Review of the state of competition in the New Zealand dairy industry

Consultation paper – process and approach

Date: 12 June 2015
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Why we have written this paper

Purpose of this paper

1. We have been asked by the Minister of Primary Industries to produce a report on the state of competition in the New Zealand dairy industry.

2. This paper:
   2.1 outlines the process we intend to follow;
   2.2 outlines our proposed approach for addressing the objectives and key questions in the terms of reference; and
   2.3 seeks interested parties’ views on this approach and whether or not there are further matters that we should analyse or bear in mind.

3. We invite interested parties to provide their views on this paper.

4. Submissions on this paper are due by **5pm, Friday, 10 July 2015**.

5. Cross-submissions are due by **5pm, Friday, 24 July 2015**.

Why we are doing this review

6. Section 148A of the Dairy Industry Restructuring Act 2001 (DIRA) requires the Minister, in consultation with the Minister of Commerce, to request a report on the state of competition in the New Zealand dairy industry if such report has not already been requested under s 148(1) before 1 June 2015.¹

7. Within 90 days of receiving our report, s 148(3) of the DIRA requires the Minister to give notice of whether he:

   **Intends to promote the enactment of legislation that resets either or both of the market share thresholds specified in s 147 or to promote the adoption of measures that provide a transition pathway to deregulation, or to promote both²**

8. The purpose of the report is, therefore, to provide the Minister with an independent view on the state of competition in the dairy industry, to assist him in making the decision required under s 148(3) of the DIRA.

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¹ Under s 5 of the DIRA, “Minister” means the Minister of the Crown who is responsible for the administration of the DIRA. The DIRA is administered by the Ministry for Primary Industries.

² Section 147 of the DIRA sets out market share threshold triggers which specify when the industry-specific regulations relating to Fonterra’s conduct will cease to operate in each of the North Island and South Island.
Structure of this paper

9. We first explain the scope of the report, our process for reporting to the Minister, and how interested parties can contribute.

10. We then explain our initial views on how to approach the review. We set out our framework for evaluating the sufficiency of competition, the relevant markets, and our initial thoughts on resetting the thresholds and pathways to deregulation.

The scope of our report

11. The scope of our report is determined by the terms of reference issued to us by the Minister.³

12. The objectives of the report under the Terms of Reference are:

12.1 to provide an assessment of the state of competition in the New Zealand dairy industry; and

12.2 if the state of competition is insufficient, to ascertain whether the market share thresholds should be reset, the options for a transition pathway to deregulation (if any), and whether particular deregulation options (if any) should be pursued.

13. Our report to the Minister must address specific questions that have been included in the Terms of Reference. These questions are:

13.1 What is the state of competition that exists in the relevant New Zealand dairy markets, in particular the farm gate and factory gate markets?

13.2 In relation to the wholesale and retail dairy markets, is there new information that would alter the conclusions reached in the Commission’s preliminary inquiry into domestic milk markets in 2011 under Part 4 of the Commerce Act?

13.3 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 (together referred to as “the regulations”):

13.3.1 Is the current state of competition in the relevant New Zealand dairy markets sufficient to ensure the efficient and contestable operation of these markets?

13.3.2 Would Fonterra 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?

13.4 If the current state of competition is insufficient in one or more of the relevant New Zealand dairy markets, the Terms of Reference asks us to address these additional questions:

13.4.1 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))? 

13.4.2 Are there other expiry triggers that should be provided for, either in addition to or in place of the market share thresholds? 

13.4.3 What options there are for a transition pathway to deregulation, and if there are any, which of the options should be pursued? 

13.5 In undertaking our assessment of whether the state of competition in the relevant New Zealand dairy markets is sufficient or insufficient, we will examine the impact of the regulations on competition and the efficient operation of those dairy markets. 

13.6 If we find that the state of competition is insufficient, we may suggest changes to the existing regulations as part of one transition pathway option that could be pursued. We may also suggest that certain components of the current regulations could be continued or revoked. 

