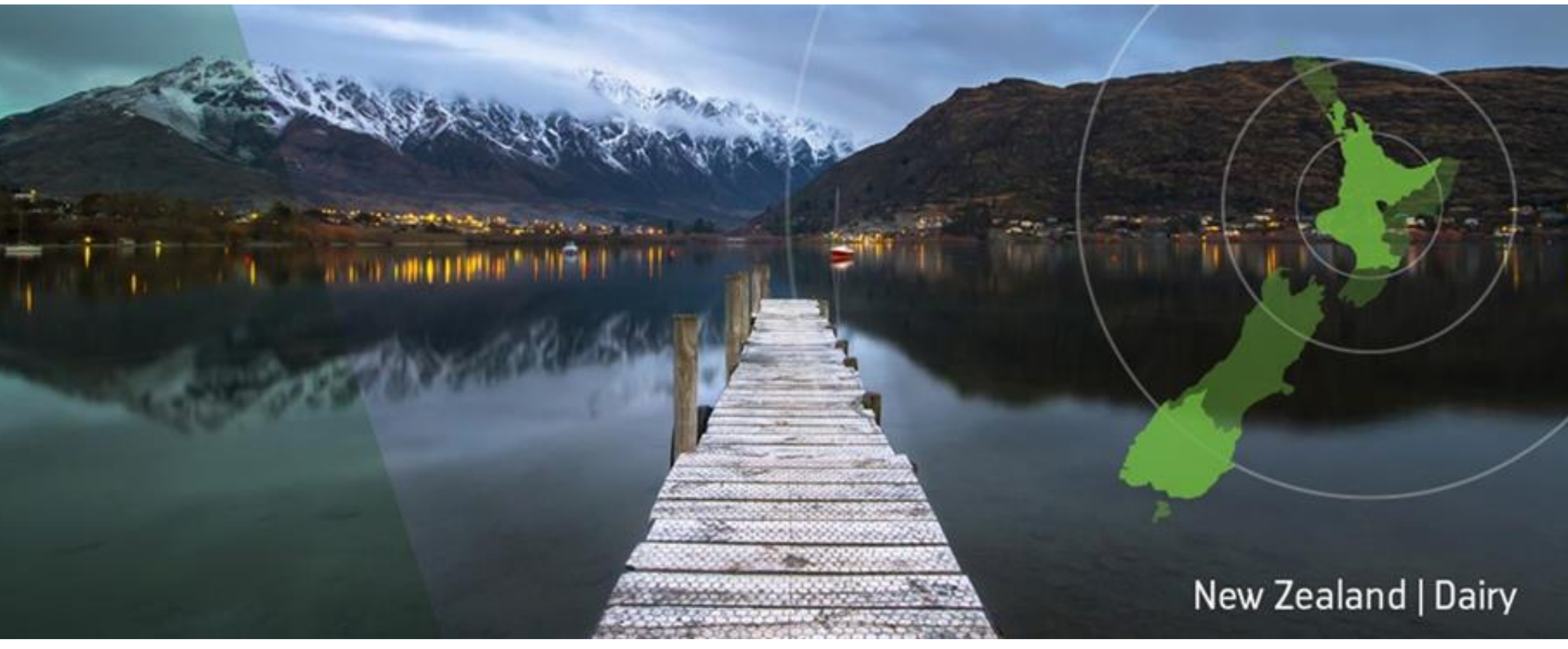
Open Country Dairy Limited

CROSS-SUBMISSION – REVIEW OF COMPETITION IN THE DAIRY INDUSTRY

August 2015



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Open Country Dairy (Open Country) is pleased to make this cross-submission on the Commerce Commission's (Commission) Consultation on substantive issues as part of its review of competition in the dairy industry.

EXECUTIVE SUMMARY

1.1 Open Country's view continues to be that there is not yet workable competition in the dairy industry—consistent with the submissions of Danone, Tatua and Waimata Cheese, and the analysis by Fonterra's economic advisors, NERA.

1.2 Open Country also agrees with the majority of submitters (other than Fonterra) that note the importance open entry and exit continues to play in disciplining Fonterra's market power. Open entry and exit are essential to contestability. Fonterra argues open entry should be removed because it has insufficient ability to deal with costly new conversions, however DIRA already provides Fonterra with mechanisms to address this. Even if Fonterra's existing powers under DIRA were insufficient, then the obvious and appropriate response would be to strengthen Fonterra's ability to reject new conversions—not to undermine open entry and exit.

1.3 Open Country has long-held the view that the milk price is set in a way which is not practically feasible and that further improvements are necessary to ensure contestability. Open Country agrees with Tatua that there needs to be greater independent input into Fonterra's calculated milk price and this will lead to a more practically feasible milk price. We see efficiency gains from strengthening the Commission's role in the milk price regulatory oversight regime so that the Commission has the ability to determine notional inputs and the weighted average cost of capital (WACC) of the notional processor. Our position is that it is within the Commission's jurisdiction in the current review to recommend to the Minister possible adjustments to existing regulations (not simply their removal).

INTRODUCTION

2.1 Open Country submitted on the substantive issues in our process and approach submission dated July 2015 (our July submission).

