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Dear Alex

Cross-Submission on the Commerce Commission's Draft Report – Review of the State of Competition in the New Zealand Dairy Industry

Open Country Dairy (Open Country) is pleased to make this cross-submission to the Commerce Commission's (Commission) on its draft report as part of its review the state of competition in the dairy industry.

Open Country re-emphasises the points made in our original submission

Open Country agrees with the Commission and other submitters that there is insufficient competition in the dairy industry, and that the Dairy Industry Restructuring Act 2001 (DIRA) is critical to the success of the New Zealand dairy industry. Without DIRA, Fonterra would have the ability and incentive to exercise its market power to increase prices and decrease contestability in the market for raw milk.

Open Country recommends the Commission takes the current opportunity to recommend:

- The scope of the next review focus more broadly on opportunities to enhance regulatory settings with the objective of improving efficiency
- The legislative drafting of DIRA should clarify that any changes to DIRA will only occur after the review of the state of competition is undertaken and Parliament has considered the matter.

Open Country (and a number of others) consider that Fonterra does have the incentive to increase prices and decrease contestability in the market for raw. Considerable evidence has been presented over the course of the review of Fonterra using this incentive.

Fonterra overstates the efficiency costs of DIRA, and Fonterra's comments again raise questions about the treatment of spare capacity in the milk price manual

Our previous submissions and Castalia's reports have provided strong evidence that Fonterra already has a number of ways to manage the costs of open entry. The presence of these options significantly limits Fonterra's argument regarding the efficiency costs DIRA imposes on Fonterra.

Any costs of open entry also need to be balanced against the benefits, alternative drivers of investment, and Fonterra's ability to manage costs. Fonterra's submission estimates the cost it faces from needing to maintain spare capacity as a result of open entry. As identified in our cross-submission on substantive issues, the open entry provisions continue to have significant benefits that any costs need to be considered against.

Further, we think Fonterra is over-stating the costs it bears as a result of open entry. Fonterra states that it must maintain spare capacity in relation to farmers wanting to enter Fonterra. However, any measurement of the costs needs to clearly differentiate between:

- Plant Fonterra invests in as part of its strategy to grow milk supply globally
- Plant Fonterra invests in because of open entry.

It is unclear to Open Country what the relative proportions are, but it is not credible that Fonterra's plant investments since DIRA have been primarily driven by open entry. As referred to above, Fonterra also has some ability to control or recover these costs (such as charging separately for transport costs).

In addition, Fonterra's comments once again raise questions for the milk price manual. Fonterra previously stated that the manual included buffer capacity, and in last season's calculation changed its position, stating that the manual does not include buffer capacity. If Fonterra must maintain buffer capacity because of open entry and exit, then surely the notional processor must also. Given that Fonterra states that the manual includes no buffer capacity, we once again ask for clarity and consistency on this matter as a matter of urgency.

Asset stranding risk is not solely driven by DIRA, and its comments further raise questions on Fonterra's incentives

Fonterra states that it faces risks/costs from asset stranding due to open exit. However, all businesses face the risk of asset stranding from suppliers/customers leaving the business for competitors. We accept that open exit plays a role, but as above we need to be clear about the risks Fonterra might face because of DIRA and those it would face with or without DIRA. Failing to do this would unjustifiably attribute costs to DIRA.

Fonterra's comments on asset stranding also raise questions about Fonterra's incentives to lock-in farmers. Fonterra's comments suggest that Fonterra will reduce the risk of asset stranding without DIRA by locking-in farmers. If this is the case, it supports our position on Fonterra's incentives in the absence of DIRA.

Fonterra understates the switching costs faced by farmers

Fonterra's submission states that farmers have low switching costs (at para 13.5). We do not find this statement credible given that ensuring farmers have the confidence that they can re-enter Fonterra has always been a key rationale for having DIRA.

Conclusion

Open Country supports the Commission's overall recommendations and appreciates the opportunity to suggest a wider scope for the next review of competition, comment on Fonterra's incentives, and to address issues raised in other submissions.

We continue to support a detailed review of ways to improve DIRA. Unlike Fonterra, we see no reason to exclude the milk price regime, a key element of DIRA, from such a review. This is particularly given the opportunities we have previously identified to enhance the Commission's independent role in the milk price regime.

We also support the Commission's focus on ensuring that Fonterra's interest-free loans do not create additional barriers to switching, and monitoring Fonterra's targeted geographical pricing/offers and the impact these have on competition.

Best regards,

Steve Koekemoer

Chief Executive Officer

Open Country Dairy Ltd