



Dairy Industry Restructuring Amendment Bill 2012

Submission to the Primary Production Select Committee

Date: 24 April 2012

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Executive Summary

- X1 The Commerce Commission welcomes the opportunity to comment on the Dairy Industry Restructuring Amendment Bill 2012. The purpose of our submission is to assist the Primary Production Select Committee by providing our views on the new roles proposed for us in the Bill, namely:
- monitoring Fonterra’s methodology for setting the farm gate milk price and its application of that methodology against a specified purpose and principles
 - enforcing the Trading Among Farmers (TAF) behavioural obligations, and enforcing the fair value share requirement should TAF not proceed.
- X2 Our submission focuses on the proposed new milk price monitoring regime. We are not saying what the policy objectives of that regime should be; we are concerned that the policy intent is not clear in the Bill. We also provide our views on what the regime might realistically achieve.
- X3 Our key messages to the Committee are:
- the policy intent of milk price monitoring regime is unclear—there are three relevant purpose statements open to various interpretations
 - this lack of clarity may lead to unintended outcomes and to higher direct and indirect costs of implementing the monitoring regime
 - if our interpretation of the policy intent is correct (and which we are applying in undertaking our non-statutory ‘dry run’ review of Fonterra’s milk price), we **recommend** that the Committee consider our proposed new text for the s 150A purpose (and related sections), as set out in paragraph X13 below
 - if our interpretation of the policy intent is incorrect, we **recommend**: clarifying which of the purpose statements in s 4(f), s 4(fa), and s 150A has priority; providing clearer guidance on the desired extent of entry by Fonterra’s competitors; and indicating which of Fonterra’s and its competitors’ costs are intended to be relevant to our milk price reviews
 - even if the purpose of the monitoring regime is made clearer, the regime will not resolve all concerns about dairy sector prices—Fonterra will continue to have significant discretion in setting the milk price; many aspects of how Fonterra sets the price will be more transparent, but not all; and more weight will be given to improving Fonterra’s cost efficiencies than other efficiencies
 - we **recommend** considering whether the Commission or the Financial Markets Authority (FMA) is best placed to take on the proposed new role of enforcing TAF’s behavioural obligations
 - in addition to recommended changes to the s 150A purpose, we **recommend** a number of other specific drafting changes (refer Attachment C).

The policy intent of the milk price monitoring regime is unclear

Three purpose statements may lead to conflicting statutory interpretations

- X4 If the Bill is passed in its current form, there will be three purpose statements relevant to the milk price monitoring regime—s 4(f) which is already in the Dairy Industry Restructuring Act (DIRA), as well as s 4(fa) and s 150A from the Bill.

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** [existing s 4(f)]

to promote the setting of a base milk price that provides an incentive to [Fonterra] to **operate efficiently** [new s 4(fa) from the Bill]

to promote the setting of a base milk price that provides an incentive to [Fonterra] to **operate efficiently** and that as far as possible **preserves contestability** in the market for the purchase of milk from farmers [new s 150A from the Bill]

- X5 The purpose statements rely on the concepts of efficiency and contestability, but it is not clear which statement, and therefore which concept, would have priority. This raises a fundamental question about the policy intent of DIRA and the Bill—is contestability an explicit objective in its own right, or simply a means to achieving an overall objective of efficiency? We think the latter. However, we recommend that, in either case, the intent be made more explicit.

It is not clear whether productive, allocative or dynamic efficiency is more important

- X6 The milk price monitoring regime is intended to provide incentives for Fonterra to ‘operate efficiently’—which implies promoting Fonterra’s *productive* efficiency. It is less clear to what extent a milk price that “as far as possible preserves contestability in the market for the purchase of milk from farmers” is realistically expected to promote improvements in respect of *allocative* and *dynamic* efficiency as well.

The ‘contestability standard’ and ‘efficiency standard’ are open to different interpretations

- X7 The policy documents supporting the Bill explain that the milk price should be based on “assumptions designed to promote incentives for Fonterra to be efficient in the context of DIRA’s contestable market aims,” and “to operate in accordance with DIRA’s contestability standard.” Low barriers to entry are the key characteristic of a contestable market. However, neither ‘contestability’ nor ‘barriers to entry’ are unambiguous concepts, and the documents explain the desired contestability standard in three different ways: efficient pricing outcomes; the credible threat of entry; and the ability to compete or enter.
- X8 Each of these explanations has different implications for the appropriate level of Fonterra’s farm gate milk price. As a result, it is not clear what the reference to “preserving contestability” in s 150A is meant to imply for the extent of Fonterra’s efficiency. It is also unclear what it is meant to imply for the ability of existing independent processors to compete or new independent processors to enter. Is the intention not to preclude *any, some, or all* processors from *potentially* or *actually* competing?

It is unclear whether the Commission should consider both Fonterra's and competitors' costs

X9 Finally, it is also unclear whether the Commission's review should only focus on *Fonterra's* achievable costs and revenues, or whether satisfying the s 150A purpose might require the Commission to also determine or estimate *independent processors'* existing and potential costs (and revenues).

Lack of clarity may lead to unintended outcomes, litigation and higher costs of regulation

X10 Debates about the meaning of terms such as 'efficiency' and 'contestability', and the relative weight to be given to them, are not semantic or academic. Different interpretations of the statute may lead to outcomes which differ from those intended by Parliament. Even though the proposed regime only involves price monitoring, there is a risk that disputes about the appropriate level of the milk price may end up before the Courts. If the legislative intent is confused, the Courts may form a view on the regulatory objectives which is different from the intention. The costs and wasted effort of such litigation could be significant for all parties concerned, yet could be avoided by providing clarity in the legislation.

X11 Also, to the extent that the legislation does not provide clear guidance to Fonterra or the Commission in setting and reviewing the milk price, it raises the prospect that the direct costs of the regime are unnecessarily high as well. For instance, the extent to which Fonterra's or competitors' costs are intended to be relevant is important, because that will affect the amount of information the Commission would need to collect, review, verify and analyse, and therefore the cost of implementing the monitoring regime. It is in the interests of all industry stakeholders to have certainty about the objectives and relevant considerations for the monitoring regime.

We have had to interpret the policy intent for our 'dry run' review of Fonterra's milk price

X12 The Minister for Primary Industries has requested we conduct a non-statutory 'dry run' of the milk price monitoring regime. The dry run, which is currently ongoing, involves a review of Fonterra's current Milk Price Manual and recent milk price calculation. For the purposes of the dry run, and based on statements in the Cabinet Paper supporting the Bill, our interpretation of the policy intent of the monitoring regime is that:

- it is acceptable the milk price might be set at a level such that an independent processor more efficient than Fonterra might not be able to enter
- the Milk Price Manual's assumptions should not be over-optimised to an extent the price precludes *all* efficient processors from potentially competing
- we need not model the milk price independent processors can afford to pay.

We propose a revised purpose for the monitoring regime based on that interpretation

X13 If this interpretation of the policy intent for the purposes of the dry run is correct, then we would recommend changing the current wording of the s 150A purpose, and making consequential changes to ss 150C and 150P, to make that intent clearer. In recommending these changes we are not expressing a view about the correct policy

settings for the new milk price monitoring regime—we are simply seeking to ensure that the policy as we understand it is implemented as effectively as possible.

Section 150A [amendment]: The purpose of this subpart is to promote the setting of a base milk price that—

- a) provides an incentive to new co-op to operate efficiently; and
- b) consistent with ensuring the market for the purchase of milk from farmers is contestable, does not prevent all efficient independent processors from potentially competing with new co-op.

Section 150C(1)(bi) [new]: any notional costs, revenues or other assumptions taken into account in calculating the base milk price must be practically feasible for an efficient processor to replicate:

Section 150P(4) [new]: For the avoidance of doubt, in making the report the Commission is not required to assess the costs of any independent processor or model the costs of a new entrant into the market for the purchase of milk from farmers.

The milk price monitoring regime will not resolve all concerns about dairy sector prices

- X14 DIRA already includes a number of regulatory provisions intended to enhance contestability by lowering barriers to entry. However, a number of concerns continue to be raised by industry stakeholders.
- X15 We acknowledge that the proposals in the Bill are not intended to address stakeholder concerns about the level of retail milk prices, factory gate milk prices, or town milk prices. Rather, we understand that the milk price monitoring regime is intended to address Fonterra's *significant discretion* in setting its farm gate milk price, the *lack of transparency* in how Fonterra sets that price, and the *potentially inefficient outcomes* which might arise if that price is set inappropriately.

Fonterra will continue to have significant discretion in setting the milk price

- X16 The Bill places little constraint on Fonterra's ability to set the milk price as it sees fit.
- The Bill allows Fonterra to change its methodology and the application of that methodology each year. The range within which the milk price is found to be consistent with the purpose and principles might be fairly wide, potentially making it difficult to predict the price from one year to the next.
 - Section 150R of the Bill makes it clear that Fonterra may vary the milk price, even *after* the Commission has published its report on that price.
- X17 Purchasing raw milk is the most significant cost for milk processors, so even small changes in the milk price can have a significant effect on their expected profitability. Therefore, Fonterra's ability to unilaterally vary the milk price, and the uncertainty this might create, arguably raises a barrier to entry for potential competitors.
- X18 In addition, it is questionable whether the monitoring regime, as currently proposed, will provide an appropriate level of certainty to Fonterra's farmer members or TAF investors by helping them to predict the milk price.

Many aspects of how Fonterra sets the milk price will become transparent, but not all

- X19 The monitoring regime's disclosure requirements and the Commission's review of the milk price will clearly improve the transparency of Fonterra's price setting. However, one of the key concerns of Fonterra's competitors relates to Fonterra's management of its foreign exchange risk. Although Fonterra and some of its competitors will be similarly exposed to foreign exchange fluctuations, under s 150B(c) of the Bill Fonterra's competitors would have to pay a milk price that reflects the way Fonterra manages that risk. Arguably, this is a barrier to entry. Further, treating foreign exchange fluctuations as a safe harbour does not improve transparency or certainty over this potentially significant aspect of the milk price.
- X20 One way to mitigate this barrier to entry, as well as to promote greater transparency and certainty, would be to include a requirement in s 150C(1) for Fonterra to set out in the Manual the foreign exchange rates it will apply for the coming season, or the formula or benchmark it will apply to determine those rates. If such a requirement were included, s 150B(c) would need to be removed for consistency.