13.7 We do not intend to conduct a specific review that sets out to identify whether or not different regulations would better promote efficient New Zealand dairy markets. Policy issues and choices on how to best give effect to the objectives of the DIRA are outside the scope of our review, and are rather issues for consideration by the Minister.
Next steps: Our process for reporting to the Minister

14. Table 1 sets out our process steps and indicative dates.

<table>
<thead>
<tr>
<th>Indicative date</th>
<th>Process step</th>
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<tbody>
<tr>
<td>10 July 2015</td>
<td>Submissions on this consultation paper are due.</td>
</tr>
<tr>
<td>24 July 2015</td>
<td>Cross-submissions on this consultation paper are due.</td>
</tr>
<tr>
<td>June – July 2015</td>
<td>Planned period for interviews with market participants.</td>
</tr>
<tr>
<td>Early Nov 2015</td>
<td>Draft report published. This will include our findings on the state of competition, and our initial views on pathways to deregulation and resetting of thresholds. We will be seeking submissions.</td>
</tr>
<tr>
<td>Late Nov 2015</td>
<td>Submissions due on draft report. We anticipate providing four weeks for submitters to provide their views.</td>
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<tr>
<td>Mid Dec 2015</td>
<td>Cross-submissions due. We anticipate providing two weeks for cross submissions.</td>
</tr>
<tr>
<td>29 Feb 2016</td>
<td>Final report published.</td>
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</tbody>
</table>

15. Our process and indicative dates may change. Any changes to these dates will be posted on our website.⁴

16. If interested parties have any questions about this process, they should contact us at regulation.branch@comcom.govt.nz

How interested parties can contribute

17. Interested parties can send us written submissions on this paper and will also be invited to comment on our draft report.

18. We invite interested parties to provide written submissions on this paper no later than 5pm, Friday, 10 July 2015.

19. We invite cross-submissions on this paper no later than 5pm, Friday, 24 July 2015.

20. Submissions on this paper should be addressed to:

   Alex Sim
   Chief Adviser, Regulation Branch
   c/o regulation.branch@comcom.govt.nz

21. We are particularly interested in whether or not interested parties agree with our proposed approach and whether we have identified all key issues that should be considered when conducting the review. We have included a number of specific questions in this paper to assist interested parties in providing feedback.

22. Less weight may be given to a statement or submission that a party cannot support with corroborating evidence, than a statement or submission that a party can support with corroborating evidence.

23. In addition to written submissions, we anticipate requesting information from and interviewing a number of industry participants as part of our review. We will contact the parties we consider best able to provide information to help us assess the issues we have identified below.

Format for responses
24. Please include “Submission on the Dairy Competition Review Consultation Paper, 12 June 2015” in the subject line of your email. We prefer submissions in both a format suitable for word processing (such as a Microsoft Word doc), and a ‘locked’ format (such as a PDF) for publication on our website.

Disclosure of your submission
25. We intend to publish all submissions on our website. We encourage full disclosure of submissions so that all information can be tested in an open and transparent manner. However, we offer guidance below where interested parties wish to provide information in confidence.

25.1 Where confidential information is included in a submission, such information should be clearly marked.

25.2 Both confidential and public versions of submissions should be provided.

25.3 The responsibility for ensuring that confidential information is not included in a public version rests on the party providing the submission.

26. Parties providing us with information can request us to make orders under s 100 of the Commerce Act in respect of information that they do not wish to be made public.

27. Any request for a s 100 order must be made when the information is supplied to us, and must identify the reasons why the relevant information should not be made public. We will provide further information on s 100 orders if requested by parties.

28. Any s 100 order will apply for a limited time only. Once an order expires, we will follow our usual process in response to any request for information under the Official Information Act 1982.
Our initial views on the approach to the review

Our interpretation of “sufficient” and “insufficient”

29. The approach we propose in order to determine whether the state of competition is sufficient or insufficient is to assess whether the relevant New Zealand dairy markets would be more efficient with or without the regulations.

30. The objectives of the Terms of Reference (ie what we must ascertain) are the s 148 provisions referred to in paragraph 12 above.

