the other dairy co-ops, or any other co-op, for that matter?

3. COMPETITION AT THE FARM GATE

3.1. There is competition at the farm gate, but it is variable across the country.

3.2. Where there is competition, farmers have been able to switch in and out of Fonterra by selling/buying shares via TAF, relatively easily and over time. Actual switching the supply of milk is done at the beginning of the new season, not during the season.

3.3. However, some processors have certain requirements that need to be factored into the ability to switch processors. Often standards are set higher than Fonterra's in order to get the milk that is required for certain customers or certain products (e.g. 'sleepy' milk, A2 milk).

3.4. Many of the independent processors, because they are either full, close to capacity or seeking special contracts, can choose which farm they will pick up milk from. They will also cherry pick the best farms and farmers close to the factory gate.

3.5. In some areas, especially around Tatua and other full processors, the price of farm land is much higher than other land outside of the collection area, showing another aspect of competition at the farm gate.

3.6. **Canterbury**.

3.6.1. Westland Milk Products is no longer seeking new suppliers in Canterbury. It has just enough milk to keep its Canterbury plant efficient, and that, for the time being, suits them. Prospecting for more suppliers in Canterbury could lead to a greater Fonterra presence in Westland, which would damage its own 'home' supply base. The majority of Westland supply in Canterbury came from new conversions so there were few complications around switching supply.

3.6.2. Synlait is still accepting new suppliers, and those who do switch find it fairly easy to switch from Fonterra. Many of Synlait's suppliers are new conversions.

3.6.3. Oceania is growing and accepting supply from within a 50 km radius of their factory. They had 49 suppliers last year, 55 this year, 80 next year and more the year after that. Of their new suppliers, around one third are conversions and two thirds are people shifting from Fonterra.

3.7. **Waikato.** Waikato does have a number of processors for farmers to supply, with Tatua, Open Country Dairies (OCD), Miraka and Fonterra being the main ones. However, with the exception of Fonterra, all are full and none are taking in new supplier farmers.

3.8. **Manawatu, Taranaki and Southland.** OCD is an active and growing competitor in all three of these regions.

3.9. **Switching behaviour at the farm gate**. The co-operative ethos is very important in New Zealand agriculture. The whole agriculture industry, and especially the dairy industry, has been developed via the co-operative pathway. However, belonging to a co-op does tie up farmer capital given they have to buy shares to belong.

3.10. Farmers switch suppliers for monetary and philosophical reasons or because of a dispute (sometimes minor) with their processor. These minor disputes include missed milk pick-ups (the tanker doesn't arrive at the scheduled time) and communication difficulties.

3.11. What makes switching from Fonterra attractive for some farmers is that they are able to sell their Fonterra shares and realise capital. This capital is often used to either invest in additional farm land or to repay debt, with some farmers being encouraged to do so by their banks. The average dairy farm requires about $700,000 – $1 Million, at $5 per share, in order to be fully shared up. Releasing this capital is significant.

3.12. **Milk price at the farm gate.** New Zealand sees very little competition regarding the milk price offered at the farm gate.

3.13. It is a common feature around the world that the strongest co-op in a market is usually the price setter for that market, and other companies base their price paid to farmers on that co-op's price. Murray Goldburn in Australia is an example within the dairy industry.

3.14. Fonterra is no exception, with Fonterra setting the milk price in New Zealand and all other processors offering a price which is pegged to Fonterra's, either just above or just below.

3.15. With the exception of the two other co-ops (Westland and Tatua), it is important to note that for all farmers to get an accurate and fair return for their milk it is important that Fonterra performs and remains strong. If it were to lose too much supply to other companies then it could suffer from inefficiencies in its milk collection and processing infrastructure, which would be reflected through the farm gate milk price.

3.16. While encouraging competition is good, those who regulate the industry must ensure that balance is maintained and ensure that New Zealand does not subsidise competition for competition's sake. Having too much competition could in fact not be in the long term interests of New Zealand's dairy farmers.

3.17. New Zealand needs a strong dairy performer on the world stage in order to successfully contribute to the economic wellbeing of the New Zealand economy. A fractured industry, with too many players competing in the international market is not what farmers want or the New Zealand economy needs.

4. INCREASING COMPETITION AT THE FARM GATE

4.1. Federated Farmers is aware that the sunset clauses within the DIRA for the South Island will be close to being met during the 2016/17 season. We expect that independent processors will be close to collecting 20 percent of milk solids in the South Island.