The regime is focused more on Fonterra's cost efficiencies than other types of efficiencies

- X21 The policy documents supporting the Bill highlight concerns about:
- the risk of waste and of weak incentives for Fonterra to drive cost efficiencies (ie *productive* efficiency concerns)
 - the risk of distorted price signals caused by inefficiencies in Fonterra's milk price or share price (ie *allocative* efficiency concerns)
 - the risk that Fonterra may have weak incentives to innovate and invest optimally (ie *dynamic* efficiency concerns).
- X22 Given that references to incentives for Fonterra to 'operate efficiently' occur in both s 4(fa) and s 150A of the Bill, the primary focus of the milk price monitoring regime appears to be improving incentives for Fonterra to drive cost efficiencies (ie productive efficiency). Concerns about whether investment to cater for new milk supply is undertaken by the most efficient processor (ie dynamic efficiency) appear to be given less weight. In any event, there are limits to which an administratively determined price like Fonterra's farm gate milk price can provide the same kinds of incentives for efficiency as would occur in a competitive market.

We may not be best placed to enforce the TAF behavioural obligations

- X23 The Bill includes obligations on Fonterra in relation to trading of its shares and the new TAF fund, and restrictions on Fonterra's behaviour under TAF. It is not clear to us whether the Commission is best placed to take on the new role of enforcing TAF's behavioural obligations, or whether these should be enforced by the FMA along with its existing responsibilities under the Securities Markets Act.

Introduction

Purpose and scope of our submission

1. The Commerce Commission welcomes the opportunity to comment on the Dairy Industry Restructuring Amendment Bill 2012.¹ The purpose of this submission is to assist the Primary Production Select Committee by providing our views on the new roles proposed for us in the Bill. We are also available to assist the Committee or officials further in providing additional information if that would be helpful.
2. Our proposed new roles are:
 - monitoring Fonterra's methodology for setting the farm gate milk price and Fonterra's application of that methodology
 - enforcing the Trading Among Farmers (TAF) behavioural obligations
 - enforcing the fair value share requirement should TAF not proceed.
3. The focus of our submission is on the milk price monitoring regime because:
 - this is the key new role for the Commission proposed in the Bill
 - at the request of the Minister for Primary Industries, we have already begun a 'dry run' of the monitoring regime. The dry run involves a review of Fonterra's current Milk Price Manual and recent milk price calculation.
4. We are not submitting on what the appropriate policy objectives of the amendments to the Dairy Industry Restructuring Act 2001 (DIRA) should be. Rather, our comments are on:
 - the extent to which the Bill is likely to give effect to the policy intent
 - any lack of clarity in the policy intent
 - implications that different interpretations of the policy or of the language in the Bill might have on the Commission's effective implementation of the milk price monitoring regime
 - other issues we consider relevant to our implementation of the milk price monitoring regime.
5. We also have some brief comments on our expertise and capability to enforce the TAF behavioural obligations, and some observations on the fair value share requirement.

¹ A brief overview of the Commission, and its role in the dairy sector, is provided in Attachment A.

Proposed DIRA amendments

6. The Bill introduces a new regime under DIRA in relation to Fonterra's farm gate milk price setting, proposed capital restructure, and share valuation.
7. We recognise the important role the proposed milk price monitoring regime can play in ensuring Fonterra's milk price is set consistent with the wider efficiency objectives of DIRA, and we are ready to play whatever role Parliament considers appropriate in implementing that regime.
8. We also acknowledge the significance of the proposed TAF scheme to the New Zealand economy, as it is intended to provide Fonterra with the opportunity to raise additional capital to expand in New Zealand and international dairy markets, and for the development of New Zealand's capital markets.

'Dry run' of the milk price monitoring regime

9. The Minister for Primary Industries has requested we conduct a non-statutory 'dry run' of the milk price monitoring regime. We recognise the importance of the dry run review in providing increased investor certainty ahead of the potential launch of TAF in November this year.
10. We issued the terms of reference for our dry run review on 6 March 2012.² The dry run review is intended to assess whether Fonterra's current Milk Price Manual and its application are consistent with the purpose and principles in the proposed DIRA amendments. On 30 March we advised stakeholders that we proposed to undertake the dry run review by reference to the revised purpose and principles in the Bill introduced to the House, rather than those in the Exposure Draft of the Bill released in January.³ We are intending to complete the dry run review by 14 August this year.

Outline of our submission

11. The remainder of our submission covers the following:
 - our understanding of the policy concerns that the milk price monitoring regime is intended to address, and our views on the extent to which the regime is likely to address to those concerns
 - our key concerns about the clarity of the policy intent
 - our interpretation of the policy intent for the purposes of our dry run review
 - our proposed purpose statement for the monitoring regime based on that interpretation
 - our views on the inclusion of milk price principles and assumptions in the Bill

² Commerce Commission, *Monitoring of Fonterra Milk Price Manual and Base Milk Price Calculation, Terms of Reference for 2012 Pre-Legislation Review*, Wellington, 6 March 2012

³ Commerce Commission, *Further information on our approach to dry run review of Fonterra's Farm Gate Milk Price*, Wellington, 30 March 2012

- a brief description of the Commission and our role in regulating the dairy sector (Attachment A)
- the purpose of DIRA, and the key concepts of ‘efficiency’ and ‘contestability’, which relies on the concept of ‘barriers to entry’ (Attachment B)
- our recommended drafting changes to specific clauses of the Bill (Attachment C).

Our views on what a milk price monitoring regime might achieve

DIRA enhances contestability by reducing barriers to entry

12. In Attachment B we discuss the purpose of DIRA, and the key concepts of ‘efficiency’ and ‘contestability’. Fonterra is considered to benefit from a number of ‘barriers to entry’. DIRA enhances contestability in New Zealand dairy markets by seeking to reduce some of those entry barriers, including through the following.

- **Raw Milk Regulations.** Fonterra is required to supply a percentage of its milk to independent processors on specified terms, because independent processors can face difficulties in sourcing milk directly from farmers in their start-up years. Levelling the playing field between Fonterra and its rivals in this way is intended to provide independent processors with a pathway to entry and a means to obtaining a sustainable scale.
- **Open entry and exit regime.** Fonterra is prohibited from imposing restrictions on the ability of farmers to enter and exit the cooperative. Doing so is intended to lower barriers to entry for independent processors looking to enter the market, as farmers are more easily able to move their milk supply between different processors. In addition, the freedom of entry and exit requirements are intended to strengthen Fonterra’s commercial incentives to price its milk and its shares efficiently over the long term.⁴

Problem definition and how the milk price monitoring regime might assist

13. Despite the requirements and constraints that DIRA’s existing regulatory provisions place on Fonterra, a number of concerns continue to be raised by industry stakeholders. The policy documents identify the following problems that the milk price monitoring regime set out in the Bill is intended to address:

- Fonterra’s significant discretion in setting the milk price
- the lack of transparency in how Fonterra sets its milk price
- the potentially inefficient outcomes that might arise if the milk price is set inappropriately.

⁴ Ministry of Agriculture and Forestry (MAF), *Regulatory Impact Statement: Fonterra’s Milk Price Setting, Capital Restructure and Share Valuation*, Wellington, 14 March 2012, (RIS), paragraph 6. The RIS notes that because Fonterra exports the vast majority of its production it faces strong competitive pressure from international dairy markets.

14. We set out our understanding of the problem definition for each of these issues below.
15. The Bill introduces a new Subpart 5A into DIRA relating to Fonterra's process for, and calculation of, its farm gate milk price (referred to in the Bill as the 'base milk price'). The subpart provides for a milk price monitoring regime under which the Commission would undertake annual reviews of the milk price methodology set out in Fonterra's Milk Price Manual, and the application of that Manual in setting the milk price, against a specified purpose and principles.
16. For each problem we therefore also set out our views on the extent to which the milk price monitoring regime, as drafted, is likely to address the identified policy concerns (assuming the purpose and principles are appropriately clarified, which is our primary concern about the Bill).
17. We acknowledge that the proposals in the Bill are not intended to address some of the other concerns raised by various stakeholders about the dairy sector, such as the level of retail milk prices (or the level of the factory gate milk price, or the town milk price).⁵

Significant discretion and lack of certainty

18. The Regulatory Impact Statement (RIS) to the Bill explains that Fonterra has had a significant ability to change both the milk price and share price in the short to medium term, as well as the methodology and process by which those prices are derived. Fonterra has potentially been able to manipulate prices over the short to medium term to gain a competitive advantage over its rivals.⁶ A key reason why this may be a concern is that purchasing raw milk is the most significant cost for milk processors, so even small changes in the milk price can have a significant effect on profitability.
19. A related concern is the impact this discretion might have on certainty for Fonterra's shareholders—both Fonterra's farmer members and TAF investors. For instance, a key objective of our dry run review of Fonterra's Milk Price Manual is to provide increased investor certainty ahead of the potential launch of TAF.⁷
20. A number of commentators have suggested that the proposed milk price monitoring regime amounts to 'heavy-handed regulation'. However, the proposals deliberately place no constraints on Fonterra's ability to set the farm gate milk price as it sees fit,⁸ either before or after the Commission undertakes its annual review of how that price has been determined.

⁵ For example, refer Office of the Minister for Primary Industries, *Dairy Regulatory Framework – Fonterra's Milk Price Setting (Paper 1)*, to the Chair, Cabinet Economic Growth and Infrastructure, March 2012, (Cabinet Paper) paragraph 23

⁶ RIS paragraphs 21, 28 and 31-32

⁷ This concern is not explicitly mentioned in the policy documents supporting the Bill. However, the RIS (paragraph 17) does note that an effective regulatory regime would be consistent with general principles of good regulatory practice, which include the certainty and predictability of regulatory outcomes.