31. Therefore, we must answer the specific questions in the Terms of Reference referred to in paragraph 13 above, in the context of interpreting the s 148 provisions.

32. Under s 148(2)(d)(ii) of the DIRA we are required to determine whether or not the state of competition in the relevant New Zealand dairy markets “is insufficient”.

33. The questions in the Terms of Reference, however, require us to determine whether:

33.1 the state of competition in the relevant New Zealand dairy markets is sufficient to ensure the efficient and contestable operation of those markets; and

33.2 if the state of competition is insufficient to consider market share thresholds for deregulation, other potential triggers for deregulation, options for a transition pathway to deregulation, and what options for deregulation should be pursued.

34. As neither the DIRA, nor the Terms of Reference explain or define when the state of competition will be “sufficient” or “insufficient”, we have to decide what these terms mean, when we conduct our review.

35. Our preliminary interpretation is driven by the overriding purpose of the DIRA, and the obligations it imposes upon Fonterra to promote the efficient operation of New Zealand dairy markets.\(^5\) We, therefore, consider that the most appropriate meaning of the words “sufficient” and “insufficient” is an interpretation that best gives effect to that efficiency purpose.

36. In order to assess whether the state of competition in the New Zealand dairy markets is sufficient, we will assess whether the competition is sufficient to ensure the efficient and contestable operation of the markets even without the regulation. If so, we would recommend deregulation. If not, we will go on to assess whether the markets would be more efficient with deregulation, even if it did not meet the efficient and contestable standard.

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\(^5\) See s 4(f), s 70, s 71 and s 150A(1) of the DIRA.
37. If the relevant markets work more efficiently without the regulation, then the regulation is no longer promoting the DIRA purpose and the state of competition will be sufficient in s 148 terms. If not, then the state of competition will be insufficient.

The relevant markets

38. The Terms of Reference asks us to report on the state of competition in the relevant New Zealand dairy markets. Market definition provides a framework to help identify and best isolate the key competitive constraints faced by market participants. As noted in the Terms of Reference, the regulations are directed at two product markets, being:

38.1 a farm gate market – in which dairy farmers supply raw milk to dairy processors and dairy processors compete to secure farmer supply; and

38.2 a factory gate market – in which dairy processors supply raw milk they have collected from farmers to other processors (this includes the current regulated supply of raw milk by Fonterra to independent processors) and some food and beverage manufacturers.

39. Consistent with past decisions of the Commission and in order to accurately assess the state of competition, we propose to examine regional farm gate and factory gate markets. We will consider more closely the geographic boundaries of the relevant markets as part of our investigation.

40. We do not propose to analyse the state of competition in other dairy markets. This includes markets in which dairy processors supply cream and other inputs to food producers and markets for the wholesale and retail supply of specific dairy products. We do not consider that the scope of the Terms of Reference extends to detailed analysis of these markets, as they are not covered by the regulations. However, we intend considering these markets at a high level as part of evaluating access issues and the costs and benefits of regulation (or the removal thereof).

How we will evaluate the state of competition

41. In conducting our review, we propose to compare the likely state of competition that would exist with deregulation (ie, in the absence of the regulations) with the state of competition under the status quo (ie, where the regulations continue).

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7 For example, we may consider how the removal of regulations requiring Fonterra to supply raw milk to independent processors might impact on the ability of independent processors to compete with Fonterra in the wholesale and retail supply of specific dairy products.
42. We consider that our assessment of the state of competition with and without the regulations should distinguish between the different regulations that are in place. As part of our analysis of the two scenarios, we intend to separately examine the likely state of competition with and without:

42.1 Subpart 5 of Part 2 of the DIRA (which sets out, amongst other things open entry and exit requirements for Fonterra farmers);\(^8\)

42.2 Subpart 5A of Part 2 of the DIRA (which sets out provisions around Fonterra’s base milk price);

42.3 the provisions of the DIRA Raw Milk Regulations (which provide for the regulated supply of raw milk by Fonterra to independent processors);\(^9\) and

42.4 all the regulations referred to in paragraphs 42.1 to 42.3, or different combinations thereof.