4.2. This is thanks to the DIRA, which allows new processors certainty to some milk (through the Raw Milk Regulations which sit within the DIRA) while it sets up its supply base. This is, after all, what the DIRA was set up to do. It has supported new independent suppliers to develop competition in the South Island

4.3. We are also aware that demand for Regulated Raw Milk is unlikely to outstrip supply in the short term, given those established processors with own supply will be ineligible for this milk after the 2015/16 season.

4.4. However, those processors with no own supply or limited own supply are allowed unfettered access to Regulated Raw Milk. It is this demand which will outstrip the amount of milk set aside within the DIRA, in the mid to long term, given the total quantity set aside in the DIRA is fixed.

4.5. The DIRA does have a contingency for over demand via the imperfect pro-rata system (which is prone to lobbying) or an auction system, which would set a true value for this milk in times of excess demand.

4.6. **Managing the demand for Regulated Raw Milk: all processors treated the same**

4.6.1. New Zealand has seen the rise of small processors who turn 50ML into any number of products. Federated Farmers does not see these enterprises adding to farm gate competition, given there is no incentive to do so.

4.6.2. Federated Farmers submits that all processors be treated the same, regardless of whether they have own supply or not, and that access to this milk is limited to three years.

4.6.3. In its submission to the Ministry of Agriculture and Forestry (MAF) in 2011 (Review of the Raw Milk Regulations, Discussion Paper No: 2011/09), the Federation submitted in paragraph 3.24: *"IPs (independent processors) sourcing milk at the factory gate should come under the same rules as those who are able to source milk at the farm gate. While they may not wish to enter the farm gate market, there is no reason to not incentivise them to enter into normal contractual arrangements with any dairy processor. Federated Farmers submits that the same rules apply to both the farm gate and the factory gate market."*

4.6.4. The Federation's opinion has not changed. This would see access to Regulated Raw Milk limited to three years. This could increase competition at the farm gate.

4.7. **Managing the demand for Regulated Raw Milk: managing the quantity**

4.7.1. In 2011 the Federation also lobbied for an auction system to manage demand for Regulated Raw Milk. In the same Submission referenced above, we stated in paragraph 3.115: *"….an auction system is the only way to manage excess demand for RRM (Regulated Raw Milk). Those who need it most will be able to pay what it will be worth to them. Those who think that the price is too high can make normal contractual arrangements at either the farm or the factory gates".*

4.7.2. Again, our opinion has not changed, but the new Regulations do manage some aspects, like shoulder milk and the supply curve, better.

4.7.3. The Federation now submits that, if the demand exceeds supply, then rather than rely on the pro rata system allowed for in the DIRA, an auction system (also allowed in the DIRA) be implemented. The pro rata system is flawed and open to lobbying. Again, an auction could drive competition at the farm gate, with processors looking to process more for themselves. It could also drive competition at the factory gate as processors with no own supply looked to buy at a competitive price.

4.8. Both of these actions could increase competition at the farm gate.

4.9. **Managing the demand for Regulated Raw Milk: managing new processors in areas of sufficient competition**

4.9.1. The Commerce Commission, in its research, will be able to ascertain the regions where Fonterra is close to picking up 80 percent or less of the milk produced in that region. This should indicate, according to the DIRA, that there is sufficient competition for milk at the farm gate in that region.

4.9.2. Federated Farmers suggests these regions where this is most likely to occur are Canterbury, Waikato and the Manawatu, where Open Country Dairies picks up almost 20 percent of the milk produced in the region.

4.9.3. The Federation submits that the legislation be altered so that any new processors coming into these areas where competition has been deemed to be sufficient, be denied access to Regulated Raw Milk. This will drive competition to regions where more competition would be welcomed. Northland would be one such area where competition could benefit farmers.

5. FONTERRA, THE PROCESSOR OF LAST RESORT

5.1. Fonterra is required by the DIRA to pick up and process all milk offered to it. In some areas, due to historical reasons only, it adds a transport charge to it. Gisborne and some parts of the Coromandel Peninsula are two such regions.

5.2. Currently the only reason Fonterra has for not picking up supply is if the supplier does not meet the condition of supply. This bar is set very high and so is rarely used as refusing to do so can lead to further animal welfare or environmental issues.

5.3. Some farmers see this “automatic pick-up service” as a licence to print money. Some of the land being converted to dairy farming is on the margins, either environmentally or transport-wise.

5.4. Giving Fonterra the ability to say ‘no’ could allow Fonterra to improve efficiency by not having to pick up milk on roads that are ill-fit for tankers. Compelling Fonterra to pick up milk in these areas forces costs onto all suppliers, due to the co-operative nature of the business, unless extra costs can be shifted to the new dairy conversion.

5.5. This option to deny supply pick-up would put Fonterra on a more even playing field with other processors, who are able to pick and chose their suppliers.

