

SUBMISSION

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To: Commerce Commission

Submission on: Submission on the Dairy Competition Review Draft Report, 4 December 2015

From: Federated Farmers of New Zealand

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DAIRY COMPETITION REVIEW DRAFT REPORT, 4 DECEMBER 2015

1. EXECUTIVE SUMMARY

- 1.1. Federated Farmers submits:
 - 1.1.1. Against a pathway to deregulation in either the farm gate market or the factory gate market and the Commerce Commission instead considers changes to the Dairy Industry Restructuring Act (DIRA), in order to allow the industry to work in an innovative and efficient manner over a period of decades.
 - 1.1.2. That the Commerce Commission reconsiders the notion of Fonterra as processor of last resort by giving thought to changes to the open entry and exit clauses (paragraph 3.11.4 of this submission) and the 20% Rule (paragraph 3.11.7)
 - 1.1.3. That all independent processors (IPs) (except Goodman Fielder¹) should be allowed access to regulated raw milk (also known as DIRA milk) for three years only, regardless of if they have any own supply or not, how much they take, what they do with it and who owns them (paragraph 3.12). This will allow new entrants certainty of supply for the time it takes to build up their business.
 - 1.1.4. An auction for DIRA milk is the alternative that will allow all IPs the opportunity to purchase this milk for as long as the price discovered makes it valuable to them.
- 1.2. Federated Farmers supports resetting the time limited provisions of the DIRA to 1 June 2020, rather than the 2021/22 season, which is five years after the previous time threshold.
- 1.3. Federated Farmers is unsure of the need to have a market share thresholds at all.

2. NEW ZEALAND INC

- 2.1. Federated Farmers respects the Commerce Commission's role to solely safeguard competition within New Zealand. However it is important for decision makers to also focus on the big picture: New Zealand exports 95 percent of its dairy products into highly competitive international markets, where, more often than not, it has to compete against subsidised product, tariff and non-tariff barriers. We think it is therefore important for the Commission to also consider the NZ Inc approach here.
- 2.2. The Federations' view is that a high level of internal competition is not actually in the best interests of NZ Inc. While we do have some smaller dairy co-ops and other IP's that operate successfully in the international marketplace, we strongly believe that having a large player, like Fonterra, on the international scene is beneficial to New Zealand.

¹ Federated Farmers supports the current arrangement Goodman Fielder has with Fonterra and this submission is not intended to alter this.

- 2.3. There is also a benefit of having a small group of processors working in the industry good space. It is easier to organise industry good activities and to bring farmers together on some of the tough issues facing the dairy industry such as climate change, nutrient management and animal welfare. With a larger number of processors, progress may be slower on a number of important issues.
- 2.4. While internal competition within New Zealand is important, Federated Farmers urges the Commission not to lose sight of this big picture.

3. OVERVIEW

- 3.1. Federated Farmers does not support the Commerce Commission's push for deregulation.
- 3.2. Federated Farmers commends the conclusions the Commission has come to, that once a fully functional factory gate market exists, there will be no need for regulation. This is based on assumptions that all parties in the dairy industry will act rationally. We are somewhat sceptical that this will occur.
- 3.3. We note that continuation of some sort of regulatory oversight was recommended by Miraka, Tatua, Open Country Dairies and Synlait. As stated in our submission to the Commission (*Review of the state of competition in the New Zealand dairy industry, consultation paper – process and approach, 10 July 2015*) Federated Farmers is also of this opinion: we agree that the regulations in some form should remain for both the farmgate market and the factory gate market.
- 3.4. The New Zealand dairy industry is unlikely to ever reach a state of competition where regulatory oversight can be withdrawn, because:
 - 3.4.1. A pathway for new entrants is needed, allowing certainty of supply during the start-up phase of a new firm;
 - 3.4.2. The track record of the dairy industry, even before the formation of Fonterra, shows that uncompetitive behaviour does occur;
 - 3.4.3. Independent processors (IPs) are likely to lobby government for their cause; and
 - 3.4.4. We anticipate deregulation would lead to more work for the Commerce Commission due to complaints.
- 3.5. We agree with having time limited provisions within the DIRA and consider that this could be used to manage the industry alone, without the need for a market share threshold. Resetting the time limited provision to the 2021/22 season seems too far, however, as a review takes some years to take effect. We consider that the review could be set for 1 July 2020, five years after the current date. This will allow the industry to be settled for five years, something the Federation values. We consider that these reviews could then occur every five years.
- 3.6. While Federated Farmers disagrees with re-setting the market share thresholds to 30 percent, we are unable to offer an alternative threshold. However, we wonder if a market share threshold is actually necessary at all, given it only triggers a review.