43. A comparison of the extent of competition under these scenarios will enable us to assess (as requested in the Terms of Reference), under each of the above counterfactuals, whether Fonterra would be likely to have both the ability and the incentive to exercise market power against competitors, suppliers or purchasers in the relevant dairy markets in the absence of some, or all, of the regulations. This will allow us to conclude whether the current state of competition in the relevant New Zealand dairy markets is sufficient to ensure the efficient and contestable operation of these markets.

44. We intend to evaluate the state of competition by examining both how competition has developed since Fonterra was established and how competition may develop in the future. In examining how competition has developed, we intend to focus on what has changed in the five years since the Government’s 2010 review of competition in the dairy industry.

45. In examining how competition has developed to date and may develop in the future, we propose to examine generally and, where applicable and practical, for each farm gate and factory gate market:

45.1 the extent to which independent processors have entered, exited and expanded, relative to expansion by Fonterra and the growth of the market;

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\(^8\) In examining the impact of the Subpart 5 of Part 2 of the DIRA, we may examine distinct provisions within this Subpart separately (eg, sale of milk vats, 20% rule).

\(^9\) In examining the impact of the regulations that require Fonterra to supply raw milk to independent processors, on the likely future state of competition, we will have regard to reg 6(3) which provides that from 1 June 2016 independent processors that have collected (in three consecutive seasons) 30 million litres or more of raw milk from their own farmer suppliers will no longer be eligible for regulated milk.
45.2 how the proportion of farm gate milk collected by independent processors and the amount of factory gate milk supplied by Fonterra to independent processors have changed over time and are forecast to change in the future;

45.3 the extent to which independent processors compete with Fonterra in the supply of factory gate milk (including competition around the price paid to dairy farmers);

45.4 the extent of switching by dairy farmers between dairy processors; and

45.5 whether further entry and/or expansion by independent processors is planned or otherwise likely to occur (eg, through the development of new or expanded processing plants or increasing the number of direct farmer suppliers), as well as the extent and timing of any entry and/or expansion.

46. We will further consider to what extent the regulations have positively or negatively impacted competition and the efficiency of the markets over time. For example:

46.1 how the open entry and exit provisions in Subpart 5 of Part 2 of the DIRA have facilitated entry and expansion by independent processors to date and how removal of these provisions would likely impact on future entry and/or expansion;

46.2 how the requirement set out in provisions of the regulations that Fonterra supply raw milk to independent processors has facilitated entry and expansion by independent processors to date and how removal of this requirement would likely impact on future entry and/or expansion; and

46.3 the impact of the base milk price monitoring regime contained in Subpart 5A of Part 2 of the DIRA, on entry and expansion by independent processors to date, and how removal of these provisions would likely impact on prices in the future as well as future entry and/or expansion.

47. If Fonterra cannot exercise significantly more market power in a market without the regulations than with the regulations, under any of the counterfactuals we assess, we will conclude that the state of competition is sufficient and recommend deregulation.

48. If Fonterra can exercise significantly more market power in a market without the regulations than with the regulations, under any of the counterfactuals we assess, then we will conclude that there is insufficient competition in that market. We will then consider whether the market share thresholds should be reset. In doing so, we will also consider the forms of the thresholds. That is, whether the thresholds usefully illuminate competition concerns to trigger the timely assessment of these markets.
49. Our assessment of Fonterra’s market power will consider whether without regulation:

49.1 Fonterra would be likely to increase farm gate prices above competitive levels, or otherwise change its terms and conditions of supply, thereby excluding potentially more efficient processors;

49.2 Fonterra would be likely to decrease farm gate prices below competitive levels, thereby suppressing supply; and/or

49.3 Fonterra would be likely to exercise market power through increasing factory gate prices above competitive levels.\(^\text{10}\)

50. To the extent that Fonterra has only a marginally greater ability and incentive to exercise market power without regulation then we would likely need to explicitly consider the efficiency impacts of regulation.