⁸ Cabinet Paper paragraph 50

21. Although the measures intended to improve transparency (discussed further below) may go some way to assisting Fonterra's competitors and investors to predict the future level of the milk price, Fonterra will still have the discretion to change the base milk price.
- First, Fonterra may change its methodology and the application of that methodology each year. It is possible that the range within which the milk price is found to be consistent with the purpose and principles is fairly wide, potentially making it difficult to predict the price from one year to the next.
 - Second, s 150R of the Bill makes it clear that Fonterra may vary the base milk price for a particular year, even *after* the Commission has published its report on that price.
22. We are certainly not advocating any type of regulation more intrusive than the proposed monitoring regime—the industry is not a natural monopoly and it is subject to competitive pressures from global dairy markets. However, we highlight that the proposals do not directly address the barrier to entry that may arise from Fonterra's ability to unilaterally vary the milk price.
23. Nor do the proposals appear to specifically promote the short-term objective underpinning our dry run review over the longer term—namely, providing increased certainty to TAF investors. It is questionable whether the monitoring regime would provide an appropriate level of certainty to farmers or other investors by helping them to predict the milk price. Potential investors are still likely to be concerned about Fonterra being able to change the split between the milk price and dividends after they have invested.

Lack of transparency

24. Until recently, the methodology which Fonterra applied to derive the farm gate milk price, set out in Fonterra's Milk Price Manual, and the way the Manual was applied in practice to derive the milk price, was confidential. The RIS notes that, without an explicit provision for ongoing monitoring and assessment of Fonterra's pricing, it is difficult to assess whether the milk price in any given season is meeting DIRA's regulatory objectives.⁹
25. The monitoring regime's disclosure requirements and the Commission's review of the milk price are primarily directed at improving the transparency of Fonterra's price setting. Any exercise of Fonterra's discretion is likely to be made more transparent. However, a key concern of industry stakeholders that relates to transparency does not appear to be directly addressed by the proposals—the management of Fonterra's foreign exchange risk.
26. Although both Fonterra and independent processors that export milk products are exposed to foreign exchange fluctuations, Fonterra's competitors are also exposed to the way in which Fonterra manages that risk, thereby arguably creating a barrier

⁹ RIS paragraphs 22 and 27

to entry. Fonterra can pass its actual foreign exchange gains and losses through to farmers via the milk price. Under the Bill, Fonterra would be expressly permitted to do so by s 150B(c).

27. One way to mitigate this barrier to entry, as well as to promote greater transparency and certainty, would be to include a requirement in s 150C(1) for Fonterra to set out in the Manual the foreign exchange rates it will apply for the coming year, or the formula or benchmark it will apply to determine those rates. For example, s 150(1)(a) could be revised as follows.
- (a) revenue taken into account in calculating the base milk price is determined--
 - (i) from prices of a portfolio of commodities at the times that those commodities are contracted to be sold by new co-op; and
 - (ii) using foreign exchange rates that are either set out in the milk price manual (see **section 150F**) for that season or derived from a formula or benchmark set out in the milk price manual for that season
28. If such a requirement were included, s 150B(c) would need to be removed for consistency.

Potentially inefficient outcomes

29. The RIS recognises the importance of all three dimensions of efficiency—productive, allocative and dynamic.
- The RIS highlights the risk of waste and of weak incentives for Fonterra to drive cost efficiencies (productive efficiency concerns).
 - The RIS refers to the risk of distorted price signals caused by inefficiencies in Fonterra’s milk price or share price (allocative efficiency concerns). Although officials consider that the approach taken in Fonterra’s Milk Price Manual is conceptually consistent with outcomes in a competitive market, they have identified a number of “crucial—but necessarily subjective—decisions” required in calculating the milk price, which would have a material impact on the efficiency of the final pricing outcome.¹⁰
 - The RIS observes that, in the absence of effective competition, Fonterra may have weak incentives to innovate and invest optimally (dynamic efficiency concerns).
30. Given that references to incentives for Fonterra to ‘operate efficiently’ occur in both s 4(fa) and s 150A of the Bill, the primary focus of the milk price monitoring regime appears to be improving Fonterra’s productive efficiency. Dynamic efficiency concerns, such as whether investment to cater for new milk supply is undertaken by the most efficient processor, appear to be given less weight.

¹⁰ RIS paragraphs 24-26

31. In any case, there are limits to which an administratively determined price like Fonterra's farm gate milk price can provide the same kinds of incentives for productive, allocative and dynamic efficiency as would occur in a workably competitive market. In addition, although the milk price methodology is determined annually up-front, the methodology is applied to determine Fonterra's milk price toward the end of the season. While an end-of-season farm gate milk price is a feature of the New Zealand market, it weakens the extent to which the price is likely to act as a signal that provides incentives for farmers to undertake efficient milk production and capital investment within a season. Fonterra publishes forecasts of the milk price throughout the season—but this is not something the milk price monitoring regime itself requires.
32. Therefore, even if the milk price monitoring regime results in a milk price consistent with a productively efficient Fonterra earning a normal return over time, it is an open question whether that price would also promote allocative and dynamic efficiency, including the appropriate split between the milk price and the dividend payment.
33. Finally, we acknowledge that some independent processors have concerns that, irrespective of the proposed milk price monitoring regime, Fonterra will still be able to set the milk price so high that potential new entrants will be unable to enter, despite being as efficient, or more efficient, than Fonterra. The extent to which the milk price calculation is based on optimised costs will affect the extent to which such an outcome is likely.
34. The Bill attempts to address these concerns by implying an upper limit to how high the milk price could go, by referring to the concept of 'contestability'. However, as is discussed in the following section, neither the Bill as drafted, nor the supporting policy documents, provide sufficient clarity as to the desired upper limit, or how it might be established.

Our concerns with the clarity of the monitoring regime's policy intent

Purpose of the milk price monitoring regime

35. Like s 4(f) of DIRA, the new milk price monitoring regime has both efficiency and contestability objectives. For instance, the Explanatory Note to the Bill observes that the purpose of subpart 5A "is, in loose paraphrase, to promote the setting of a base milk price that encourages efficiency and contestability in the market for the purchase of milk from farmers".¹¹ Specifically, the purpose of the new subpart (s 150A) is:

to promote the setting of a base milk price that provides an incentive to [Fonterra] to operate efficiently and that as far as possible preserves contestability in the market for the purchase of milk from farmers

36. In addition, the Bill also proposes amending s 4 to include an additional objective in DIRA's overall purpose statement (s 4(fa)) which is:

¹¹ Dairy Industry Restructuring Amendment Bill, Explanatory Note, [3 April 2012], (Explanatory Note), p 6

to promote the setting of a base milk price that provides an incentive to [Fonterra] to operate efficiently

Policy intent of milk price monitoring regime

37. It is clear from s 150A and s 4(fa) that a key element of the policy intent of the milk price monitoring regime is to provide incentives for Fonterra to operate efficiently. Given Fonterra is the dominant processor of raw milk, providing incentives for Fonterra to operate efficiently is also consistent with the efficiency objective in s 4(f) of DIRA.
38. The RIS discusses four potential ‘standards’ that could apply if a milk price monitoring regime is introduced. The milk price could be based on:
- a) Fonterra’s actual performance
 - b) a perfectly optimised notional competitor
 - c) assumptions Fonterra would be expected to employ in a competitive market
 - d) assumptions designed to promote incentives for Fonterra to be efficient in the context of DIRA’s contestable market aims.¹²
39. The RIS explains that options a) and b) represent extremes—with a) regulating for entry, and b) regulating for efficiency but precluding entry. Neither option a) or b) is considered to promote the efficient operation of New Zealand’s dairy markets.
40. By contrast, options c) and d) would be seeking a milk price somewhere between a) and b), such that “entry is not precluded (subject to a particular level of efficiency of entrants).” The RIS recommends that option d) is preferred to option c), “since it provides a more objective standard for the Commerce Commission to assess assumptions against, and as such will have lower direct regulatory costs (both for the Commission and for Fonterra in reporting to the Commission).”¹³
41. We agree that option d) could, in principle, provide a more objective standard than option c), resulting in a more straight-forward assessment. However, it is not clear what “the context of DIRA’s contestable market aims” implies for our review of Fonterra’s milk price methodology and its application.

The clarity of the policy intent and drafting could be improved

42. Our key concerns with the purpose of the milk monitoring regime are as follows.
- **Three purpose statements.** Having three relevant purpose statements governing the milk price monitoring regime—ie s 4(f), s 4(fa) and s 150A—may lead to conflicting statutory interpretations.

¹² RIS paragraph 63

¹³ RIS paragraph 67

- **Relevant dimensions of efficiency.** It is clear that the milk price monitoring regime is intended to provide incentives for Fonterra to ‘operate efficiently’—which implies promoting Fonterra’s productive efficiency. It is less clear to what extent a milk price that “as far as possible preserves contestability in the market for the purchase of milk from farmers” is realistically expected to promote significant improvements in respect of all three dimensions of efficiency.
- **Appropriate contestability standard.** It is not clear what standard of contestability is implied in the reference to “preserving contestability”. In particular, it is not clear what this standard implies for the ability of existing independent processors to compete, or new independent processors to enter.
- **Appropriate efficiency standard.** It is not clear how the contestability standard is intended to guide the appropriate extent of Fonterra’s efficiency in the context of a milk price intended to provide incentives for Fonterra to be efficient. Again, it is not clear whether the intention is not to preclude any, some, or all processors from potentially or actually competing.
- **Relevance of Fonterra’s costs or competitors’ costs.** Finally, it is also not clear whether the Commission’s review should only focus on Fonterra’s achievable costs and revenues, or whether satisfying the s 150A purpose statement might require the Commission to also determine or estimate independent processors’ existing and potential costs and revenues.

43. We expand on each of these concerns below. We then describe how we have interpreted the policy intent and draft legislation for the purpose of our dry run review. We then recommend specific text for the purpose statement for the milk price monitoring regime that we consider would give effect to what we understand the policy intent to be.

Three purpose statements

44. As is discussed further in Attachment C, it is not clear which of the purpose statements in s 4(f), s 4(fa) and s 150A would have priority. This raises a fundamental question about the policy intent of DIRA and the Bill—is contestability an explicit objective in its own right, or simply a means to achieving an overall objective of efficiency?
45. To us, s 4(f) read on its own would imply that DIRA’s regulatory provisions should promote contestability, but only to the extent that this promotes efficiency. This would suggest that promoting entry for entry’s sake is not sufficient to satisfy the intent of DIRA.
46. For example, where expanding milk production requires new processing plants, a regime which allowed the most efficient processor to make this investment, whether an existing market participant (including Fonterra) or a new entrant, would promote

efficiency. However, if new entry resulted in investments that inefficiently duplicated or stranded existing processing plant, then overall efficiency might be reduced.

