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**Re: Consultation on substantive issues – review of competition in the dairy industry**

**1. Introduction**

1.1 We refer to the Commerce Commission's (**Commission's**) amended consultation paper dated 20 July 2015 in relation to its review of the state of competition in the New Zealand dairy industry (the **Dairy Industry Review**).

1.2 This letter sets out the substantive views of Nutricia Ltd and Danone Nutricia NZ Ltd (collectively referred to in this letter as **Danone Nutricia**) on the matters to be considered by the Commission as part of the Dairy Industry Review. In summary, Danone Nutricia considers that:

- (a) Fonterra is dominant in New Zealand's raw milk markets and as a result these markets are not currently competitive; and
- (b) regulation of the raw milk markets remains necessary in order for those markets to be workable and efficient, until Fonterra's market dominance is addressed.

1.3 Accordingly, Danone Nutricia considers that it is of paramount importance to ensure that the current regulations relating to:

- (a) the entry and exit of dairy farmers to and from Fonterra (e.g. no discrimination between suppliers, regulation of supply contracts for raw milk, right to supply independent processors, etc.);
- (b) the regulations providing independent milk processors with access to raw milk (i.e. the requirements for Fonterra to supply independents with raw milk); and
- (c) the regulations in relation to default milk pricing,

should at the very least be retained going forward.

**2. Background**

2.1 Danone Nutricia is part of Danone, a global dairy food corporation based in Paris. The Danone Group has operations in over 140 countries and has a collective turnover of over €21 billion. In New Zealand, Danone Nutricia manufactures the Karicare range of formula for infants and toddlers from its two blending, packaging and canning facilities in Auckland.

2.2 Danone Nutricia currently manufactures the milk powder required for its infant formula internally at its Balclutha spray drying facility which it acquired on 1 August 2014. [

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2.3 Previously, Danone Nutricia had acquired the majority of its milk powder requirements from Fonterra (with the balance acquired from Westland and Synlait). Danone Nutricia's supply relationship with Fonterra ended in March 2014 because of serious concerns as to Fonterra's food safety standards and lack of food safety culture.

2.4 Danone Nutricia is planning to invest in its NZ operations over the next 5 years. [

]. It sees the regulations applying to Fonterra as critical to support this growth.

### 3. **Current state of competition in New Zealand Dairy markets**

3.1 The proportion of milk collected by Fonterra has reduced from its inception to around 87%.<sup>1</sup> However, despite a reduction in the percentage of raw milk collected, it is still a very high proportion by global standards. In addition, in terms of total volume, Fonterra has reached a level far beyond the volumes produced in the early 2000's. As a result, Fonterra has retained or achieved a dominant position both domestically and in worldwide markets.

3.2 As a result of Fonterra's dominant position domestically at both the farm gate and the factory gate, it is generally able to dictate market conditions. This is especially the case in remote areas where there is little or no competition. Indeed, while there are now some regions with competition where the farmers can opt for a different supplier of raw milk other than Fonterra, there are a number of regions where there are still no alternatives.

3.3 Furthermore, New Zealand raw milk markets are not competitive when viewed from a global perspective. For example, in Germany, the national competition authority (Federal Cartel Office (FCO)) conducted a sector inquiry into the milk and dairy industry in 2011/2012 and published a very comprehensive report with its findings. The FCO states that no milk purchaser has a dominant market position on any of the regional markets in Germany (r. 41, para. 101 of the report) - though at the time market dominance was presumed under German law whenever market shares exceeded 33%. However, the FCO is still very concerned about "relatively strong" market positions and long-term contracts as well as a high degree of market transparency (p. 10, para.3).<sup>2</sup>

3.4 Until Fonterra's market share is materially reduced, there will continue to be little opportunity for meaningful competition for the collection or distribution of raw milk.

