

10 July 2015
Alex Sim
Chief Adviser, Regulation Branch
By email: regulation.branch@comcom.govt.nz

Miraka Submission to the Commerce Commission:

Consultation Paper – process and approach: Review of the state of competition in the New Zealand dairy industry (12 June 2015)

1.0 Background

The Minister of Primary Industries has requested the Commerce Commission to produce a report on the state of competition in the New Zealand dairy industry. The Commission has issued a paper (the Consultation Paper) outlining the process and approach it proposes to take in a review on which to base its report. The Commission has invited submissions on the Consultation Paper. Miraka appreciates the opportunity to submit on the Paper.

2.0 State of Competition and Fonterra Market Power

Miraka considers that:

- there is insufficient competition in the New Zealand farm gate milk market;
- in the absence of regulation, it is unlikely a significant factory gate (or secondary) milk market will emerge in the foreseeable future; and
- Fonterra would be able and incentivised to exert market power over its competitors in the event the industry is deregulated.

2.1 Insufficient competition in the farm gate milk market:

Miraka notes that the current sunset clauses under Section 147 of the Dairy Industry Restructuring Act 2001 (DIRA) have not yet been reached. Miraka also notes that in the “Assessment of the DIRA Triggers” paper (dated 30 March 2010) attached to the Commissions Consultation Paper, NERA Economic Consulting suggested the ability to exert significant market power would continue down to a 75% (or even lower) market share. This 75% is lower than the current threshold in the sunset clauses (80%) and is well below Fonterra’s current market share. It seems clear then that Fonterra would have the ability to exert significant market power if the farm gate milk market were deregulated.

2.2 A significant secondary milk market is unlikely to emerge:

Given the supply of milk in New Zealand is dominated by the seasonal milk curve, it seems unlikely that a secondary market for milk will naturally emerge. Dairy processors must invest in capacity sufficient to process peak milk, they typically have surplus capacity in the shoulders of the season. This makes incremental shoulder milk more valuable than incremental peak milk. It is then understandable that Fonterra or any dairy processor would

have little commercial interest in releasing a supply of shoulder milk into a secondary milk market, except perhaps at a price which would tend to be prohibitively high.

2.3 Incentive to exert market power: There is a strong co-incidence of interests which result in Fonterra being incentivised to exert market power to secure a maximum share of the raw milk market. Miraka has argued¹ that Fonterra is naturally and primarily incentivised to maximise the farm gate milk price (FGMP). Furthermore, Fonterra has shown it is willing to maximise the FGMP to a level higher than warranted by the performance of its commodity business activities. Fonterra is able to do this by supporting the FGMP from profits of its non-commodity business activities. On the other hand, the countervailing incentive to maximise reportable profit seems relatively weak. Fonterra is therefore both able and incentivised to inflate the milk price to put pressure on competitors' profitability.

2.4 Basis for determining sufficient competition

2.4.1 Paragraphs 29 to 37 of the Consultation Paper outline how the Commission proposes to assess "sufficiency" of the state of competition. The Commission indicates it could assess the state of competition by comparing it against the purpose of the DIRA (paragraph 35). The overarching purpose of the DIRA is contained in Section 4 (f) and is as follows:

"[to] promote the efficient operation of dairy markets in New Zealand by regulating the activities of [Fonterra] to ensure New Zealand markets for dairy goods and services are contestable".

2.4.2 The primary outcome sought under section 4 (f) then is to ensure contestable markets. The means to this end is through the promotion of the efficient operation of New Zealand dairy markets. The tools to promote the efficient operation of the market is the regulation of Fonterra activities.

2.4.3 While the substance of the DIRA concerns the regulation of Fonterra, the purpose of that regulation and therefore reason for that regulation is to achieve contestable markets. Notably, the promotion of efficient markets is only the means to that end. On the basis of the DIRA purpose then, the benchmark for sufficient competition should depend on the extent to which there is real and demonstrable (and not merely hypothetical) contestability in the markets.

2.4.4 The Commission however appears to interpret the purpose of the DIRA in a different way, placing a greater focus on Fonterra itself and the efficient operation of markets. For example, at paragraph 35 of the Consultation Paper, the Commission describes the overriding purpose of the DIRA in terms of "the obligations it imposes upon Fonterra to promote the efficient operation of New Zealand dairy markets (sic)". It then goes on to conclude that "the most appropriate meaning of the words "sufficient" and "insufficient" [competition] is an interpretation that best gives effect to that efficiency purpose".

¹ Refer for example to paragraphs 2.4 to 2.6 of the Miraka submission (28 April 2015) on the Commerce Commission Process and Issues Paper for its review of the 2014/15 Base Milk Price Calculation. A copy of that earlier submission is attached to this submission.