Relevant dimensions of efficiency

47. As is noted above, the RIS raises potential productive, allocative and dynamic efficiency concerns about Fonterra's performance given the absence of a workably competitive dairy market. However, both s 150A and s 4(fa) appear to focus solely on promoting Fonterra's *productive* efficiency, given the specific reference to providing incentives for Fonterra to 'operate efficiently'.
48. Also, the focus of the Bill on *Fonterra's* efficiency might be seen as downplaying the possible dynamic efficiency concern that investment to cater for new milk supply ought to be undertaken by the most efficient processor. The policy documents do not appear to distinguish between investing to meet the expected growth in milk supply and investing to meet the existing milk supply.
49. Nevertheless, the reference in s 150A to a milk price that "as far as possible preserves contestability" suggests that dimensions of efficiency other than productive efficiency are also relevant.

Appropriate contestability standard

50. The Explanatory Note states that the Bill "introduces a new milk price regime to bolster the existing incentives for Fonterra to operate in accordance with DIRA's contestability standard."¹⁴ However, the Explanatory Note and the other policy documents supporting the Bill explain this contestability standard in a number of ways, each of which have different implications for the appropriate level of Fonterra's farm gate milk price:
 - efficient pricing outcomes
 - credible threat of entry
 - ability to compete or enter.

Efficient pricing outcomes

51. In referring to the 'contestability standard', the Explanatory Note explains that the Bill's provisions will promote "greater confidence in the consistency of Fonterra's farm gate milk price with contestable outcomes."¹⁵ Similarly, the RIS states that: "Contestability essentially means that outcomes should be efficient", and observes that the preferred option d) would "enhance confidence in the consistency of milk price *outcomes*, with those arising in a contestable market."¹⁶
52. The Commission has previously considered what the standard of contestability in DIRA means for efficient pricing outcomes, although in a different context than the

¹⁴ Explanatory Note p 2

¹⁵ Explanatory Note p 2

¹⁶ RIS paragraphs 20 and 61 (emphasis in original). Also refer RIS paragraph 30 and pp 3 and 14

farm gate milk price. In 2005 the Commission considered the meaning of the ‘reasonable cost’ of transporting raw milk to independent processors (under the Raw Milk Regulations).

53. The Commission concluded that, in light of s 4(f) of DIRA, any consideration of the reasonable cost of transporting raw milk to independent processors “must be guided by the principles of efficiency and contestability”.

A firm in a contestable market would not charge a price above the unit stand-alone cost, because such a price would invite entry, making it unsustainable. ... The stand-alone cost of a particular product is the cost that would be incurred by an efficient firm in producing only that product. It is the total cost of producing that product on a stand-alone basis, including a normal return on capital. ... The Commission considers that Open Country should not have to pay a price for transport services from Fonterra that is higher than the maximum it would have to pay in a hypothetical contestable market.¹⁷

54. This interpretation of contestability would imply that the appropriate milk price would be the price *just low enough not to invite entry* from a productively efficient competitor that expects to earn a normal return on its efficient investments.¹⁸ In other words, the milk price would need to be even lower to make actual entry attractive.
55. The Cabinet Paper to the Bill states that: “A contestability standard should, in effect, result in a farm gate milk price consistent with that which would emerge in a workably competitive market”.¹⁹ However, the contestable market price would not necessarily be the same, at any particular time, as the price in a workably competitive market.²⁰ Rather, as Annex 1 of the RIS explains, the price is difficult to

¹⁷ Commerce Commission, *Decision 570, Determination in the matter of an application for determination of a dispute under the Dairy Industry Restructuring Act 2001 involving Open Country Cheese Company Limited And Fonterra Co-Operative Group Limited*, Wellington, 23 December 2005, paragraph 184 (emphasis added)

¹⁸ Also: “In a perfectly contestable market, competitive behavior is imposed upon the incumbent firm by the threat of entry. Thus, the highest price ... that the incumbent can select is one that is **just insufficient to attract the entry of new firms**. Any price that would attract entrants is too high, for it could not persist in a perfectly contestable market” (W. Baumol and G Sidak, *Toward Competition in Local Telephony*, The MIT Press, Cambridge MA, pp 77-78, emphasis added). In contrast to these quotes, in this context the contestable market price would be the *minimum* farm gate milk price that would invite entry, rather than the maximum price, because the farm gate price would be found from the revenue tied to global dairy market prices, less the efficient stand-alone costs of collecting, processing and selling milk, divided by the volume of milk sold. In other words, the relevant maximum price is that component of the farm gate milk price which would recover the efficient stand-alone costs of collecting, processing and selling milk.

¹⁹ Cabinet Paper paragraph 41

²⁰ In addition, the contestable market price would not require the same assumption as option b) in the RIS—ie a perfectly optimised notional competitor. Nor would it need to be based on a *perfect* contestability standard (as it is not necessary to assume away all barriers to entry). For instance, in its Decision 570, the Commission decided not to take a benchmarking approach to estimate independent transport operator costs, because this was seen as requiring assumptions that could introduce estimation errors. Rather, the Commission assessed Fonterra’s *own* reasonably efficient transport stand-alone costs as if it were hypothetically operated as a separate business unit (Commerce Commission, *supra* n 17, paragraphs 194-197).

objectively estimate for a market where competition is *not* workable, and is likely to lie within a range.

Exactly where it sits will depend on a range of factors, including rate of innovation, fluctuations in the international price for milk products, and firm specific factors such as where they are located and the presence of local market power.

The evolution of price between these extremes is part of the ongoing process of competition. The impossibility of determining the efficient price at any moment in time is precisely why it is left to the market whenever competition is a real possibility.²¹

56. Given the absence of a workably competitive market for farmers' milk, Fonterra's farm gate milk price has to be determined using an 'administrative methodology'.²² However, there are limits to which an administratively determined price, or any regulated price, can provide the same kinds of incentives for productive, allocative and dynamic efficiency as would occur in a workably competitive market.
57. Setting the price at a level just sufficient not to invite efficient entry would provide some incentives for Fonterra to operate efficiently. Yet setting such a precise price as a regulatory target would present real practical difficulties. However, the price level does not have to be 'right' to provide incentives for Fonterra to improve its productive efficiency. Setting any realistic achievable benchmark for the costs that underpin the milk price would provide a target for Fonterra's management to beat.

Credible threat of entry

58. Both the RIS and the Cabinet Paper also explain the contestability standard (or contestability aims) of DIRA in terms of a credible threat of entry. Fonterra should be incentivised to constantly strive to be more efficient, even if entry does not take place. For example:

In general, the DIRA is premised upon regulating to ensure that the dominant player has the right incentives to be efficient. It does this through ensuring a **credible threat of entry by efficient competitors** – i.e. the DIRA imposes a contestability standard. Contestability essentially means that outcomes should be efficient, **whether or not there is an increase in the number of competitors in the farm gate milk market.**²³

59. This interpretation of DIRA's contestability standard is not dissimilar to the efficient pricing outcome discussed in the previous sub-section, where it is assumed that entry does not take place. However, this interpretation recognises that entry *might*

²¹ RIS p 35. In our report last year on whether to initiate a Part 4 inquiry into milk prices, we observed that: "Whether or not applying these concepts [ie contestability and workable competition] would result in different regulated pricing principles [ie the competitive standard or benchmark used to inform regulation of prices] and/or price is an open question and ultimately depends on the characteristics of the market in question" (Commerce Commission, *Milk Markets, Consideration of whether to initiate a Commerce Act Part 4 Inquiry into milk prices*, August 2011, paragraph 135).

²² Explanatory Note pp 1-2

²³ RIS paragraph 20 (emphasis added). Also: RIS paragraphs 26 and 63b, and Cabinet Paper paragraph 35.

take place, but whether it actually does so is considered not important to the achievement of DIRA's efficiency objective.

Ability to compete or enter

60. The Explanatory Note states that: "In order to be consistent with the existing contestability standard in the DIRA, the Commerce Commission will be assessing whether the farm gate milk price provides incentives for Fonterra to operate efficiently but does not preclude efficient processors from potentially competing". This statement might be interpreted as going a step further than a 'credible threat of entry'. However, the RIS is more explicit:

That is, as long as Fonterra does not use the farm gate milk price as a barrier to entry for efficient competitors, **then the price should allow an efficient processor to compete**; and incentivise Fonterra to itself operate efficiently.²⁴

61. There are a number of other references in the policy documents to the concern that, if the farm gate milk price is set at a sufficiently high level, the price will itself act as a barrier to entry.²⁵ One way of thinking about the influence of the milk price on market behaviour is the extent to which a lower farm gate milk price might *attract* entry. In other words, a key question is whether the price is sufficiently low to overcome the barriers to entry that provide Fonterra with a comparative advantage—such as some of those listed in paragraph B.21 below—and which are not already adequately addressed by DIRA's existing regulatory provisions.
62. The level of the farm gate milk price necessary to mitigate these costs and risks to an extent that a potential competitor would be prepared to invest significant capital in the dairy industry might be far lower than what could be considered an 'efficient' farm gate milk price if the market were contestable. For instance, if Fonterra retains the discretion to change its price as it sees fit after the Commission's review, the risk of a retaliatory price response remains. Therefore, even if the purpose and principles set out in DIRA imply a milk price that should *promote* entry, and the base milk price reviewed by the Commission is found to be consistent with that purpose and principles, there might still be a barrier in place that might discourage actual entry.
63. In conclusion, a lower farm gate milk price might not necessarily be low enough to mitigate barriers to entry sufficiently to attract actual entry. The Explanatory Note states that "an inefficient farm gate milk price could act as a barrier to efficient entry of processors, and therefore could hamper the contestability objectives of DIRA." However, there is an inherent contradiction in this statement, because the more productively efficient Fonterra is, the higher the milk price can be (while still allowing Fonterra to earn a normal return over time), but the less likely actual entry will be.²⁶ On the other hand, the further the price drops below the level consistent with Fonterra operating efficiently, the more likely entry is. The efficient contestable

²⁴ RIS paragraph 20

²⁵ For example: Explanatory Note p 2, RIS paragraph 25, Cabinet Paper paragraph 27

²⁶ The milk price calculation would involve assumptions about an appropriate level of productive efficiency which could differ from Fonterra's actual productive efficiency in any number of respects.

market milk price, and the milk price that would allow an efficient processor to compete, are not necessarily the same.

