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## **Submission on review of the state of competition in the New Zealand dairy industry – process and approach**

### **Introduction and summary**

- 1 Thank you for the opportunity to comment on the New Zealand Commerce Commission (*Commission*) “Consultation paper – process and approach”, which sets out the Commission’s proposed process and methodology to be used in the Commission’s review of the state of competition in the New Zealand dairy industry (*Review*). Fonterra welcomes the opportunity to contribute to the Review and to comment on the consultation paper.
- 2 In this submission, Fonterra provides comments on the process and methodology proposed in the consultation paper. Its views on substantive issues raised by the Review will be provided separately. In general, Fonterra supports the process and methodology that are proposed in the consultation paper. The following sections set out additional issues regarding process and methodology that in Fonterra’s view would assist in ensuring the Review’s process and findings are as robust as possible. These are:
  - 2.1 *Process* – Fonterra generally supports the Commission’s proposed process. Fonterra submits that the process would benefit from allowing for additional engagement with interested parties.
  - 2.2 *Methodology* – Fonterra generally supports the Commission’s proposed methodology and makes a number of specific submissions in relation to the detail of the methodology, and the considerations the Commission proposes to take into account.

### **Process**

- 3 Fonterra generally supports the Commission’s proposed process and appreciates the opportunities to engage with the Commission so far. There are two aspects of the proposed process in respect of which Fonterra submits the Review would benefit from additional interaction with interested parties.

### **Engagement with interested parties while the Commission prepares its draft report**

- 4 First, the proposed process steps and indicative dates (set out in table 1 of the consultation paper) provide for a period from July 2015, when interviews with market participants would be completed, until early November 2015, when the draft report would be published. The process currently does not explicitly envisage interested parties making submissions on substantive issues prior to November 2015.
- 5 Fonterra submits that the robustness of the Commission's process and findings would be enhanced if, prior to publishing its draft report, the Commission were to take steps to engage on material questions as it works through its analysis. Fonterra notes that the proposed timetable does not expressly provide for engagement (formal or informal) with interested parties, including market participants, to this end.
- 6 Given the importance and complexity of the issues the Commission will be considering, Fonterra considers the Review would benefit from collaboration with interested parties during this period including:
  - 6.1 the Commission indicating specific topics, or preliminary views, on which it wishes to receive input, and giving opportunity for interested parties to provide such input; and
  - 6.2 more generally, interested parties being permitted to provide information to the Commission that they consider would be helpful for the Commission in the preparation of its draft report. In this regard, and as discussed during the interview process, Fonterra will be making written submissions on the substantive issues raised by the Review, including the particular areas of interest the Commission has identified. Fonterra expects these submissions would be published by the Commission in the normal way.

### **More time and engagement with interested parties following publication of draft report**

- 7 Secondly, the proposed timetable allows a period of four weeks between publication of the Commission's draft report and the deadline for submissions on the draft report.
- 8 As the Commission is aware, the issues that will be addressed in the Review are likely to be complex in places. Fonterra submits that:
  - 8.1 A longer period may be required in order to prepare a meaningful submission on the Commission's draft report. Fonterra suggests an additional four weeks.
  - 8.2 The integrity of the process and robustness of the findings would likely benefit from direct engagement at this stage of the process, in the form of seeking additional input from interested parties.
- 9 Fonterra recognises the constraints imposed by the statutory timeframe within which the Commission must work, but submits an extension to the time allowed for submissions on the Commission's draft report would add to the quality of the process without imperilling the statutory deadline.

### **Methodology**

- 10 Fonterra generally supports the Commission's proposed methodology. The following sections contain specific suggestions in relation to the detail of the methodology, and the considerations the Commission proposes to take into account.

### **Relevant markets**

- 11 The Commission proposes to report on the state of competition in regional farm gate and factory gate markets. Fonterra agrees with the product markets the Commission has

identified as relevant to the Review and considers that these two markets represent an appropriate focus.

- 12 The Commission is not proposing to examine in detail competition in other dairy markets, as they are not covered by the regulations.<sup>1</sup> The Commission proposes that these will be relevant solely to evaluate access issues in the farm gate and factory gate markets and assess costs and benefits of regulation. Fonterra agrees with this approach.
- 13 Fonterra also welcomes the Commission's openness to examine the appropriate geographic boundaries of those markets. Market boundaries may assume more importance in a regulation / deregulation context than they do in a standard competition analysis, given, for example, different markets might be subject to different regulatory interventions depending on how competitive they are found to be. Fonterra encourages the Commission to engage with market participants on a robust approach for determining market boundaries, including how they may evolve over time.