2.2 This cross submission therefore:

(a) Addresses issues raised in submissions on the substantive issues paper;

(b) Comments on issues put forward in submissions;

(c) Relates the issues raised by other submitters to the points made in our July submission.

2.3 In Open Country's view the substantive submissions received:

(a) Confirm that the dairy industry does not yet have workable competition;

(b) Highlight our concerns regarding Fonterra's incentives without DIRA;

(c) Generally support Open Country's views on how DIRA should evolve to best promote efficient outcomes in the dairy industry.

2.4 Attached to our submission is a commissioned report from economic consultants Castalia. The report further analyses submissions with respect to open entry and exit (and non-discrimination), and the milk price regulatory oversight regime. This follows Castalia's report that was attached to our July submission (Castalia's July report). Also attached is a letter regarding Fonterra's offer to farmers of interest-free loans.

STATE OF COMPETITION

3.1 The consensus in all submissions, other than Fonterra's, is that there is not yet workable competition in either the farm gate or factory gate markets—consistent with our July submission.[1]

3.2 Open Country's experience is that Fonterra is clearly still setting market prices for milk. Independent processors simply cannot attract supply without offering a price that is benchmarked against Fonterra's milk price.

3.3 Our July submission noted that independent processors have had mixed success, and that recent investment is still untested. While there has been recent growth, we agree with Tatua that the current slump in commodity prices and outlook for slower growth in supply is likely to test the viability of recent investments. As a result, the Commission's review must be mindful that the current levels of competition (following the recent peaks in milk prices) are by no means entrenched and may erode over the commodity price cycle.

3.4 We also add that assessing competition based on the share of milk volumes processed may overstate the true level of competition where independent processors are not accepting, or cannot accept, new supply. Where other processors are at capacity, the competitive outcomes would be the same as not accepting supply (like Tatua) in practice—at least until any new planned capacity is operational. While NERA's report suggests planned investment in capacity by independent processors, this is limited to certain areas (in many cases existing sites), is subject to uncertainty (particular given recent milk price volatility), would take time to be available, and may already be largely pre-booked.[2]

OPEN ENTRY AND EXIT REGIME

4.1 As a result of the lack of workable competition and Fonterra's dominant role in setting prices, Open Country firmly believes that the industry has not reached the point where it can discipline Fonterra's market power without the open entry and exit regime.

4.2 It is pleasing to see support on this matter in submissions on substantive issues—particularly from Fonterra's economic advisors NERA.[3]

4.3 Fonterra argues that open entry should be removed because it: requires Fonterra to provide farmers with a 'free option' to re-enter Fonterra if they switch to an independent processor; and that Fonterra has insufficient ability to deal with costly new conversions.

4.4 First, this 'free option' is precisely the point of open entry. To describe it as an 'inefficiency' is to ignore that the cost it imposes on Fonterra is outweighed by the pro-contestability benefit of giving farmers the confidence to leave Fonterra.

4.5 Second, Fonterra already has the ability to deal with costly new conversions because it can impose a transport surcharge. There is no requirement in DIRA (or elsewhere in the law) for Fonterra to set a uniform price for milk. Section 106 of DIRA provides that the terms of supply for a new shareholding farmer in Fonterra must be the same as an existing shareholding farmer "in the same circumstances". Further, where circumstances differ, Fonterra is able to reflect these differences in its pricing approaches. This is entirely consistent with Fonterra's actions to date, which has included tactical pricing, as well as applying different pricing approaches with contract supply.

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1 Our July submission summarises the history of competition the dairy industry since DIRA; see pages 1-3.
2 As NERA notes in many cases new entry has been based on partnerships with large "cornerstone" suppliers.
3 Stakeholders who agreed with this position include: NERA, Danone, Tatua and Waimata Cheese.

Open entry and exit constrains Fonterra's incentives and without open entry Fonterra is likely to exercise its market power

4.6 As noted in Castalia's July report, Fonterra is likely to have both the incentive and ability to exercise market power without the open entry and exit provisions. This is consistent with NERA's findings in its 2010 report for the Ministry for Agriculture and Forestry. In that report NERA found that Fonterra would have both the incentive and ability to behave strategically against independent processors if the DIRA provisions were removed.[4]

4.7 There is a range of conduct Fonterra is likely to engage in without open entry and exit that would materially reduce the contestability of the farm gate market in a way that harms efficiency.

4.8 Tatua highlights past instances of tactical pricing by Fonterra. We also understand that Fonterra recently engaged in conduct related to the acquisition of New Zealand Dairies Limited (NZDL) which is being investigated by the Commission. Our understanding is that Fonterra's conditions for accepting milk from NZDL farmers included that:

(a) All farmers had to agree to supply Fonterra;

(b) Farmers had to purchase a minimum of 1,000 shares in Fonterra;

(c) Farmers were locked in to Fonterra for 6 years.