Appropriate efficiency standard and relevant costs

64. The previous sub-section has covered some of the issues that could arise if the contestability standard governing the milk price monitoring regime is ambiguous. A related issue is the implication this standard has for Fonterra's expected level of efficiency, and whether the costs relevant to the Commission's assessment are those of Fonterra or of independent processors. This is important because it will affect the amount of information the Commission would need to collect, review, verify and analyse, and therefore the direct costs of implementing the monitoring regime.
65. Both the RIS and the Cabinet indicate that the assumptions Fonterra employs in setting the milk price should not be "overly optimised". The RIS also reflects the concerns of a number of industry participants have that aspects of Fonterra's current price setting might be "not feasible".²⁷
66. The RIS and the Cabinet Paper both indicate that entry should not be precluded "subject to a particular level of efficiency".²⁸ However, it is not entirely clear what that level is, or whether that level is intended not to preclude any, some, or all processors from potentially or actually competing. Furthermore, these references would imply that the relevant costs are those of independent processors. Likewise, the reference to a contestability standard more generally implies entrants' costs are the ones of interest.
67. On the other hand, the RIS also explains that the preferred regulatory option—setting the milk price based on assumptions designed to promote incentives for Fonterra to be efficient in the context of DIRA's contestable aims—would result in relatively low regulatory costs, due to the simplicity of the assessment required.²⁹

However, relative to option c. [option d.] would be a more straight-forward assessment for the Commerce Commission to make. This is because **the standard would be focussed on Fonterra. It would not therefore necessarily require complex modelling of other (actual or notional) competitors.** The standard of "assumptions designed to promote incentives for Fonterra to be efficient" would require a relatively objective assessment and would be similar to assessments the Commission typically makes through its regulatory work.³⁰

68. As noted above, setting any realistic achievable benchmark for the costs that underpin the milk price would provide an incentive for Fonterra's management to improve efficiency. By contrast, setting Fonterra's farm gate milk price entirely based on its actual costs would provide lower incentives on Fonterra to be efficient than the use of an objectively determined benchmark. The RIS suggests that doing so would be "akin to 'cost-based regulation'". In addition, the RIS notes that there is

²⁷ RIS paragraphs 26, 51 and 63d, Cabinet Paper paragraphs 36b and 40

²⁸ RIS paragraph 63d, Cabinet Paper paragraphs 12 and 36b

²⁹ RIS p 21

³⁰ RIS paragraph 63d (emphasis added)

also “a risk that this option may lead to new entry that would not have survived in a normal competitive market environment.”³¹

69. Nevertheless, to the extent that basing the farm gate milk price on Fonterra’s actual costs results in sustainable and efficient entry, the resulting additional competition would place pressures on Fonterra to be efficient. Consequently, a number of industry participants have advocated setting the farm gate milk price using Fonterra’s actual values, rather than any notional values. The assumption is that doing so would lead to a lower milk price that is more attractive to entry.
70. However, if the milk price were set based on Fonterra’s actual performance, difficulties might arise given there is a single national milk price. Some costs, such as collection costs, may vary by region throughout New Zealand and these would be averaged. Where entry is localised this might lead to entry by processors that are less efficient than Fonterra and which could strand existing plant.

Our interpretation of the policy intent for the dry run review

71. As is noted above, the Commission’s dry run review of Fonterra’s Milk Price Manual and its application is ongoing. In undertaking the dry run review we have needed to interpret the purpose statement and principles set out in the Bill. We have announced to stakeholders that, in doing, so we propose to rely on the RIS, and also the Cabinet Paper.³²

Contestability and efficiency standards

72. We have concluded that the meaning of a contestability standard and its implications for the Commission’s proposed monitoring role is most clearly and comprehensively articulated in the Cabinet Paper. Consistent with the RIS, the Cabinet Paper states that the contestability standard means that the farm gate milk price should be:
- low enough such that efficient entry is not precluded (subject to a particular level of efficiency of entrants); but
 - high enough to also incentivise Fonterra to strive to be more efficient even if such entry does not take place.³³
73. However, the Cabinet Paper goes further than the RIS by clarifying what is meant by “subject to a particular level of efficiency of entrants”.

... it is important to note that this is different to a farm gate milk price that would actively *promote* competition as an objective in itself. Moreover, a **contestability**

³¹ RIS paragraph 63a

³² Commerce Commission, *Further information on our approach to dry run review of Fonterra's Farm Gate Milk Price*, 30 March 2012

³³ RIS paragraph 63c; Cabinet Paper, paragraph 12

standard could preclude a processor that is more efficient than Fonterra from entering³⁴ and competing,

Since a contestability standard should neither actively promote nor preclude competition, the effect it will have on market structure over time is indeterminate. Therefore, a decision to assess Fonterra's farm gate milk price against a contestability standard is not a decision to either promote increased competition, at Fonterra's expense, or to enshrine Fonterra as a dominant player, at competitors' expense. ...

It is also consistent with the Government's 2001 decision to enable Fonterra to form so that it might enjoy benefits of scale and scope.³⁵

74. The Cabinet Paper further clarifies that:

This option [ie regulating to ensure contestability of the market] would result in a higher farm gate milk price than if it was based on Fonterra's actual costs and revenues. Therefore, a potential outcome is that a processor that is more efficient than Fonterra may not be able to enter. The description above [see paragraph 68 of this submission] explains that this is not abnormal in a competitive market.

There is a risk that this option would lead to a milk price that, while it incentivises efficiency, does not provide a credible threat of entry. Therefore, any regime aimed at providing for this option would need to be carefully designed to ensure the right balance is struck. In particular to ensure that it does not lead to a milk price based on an "overly-optimised" set of assumptions.³⁶

75. Finally, the Cabinet Paper provides guidance on how this balance should be struck. The Cabinet Paper explains that the assumptions employed by Fonterra in the Milk Price Manual should not be over-optimised to the extent that "the milk price precludes all efficient processors from potentially competing".³⁷

76. The Cabinet Paper describes this preferred option as a standard that provides an incentive for Fonterra to operate efficiently while *preserving contestability*—the apparent origin of the phrase used in s 150A. Unfortunately, as is indicated by the discussion above, 'preserving contestability' is not unambiguous. In particular, it does not provide the guidance set out in the Cabinet Paper that:

- it is acceptable the milk price might be set at a level such that an independent processor more efficient than Fonterra might not be able to enter
- the assumptions in Milk Price Manual should not be over-optimised to the extent that the milk price precludes *all* efficient processors from potentially competing.

³⁴ This is because an existing firm in a competitive market – such as Fonterra – can choose not to recover, or to defer recovery of, capital costs that are already sunk. A potential entrant on the other hand will need a reasonable expectation of recovering capital before investing.

³⁵ Cabinet Paper, paragraphs 13-14 and 41 (emphasis added)

³⁶ Cabinet Paper, paragraph 36b

³⁷ Cabinet Paper, paragraph 40

77. In our recent announcement to stakeholders on our ‘dry run’ review we indicated that the above interpretation of the policy intent would guide our dry run review.³⁸
78. Significantly, this guidance occurs *only* in the Cabinet Paper. Yet, in the event of a legal challenge to the Commission’s review of Fonterra’s Milk Price Manual and its application, it is unclear whether the Courts would place any weight on the Cabinet Paper as an appropriate tool for statutory interpretation. Therefore, it is important that, if these two principles are a key element of the policy intent, that they are expressed as unambiguously as possible in the legislation.

Significance of the use of Fonterra’s and competitors’ costs

79. We also drew the attention of stakeholders to the statement in the RIS that “the standard would be focussed on Fonterra”, and “would not therefore necessarily require complex modelling of other (actual or notional) competitors”. We indicated that, for the dry run review, we do not propose to model the milk price that independent processors can afford to pay. We also noted that, in any event, robust modelling of processors could not be achieved within the timeframes set for the dry run.
80. Our current dry run review of the milk price is a non-statutory review. However, we do have concerns if the intention to focus on Fonterra’s costs is not clear in the legislation by the time we undertake our first statutory review of the milk price. Modelling the costs of actual or notional competitors will affect the approach we take to the review, as well as putting pressure on our ability to meet the proposed statutory timeframes for the review, and increasing the review’s direct costs.

Our proposed purpose statement for the regime based on that interpretation

81. If our interpretation of the policy intent (as expressed in the previous section) is correct, then we would recommend changing the current wording of the s 150A purpose statement to make that intent clearer. Reducing the potential for ambiguity should reduce the direct costs of implementing the regime, as well as reduce the prospect of indirect costs from possible litigation.
82. We **recommend** making the following changes to the s 150A purpose statement, and consequential changes to ss 150C and 150P.

Section 150A [amendment]

The purpose of this subpart is to promote the setting of a base milk price that–

- a) provides an incentive to new co-op to operate efficiently; and
- b) consistent with ensuring the market for the purchase of milk from farmers is contestable, does not prevent all efficient independent processors from potentially competing with new co-op.

³⁸ Commerce Commission, *supra* n 32

Section 150C(1)(bi) [new]

any notional costs, revenues or other assumptions taken into account in calculating the base milk price must be practically feasible for an efficient processor to replicate:

Section 150P(4) [new]

For the avoidance of doubt, in making the report the Commission is not required to assess the costs of any independent processor or model the costs of a new entrant into the market for the purchase of milk from farmers.

83. To reiterate the discussion above, these proposed changes are seeking to better reflect the following policy intent.
- The ‘contestability’ aspect of the purpose statement is only intended to keep the prospect of competition open (ie “... does not prevent all efficient independent processors from potentially competing with new co-op”). It does not seek to ensure that any independent processor that is more efficient than Fonterra will necessarily be able to compete for the supply of raw milk.
 - In assessing the base milk price against the purpose statement, the Commission must look at Fonterra’s costs, but is not required to model current or potential entrants (new subsection 150N(4)).
 - So long as the costs, revenues and assumptions that go into the base milk price calculation can be replicated by an efficient processor—ie are not over-optimised (new subsection 150C(1)(bi))—the aim of having some level of contestability is met. In making this assessment, the Commission is able to rely on the actual costs from the most efficient aspects of Fonterra’s operations as a proxy for what is achievable by an efficient processor (consistent with new subsection 150N(4)).
84. Finally, for the avoidance of doubt we note that in recommending these changes the Commission is not expressing a view about the correct policy settings for the new DIRA milk price monitoring regime—we are simply seeking to ensure that the policy as we understand it is implemented as effectively as possible.