5.6. Fonterra is also the processor of last support for those independent processors that prove uneconomical. The demise of NZ Dairies in South Canterbury is an example, where many sharemilkers and dairy farm owners who supplied the business were fearful for their bottom line when the processor closed. While it required a number of conditions to be met, Fonterra helped farmers by agreeing to allow them to buy into the co-op. This also helped the rural community as both are affected when a firm closes.

6. THE TWENTY PERCENT RULE

6.1. The “Twenty percent rule” allows Fonterra suppliers to divert up to twenty percent of their milk supply, on a daily basis, to independent processors. In its 2011 submission to MAF referenced above, the Federation lobbied for change and was disappointed that this section was not updated to reflect what could become common practice, given the size of corporate farms, TAF and the impact of the new Raw Milk Regulations.

6.2. Federated Farmers submits that the twenty percent rule within the current DIRA (s108) be EITHER dropped; OR replaced with a secondary volumetric limit to protect the boutique cheese makers and other small independent processors who rely on this type of supply; OR tied to the amount of milk taken in October.

6.3. Today, many farms are large holdings and twenty percent of a weekly supply is a large volume that could compromise Fonterra’s business plans. Also, farmers are now able to hold more shares than that required to support their milking platform and this “dry share” holding increases to 200 percent on the full realisation of TAF.

6.4. This “twenty percent rule” will make it very attractive for those shareholders with large holdings to divert large quantities of milk to other processors, ad hoc, to the detriment of Fonterra. These shareholders will gain from having sold milk to an independent processor (probably at a premium) as well as gaining from the dividend held on the dry shares and the Fonterra return on the twenty percent wet shares diverted to the independent processor.

6.5. Independent processors who use this rule to source milk tend to only offer this opportunity close to their factory gate. They also tend to use it to fill up their factories at the beginning and end of the season, when their own milk supply is low. This in turn impacts on Fonterra during these times of low milk volume.

6.6. Currently few farmers use this rule and so it is not seen as an issue either by Fonterra, farmers or MPI. However, Federated Farmers predicts that volumes processed under this rule will increase dramatically, given that those independent processors who may no longer have access to regulated raw milk will find this rule attractive.

6.7. Making these changes would mean that Fonterra would have greater certainty of milk supply at times of low volume, while allowing niche processors the opportunity to take small quantities of milk.

7. FONTERRA’S ABILITY AND INCENTIVE TO EXERCISE MARKET POWER AT THE FARM GATE

7.1. Fonterra is curtailed from using market power at the farm gate by the DIRA and the co-operative nature of the firm.

7.2. The DIRA, with TAF, requires Fonterra to:

7.2.1. Accept all milk from suppliers who wish to belong to Fonterra, with specified exceptions.

7.2.2. Not discriminate between suppliers, with specified exceptions.

7.2.3. Contract annually with farmers. Fonterra is unable to ‘lock in’ suppliers through long term contracts because the DIRA requires one-third of supply contracts to either expire or be terminated at the end of the season.

7.2.4. Allow its supplier-shareholders to divert up to 20 percent of their milk, on a weekly basis, to an independent processor without having to redeem shares.

7.2.5. Sell the milk vat to an exiting farmer or the exiting farmer’s new processor, at the market value.

7.3. The DIRA, without TAF, also requires Fonterra to allow farmers to enter and exit Fonterra at the same share price, and exiting shareholding farmers must receive their capital within 30 working days after the end of the relevant season.

7.4. Federated Farmers submits that these restraints work in favour of farmers.

8. INCENTIVE AND ABILITY FOR FONTERRA TO USE MARKET POWER AGAINST FARMERS IF THE DIRA WERE REVOKED

8.1. If the DIRA fell away, Fonterra could, in theory:

8.1.1. Discriminate between farmers so that farmers in areas which Fonterra deems uneconomical (but is currently required to pick up milk from) could be refused entry to the co-op. This would leave farmers stranded with no processor willing to process their milk.

8.1.2. Lock farmers into long term contracts, especially in areas where there is competition or in areas which are close to the Fonterra factory. Fonterra used this strategy in 2012 when it rescued farmers who were left stranded after NZ Dairies folded. These farmers have been locked into Fonterra for five years and have had other conditions placed on them.

8.1.3. Require all suppliers to only supply Fonterra and to not pay the market price of the vat should a farmer switch processors.

8.1.4. Should TAF fall away, the exiting farmer may not necessarily get the same price for their shares as those buying shares to enter, and the capital owing may not necessarily be paid to the farmer promptly.