4.9 Further, MyMilk also has supply terms which are only available to new suppliers in Canterbury, Otago and Southland.

4.10 This gives some indication of the likely behaviour Fonterra would engage in without DIRA. Castalia comments further on Fonterra's incentives in the report attached to this submission. Submissions by Danone, Foodstuffs, Synlait, Waimata Cheese also support Fonterra likely having both the incentive and ability to exercise market power without open entry and exit.

Open entry and exit should remain in place, and there are more targeted ways to address Fonterra's concerns (if justified)

4.11 As a result of the importance of open entry and exit, and Fonterra's incentives and ability to exercise market power without these provisions, Open Country's view is that open entry and exit must be retained.

4.12 The attached Castalia report considers Fonterra's concerns and NERA's analysis in greater detail. It does not find compelling evidence that open entry obliges Fonterra to accept supply that results in net incremental costs. Further, Castalia finds that even if there was a justifiable concern regarding Fonterra's ability to deal with costly new conversions, there are targeted approaches to addressing this that do not undermine open entry and exit.

4.13 Open Country also considers the milk vat sale rule should remain in force but that practical improvements should be made. Our understanding is that currently a farmer must give notice to purchase a milk vat before giving notice of wanting to exit Fonterra (or at the time of giving notice, at the latest). This is an absurd result given that any decision to purchase a milk vat is merely a secondary matter to wanting to exit the co-operative. It

4 See page 18 of NERA "An Assessment of the DIRA Triggers", 30 March 2010.

would therefore be efficient for farmers to be able to provide notice of the intention to purchase a milk vat for a period after giving notice of wanting to exit Fonterra.

MILK PRICE AND MILK PRICE MANUAL

The milk price regulatory oversight regime should continue, and the Commission's role should be strengthened

Open Country supports the general consensus that retaining the milk price oversight regime will promote efficiency, and also give unitholders in the Fonterra Shareholders' Fund greater transparency around their investments.

5.1 As discussed in our July submissions, in addition to retaining the regime we suggest strengthening the Commission's role.

5.2 Where inputs are purely notional and the Commission is well-placed, the Commission should have the power to determine those inputs.

5.3 This is particularly true of the notional producer's weighted average cost of capital (WACC). We see no value in having Fonterra set the WACC for the notional producer, apart from giving Fonterra a lever to influence the milk price. Although Fonterra's discretion to set the WACC is limited to a range, even a small movement in WACC has significant effects on the practical feasibility of the milk price.

5.4 As Castalia notes, giving the Commission the ability to set the notional processor's WACC would both:

(a) allow the Commission to directly address practical feasibility concerns with the WACC (which it has already acknowledged);[5]

(b) promote consistency in the treatment of regulated businesses—because Fonterra's approach is inconsistent with the Commission's approach to the other businesses it regulates under Part 4 of the Commerce Act 1986.

OUTCOME OF THIS REVIEW

The Commission should consider and recommend incremental improvements that enhance efficiency

6.1 Open Country continues to urge the Commission to take a wider scope to its review. In particular, the Commission should consider incremental changes that improve the efficiency of the dairy industry, as sought in the Commission's substantive issues paper. This is consistent with a number of submissions (with the notable exception of Fonterra).

6.2 This approach would be:

(a) consistent with DIRA's legislative intent—which was to promote contestability and competition to the point where DIRA was no longer needed;

(b) ensure the Minister is fully informed with all credible options that address this intent.

6.3 We also suggest the Commission should consider further how downstream markets may be affected by DIRA's evolution. Foodstuffs, for example, argue that DIRA regulations are

5 Commerce Commission 'Review of Fonterra's 2014/15 Base Milk Price Calculation: Dairy Industry Restructuring Act 2001—Draft Report'

essential for competition in downstream markets. Further, Danone suggest they would exit the New Zealand dairy industry if the DIRA provisions were removed.

Open Country's views on how DIRA should evolve

6.4 Open Country's view is that this review should lead to:

(a) Open entry and exit remaining in place. Even if the Commission obtains evidence that Fonterra's concerns with accepting new conversions with high transport costs are justified, and result in net inefficiencies, a more targeted approach should be taken to address this;

(b) The milk price regulatory oversight regime continuing, and the Commission's role being strengthened;

(c) As discussed below, a fresh review of competition being scheduled for 2020.

TRIGGER FOR NEXT REVIEW

7.1 As discussed in our July submission, Open Country agrees with the Commission that a mechanistic approach whereby Fonterra reaching a percentage market share automatically triggers deregulation is inappropriate.

7.2 Our July report discussed the options for a process and trigger for a future review of competition.

7.3 Further to our July report, we suggest a review of dairy industry competition and regulatory settings be scheduled for 2020.

CONCLUSION

8.1 The evidence supports Open Country's view that there is not yet workable competition in the dairy industry.

8.2 Open entry and exit continues to play an important role in disciplining Fonterra's market power and addressing the "catch-22" for new processors in investing in capacity and attracting milk supply. Open Country supports the continued application of open entry and exit provisions.

8.3 We believe the scope of the review should incorporate recommendations on efficiency improvements possible in the application of the DIRA provisions. In particular, Open Country supports strengthening the Commission's role in the milk price regulatory oversight regime so that the Commission has the ability to determine notional inputs and the WACC of the notional processor.

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