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Alex Sim

Chief Adviser, Regulation Branch

By email: regulation.branch@comcom.govt.nz

## Miraka Submission to the Commerce Commission:

### Consultation on substantive Issues – review of competition in the dairy industry (20 June 2015)

#### **1.0 Background**

- 1.1 The Minister of Primary Industries has requested the Commerce Commission to provide a report on the state of competition in the New Zealand dairy industry. The report has been requested in accordance with Section 148A of the Dairy Industry Restructuring Act (DIRA). The Commission issued a consultation paper dated 12 June 2015 (“Process and Approach”) and sought submissions from interested parties. Miraka forwarded a submission on that paper on 10 July 2015 (Submission 1). In a further paper dated 20 June 2015, the Commission has separately invited submissions on “substantive issues”.
- 1.2 Miraka addressed certain substantive issues in its Submission 1. This included (in section 4.2) a concern that the scope of the review of dairy competition did not include consideration of changes to the regulatory framework to more effectively meet the purpose of the DIRA (to ensure dairy market are contestable<sup>1</sup>. Miraka outlined two areas where changes in the regulatory framework are needed. This include the regulatory framework for setting the Base Milk Price (section 4.2.5).
- 1.3 This latest submission elaborates further on the regulatory framework for the Base Milk Price.
- 1.4 Miraka appreciates the opportunity to make this further submission on the review of dairy competition in New Zealand.

#### **2.0 The Regulatory Framework for the Base Milk Price**

- 2.1 In terms of assessing the adequacy of competition in dairy markets, Miraka recognises three distinct sub-markets, namely:
  - **the ‘factory gate’ market:** This involves the procurement and delivery of raw milk supplied on the basis of an even monthly volumetric profile (i.e. a ‘square curve’) from a processor by another processor.
  - **the ‘farm gate’ market:** This is where processors access raw milk directly from farmers.

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<sup>1</sup> Refer Section 4(f) of the DIRA.

- **the ‘processing’ or ‘manufacturing’ market:** This is where processors turn raw milk into dairy products.

Miraka’s focus in this submission is the interaction between the processing market and the farm gate market.

- 2.2 Given the relationship between competition *for* the farm gate market due to actual and potential competition *in* the processor market, Miraka considers the current competition review is an opportune time to revisit a range of issues and take account of practical lesson from the last three seasons.
- 2.3 In February 2012, Miraka submitted to the then Ministry of Agriculture on proposed amendments to the DIRA<sup>2</sup>. A key concern Miraka outlined in that submission was Fonterra’s ability to set a farm gate milk price based on the performance of a hypothetically efficient competitor (HEC). Miraka noted the HEC was assumed to have a higher value product mix and more efficient plants compared to Fonterra’s actual product and plant portfolio. This was rationalised as being consistent with the efficiency objective contained in section 150A of the *Dairy Industry Restructuring Act* (2001) (DIRA). Miraka, however, disputed this rationalisation arguing that price setting should be based on the marginal plant, which is the least efficient plant rather than the most efficient one (or notionally most efficient one).
- 2.4 Miraka argued that given (1) Fonterra’s market share in the farm gate market in the North and South Islands (over 80%) and (2) the role Fonterra’s farm gate milk price (FGMP) plays in setting the industry benchmark, Fonterra’s use of a HEC was inappropriate as it was anti-competitive in nature. This is because use of the HEC enables Fonterra to set an artificially high FGMP that competitors must match (otherwise competitors risk losing supply or fail to attract sufficient supply). The result is Fonterra is able to vertically foreclose its rivals via a process of margin squeeze. At the same time, Fonterra can avoid an HEC based price where it creates unacceptable margin squeeze on itself. This is because the HEC based pricing is at Fonterra’s discretion, and it can choose to set a lower milk price.
- 2.5 Compared to a counterfactual where Fonterra sets the FGMP based on its actual performance, Fonterra setting the FGMP on the basis of a HEC had three potentially chilling effects on competition, namely:
- Reducing contestability in the processing market
  - Decreasing the level of competition in the processing market, and
  - Reducing competition in the farm gate market
- 2.6 Miraka therefore contended that the use of the HEC is inconsistent with the contestability objective of section 4 (f) of the DIRA due to the potential for vertical foreclosure.
- 2.7 In 2012 Miraka co-commissioned analysis of Fonterra’s Milk Pricing Manual (MPM) by Professor Patrick Rey of the Toulouse School of Economics. A copy of that paper was

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<sup>2</sup> Miraka Submission to the Ministry of Agriculture and Fisheries: Response to MAF Discussion Paper No: 2012/1; 24 February 2012. A full copy of the paper is available on request.

attached to the Miraka submission of February 2012, and is again attached to this paper. Professor Rey is an expert in competition policy and an internationally renowned specialist regarding the issue of vertical foreclosure. Professor Rey has co-authored a number of the widely recognised key academic papers on the subject with 2014 Nobel Laureate Professor Jean Tirole.