- 3.7. Federated Farmers disagrees with the Commerce Commission's opinion that, with or without regulation, Fonterra does not have the ability to exercise market power at the farm gate. However, we do agree that the co-operative nature of Fonterra governs Fonterra's behaviour to some extent which could limit competitive behaviour at the farm gate.
- 3.8. Federated Farmers agrees with the Commission's conclusion that the DIRA is restricting growth in the factory gate market. It is so easy (and cheap) for IPs with little or no own supply to buy DIRA milk, leaving no incentive at all to go to the market.
- 3.9. We agree that, without the DIRA, the price of milk at the factory gate is likely to increase and the conditions of supply of this milk could change too. The current price of non-DIRA factory gate milk may give some indication of future pricing of milk in a regulation-free, factory gate market; Federated Farmers is unwilling to speculate on the efficiency of this market in an unregulated environment.
- 3.10. **Farm gate market** – reasons to keep the DIRA
- 3.11. As noted above, Federated Farmers expects the co-operative nature of Fonterra to manage Fonterra's farmgate power without (and with) regulation but there are certain aspects of regulation that could be used to the dairy farmer's advantage.
- 3.11.1. Regulation allows Fonterra to concentrate on things that matter. Without regulation, Fonterra could spend time deciding on actions on a case-by-case aspect, which would take time (and money). Shareholders want Fonterra to spend time on making sure the co-operative is working for them.
- 3.11.2. Federated Farmers considers there are some aspects of the regulations which could be altered: managing conversions on marginal land (the idea that Fonterra is the processor of last resort) and the 20% Rule, which were both mooted in the Federation's submission *Review of the state of competition in the New Zealand dairy industry consultation paper – process and approach, 10 July 2015*.
- 3.11.3. While the Commerce Commission has commented on this, we consider that both should be reconsidered.
- 3.11.4. **Inefficient dairy conversions:** The Commission considers in its draft (paragraph 6.77) that conversions are cost neutral and are, in any case, few in number.
- 3.11.5. The Federation submits that the open entry and exit requirements in the DIRA should be studied to discover if some variation could be appropriate which would give Fonterra some discretion over the milk it collects.
- 3.11.6. As stated in the Federations' submission, *Review of the state of competition in the New Zealand dairy industry consultation paper – process and approach, 10 July 2015*, Fonterra is required to take all milk with few exceptions. This "processor of last resort" role means that Fonterra is forced to manage excess capacity, often resulting in more stainless steel being built. If it was not forced to take all milk

offered, then it could choose its own path, which may include investing more in value-add processing.

- 3.11.7. **20% Rule:** We agree that this is an important route for niche dairy processors of all types.
- 3.11.8. Federated Farmers submits that the twenty percent rule within the current DIRA (s108) be EITHER replaced with a secondary volumetric limit to protect the boutique cheese makers and other small independent processors who rely on this type of supply; OR tied to the amount of milk taken in October.
- 3.11.9. We are disappointed that it appears that the Commission did not gather information about how much milk is diverted from Fonterra under this rule i.e. how many farmers took advantage of this rule and what volumes this represented.
- 3.11.10. The risk to Fonterra lies on the shoulders of the season when this milk is most valuable. If 20% of large holdings is diverted, then this leaves Fonterra scrambling for milk to fill its vats at this time. Federated Farmers considers that this outcome was never intended in the DIRA.
- 3.11.11. Using the 20% rule will make good sense to some farmers once they understand the financial benefits and if they have no regard of the downstream affect this will have on Fonterra.
- 3.11.12. The advent of TAF means that farmer shareholders are able to hold more shares than needed to support their actual milk supply. These “dry shares” (up to 200% of their shared up “wet” shares) allow farmers to gain from selling milk (probably at a premium) as well as gaining from the dividend held on the dry shares and the Fonterra return on the twenty percent wet shares diverted to the independent processor. It will be most attractive to larger holdings and “Queen St” farmers.