8.2. However, while the economic theory may suggest that Fonterra could act in an anti-competitive manner at the farm gate, the reality is that Fonterra is a co-op and is therefore very unlikely to. If it acts against farmer shareholders' interests then the Board will be brought to account at the AGM and a new board would ensure the wishes of the shareholders are acted upon.

9. THE MILK PRICE MANUAL

9.1. Federated Farmers supports the function of the Milk Price Manual and how it is currently formulated. The Milk Price Manual provides transparency not only to Fonterra shareholding farmers but also to those supplying other companies.

9.2. The Federation believes this Manual calculates what the true base value of the raw milk in farmers' vats is worth if it were to be produced simply into a commodity product. Farmers can then see, through the dividend Fonterra pays or the total milk price paid by the other co-ops, what value is added to that milk in added-value processing, marketing, and customer relations.

9.3. This transparency is also vital for Fonterra shareholding farmers in relation to TAF, in that it gives assurances that the milk price will not subsidise the dividend or vice versa.

9.4. Federated Farmers is not, however, against tweaking the weighting of the basket of products used in the Manual or against the introduction of new commodity products to the basket over time, if such actions are genuinely reflective of changes in the market realities.

10. A DIRA FOR THE FUTURE

10.1. The Commerce Commission, in its Consultation Paper to which Federated Farmers is submitting on, stated in paragraph 66 :

10.2. "NERA's 2010 report suggested that the standard for removing the regulations is workable competition. We do not agree with this conclusion as workable competition is not always a necessary or sufficient condition for an efficient or contestable market. While workable competition is a sufficient condition for deregulation, it is not a necessary condition for removing the regulations. As discussed in paragraphs 34-37, the test for deregulation is whether removing the regulations would result in more efficient New Zealand dairy markets."

10.3. Federated Farmers agrees with this and suggests a DIRA that would take the dairy industry into the long term future could be developed and might include:

10.3.1. Continued provision for TAF. The special provisions currently contained in the DIRA sit outside any other money raising scheme/profit sharing arrangement. If the DIRA were to be repealed, these conditions would possibly be changed and made more onerous to Fonterra.

10.3.2. Altered provision for open entry and exit of farmers, allowing Fonterra to set the share price, as found in the 2001 DIRA, should TAF not remain (see paragraphs 2.6 – 2.7).

10.3.3. Ability for Fonterra, when considering new dairy conversions, to choose to either pick up or reject milk or place added costs onto those farmers.

10.3.4. Continuation of Fonterra's ability to refuse to pick up supply if certain supply conditions are not met.

10.3.5. Continuation of the sale of milk vats.

10.3.6. Continued use of the Milk Price Manual and all the provisions surrounding that.

10.3.7. Altered provision around the "Twenty percent rule", with the current rule being EITHER dropped; OR replaced with a secondary volumetric limit to protect the boutique cheese makers and other small independent processors who rely on this type of supply; OR tied to the amount of milk taken in October.

10.3.8. Altered Raw Milk Regulations, limiting the number of years to three for all processors, regardless of whether they have some, all or no own-supply.

10.3.9. Deleting the pro-rata provision in the Raw Milk Regulations and replacing it, should demand exceed supply, with the auction process set out in the DIRA.

10.3.10. Restricting competition to areas where there is less than twenty percent (see paragraph 4.7) by not allowing them access to Regulated Raw Milk in areas where there is sufficient competition.

10.4. Federated Farmers submits that the dairy industry would be more stable, have sufficient competition and still allow Fonterra to remain a dominant player in the New Zealand dairy industry, by having legislation.

10.5. The Federation also submits that New Zealand needs a strong single player on the world stage in order to lead the dairy industry world-wide. The world looks to Fonterra to set standards and prices.

11. ROLE OF THE DIRA IN TRADE NEGOTIATIONS

11.1. The Federation is unsure of the role of the DIRA in trade negotiations. We are aware that many trading partners perceive New Zealand being a one-dairy-company country and look on the DIRA as the only thing saving the New Zealand dairy industry from being a monopoly. If it was decided that there was sufficient competition for the DIRA to fall away, would this alter New Zealand's trade negotiations? We would be interested in the Commerce Commissions and MPI's opinions as the answer will have ramifications for New Zealand.

12. ABOUT FEDERATED FARMERS

12.1. Federated Farmers of New Zealand is a primary sector organisation that represents farming and other rural businesses. Federated Farmers has a long and proud history of representing the needs and interests of New Zealand farmers.

12.2. The Federation aims to add value to its members' farming business. Our key strategic outcomes include the need for New Zealand to provide an economic and social environment within which:

- Our members may operate their business in a fair and flexible commercial environment;
- Our members' families and their staff have access to services essential to the needs of the rural community; and
- Our members adopt responsible management and environmental practices.