51. If we conclude that all the relevant markets would be sufficiently competitive to warrant deregulation because they would be more efficient without the regulations under all the counterfactuals, then we do not have to assess whether or not the market share thresholds should be reset and options for pathways to deregulation.

52. If the markets are insufficiently competitive to warrant deregulation because they would be more efficient with all or some of the current regulations, then we will consider what pathways to deregulation may be appropriate. Importantly, not all regulations may need to be retained in order to reap the benefits of regulation accruing to the markets.

53. Each of these options is discussed in more detail below.

How should the market share thresholds be reset?

54. If we determine that there is insufficient competition in any of the relevant New Zealand dairy markets, the Terms of Reference asks us whether either or both of the market share thresholds specified in s 147 of the DIRA should be reset (and if so, to what levels).

55. The provisions in the regulations directed at ensuring contestability were not intended to last for an indefinite period of time and it was anticipated that they would fall away when a sufficient level of competition had been reached.

\(^{10}\) Consideration of allocative inefficiencies resulting from the use of market power involves a longer term assessment and incorporates not only the current state of competition, but also how the market might unfold in the future with and without the regulations. In addition to allocative inefficiencies, productive inefficiencies can result if Fonterra’s costs are higher than they would be in a more competitive market. Dynamic inefficiencies would occur if Fonterra has lower incentives to innovate than in a competitive market.
56. The DIRA therefore included triggers which set out when the industry-specific regulations relating to Fonterra’s conduct would cease to operate in each of the North Island and South Island.

57. Section 149 of the DIRA states that subparts 5 (except s 134) and 5A of the DIRA expire in the relevant islands, ie, the North and/or South Island, if, as provided by s 147, independent farmers have directly or indirectly collected 20% or more milk solids on or from dairy farms in a season in the relevant island.

58. NERA, in 2010, provided an evaluation of the DIRA triggers. NERA concluded that the “DIRA triggers are quite mechanistic and simplistic. While quantities and market shares have a role in competition analysis, they are just one consideration”. ¹¹

59. NERA also concluded that:¹²

While it is important that the DIRA should be removed at some point (when the market is workably competitive), it would seem inappropriate for the expiry of the DIRA to be triggered by simple quantity and/or market share thresholds. In our view, a more comprehensive competition analysis should be required.

60. NERA went on to suggest that the thresholds be used to trigger a comprehensive competition analysis, rather than for the automatic expiry of the DIRA.¹³

61. The current thresholds do not appear to provide a meaningful representation of the level of competition in the industry as these thresholds are not, for example, based on the relevant markets. Therefore, it is likely that we will agree with NERA that the decision to remove the regulations should rather be based on a comprehensive competition analysis.

62. Under the Terms of Reference, we are only required to answer this question if we determine that there is insufficient competition in any of the relevant New Zealand dairy markets. However, we are interested in interested parties’ views on this matter. Do interested parties agree that it would be more appropriate to base the removal of the regulations on a more comprehensive competition analysis, rather than the current threshold triggers?

63. Do interested parties think that the current triggers set at 80% are at an appropriate level to trigger either the removal of the regulations, or to trigger a more comprehensive competition analysis? If not, what do interested parties consider to be more appropriate?

¹² Ibid, at 25.
¹³ Ibid.
What options, if any, are there for a transition pathway to deregulation?

64. If we determine that there is insufficient competition in any of the relevant New Zealand dairy markets, the Terms of Reference asks us what options, if any, there are for a transition pathway to deregulation.

65. We are of the view that the right condition that would need to be met, prior to recommending the removal of the regulations, would be that the markets are likely to be more efficient without the regulations, than with the regulations. This is because the overall purpose of the regulations is to promote the efficient operation of the markets as discussed in paragraph 35.

66. 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.

67. We will use our assessment of the current state of competition and the state of competition without the regulations to better understand the impact of the potential options for a transition pathway to deregulation.

68. In considering pathways to deregulation we may consider matters such as:

   68.1 whether all the regulations would be removed at once; or

   68.2 whether the removal of the regulations should be staggered.