- 2.4.5 The Commission considers that the purpose of the DIRA is found more widely than just section 4 (f) and also includes sections 70 and 71, and section 150A (1)². Those latter sections however only relate to the purpose of specific sub-parts of the DIRA. They place a greater emphasis on Fonterra itself and on promotion of efficiency in the markets. Section 150A (1) for example is concerned with the efficient operation of Fonterra (not the wider market), while the contestability purpose of the DIRA is merely deemed to be satisfied provided certain conditions are met (i.e. actual contestability is not a purpose as such).
- 2.4.6 Miraka does not agree that sections 70, 71 or 150A (1) are relevant to the over-arching purpose of the DIRA. This is especially where they dilute the purpose of Section 4 (f). Miraka is therefore concerned that the Commission is signalling it could take a similar approach to the determination of sufficiency of competition, to the approach it takes in its annual reviews of the Base Milk Price. The focus in those reviews is drawn from Subpart 5A of the DIRA, including section 150A (1). The reviews focus on the behaviour of Fonterra (e.g. to operate efficiently). On the other hand, as regards the over-arching purpose of the DIRA (contestability of markets), this is merely deemed to exist where a hypothetical test is met (the “practically feasible” test of section 150A (2)). That test is constrained by the “safe harbour” provisions of section 150B, and is interpreted by Fonterra and the Commission in a way that means it is not actually feasible³. Actual contestability as such is therefore not considered a purpose.
- 2.4.7 This issue goes to the heart of much of the Miraka submissions to the Commission on its reviews of the milk price. Resulting from inconsistencies in the DIRA, and on differing interpretations, it has not been satisfactorily resolved. Miraka submits that this conflict between the over-riding purpose of the Act and these “sub-purposes” should not undermine the assessment of the state of competition and that sections 70, 71 and 150A should be put aside for purposes of assessing “sufficiency” of competition.
- 2.4.8 In conclusion, Miraka agrees it is appropriate to assess the state of competition against the purpose of the DIRA. However, the purpose of the DIRA, clearly established in section 4(f), is to ensure contestability of the markets. The state of competition should therefore be assessed by the demonstrable and actual (not hypothetical) contestable operation of the markets. Miraka seeks assurance from the Commission that it will restrict its interpretation of the purpose of the DIRA to section 4(f).
- 2.4.9 Miraka also draws attention to paragraphs 37 and 47 of the Consultation Paper. These concern an assessment of effectiveness of the current regulatory framework (as against achieving market efficiency and limiting Fonterra market power respectively). In both cases, where the Commission considers the regulations are not effective, the Commission indicates it would conclude the State of Competition is sufficient (and in paragraph 47 - and presumably in the circumstance in paragraph 37 - recommend deregulation). While it is proper to consider the repeal of ineffective regulation, it is not correct to conclude that ineffective regulation provides evidence of sufficient competition. Rather the correct

² Refer footnote 5 of the Consultation Paper.

³ Refer paragraph 2.7 of the Miraka submission (28 April 2015) on the Commerce Commission Process and Issues Paper for its review of the 2014/15 Base Milk Price Calculation (copy attached).

conclusion, assuming the purpose of the DIRA (contestable markets) has not been sufficiently achieved and remains a required outcome, is that other regularity options need to be developed and considered.

3.0 Fonterra Market Power

With the exception of certain aspects of Subpart 5A of the DIRA (refer 4.2.5 below), Miraka supports the current regulatory framework. Miraka has the following specific concerns that Fonterra could exercise market power against competitors in the event the dairy markets were deregulated:

3.1 Open entry/exit for Fonterra Suppliers

3.1.1 The existing provisions governing the entry and exit of Fonterra suppliers have enabled competitive access to the farm gate milk market for independent processors. Miraka has for example been able to secure milk which meets its current processing requirements. Given Fonterra market power and incentives to secure milk supply, repeal of these provisions would however have a significant dampening effect on investment to grow Miraka activities, and could place Miraka current milk supply at risk.

3.2 Milk price transparency and oversight

The current regulatory framework achieves two objectives (milk price oversight/accountability, and transparency) that are important to at least sustain a current level of competition.

3.2.1 Oversight/accountability: The Commission's annual reviews of the Farm Gate Milk Price Manual and of the Base Milk Price calculation provide a necessary tension to limit Fonterra's exercise of market power in setting the milk price.