2.8 Professor Rey's 2012 conclusions were:

2.8.1 The structure and set up of Fonterra is akin to the organisation of a cartel that permits farmers to capture rents at the expense of a range of parties, including independent processors and domestic consumers of dairy products.

2.8.2 The creation of Fonterra led to the establishment of a vertically integrated entity that has the incentive to foreclose downstream markets by degrading independent processors' access to regulated milk or through raising the farm gate milk price.

2.8.3 The removal of competitive pressures on Fonterra, combined with an atomistic shareholder base, may give Fonterra additional incentives to foreclose its downstream rivals.

2.8.4 Squeezing competitors' margins is not in farmers' long term interests as it could result in higher processing costs than would arise from a competitive market.

2.8.5 Fonterra's MPM appears to rely on some average plant of Fonterra (dedicated to the product mix that its rivals seem to be targeting). However, in a competitive market, prices are instead determined by the cost of the marginal plant – that is, the least efficient plant amongst those operating.

2.8.6 An approach based on Fonterra's MPM will bias the milk price upwards. This prevents potential rivals from entering the processing market because the incentive to do so (the opportunity from more efficient processing) has been eroded by a higher milk cost. At the same time for those that are successful in entering the market, the margin squeeze from the high milk cost reduces the opportunity to invest in higher returning opportunities. This same problem would also shackle Fonterra.

2.9 In the interests of clarity, it is useful to define what is meant by vertical foreclosure. Vertical foreclosure occurs when a firm controls access to, or sets the price of access to, a 'bottleneck facility' (e.g. a railroad). The monopolist can act in an anti-competitive fashion by:

- Restricting a competitor's access to that bottleneck facility; or
- Setting the price of access at such a level as to reduce the profitability of rivals – potentially up to the point a rival becomes unprofitable once the access price has been paid.

Miraka considers the notion of vertical foreclosure is a relevant and useful conceptual framework in this instance as raw milk can be conceptualised as being akin to a bottleneck facility; with vertical foreclosure impacting on competitors through a **pricing** route and an **access** route.

- 2.10 It is useful to tease through the implications of Fonterra's ability to vertically foreclose its competitors on the pricing and access routes.
- 2.10.1 In terms of the pricing route, it is relevant to note that procurement of raw milk represents the vast majority of most dairy processor's costs. The static effect of an artificially high FGMP is that it reduces a firm's profitability (and hence its ability to reinvest - via surpluses - and/or pay dividends). This in turn reduces the level of competition (as lower profitability will result in fewer firms compared with a situation where margin squeeze was not taking place).
- Margin squeeze also makes a market less contestable: while a firm will stay in an industry as long as it is earning its weighted cost of capital (WACC), for a firm to enter or expand typically requires a higher return than WACC (and the margin squeeze abates that away).
- 2.10.2 In terms of the access route an artificially high milk price (which would correspond with an artificially low Fonterra share price) starts undermining the open entry and exit regime: while it may become easier to enter (because share prices are low) it would be harder to convince farmers to switch (especially if farmers perceive they are leaving 'money on the table' via having an under-priced share). It is also notable that the inflated milk price is a double whammy for Fonterra: margin squeeze leads to both a reduced surplus for investment opportunities AND a deflated share price with the latter meaning some of that squeezed margin is redirected back to commodity plant to fund processing capacity growth).
- 2.13 The 2013/14 season provides a salutary example of the distortions the use of the HEC by Fonterra not only imposes on the industry, but also on itself. The 2013/14 season was unique as the price of powder products spiked compared to other product streams (e.g. cheese or protein products). Given the HEC is based on powder stream prices the milk price that could be paid by the HEC also spiked. This resulted in:
- The collapse of the Fonterra dividend;
  - A substantial margin opening between the price the HEC could pay and the maximum price Fonterra could actually afford (which forced Fonterra to abandon its milk price manual and reduce the farm gate milk price by 53 cents kgMS below what the HEC could theoretically pay; and
  - The Fonterra share/unit price suffering a substantial loss in value (from which it is yet to recover; the share price was further damaged by the low dividend projection for 2014/15 being contrary to quite proper market expectations that the decline in milk price should have increased profitability.
- 2.14 The simple point is the industry only avoided significant economic harm imposed by Fonterra's HEC because the HEC also threatened to vertically foreclose Fonterra itself, thus forcing the Fonterra Board to abandon its own milk price manual (indeed, had the Board not intervened Fonterra would have needed to undertake substantial borrowings in order to match the theoretical milk price set by the HEC).
- 2.15 It is anomalous that the HEC provides Fonterra an instrument with which it can impose vertical foreclosure on its competitors, while at the same time Fonterra can abandon the HEC when it does not suit it. The HEC is justified on the basis of a policy objective of