### **Evaluating competition in the markets**

- 14 The Commission proposes to examine how competition has developed since Fonterra was established and how it may develop in the future. When examining how competition has developed, the Commission proposes to focus on the most recent 5 years.
- 15 When assessing how competition has developed and may develop, the Commission will look at:
  - 15.1 Entry, expansion and exit of independent processors.
  - 15.2 Proportion of farm gate milk collected by independent processors.
  - 15.3 Extent to which independent processors compete for supply of factory gate milk.
  - 15.4 Farmer switching.
  - 15.5 Further planned entry or expansion by independent processors.
- 16 The Commission will also consider the extent to which regulations have positively or negatively impacted competition and efficiency to date. Fonterra agrees that any inefficiency brought about by the current regime should be taken into account.
- 17 While Fonterra supports the areas of focus of the Commission described in paragraphs 15 and 16 above, Fonterra submits that it will be important for the Commission to consider the full period since the DIRA came into effect, in addition to focusing on the most recent 5 years, for the following reasons:
  - 17.1 When looking forward only a short period (say, two years), recent history may well be the best guide.
  - 17.2 But when drawing conclusions about the long term trends in the market, the sustainability of competition and the likely health of the market absent regulation, then a longer term view is important. In this regard it would be important, for example, to examine the entire "life cycle" of entry and growth of independent processors. It would be misleading to look at and make assumptions concerning a period of limited growth or stability of one or more independent processors in the last 5 years where there had been significant growth by those processors prior to 2010.

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<sup>1</sup> Subparts 5 and 5A of Part 2 of the Dairy Industry Restructuring Act 2001 (*DIRA*) and/or the provisions of the DIRA Raw Milk Regulations.

- 17.3 Some big, pro-competitive changes in institutional arrangements are best understood in the context of the period that preceded the change, such as the GlobalDairyTrade auction platform and the Trading Among Farmers regime (TAF).
- 18 Some important features of New Zealand dairy markets are not explicitly identified in the consultation paper. The following features are an important part of the backdrop to the Commission's evaluation of the competition factors set out in paragraphs 45 and 46 of the consultation paper and accordingly Fonterra submits the Commission should take them into account in examining competition in the relevant markets:
- 18.1 Regional variations in competition. The Commission alludes to these in the consultation paper by identifying the relevant markets as regional in their geographic scope. This dynamic will need to be considered explicitly.
- 18.2 Aspects of Fonterra's institutional form, particularly TAF (how it has affected Fonterra's conduct in relevant markets since its introduction in late 2012, and the ways in which it may address the objectives of the DIRA), and obligations arising out of securities markets. For example, TAF resulted in a more liquid market for Fonterra's shares, with farmers who cease supplying Fonterra being able to hold listed units that are exchangeable for shares if they later return to Fonterra as suppliers.
- 18.3 How Fonterra's conduct as a co-operative operating in the relevant markets can affect competition in those markets. Key institutional features of Fonterra as a co-operative are a link between ownership and control through a share standard, and typically transparent and detailed rules for setting and allocating the farm gate milk price.
- 18.4 The effect of the Milk Price regime in constraining Fonterra's conduct at the farm gate, including its enshrinement in the DIRA (and Fonterra's Constitution) in mid-2012.
- 18.5 The effect of the Commerce Act 1986 in constraining Fonterra's conduct in relevant markets.
- 18.6 The strategic drivers of international investors entering New Zealand dairy markets in addition to traditional commercial incentives, including securing access to milk supply.
- 19 In addition, Fonterra notes that forming a view on how competition may develop will require a rounded assessment of the likely future state of markets, both domestically and internationally, rather than a simple extrapolation of current trends. Account will need to be taken of, for example, projections of increased global demand for dairy products, current and anticipated continued liberalisation of foreign dairy markets, including the European Union and partners to the Trans-Pacific Partnership, and the strategic imperatives of countries currently importing large volumes of New Zealand-sourced dairy products.