3.2.2 Transparency: Due to its position in the market, Fonterra sets the benchmark milk price for the entire farm gate milk market. The Fonterra milk price is not finally determined until September, over three months following the end of the Season. For most if not all dairy companies (including Fonterra and Miraka) that is over a month following financial year end (in July). Milk represents by far the largest input cost for dairy processors. Uncertainty about the milk price creates risk for operating and financial performance. While still limited, the current transparency over the way the milk price is determined provides some assistance in forecasting the milk price and thus helps dairy companies to manage these risks. While Fonterra does provide forecast updates through the Season, a lack of market imposed discipline means they are not sufficiently regular, nor can they always be relied on.

4.0 Insufficient Competition

If the Commission concludes competition is insufficient, the Commission is required to consult and report on the DIRA expiry triggers (current or alternative), and on options for a transition pathway to deregulation (paragraph 13.4 of the Consultation Paper). Miraka offers the following initial views on these two areas:

4.1 DIRA Expiry Triggers

- 4.1.1 The current DIRA regulatory framework will start to phase out when the Fonterra share of the farm gate milk market in either the North or South Islands falls below 80%, with the regulations in effect expiring in full only when the market share falls below 80% in both islands.
- 4.1.2 The distinction between the North and South Islands seems arbitrary. They are not naturally separate markets, and this distinction would seem to add unnecessary complexity to the sunset provisions of the DIRA. Miraka considers section 147 (1) should be reset on a single New Zealand wide basis, although also note paragraph 4.1.4 below.
- 4.1.3 As noted in 2.1 above, NERA Economic Consulting considered that down to a threshold of 75% (or even lower) a New Zealand organisation would have significant market power. In the absence of any other expert evidence, Miraka considers the market share threshold in Section 147 (1) should therefore be changed to reflect a Fonterra market share not exceeding 75% nationwide.
- 4.1.4 The current sunset provisions in the DIRA variously set in train deregulation once the market share thresholds are met. While this also triggers a “report on the state of competition” in dairy markets it is unclear how that report would impact deregulation. Miraka agrees with the Commission (paragraph 62 of the Consultation Paper) that the market thresholds in themselves should not trigger deregulation, but that deregulation should happen only as a result of a decision of Government following a “comprehensive competition analysis”. This analysis would also consider whether and what regulations might still be required where competition remains insufficient in specific geographic locations. This facilitates the simplification of the sunset clause into a single threshold for the entire NZ market.
- 4.1.5 Miraka further considers that section 148A should be renewed to provide for a “State of Competition” report to be completed each five years, unless or until the market threshold is met.

4.2 Pathway to Deregulation

- 4.2.1 The Commission is only required to consider pathways to deregulation if it determines the state of competition in the Dairy Industry is insufficient. A regulatory response to insufficient competition raises three possible scenarios:

Scenario 1: The current regulatory framework is operating effectively and can still ultimately achieve the purpose (contestable markets) of the DIRA. This scenario could result in the status quo, or changes in the thresholds and expiry triggers to improve the efficiency (including timeliness) of achieving the purpose of the DIRA.

Scenario 2: The current regulatory framework is not effective, is either neutral or detrimental to market efficiency, and the DIRA purpose is unlikely to be achieved. Whether this leads to deregulation should depend on 3 below.

Scenario 3: The DIRA purpose (contestable markets) continues to be a proper and necessary objective. Changes to the regulatory framework would be required to ensure the DIRA purpose (contestable markets) is achieved.

4.2.2 At 13.7 of the Consultation Paper, the Commission indicates it considers the scope of its review does not extend to considering scenario 3 above. Miraka does not agree with that position. If the purpose of the DIRA (contestable markets) can be achieved, or achieved more efficiently and quickly, by changes to the regulatory framework, this is as an appropriate pathway to ultimately achieve deregulation. The Commission has also suggested in the event of Scenario 2 above that it would recommend deregulation (e.g. paragraph 47). This leads to the unsatisfactory possibility that the Commission could report that competition in the dairy industry is insufficient, AND that the industry should be deregulated. That is an inefficient use of the current opportunity to review competition and could provide pre-conditions for complaints under the Commerce Act. The Commission indicates (paragraph 13.7) its role does not extend to “policy issues and choices”. The review of competition should therefore include an appropriate arm of government that will consider policy issues and choices that arise from the review.

4.2.3 Miraka considers that changes in the regulatory framework are indeed needed to ensure the DIRA purpose can be achieved in a timely manner. These are described below. The first (supply of regulatory milk) could arguably be considered within the review of expiry triggers; the second (the Base Milk Price) would seem to require a more substantive reshaping of Subpart 5A (Base Milk Price) of the DIRA.