Our views on the principles and assumptions for setting the milk price

85. The RIS identifies a number of crucial assumptions utilised in applying the Milk Price Manual that may have a material impact on the efficiency of the milk price.³⁹ As a result, the Bill sets out certain assumptions (in new s 150B) which are considered ‘not adverse’ to the purpose expressed in s 150A, and states certain principles (in new s 150C) with which the setting of the milk price ‘must accord’ if that purpose is to be achieved.⁴⁰

³⁹ RIS paragraph 25

⁴⁰ Explanatory Note p 6

86. Our understanding is that the s 150B assumptions are intended to be ‘safe harbours’. In other words, if Fonterra applies one of those assumptions in setting the milk price, our review could not conclude that doing so is inconsistent with the purpose statement. We have informed stakeholders that we are undertaking our dry run review on that basis.⁴¹ However, in Attachment B of our submission we query whether the language used in s 150B unambiguously achieves such a safe harbour status.
87. The policy documents do not justify why the assumptions in s 150B are not inconsistent with the purpose, or why it is essential that the principles in s 150C must be met for the purpose to be achieved. We therefore do not comment on the appropriateness of the choice of matters set out in s 150B or s 150C.⁴² In principle, providing such a list of assumptions and principles should give helpful guidance to the Commission in assessing the Manual and the milk price, thereby lowering the direct costs of the review.
88. There are of course many other assumptions which Fonterra needs to make in developing and applying its milk price methodology. Where s 150B and s 150C provide no guidance, then Fonterra and the Commission will only be able to rely on the purpose statements in s 150A, s 4(f), and s 4(fa). Therefore, as is discussed in the preceding sections, it is important that the policy intent is clearly articulated in those purpose statements, and the relative priority that ought to be given to those statements is as unambiguous as possible. Otherwise, even though the regime only involves price monitoring, there is a risk that disputes about the appropriate level of the milk price may end up before the Courts, and the Courts may form a view on the regulatory objectives that differs from the intended policy.

Our views on the new enforcement provisions

TAF behavioural obligations

89. The Bill includes certain obligations on Fonterra in relation to trading of its shares and the new TAF fund, and certain restrictions on Fonterra’s behaviour under TAF (ss 109J and 109K). For example, Fonterra must not engage in any conduct for the purpose of preventing or hindering trading in its shares, or preventing or hindering the liquidity of the market for its shares or securities in the fund.
90. The FMA’s “main objective is to promote and facilitate the development of fair, efficient and transparent financial markets”. Its current activities include:
- investigating potential breaches of financial markets conduct legislation and taking appropriate enforcement action

⁴¹ Commerce Commission, supra n 32

⁴² However, we have noted above (paragraphs 25-27) that permitting Fonterra to reflect its actual foreign exchange gains and losses in the milk price would appear to create a barrier to entry, which seems inconsistent with the proposed objective of preserving contestability.

- reviewing financial markets and participants' activities to identify and assess possible risks to investors, market fairness, efficiency and transparency, or risks to the financial system
- monitoring and enforcing the market manipulation and other dealing misconduct provisions of the Securities Markets Act 1988.

91. We understand that, as trading in Fonterra shares and units will be undertaken on registered markets under the Securities Markets Act, such trading in Fonterra shares and units will already be subject to monitoring and enforcement action by the FMA. Requiring the Commission to also monitor trading on such markets may duplicate some of the work of the FMA, for no apparent additional benefit. We do acknowledge, however, that the scope of the behavioural obligations may, in some respects, be wider than the scope of those in the Securities Markets Act.
92. It is not clear that officials have fully considered which agency might be best placed to enforce the TAF behavioural obligations. In particular, it is not apparent that the Commission should undertake this role given the specialist expertise the FMA has, and the range of monitoring, education and enforcement roles the FMA already undertakes in financial markets. The FMA may be able to enforce the s 109K obligations more efficiently than the Commission.
93. Therefore, we **recommend** that the Committee consider whether the Commission is best placed to take on the new role of enforcing TAF's behavioural obligations, or whether these should be enforced by the FMA along with its existing responsibilities under the Securities Markets Act.

Fair value share requirement

94. The Bill includes a provision (in s 77A) to establish the fair value of Fonterra's shares, in the event that TAF does not proceed. If TAF does not proceed, we would be responsible for enforcing this provision through the general enforcement provisions of the existing legislation. We make specific drafting specifications in Attachment C of this submission, to clarify the drafting of s 77A.

Attachment A: The Commerce Commission

- A.1 The Commission is New Zealand's competition authority and economic regulator. We are an Independent Crown Entity established under the Commerce Act 1986 (Commerce Act). The Commission is responsible for enforcing laws relating to competition, fair trading, and consumer credit contract laws, and has regulatory responsibilities in the electricity lines, gas pipelines, airports, telecommunications, and dairy sectors.
- A.2 We work to ensure that markets are competitive and well regulated for the long term benefit of all New Zealanders. Competition contributes to the economic performance and welfare of New Zealand as a whole. Where competition is weak or absent, regulation may facilitate increased competition or, if that is not possible, mimic the outcomes that would be achieved if there was effective competition (ie competitive prices and quality of service).
- A.3 Our overall aim is to achieve the best possible outcomes in competitive and regulated markets for the long term benefits of New Zealanders. To achieve this goal we focus on two broad outcome areas:
- markets are more competitive and consumers are better informed
 - regulation is better targeted and more effective.
- A.4 Where competition is not possible or is limited, regulation aims to provide consumers with the benefits that competition would provide. Our work in this area involves developing and implementing the regulatory regime under Part 4 of the Commerce Act, as well as responsibilities under the Telecommunications Act 2001 and the Dairy Industry Restructuring Act 2001 (DIRA).

Our role in regulating the dairy sector

- A.5 The Commission plays a role in promoting competition in dairy markets. We have both enforcement and adjudication roles under DIRA.
- A.6 DIRA allows us to undertake enforcement action and requires us to issue determinations to resolve disputes between Fonterra and other parties. An associated piece of legislation is the Dairy Industry Restructuring (Raw Milk) Regulations 2001 which set out obligations around the supply of raw milk.
- A.7 We continue to monitor contestability in dairy markets through the entry and expansion of other dairy processors besides Fonterra. We intend to increase our education initiatives about our role in this area. This focus on information provision and education will ensure shareholding Fonterra farmers are aware of their ability to switch between processors, which is an important aspect of DIRA.

Attachment B: DIRA—rationale and key concepts

B.1 In this attachment we discuss the rationale for DIRA, and the key concepts of ‘efficiency’ and ‘contestability’. We also discuss the concept of ‘barriers to entry’, because low entry barriers are typically considered the key characteristic of a contestable market.

Rationale for DIRA

B.2 As is explained in the RIS, the rationale for DIRA was to:

- allow the formation of Fonterra, and enable the merged co-operative to capture efficiencies of scope and scale in the collection and processing of raw milk produced by New Zealand dairy farmers, to compete in international dairy markets to the overall benefit of New Zealand
- regulate the New Zealand activities of Fonterra in relation to its farmers, potential competitors, and domestic consumers.⁴³

B.3 The key objective relevant to these latter regulatory provisions is in s 4(f) of DIRA:

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

B.4 The DIRA regulatory regime is intended to be transitional. The regulatory provisions in DIRA are intended to expire at the point when domestic dairy markets have become ‘workably competitive’,⁴⁴ but during this transition phase DIRA is expected to enhance the contestability of the domestic dairy industry by lowering ‘barriers to entry’.

B.5 Once the DIRA regulatory regime expires the general competition provisions in the Commerce Act will continue to apply. Unlike DIRA, which refers to ‘contestable markets’, the relevant standard of competition in the Commerce Act is ‘workable’ (or ‘effective’) competition. Another key difference between DIRA and the Commerce Act, is that DIRA provides for ex ante constraints on Fonterra that are relatively clear cut and easy to enforce. On the other hand, the Commerce Act provides for ex post consideration of Fonterra’s actions, is less specific in its requirements, and can be more difficult to enforce in a timely way.

B.6 Given the significance to DIRA of the concepts of efficiency and contestability (which relies on the concept of ‘barriers to entry’), and particularly to the proposed new regulatory provisions in the Bill, we discuss these concepts in the following sub-sections.

⁴³ RIS paragraph 4

⁴⁴ DIRA contains ‘sunset clauses’ (ie if Fonterra’s market share drops below 80 percent in the North and South Islands) that trigger an expiry process. A comprehensive review of the need to have the DIRA regulatory regime in place must be undertaken when these market share thresholds have been met, or in 2015—whichever comes earlier.

Efficiency

B.7 Efficiency is generally considered to comprise three dimensions: productive, allocative and dynamic.

- **Productive efficiency** is present when suppliers of goods and services minimise production costs, subject to technological constraints. The RIS recognises the importance of productive efficiency, referring to the risk of waste if Fonterra has low incentives to drive cost efficiencies.⁴⁵
- **Allocative efficiency** occurs when resources are allocated within the economy to the uses in which they have the highest value. Prices provide the signals by which information is conveyed within the economy about the relative value of various goods and services. The RIS recognises the importance of allocative efficiency, highlighting that the distorted price signals caused by an inefficient farm gate milk price or an inefficient Fonterra share price might lead to poor decisions by farmers about milk production, capital investment, or the choice of dairy processor.⁴⁶
- **Dynamic efficiency** refers to decisions made over time, and includes decisions relating to investment and/or innovation that can improve productivity, as well as the range and quality of services. The RIS highlights that long-term growth and dynamic efficiency of an industry are normally driven by the process of competition among rival suppliers exerting competitive pressure on each other. In the absence of effective competition, Fonterra may have fewer incentives to innovate and invest optimally.⁴⁷

Contestability and barriers to entry

Contestability in economics

B.8 In economics, the key assumptions for a ‘perfectly’ contestable market are that:

- entry to the market is completely free and exit is costless (ie there are no barriers to entry or exit), which requires entry must not cause firms to incur any ‘sunk’ costs (eg investments in assets with little use outside the particular industry)
- entrants and incumbents compete on a ‘level playing field’
- entry is not impeded by the fear of incumbents ‘retaliating’ by changing the price in response to entry.⁴⁸

B.9 In such a perfectly contestable market the market power of existing suppliers is constrained by the *threat of entry* from potential competitors outside the market.