### **Approach to test whether competition is sufficient or insufficient**

- 20 To assess whether competition is sufficient or insufficient, the Commission proposes to ask whether the relevant dairy markets would be more efficient without the regulations.
- 21 If competition is sufficient to ensure the efficient and contestable operation of the markets without regulation, the Commission will recommend deregulation; if not, the Commission will nevertheless assess whether the markets would be more efficient with deregulation (even if competition is not at the efficient and contestable standard).

- 22 Fonterra supports the Commission’s proposed approach to assessing whether competition is sufficient or insufficient.

**“With and without” assessment**

- 23 The Commission proposes to compare the likely state of competition with deregulation against the state of competition under the status quo. This “with and without” assessment of competition will enable the Commission to assess whether Fonterra would in a deregulation counterfactual have the ability and incentive to exercise market power against competitors, suppliers or purchasers.
- 24 Fonterra notes that the Commission has proposed to conduct its evaluation by reference to a number of permutations of “with and without” scenarios. In particular it will evaluate permutations of different regulatory interventions: open entry and exit; base milk price; supply of raw milk.
- 25 Fonterra agrees there is a need to examine discrete regulatory interventions. However Fonterra would welcome further information as to how the Commission proposes to carry out this assessment as there is a risk that this analysis will become complex, potentially obscuring where the efficiency of regulation could be improved.
- 26 The Commission will assess Fonterra’s market power without regulation, including whether it would be likely to:
- 26.1 increase farm gate prices or change terms and conditions of supply to exclude competition;
  - 26.2 lower farm gate prices to suppress supply; and/or
  - 26.3 increase factory gate prices.
- 27 If deregulation does not significantly increase Fonterra’s ability and incentive to exercise market power then the Commission will conclude competition is sufficient and recommend deregulation. To the extent that Fonterra has only marginally greater ability and incentive to exercise market power then the Commission will consider the efficiency impacts of regulation.
- 28 Fonterra submits that in making this assessment it will be important for the Commission to take into account all aspects of Fonterra’s business and the context in which it operates, and would operate in any counterfactual – see in particular the factors identified above at paragraph 18.
- 29 If Fonterra can exercise significantly more market power then the Commission will conclude there is insufficient competition and move to consider the statutory competition thresholds.

**Deregulation thresholds**

- 30 The Commission has indicated it favours a comprehensive competition analysis as the basis for a decision to remove the regulations, over the current market share triggers, but that it is interested in views on this matter.
- 31 The Commission is correct, of course, that in the abstract market share information is only one indicator of competition in a market. In contrast, a comprehensive competition assessment is appealing in its potential to take account of complexity, all features of a market that should influence competition, and changing circumstances.

- 32 However, a deregulation threshold based on a competition assessment also gives rise to uncertainty in relation to when and how the thresholds would be considered met. In contrast, the current threshold triggers (at least if they are based on settled market definitions) have the advantage of being relatively certain in their application.
- 33 In addition, the market share triggers are not set in the abstract, but in the context of known dairy markets with known competition features and competition dynamics. Where pathways to deregulation are being considered, Fonterra submits the Review should examine whether, for some stages of deregulation at least, it is possible to identify market share thresholds that are a robust indicator of sufficient competition.

### **Transition pathway to deregulation**

- 34 The Commission proposes to consider matters such as whether:
- 34.1 all the regulations would be removed at once; or
  - 34.2 the removal of the regulations should be staggered.
- 35 Fonterra submits the assessment of any staggered deregulation could include whether the first stage incorporates immediate removal of current regulatory provisions that time and practice have shown to be redundant, and whether intermediate and final stages of deregulation can be identified where elements of the regulations fall away as competition continues to develop.

### **General comments**

- 36 The Commission has referred to certain reports in the consultation paper, namely:
- 36.1 Fonterra Limited and New Zealand Dairies Limited [2012] NZCC 21;
  - 36.2 Commerce Commission “Milk markets: consideration of whether to initiate a Commerce Act Part 4 inquiry into milk prices” (August 2011); and
  - 36.3 NERA Economic Consulting “An Assessment of the DIRA Triggers” (30 March 2010).
- 37 Fonterra acknowledges the Commission’s references to these reports. Noting the limited scope of the current consultation, Fonterra intends to comment on these reports in its substantive submissions on the Review.
- 38 Finally, this submission sets out Fonterra’s current key priorities in relation to the Commission’s process and methodology, as encapsulated in the consultation paper. Fonterra notes that it may wish to make additional points regarding process and methodology as the Review proceeds.



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