4.2.4 Supply of regulatory milk

4.2.4.1 The supply of regulatory milk to dairy processors with an independent supply will phase out commencing the 2016/17 Season⁴. Access to regulatory milk at a reasonable price assists the entry of new competitors, and can also assist current competitors to grow and achieve a scale to more effectively compete against Fonterra. The option to purchase regulatory milk provides “breathing space” to smooth the investment step change required to grow processing capacity. For smaller processors, a step change in processing capacity will typically represent a substantial investment. Access to regulatory milk allows for more efficient capacity utilisation of the step change investment in two ways. The initial take up of regulatory milk provides for increased “early stage” utilisation of the step change capacity. Subsequently as own supply grows, regulatory milk can be shed to provide space for natural growth in own supply.

4.2.4.2 A supply of regulated milk to processors would not be required if an effective factory gate (or secondary) milk market had developed. As noted in 2.2 above, this is unlikely to occur in the foreseeable future. The regulated supply of milk to the factory gate milk market is therefore not a temporary requirement, but is an ongoing requirement to reduce entry barriers to competitors. For larger processors, the absence of an effective secondary milk

⁴ Applies to processors with an independent supply of raw milk of at least 30 million litres in the preceding three years (clause 6 (3) of the Raw Milk Regulations 2012)

supply market is a natural feature of operating in the New Zealand market against which regulated protection would seem inappropriate.

4.2.5 Base Milk Price

- 4.2.5.1 In various submissions to the Commission on the FGMP, Miraka has contended that the current regulatory framework as implemented does not assure a competitive milk price. The methodology will over-state the milk price, dampening competitive activity, providing incorrect price signals to suppliers, and providing incorrect signals to investors in the dairy processing industry. As such, it is not consistent with the over-arching purpose (contestability of markets) of the DIRA laid out in section 4 (f).
- 4.2.5.2 This situation arises because Fonterra and the Commission interpret the efficiency requirement under Section 150A (1) of the DIRA will be met if the milk price is set with reference to costs and operating performance of a “super-competitor” (the efficient notional competitor). This means that the milk price is set at a level which does not reflect Fonterra actual performance and would typically be at a level which is higher than Fonterra could afford to pay based on its performance. While this is not necessarily atypical to normal competitive behaviour in the short term, in the medium to longer term organisations that cannot afford their input cost will decline and ultimately fail. In Fonterra’s case though, it can support an inflated milk price from its non-commodity activities. Even in the 2013/14 Season where Fonterra did reduce the milk price on the grounds of affordability, it would seem the price was still considerably higher than the Fonterra commodity business could sustain. Based on comments attributed to the Fonterra chairman, Fonterra inventories (and therefore profits) for the 2013/14 financial year might have been overstated by some \$184M⁵. If correct, this suggests that while the 2013/14 milk price was lower than calculated using the Fonterra Milk Price Manual, it nevertheless still consumed the entire profit from non-commodity business activities (group profit before tax was \$157M, or a possibly loss of \$27M after adjusting for the error). Neither Fonterra members, investors nor the wider market actually know the real effect of the milk price calculations on Fonterra performance measures, because Fonterra does not disclose what an “actual performance” based milk price would be.
- 4.2.5.3 Rather than mitigate market power, Subpart 5 A of the DIRA has in fact assisted to reinforce Fonterra market power. It provides a smokescreen behind which gains from Fonterra’s non-commodity business activities are able to prop up the commodity milk price. This perpetuates an “uneven playing field” in the farm gate milk market.
- 4.2.5.4 Putting aside the issue of a subsidy to the Fonterra milk price from its other business, Miraka and the other independent processors have long argued the milk price determined by the Fonterra Farmgate Milk Price Manual is not a “competitive milk price” because it assumes competitors are not only more efficient than Fonterra, it assumes competitors are of a scale that cannot feasibly exist. It is the case that despite this “uneven playing field” Fonterra competitors including Miraka have successfully entered

⁵Refer <http://www.stuff.co.nz/business/farming/dairy/67794623/is-john-wilson-comfortable-with-fonterras-performance-no>

the farm gate milk market and have been able to secure milk supply. In Miraka view though the lack of a level playing field in setting the milk price dampens the rate of growth in competition because it increases the risk to investors of an uneconomic milk price. Reform of the DIRA to ensure a “level playing field” in setting the milk price would help ensure a properly competitive market emerges, ultimately leading to the conditions in which the market can be deregulated.

- 4.2.5.5 As previously noted, Miraka has addressed this issue in some detail in previous submissions to the Commission. The issues were summarised in Section 2 (Legal Framework) of its most recent submission (24 April 2015) to the Commission on the review of the 2014/15 base milk price calculations. A copy of that submission is attached.

Richard Wyeth
Chief Executive Officer
Miraka Limited