achieving static efficiency for Fonterra. In Miraka's view, its actual effect is to undermine dynamic efficiency in the wider market. It therefore undermines the proper emergence of a competitive market, or the very thing which would incentivise Fonterra efficiency. In this way it is antithetical to the overarching purpose (section 4 (f)) of the DIRA.

- 2.16 In comparison to 2013/14, the 2014/15 season saw the price of all product streams decline severely, which was reflected in a dramatically lower FGMP. In such a situation, processor profitability should increase as the key input price (milk) has decreased – with the result being a substantially higher dividend. However, Fonterra's dividend payment was substantially less than market expectations; which is entirely consistent with Fonterra suffering margin squeeze via vertical foreclosure induced via the HEC and an artificially high milk price.
- 2.17 Taking this a step further, it is difficult to see how Fonterra can have a credible dividend or retention policy whilst employing a margin squeezing HEC as the basis for setting the FGMP (with implications for the rest of the industry given the effect is for all farmers (not just Fonterra farmers) to capture rents that should have accrued to processors). Whilst such a policy would be inconsistent with the profit based objectives of commercial firms, as a cooperative this behaviour is perfectly logical behaviour for Fonterra: farmers prefer to maximise the milk price - both in its own right but also because receiving returns via higher profits and dividends also means a higher share price, making it more difficult for them to grow their business rough (milk growth requiring increased share investment).
- 2.18 In short, a milk pricing framework that permits a dominant firm to impose vertical foreclosure on its rivals via margin squeeze, and this in the guise of achieving objectives of static productive efficiency, cannot be consistent with the competition policy objectives of the DIRA; that it also undermines the dynamic efficiency of New Zealand's largest dairy processor illustrates the extent to which it is wrong.
- 2.19 In addition to reducing actual and potential competition in the processing and farm gate markets, and imposing a negative impact on processor profitability (and therefore the potential for dynamic efficiency higher levels of re-investment from retained earnings) the HEC potentially has a more corrosive effect on the functioning of dairy markets as it blunts the transmission of accurate price signals.
- 2.20 For example, a market is typically conceptualised as a decentralised discovery process that is inherently dynamic in nature – indeed, this is a reason why competition and contestability are so important. While the level of competition within a particular market at any particular point in time can be analysed via a range of static measures (e.g. industry concentration ratios, measures of market share by firms, measures of contestability, counterfactual analysis, ability to foreclose rivals, etc.) the limitation with this approach is the absence of a process or pathway between the 'point in time' assessments as to whether the level of competition is (or is not) sufficient – or more starkly, if it will ever be sufficient (and if not, why not)?
- 2.21 In short, while it is one thing to undertake 'point in time' assessments of whether competition is sufficient or not, such assessments are limited without taking into account of the need for a dynamic process that will result in sufficient competition

developing – because there is no reason why the processor and farm gate markets cannot be both contestable and competitive – but the irony is permitting Fonterra to price on the basis of HEC introduces margin squeeze that cuts across this.

2.22 The previously noted Miraka submission to MAF included a number of other supporting papers. This included a paper by Dr Michael Pickford (economic consultant and former chief economist to the New Zealand Commerce Commission) which remains especially relevant to this latest submission. A copy of Dr Pickford’s paper is attached to this paper.

2.20.1 While it is understood that a re-write of subpart 5A of the DIRA goes beyond the Commission’s mandate, if the goal is for sufficient competition to develop in order that DIRA can ultimately drop away, the Commission needs to give serious consideration to how it interprets the statute to ensure an appropriate weighting is given to the contestability objective as well as the efficiency one. Beyond that, Miraka contends that the scope of the competition review needs to broaden to include the appropriate agency of Government that can consider the issues raised in this paper.



Richard Wyeth,  
Chief Executive Officer,  
Miraka Ltd.