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<sup>1</sup> <http://www2.fonterra.com/our-financials/farmgate-milk-prices>

<sup>2</sup> This report is available at [http://www.bundeskartellamt.de/SharedDocs/Publikation/DE/Sektoruntersuchungen/Sektoruntersuchung%20Milch%20-%20Abschlussbericht.pdf?\\_\\_blob=publicationFile&v=4](http://www.bundeskartellamt.de/SharedDocs/Publikation/DE/Sektoruntersuchungen/Sektoruntersuchung%20Milch%20-%20Abschlussbericht.pdf?__blob=publicationFile&v=4)). The English version of this report is available at (note that the English version only covers some aspects less relevant to New Zealand): <http://www.bundeskartellamt.de/SharedDocs/Publikation/EN/Sector%20Inquiries/Milk%20Sector%20Inquiry%20-%20Final%20Report.html?nn=4143316>

#### 4. **Role of dairy regulations**

- 4.1 The current dairy regulations enable a degree of workable competition in dairy markets. Of utmost importance are the obligations on Fonterra in terms of:
- (a) exit and entry of farmers to and from Fonterra (e.g. no discrimination between suppliers, regulation of supply contracts for raw milk, right to supply independent processors, etc.);
  - (b) provision of raw milk to independent processors (i.e. the requirements for Fonterra to supply independents with raw milk); and
  - (c) default milk pricing.
- 4.2 Danone Nutricia considers that these regulations have enabled the independent supply to its Balclutha facility.
- 4.3 Danone Nutricia also sees these regulations as critical to its continued growth. The entry and exit provisions will allow Danone Nutricia to compete for supply from farmers within the region around its facility, while pricing regulations make pricing more transparent and mitigate tactical overpricing of milk by Fonterra.
- 4.4 As an additional consideration, although these regulations appear to be satisfactory for an established business (such as Danone Nutricia) to obtain raw milk supply, it appears unclear whether they provide a sufficient avenue for new entrants. Indeed, the 3 year exception rule<sup>3</sup> to the right to obtain raw milk from Fonterra does not appear to be long enough for a new manufacturer to establish its reputation.
- 4.5 In order to improve the current regulations so that new entrants are able to compete, Danone Nutricia considers that exception to the right to obtain raw milk from Fonterra should be extended to 5 years.

#### 5. **Deregulation counterfactual**

- 5.1 The removal of the dairy regulations would have a negative impact both on Danone Nutricia and other manufacturers of dairy products in New Zealand. Without the dairy regulations Danone Nutricia considers that Fonterra will:
- (a) seek to contract with farmers for long periods (e.g. 5 years+) particularly in areas where it considers competition is likely; and
  - (b) leverage its position in the market to absorb the balance of farmers' raw milk supply which is currently allocated to independent processors (using targeted tactical pricing, long contracts, etc.).
- 5.2 As a result, Danone Nutricia and other independent manufacturers may be precluded from acquiring new sources of milk supply in which case growth of product manufacturers outside of

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<sup>3</sup> I.e. Fonterra is not required to supply raw milk to an independent processor in a season beginning on and after 1 June 2016 if the independent processor's own supply of raw milk in each of the 3 consecutive previous seasons was 30 million litres or more.

Fonterra will stagnate. Furthermore, these tactics will create (potentially insurmountable) barriers to new entry, enabling Fonterra to solidify, or even grow, its dominant market position.

- 5.3 For example, Fonterra's latest marketing initiative, "My Milk", offers farmers the option to sell their milk without being a shareholder. Such initiatives could be used specifically to target farmers supplying independent processors with targeted pricing or supply conditions.
- 5.4 In terms of downstream markets, deregulation would give Fonterra a huge competitive advantage linked to its dominant position upstream. Absent regulation, with 87% of raw milk collection locked up by Fonterra, downstream competitors would be dependent on the willingness of Fonterra to supply them by its own choice. Danone Nutricia considers that it is clear that Fonterra would not have the incentive to do so.
- 5.5 The specific impact on Danone Nutricia from the removal of the dairy regulations would be that Danone Nutricia's ability to expand would be limited and Danone Nutricia would have to reconsider its future development in New Zealand. Furthermore, if Danone Nutricia's supply of raw milk is compromised, Danone Nutricia would be forced to consider leaving New Zealand in favour of countries with more suitable raw milk markets. (For example, Danone Group currently has factories in Europe, including Ireland, from which it can source competitive dairy products for the New Zealand market).

## 6. **Conclusion**

- 6.1 Fonterra's dominant position in New Zealand's raw milk markets has not yet resulted in meaningful competition developing. Should the dairy industry be deregulated, Danone Nutricia and other independent processors of raw milk would have significant difficulty obtaining sufficient raw milk supply at competitive prices. The likely result would be reduced competition in downstream dairy product markets and upstream (i.e. farmers will not likely to want to supply independents). Accordingly, until Fonterra's market dominance is addressed, the dairy regulations should either be kept as they are or tightened.