10 July 2015

SUBMISSION ON THE DAIRY COMPETITION REVIEW CONSULTATION PAPER 12 JUNE 2015

To: Alex Sim  
Chief Adviser  
Regulation Branch  
Commerce Commission  
c/o regulation.branch@comcom.govt.nz

Introduction
1. This Submission is made by Westland Co-operative Dairy Company Limited (Westland).

2. Westland can be contacted by reference to the following:
   - Catherine Walker, General Counsel, Westland Co-operative Dairy Company Limited, 41 Westland Place, PO Box 138, Rolleston, Christchurch. Ph. (03) 371 1676

Westland – Background

3. Westland is an independent co-operative dairy company owned by approx. 350 supplying shareholders supplying milk from approx. 430 dairy farms. Westland’s suppliers are located on both the West Coast of the South Island and Canterbury with approx. 20% of the milk supply being collected from Canterbury suppliers.

4. Westland competes with Fonterra and Synlait in the Canterbury region for milk supply.

5. Westland has purchased milk from Fonterra under the regulations to the Dairy Industry Restructuring Act 2001 (DIRA or the Act) in the 2010/11 to 2013/14 seasons (inclusive).

6. Westland has also sold and purchased milk and/or related products to/from other processors including Goodman Fielder, Synlait, NZ Dairies (prior to acquisition by Fonterra), Oceania, Fonterra, Open Country, Mondelez and Talleys.
7. Currently, in a dairy season, Westland processes more than 600 million litres of milk from the West Coast and up to 160 million litres from Canterbury.

Executive Summary
8. Westland considers that in the main there is sufficient competition in the Dairy Industry but that in order for this to continue parts of the current regulatory regime must remain, especially those relating to freedom of entry and exit (of Fonterra’s suppliers).

9. As illustrated in our submission, Westland has experienced good competition for factory gate milk (the market in which processors supply raw milk collected from its farmers to other processors and some food and beverage manufacturers) and considers this is likely to be the same or will increase without the regulations.

10. However, competition for farm gate milk (the market in which dairy farmers supply raw milk to dairy processors and dairy processors compete to secure farmer supply) is at risk from Fonterra’s dominance in this market. As noted below, a number of actions have been taken by Fonterra that hinder withdrawal from Fonterra by its suppliers and it has taken actions which are contrary to the purpose and principles of DIRA. Unfortunately a number of the regulations pertaining to farm gate milk have largely been either unused or appear to have been ineffective but in so far as they are intended to promote the concept of freedom of entry and exit (to/from Fonterra) we support their continuance.

ComCom’s proposed approach
11. On the whole we agree with the Commerce Commission’s approach:

- **If there is sufficient competition to ensure efficient and contestable operation of these markets even without regulation then the regulatory regime is no longer needed; or**

- **If there is insufficient competition to meet the efficient and contestable standard then we need to consider:**

  The expiry provision (section 147 of the Act) sets the market share thresholds for both the North and South Island at 20% - requiring independent processors to have collected 20% or more of milksolids from dairy farms in the respective Island in a season.
Should we reset the market share threshold and are there other expiry triggers that should be added? and

What options are there to transition to deregulation that should be taken?

12. We are supportive of the markets being defined as the market for factory gate milk and the market for farm gate milk. Our analysis above demonstrates the two markets have different drivers and accordingly it is logical to work through the above approach market by market.

13. We consider that it is possible to remove some of the provisions whilst leaving others. In particular it is important to retain Section 97 “the right to withdraw” and whilst not entirely satisfactory, in the absence of the introduction of new regulations, then it is also important to retain Section 106 “No discrimination between suppliers”, Section 107 “Regulation of supply contracts for raw milk.”

Current State of Competition – for Farm Gate Milk

14. Westland can speak with authority on the state of competition for Farm Gate Milk as it has established a Canterbury supply base from zero in the past 5 years.

15. In 2010 Westland commissioned a reverse osmosis plant at Rolleston in Canterbury and in the 2011/2012 dairy season we commenced collecting milk from supplying shareholders in the Canterbury region destined for our manufacturing plant in Hokitika. The majority of those Canterbury suppliers were new dairy conversions with a small number of farms who made the switch from supplying Fonterra to supply us.