⁴⁵ RIS paragraphs 3 and 63a

⁴⁶ RIS paragraphs 4b and 76, and also refer Explanatory Note pp 2-3

⁴⁷ RIS paragraph 3

⁴⁸ W. Baumol, J. Panzar, and R. Willig, *Contestable Markets and the Theory of Industry Structure*, 2nd ed, Harcourt Brace Jovanovich, New York, 1988, pp 349-350

This threat provides incentives for incumbent suppliers to reduce costs (productive efficiency) and set prices at efficient levels (allocative efficiency), irrespective of whether *actual* entry occurs. Contestability is interested in the competitive constraints provided by potential entry, rather than in actual competition.

- B.10 Perfect contestability (ie *no* barriers to entry or exit) is not the standard in DIRA, nor would it be a particularly useful standard for economic regulation more generally, as there are few markets which do not involve some level of sunk costs. Nonetheless, the concept indicates that, more generally, the lower the barriers to entry (or exit), the more contestable the market is.
- B.11 Contestability is not the same as the Commerce Act's concept of workable competition. While contestability is primarily about low barriers to entry, with the resultant threat of entry promoting efficient outcomes, workable competition is a richer concept.⁴⁹
- B.12 Workable competition involves a *dynamic process*, where the market power of a supplier may be constrained by the threat of entry, but could also be constrained by rivalry among its existing competitors, the threat of substitute goods or services, the countervailing power of buyers, or the countervailing power of upstream suppliers. These competitive pressures would be expected to move market participants closer to efficient outcomes over time.⁵⁰

Contestability in Australasian case law

- B.13 New Zealand case law also supports low entry barriers as being the most significant characteristic of contestability. For example:

In essence, contestability concerns the extent to which a market is open to potential competition and the barriers against entry, if any, confronting potential entrants.⁵¹

- B.14 However, the concept is often described more broadly, and the Courts have criticised the Commission itself for loose use of the term 'contestable'. For example:

⁴⁹ In our report last year on whether to initiate an inquiry under Part 4 of the Commerce Act into milk prices at the farm gate, factory gate, town milk, and retail level, we observed that: "If Parliament had intended Part 4 and DIRA to apply the same competition tests, it would have used the language of 'contestability' when the new Part 4 was enacted in 2008" (Commerce Commission, *supra* n 21, paragraph 135). Similarly, had Parliament intended that the appropriate competition standard for DIRA was workable or effective competition, rather than contestability, it could have used that language when DIRA was enacted in 2001.

⁵⁰ For a discussion of the meaning of 'workable competition' in economics and case law refer to: Commerce Commission, *Input Methodologies (Electricity Distribution and Gas Pipeline Services)*, *Reasons Paper*, December 2010, Section 2.5

⁵¹ *Re NZ News Ltd - New Plymouth Star Ltd* (1987) 1 NZBLC (Com) 104,069, cited in *Laws of New Zealand*, Competition, Part V, Chapter 19, paragraph 190. Similar cases referring to contestability which largely centre on the existence of barriers to entry include: *Southern Cross Medical Care Soc v Commerce Commission* (2001) 10 TCLR 25 (HC) at [37], [38], confirmed on appeal *Commerce Commission v Southern Cross Medical Care Society* (2001) 10 TCLR 269 (CA) at [68], [69], *Air New Zealand Ltd v Commerce Commission* [1985] 2 NZLR 338 at 348, *Tru Tone Ltd v Festival Records Retail Marketing Ltd* [1988] 2 NZLR 352

There is one feature of the commission staff's approach to the assessment of dominance that we would criticise; i.e. the use of the term 'contestable'. The report tended to assign market situations into two categories: those that are "contestable" and those that are not. Possibly the terminology has been encouraged by the single-firm dominance standard of the merger law. No doubt if a market is "contestable", dominance in the sense of New Zealand law cannot arise. But if the term is used merely as a synonym for the absence of dominance, it has no analytical content. In fact, the staff's **use of the term goes beyond this and gives rise to ambiguity**. Indeed the **use of the term is variable**, sometimes being used to denote **effective competition**; sometimes being used to mean that there are **no legal barriers to entry**; sometimes being used to denote **multiple suppliers**; sometimes being used to denote no more than that **entry by a second supplier is feasible**.⁵²

Barriers to entry

- B.15 Barriers to entry are sometimes described as costs or risks faced by potential entrants that are not faced by incumbent suppliers and which disadvantage those entrants. Therefore, they tilt an otherwise level-playing field in favour of the dominant supplier(s). However, there is no consensus among economists or competition agencies as to the meaning of the term or as to what factors should qualify as a 'barrier to entry'.⁵³
- B.16 One of the early definitions of a barrier to entry, by economist Joe Bain, is an advantage of established suppliers over potential entrants that allows them to persistently raise prices above competitive levels without attracting entry.⁵⁴ This definition is quite broad and has been criticised as being 'circular', because it includes the consequences of the definition in the definition itself.
- B.17 Nobel prize-winning economist George Stigler described a barrier to entry as "a cost of producing (at some or every rate of output) that must be borne by firms seeking to enter an industry but is not borne by firms already in the industry".⁵⁵ According to Stigler's definition, a barrier to entry only exists if the potential entrant's *long-run* costs after entry are greater than those of the incumbent. Therefore, with equal access to technology, economies of scale would not be considered a barrier to entry. Similarly, neither would capital requirements, unless the incumbent never paid them.
- B.18 Although the debate is often between Bain's and Stigler's definitions, some later definitions have recognised that a number of factors traditionally considered to be barriers to entry might enhance social welfare. For example, by preserving high profits for a period, patents may encourage socially beneficial research and

⁵² *Power NZ Ltd v Mercury Energy Ltd* [1996] 1 NZLR 686, 711 (emphasis added)

⁵³ OECD, *Barriers to Entry*, Directorate for Financial and Enterprise Affairs, Competition Committee, Paris, 6 March 2006, p 9. For a survey of different definitions, refer: R.P. McAfee, H.M Mialon and M.A. Williams, What is a barrier to entry? *The American Economic Review*, Vol. 94, No. 2, May 2004, 461-465

⁵⁴ J.S. Bain, *Barriers to New Competition: Their Character and Consequences in Manufacturing Industries*, Cambridge: Harvard University Press, 1956

⁵⁵ G. Stigler, *The Organisation of Industry*, University of Chicago Press, Chicago II, 1968

development. Therefore, such factors should not be considered barriers to entry.⁵⁶ Other economists have suggested that a more important practical issue is whether a factor will *delay* entry, and for how long, or have proposed using the possibly less controversial term 'conditions of entry' instead.⁵⁷

B.19 In New Zealand, a key Court of Appeal judgment leans toward Stigler's definition.

Anything is capable of being a barrier to entry or expansion if it amounts to a significant cost or limitation which a person has to face to enter a market or expand in the market and maintain that entry or expansion in the long run, being a cost or limitation that an established incumbent does not face.⁵⁸

B.20 On the other hand, the Supreme Court has recently described capital requirements as a barrier to entry, which is at odds with this description.⁵⁹

Factors described as a barrier to entry

B.21 The following are some other examples of barriers to entry that have at various times been recognised by New Zealand (and Australian) Courts:

- economies of scale and scope (eg where scale economies are such that the minimum size for an efficient firm is very large relative to the size of the market, this may dissuade a potential entrant)⁶⁰
- sunk costs⁶¹
- blocked access (control of supply of essential raw materials, for example)
- product differentiation (established goodwill from the incumbent which a new entrant could only counteract by lower prices or high promotional costs)
- expected incumbent response/reputation of incumbent
- co-operative ownership⁶²
- legal restrictions (regulation, licence requirements, intellectual property rights, production standards, consent processes, certification requirements).⁶³

⁵⁶ C.C von Weizsäcker, A welfare analysis of barriers to entry, *Bell Journal of Economics*, Vol. 11, No. 2, 399-420

⁵⁷ For example: D.W. Carlton, *Barriers to Entry*, Working Paper 11645, NBER Working Paper Series, National Bureau of Economic Research, Cambridge MA; and OECD, *supra* n 53, pp 23-25.

⁵⁸ *Commerce Commission v Southern Cross Medical Care Society* 10 TCLR 269, 293 at [73]

⁵⁹ *Fonterra Co-operative Group Limited v The Grate Kiwi Cheese Company Limited & others*, [2012] NZSC 15, at [17], [18]. Capital requirements had earlier been cited as an entry barrier in *New Zealand Co-operative Dairy Co Ltd v Commerce Commission* [1992] 1 NZLR 601

⁶⁰ *Queensland Wire Industries Ltd v Broken Hill Pty Co Ltd* (1989) 83 ALR 577.

⁶¹ *New Zealand Magic Millions Ltd v Wrightson Bloodstock Ltd* [1990] 1 NZLR 731 at 757.

⁶² *Ravensdown Corp Ltd v Commerce Commission* (HC Wellington, AP 168/96, 9 December 1996)

⁶³ *Fisher & Paykel Ltd v Commerce Commission* [1990] 2 NZLR 731.

B.22 In its Mergers and Acquisitions Guidelines, the Commission has categorised such factors into three main types of entry barriers:

- *structural* barriers, arising from the nature of the technology, resources or inputs required to establish a business in a particular market
- *strategic* barriers, which may arise from the established position of incumbents, and their acting intentionally in such a way to discourage prospective entrants
- *regulatory or legal* barriers, arising from legislation or regulations that limit the number of market participants or that may add to the costs of starting a business.⁶⁴

⁶⁴ Commerce Commission, *Mergers and Acquisitions Guidelines*, Wellington, 2003, p 28

Attachment C: Recommended drafting changes to the Bill

C.1 This attachment sets out the Commission’s recommended drafting changes for the Dairy Industry Restructuring Amendment Bill 2012 (Bill), other than the purpose-related changes proposed in the main body of our submission, as well as a number of other minor comments.