3.12. **Factory Gate Market – reasons to keep the DIRA**

- 3.12.1. As noted above, Federated Farmers agrees there is poor competition at the factory gate and supports the Commission in keeping regulation in place for the factory gate. However, the factory gate should be restricted so that it is used for its intended function: to help those firms gain a foothold in the industry and to create competition at the farm gate and the factory gate.
- 3.12.2. We commend the Commission’s desire to increase the factory and farm gate markets as it progresses to a regulation free market for milk. We consider however, that expecting the factory gate market to exist without regulation is optimistic, due to past behaviour of the industry and market forces.
- 3.12.3. The risk of a regulation-free factory gate market is that IPs will lobby the government and some of these have a powerful voice.

- 3.12.4. We note that the Commission did not consider in great detail those specialist food processors that buy DIRA milk and turn it into products like infant formula and UHT milk.
- 3.12.5. Federated Farmers accepts there is no way to restrict firms on the basis of what they intend to do with the milk they buy. Many of these firms export all or most of their product, and Federated Farmers has no issue with this. Most of these IPs, however, will have deep pockets so are able to pay a high price for this milk. We also expect that there will be an increasing number who enter our shores to secure safe food for their own countries, especially at a regulated price. It is simple to do.
- 3.12.6. Currently, in the Raw Milk Regulations there is 795 million litres set aside (and in the DIRA this is set at five percent of the milk taken across New Zealand). Out of this volume, each firm (if eligible) is able to take 50ML each, apart from Goodman Fielder, which takes more. If all firms took their maximum required, it would take only approximately 14 firms to exhaust this supply. Once exhausted, Federated Farmers expects that IPs would lobby the government to provide for more milk to be set aside in the DIRA. We note the tool of pro-rata rationing in the Raw Milk Regulations, which we consider to be an imperfect one.
- 3.12.7. We note the Commission is considering ways of reducing demand for this milk by altering the sunset clauses. While the Commission has given a number of options, Federated Farmers has always advocated that sunset clauses should be applied to all IPs, regardless of how much is taken, who owns them and what is done with the milk.
- 3.12.8. **Three years access:** Federated Farmers submits that all IPs be given access to DIRA milk for three years only. This was considered an adequate timeframe for IPs that sourced larger quantities of own supply and we can see no need to discriminate between the two groups.
- 3.12.9. This should drive more IPs to a factory gate, creating a market that should be workable. Those that don't, can go to the farm gate and create a more competitive market there.
- 3.12.10. Requiring all IPs to go to a factory gate will allow those processors with excess supply to support those that they choose to, on their own terms and which could even be below the cost of current DIRA milk.
- 3.12.11. **Auction option:** However, we know that this will be difficult for some and so recommend, again, an auction be used for DIRA milk, as allowed for in s115(1)(bb)(ii) of the DIRA. This will allow all IPs to discover the price of this milk and its value to themselves. It may be appropriate to adjust the amount of milk available and to put a floor under the auction price.
- 3.12.12. The Commission has also put forward other options that could work but we consider that these still give those IPs that have no interest in adding value to the farmgate or factory gate markets the incentive to stay on this milk.

- 3.12.13. We consider that having a glide path to a higher price for DIRA milk is commendable. We could suggest that decreasing the volumes would also work, tightening supply. However, we suggest that both these will lead to the government being lobbied by IPs and therefore another outcome.
- 3.12.14. A back-up plan of an auction for raw milk, with a decreased volume of milk in the pool, could also be seen as a permanent fix for the dairy industry, allowing newcomers in as well as giving those with no interest in doing anything except pay for the milk and turning it into something of value to them, the option to remain.

4. ABOUT FEDERATED FARMERS

- 4.1. Federated Farmers of New Zealand is a primary sector organisation that represents farming and other rural businesses. Federated Farmers has a long and proud history of representing the needs and interests of New Zealand farmers.
- 4.2. The Federation aims to add value to its members' farming business. Our key strategic outcomes include the need for New Zealand to provide an economic and social environment within which:
- Our members may operate their business in a fair and flexible commercial environment;
 - Our members' families and their staff have access to services essential to the needs of the rural community; and
 - Our members adopt responsible management and environmental practices.