16. As noted above, today 20% of our milk supply is from our Canterbury shareholder base.

17. Westland has been extremely successful in attracting milk supply from dairy farm conversions but by comparison less successful in attracting existing Fonterra suppliers to switch their supply across to us. In fact, today only approx. 25% of our Canterbury shareholders have made that switch to us from Fonterra.

18. We are concerned that actions employed by Fonterra in response to competition for milk supply at the farm gate demonstrate that Fonterra has used, and has the potential to continue to use, its position of dominance to restrict competition and thus there remains the need for regulation of Fonterra in order to sustain competition in this area.

19. Those actions, that we believe are designed to lock in Fonterra suppliers thus restraining suppliers from exiting Fonterra, include:
19.1. long term supply agreements between Fonterra and its suppliers

19.2. the establishment of mymilkTM

19.3. There is also the fact that Fonterra has on occasion departed from the Milk Price manual which in our view is an endeavour to retain and attract milk supply from dairy farmers.

20. Long term supply agreements: We are aware of a variety of long term supply agreements offered by Fonterra to new suppliers. Typically these relieve the new supplier from the usual requirement to meet Fonterra’s share standard (1 share for every kg ms supplied) when supply commences and instead allow the supplier to “share up” over time but also lock that milk supply in. We understand that in some cases these contracts cannot be terminated until the end of the seventh year of supply. On a number of occasions Fonterra suppliers who have indicated a desire to supply Westland have discovered that they have entered into such arrangements and have been precluded from switching over to Westland, even though that was their preference.

21. mymilk™: We are concerned that the creation of the Fonterra subsidiary, Mymilk Limited (marketed as mymilk™), is a further response by Fonterra to limit competition for farm gate milk. Mymilk™ is based on the contract milk supply model rather than the co-operative dairy company model and does not require suppliers to own shares. It is understood that Mymilk™ offers 5 year supply agreements, again seeking to secure long term milk supply. The Regulations do not appear to have contemplated such a development in which case it is arguable whether they will regulate the conduct of Mymilk™.

Future State of Competition – for Farm Gate Milk

22. We have resource consent for the development of an Infant Toddler Nutrition plant at Rolleston and have several years remaining in which to exercise that consent. If we proceeded with that venture it is probable that we would seek to attract additional milk from within the Canterbury region.

23. In addition to our own plant development (both current and future), the growth in start up dairy processors throughout the South Island and North Island is increasing the demand for new milk supply by way of conversions or from existing milk suppliers switching their milk supply. For example, in the South Island we also have the following processors: Gardians(Danone), Oceania(Yili), Synlait and Open Country. We believe there are another two companies with plans to collect farm gate milk – one of these is in Mataura.
Current State of Competition – for Factory Gate Milk

24. In our consideration of the current state of competition for Factory Gate Milk we have assessed the extent of the sale and purchase of raw milk and other dairy goods and services, necessary for processors to compete in dairy markets.

25. Westland has been actively involved in the sale and purchase of the following dairy goods in recent years:

25.1. raw milk
25.2. cream
25.3. retentate
25.4. permeate

Note: this excludes raw milk purchased from Fonterra pursuant to DIRA

26. The drivers for this include the following:

26.1. commercial: a preference by processors to sell or swap milk at certain times in the season. For instance, milk may be swapped or sold to enable product mix to be maximised or to accommodate new plant commissioning requirements.

26.2. environmental compliance and reputational: the drive to minimise factory waste and associated compliance costs where the product has other processing uses, and

26.3. risk mitigation: the desire to develop linkages amongst the industry in the case of natural disasters requiring alternative processing services.

Future State of Competition for Factory Gate Milk

27. As described above, because of the underlying motivation for these transactions, in our view the sale and purchase of milk and milk related dairy goods between processors and some food and beverage manufacturers, is expected to continue and is not the product of regulations.

Impact of the Regulations

28. The increased growth in the number of independent processors since 2001 is surely self-evident that the regulations have, to a degree, facilitated market entry supporting the development of an efficient dairy market in New Zealand.
29. In particular the Raw Milk Regulations (the Regulations) have enabled independent processors to purchase milk directly from Fonterra (DIRA Milk) and this has facilitated the expansion of the industry by de-risking processors’ investment in processing plant through the assurance of milk supply until the volume threshold is met for three consecutive seasons.

30. The Base Milk Price monitoring regime has also supported competition among processors by providing transparency in the market place so that processors can benchmark the price they pay their suppliers for raw milk with Fonterra’s Base Milk Price. However, we have seen that Fonterra can choose to ignore the milk price manual so that it’s not always adhered to as expected. Also, for a co-operative dairy company like Westland the Base Milk Price is less relevant (than for processors who buy milk under contract from farmers). Westland competes for milk supply based on total shareholder return rather than the Base Milk Price alone.

31. There are provisions intended to promote freedom of entry and exit from Fonterra, for instance section 97 of the Act allowing a Fonterra shareholding farmer to give notice to withdraw their milk supply from Fonterra however DIRA provides that Fonterra may set the terms of supply that govern the notice period. As noted above, supply agreements between Fonterra and a supplier locking in that milk supply for up to 10 years is not unheard of yet in our opinion it is contrary to the purpose and principles of the Act.

32. At first glance section 107 of the Act precluding Fonterra imposing long notice requirements for any of its suppliers wishing to exit, appears to operate to protect the freedom of exit principle. However, at a closer glance this only requires that at least one-third of milk supply to Fonterra within a 160 kilometre radius at any point in New Zealand is supplied under contracts that may be terminated by the supplier at the end of the current season. So conversely two-thirds of milk supply within that radius can be subject to long term notice provisions. Certainly, there have been Fonterra suppliers wishing to switch to us but they have come up against the harsh exit provisions in supply contracts with Fonterra. We also consider it to be very difficult for Fonterra’s compliance with this section to be gauged with any accuracy and as far as we know this has never been attempted.

33. There have also been provisions that have either not at all, or hardly ever, been utilised – for instance, the provision in section 108 (1) of the Act allowing farmers to sell up to 20% of their weekly production throughout the season to independent processors. In practise this provision is unattractive due to the need for farm dairy storage to be duplicated and associated issues – milk collection scheduling, the requirement for co-ordination among the two companies collecting milk from the
farm and potential for miscommunication between supplier and collection companies, and so on.

Removal of the Regulations

34. As indicated above, removal of the Regulations is unlikely to impact Westland’s current and future plans for the sale and purchase of raw milk, cream, retentate, permeate to or from other processors. However, the removal of the provisions ensuring freedom of entry and exist (including regulation of milk supply) is considered a risk to the expansion of Westland’s supply base if/when Westland seeks to expand in the market for farm gate milk.

35. Whilst the Regulations as they pertain to the freedom of entry and exit for Fonterra suppliers have not entirely succeeded in allowing Fonterra suppliers to freely and willingly exit (as described above), without the regulations Westland would expect to see Fonterra taking immediate advantage of its position and altering its terms and conditions of supply to make exit difficult across its entire supplier base.

Market Efficiency

Farm Gate Milk

36. Without the Regulations we would expect to see Fonterra to continue to jealously guard its supplier base as even with the Regulations we have seen such behaviour. We would expect that Fonterra would alter its terms and conditions of supply to extend suppliers’ notice to exit in conjunction with other measures all designed to make exiting Fonterra difficult. For example, by the introduction of more long term contracts binding those suppliers to supply Fonterra for the term and the devising of new schemes by Fonterra restricting independent processors’ ability to compete for all types of farm gate milk.

37. If all of the regulations are removed there will be very little preventing Fonterra from imposing longer notice periods in its contract/terms and conditions of supply with its farmers before they can exit. Fonterra has a vested interest in ensuring its investments in milk processing plant are not compromised by a reduction in milk supply and is incentivised to limit competition from independent processors as a result.

38. Without the regulations Fonterra could also target areas where it perceives competition for farm gate milk to be greater by offering more favourable terms to
suppliers in one area compared to those in another – there is real potential for
discrimination between suppliers by Fonterra acting to retain supply in areas where
competition for milk is the greatest and in effect disadvantaging suppliers in areas of
less competition. For Westland, if Fonterra acted in this way in Canterbury and that
prevented Westland attracting milk, this would have an impact on our expansion
plans. However, if only some of the regulations are removed, leaving the provisions
protecting the right of Fonterra suppliers to withdraw, protecting Fonterra suppliers
from discrimination and regulating supply contracts for raw milk, then to a certain
extent we believe this issue could be overcome.

Factory Gate Milk

39. The factory gate milk market is influenced by factors distinct from those influencing
the farm gate milk market (see above) such that we believe this market can operate
efficiently and will do so with or without regulations.