Purpose statements

C.2 Clause 4 of the Bill inserts an additional purpose statement (new clause (fa)) into section 4 of the DIRA:

(fa) promote the setting of a base milk price that provides an incentive to new co-op [ie Fonterra] to operate efficiently

C.3 Section 4 of the DIRA already contains:

(f) promote the efficient operation of dairy markets in New Zealand by regulating the activities of new co-op **to ensure New Zealand markets for dairy goods and services are contestable;**” (emphasis added)

C.4 Section 150A (the specific purpose statement for the new subpart relating to the milk price monitoring regime) of the DIRA states:

150A The purpose of this subpart is to promote the setting of a base milk price that provides an incentive to new co-op to operate efficiently and that **as far as possible** preserves contestability in the market for the purpose of milk from farmers. (emphasis added)

C.5 In the main text of this submission (paragraph 82 above) we have proposed revised text for the purpose statement in s 150A. Our proposal is based on the interpretation of the policy intent that we are using to guide our ‘dry run’ of the milk price monitoring regime. Should our interpretation of the policy intent not be correct, and s 150A be retained in its present form, we have some remaining concerns about the interaction between s 4(f), s 4(fa) and s 150A.

C.6 The words “as far as possible” in section 150A suggest the achievement of s 4(f) (the contestability limb) is secondary to the achievement of s 4(fa) (the efficiency limb)—in other words, the s 4(fa) purpose must be achieved, whereas the s 4(f) purpose is to be achieved only if/to the extent that it can.

C.7 However, s 4(f) uses the words “regulating the activities of new co-op **to ensure New Zealand markets for dairy goods and services are contestable**”, which is much stronger language than “provides an incentive” in s 4(fa), therefore suggesting the opposite order of priority.

C.8 We **recommend** that the appropriate priority of these respective purposes be expressly stated in the legislation.

Assumptions

C.9 Section 150B lists certain assumptions that Fonterra can use in setting the base milk price that ‘do not detract’ from the achievement of the purpose in section 150A. The Explanatory Note to the Bill describes section 150B in the following terms:

New section 150B sets out certain assumptions that are not adverse to the purpose expressed in new section 150A.⁶⁵

C.10 The Cabinet Paper describes the new intent behind new section 150B as:

Additional guidance is proposed in relation to:

- Assumptions that *could* be employed in setting the milk price that *would not be inconsistent* with the purpose; and
- Assumptions that *would need to be employed* in setting the milk price to be *consistent* with the purpose.⁶⁶

C.11 It is not clear whether the legislative intent is that the phrases “*does not detract from the achievement of*”, “*are not adverse to the purpose*” and “*would not be inconsistent with the purpose*” mean the same thing, or have slightly different meanings (given that different phrases have been adopted, it appears that the latter is possible). If section 150B intends to create ‘safe harbours’ for Fonterra, which the Commission is not entitled to have regard to when it carries out its review of the milk price setting process, we **recommend** that this should be made explicit in s 150B.

C.12 One proposed safe harbour is an assumption that Fonterra processes all milk into commodities at yields that are feasible. Feasible can take on a range of possible meanings from practically feasible to theoretically feasible, with significant implications in practice. We **recommend** changing ‘feasible’ in s 150B(d) to ‘practically feasible’.

C.13 The Cabinet Paper and RIS anticipate that the farm gate milk price should be determined from consideration of the revenues and costs of processing milk into certain commodities. However, this is not clearly expressed in the Bill. For example, some parts of ss 150A, 150B and 150C seek to define the analysis of the milk price based on the revenues and costs of processing milk into defined commodities (eg s 150C(b)(ii)), but other sections are stated much more generally (eg s 150B(a), (b) and (d)), and could be interpreted as processing milk for sale into various other products (including cheese etc). This creates the potential for inconsistencies in the interpretation of these sections, when it seems clear that a consistent approach is intended by policymakers.

C.14 To clarify this, we **recommend** that the words “into the commodities determined under **section 150C(2)**” be added to s 150B(a), (b) and (d) as follows.

⁶⁵ Explanatory Note p 6

⁶⁶ Cabinet Paper paragraph 48c

(a) that new co-op operates a national network of facilities for the collection and processing of milk into the commodities determined under **section 150C(2)**:

(b) that the size of new co-op's assumed units of processing capacity approximates to the average size of new co-op's actual units of processing capacity for processing milk into the commodities determined under **section 150C(2)**:

...

(d) that all milk processed by new co-op is processed into the commodities determined under **section 150C(2)** at yields that are practically feasible

Commerce Commission reviews

Materiality?

C.15 Sections 150I and 150P require the Commission to report on:

- the extent to which the Milk Price Manual is consistent with the purpose statement in s 150A
- the extent to which assumptions, inputs and processes Fonterra uses to calculate the base milk price are consistent with the purpose statement in s 150A.

C.16 These provisions do not incorporate a materiality threshold. We **recommend** that, particularly given the timeframes for preparing and finalising the reports, the Commission should only be required to:

- report on the extent to which the Milk Price Manual is *materially consistent* with the purpose statement in s 150A
- review those assumptions, inputs and processes that *have a material impact* on the calculation of the base milk price.

Consultation process

C.17 Sections 150M and 150U require the Commission to provide draft copies of its reports to Fonterra for Fonterra to make submissions (if it wishes to do so). The legislation is silent as to third party consultation. It could be read into these provisions that the Commission is not required to consult with third parties.

C.18 The Commission's processes are susceptible to judicial review. We therefore consider that any policy intention to exclude third party consultation should be explicit.

C.19 As a general principle, we favour testing our decisions through consultation with all interested parties as this leads to more robust decision-making. However, in this case the legislation provides relatively short timeframes for the Commission to finalise its reports once submissions have been received. It has one month to finalise its report on the review of the Milk Price Manual (ss 150J and 150M) and only two

weeks to finalise its report on the application of the Milk Price Manual (ss 150Q and 150U).

- C.20 The level of interest from third parties and the value to the Commission from their input is likely to be different for the two types of reviews. We expect that third parties will be more interested and will be in a position to provide more relevant input to the review of the Milk Price Manual. This is because the review of the *application* of the Milk Price Manual will require access to detailed Fonterra-specific information, which third parties will not have. At least some of that information will be commercially confidential to Fonterra.
- C.21 We are intending to consult on our draft report for the dry run review. This is because it is the first time that we have undertaken this work and we consider that the input from third parties will be particularly useful. Without prejudging, it is possible that the value of third party input may change over time, particularly if Fonterra makes no material changes to its Manual from the previous year's review. We think it is appropriate that we have the ability to consult with third parties, but can exercise our discretion as to whether that is required.
- C.22 We **recommend** amending section 150I to add a new section 150I(3):
- (3) In making the report, the Commission is not required to consult with any party other than new co-op.
- C.23 We also **recommend** amending section 150P to add a new section 150P(3) as follows:
- (3) In making the report, the Commission is not required to consult with any party other than new co-op.
- C.24 Alternatively, if we are unable to exercise such discretion, longer timeframes will be required for finalising the report.

Timing of the first Milk Price Manual review

- C.25 Section 150O states that the Commission's first review of Fonterra's calculation of the base milk price will be held in 2013 in respect of the 2012/2013 season.
- C.26 Sections 150H and 150I, which relate to the Commission's review of the Milk Price Manual, do not specify the year in which the first review will take place. Our assumption is that the first review under ss 150H and 150I will be held in 2012 in respect of the 2012/2013 season. We do not think it is necessary to set out this assumption in the legislation.
- C.27 We would, however, like to note that if the legislation is not introduced in the expected timeframes (enactment by 30 June 2012), then we may not be able to undertake our review of the Milk Price Manual by 15 December 2012. It will be a problem if the legislation comes into effect after 1 August 2012, which is the date that Fonterra is required to provide the Commission with the Milk Price Manual (and

other supporting information) for review. The Commission has only 10 weeks from this date to produce its draft report.

C.28 We therefore **recommend** that section 150H should be amended as follows:

- (1) The Commission must, for each season, review the milk price manual and make a report under section 150I [existing wording]
- (2) Subject to sub-clause (3), the first review under this section must be the review to be held in 2012 in respect of the 2012/2013 season
- (3) If this subpart does not come into force before 1 August 2012, the Commission's first review under this section must be the review to be held in 2013 in respect of the 2013/2014 season

Milk price calculation review

Application of Official Information Act 1982

C.29 It is likely that the Commission will need to perform its own calculations/modelling to form conclusions on the consistency of the assumptions/inputs and processes used by Fonterra to calculate the base milk price with the purpose in s 150A.

C.30 It appears from the legislative intent of the Bill that s 18(c)(i) of the Official Information Act (OIA) should apply to any calculations or models that the Commission prepares internally in the course of preparing its reports. Section 18 of the OIA provides the grounds for when an OIA request may be refused, and s 18(c)(i) specifically provides that a request may be refused if making the information available would be contrary to the provisions of a specified enactment. For the avoidance of doubt it would be helpful for the Bill to expressly address this point.

Timing

C.31 Under s 150Q the Commission must finalise and publicly release its report on the consistency of the assumptions, inputs and processes used by Fonterra to calculate the previous year's base milk price with the purpose statement in s 150A by 15 September.

C.32 This timeframe allows only two weeks for the Commission to take into account any submissions by Fonterra on the draft report (see s 150U). The Commission does not consider two weeks is sufficient time for it to properly consider any submissions by Fonterra and finalise its report.

C.33 Notably, ss 150L to 150J, which relate to the Commission's review of the Milk Price Manual, allow one month for the Commission to consider any submissions made by Fonterra. The same time frames should apply to the review under s 150P.

Certification

C.34 Sections 150L(d) and 150T(b) require Fonterra to certify certain matters to the Commission. There is no certification process specified in the legislation (e.g. no

indication of the appropriate certifiers - Fonterra's directors, the Milk Price Panel (Panel), etc).

Panel membership

- C.35 Section 150E sets out certain requirements with respect to the appointment of Panel members. Section 150D(3) prescribes the duties of the Panel in each season.
- C.36 Under section 150D(2) Fonterra is required to set the terms of reference for the Panel (which are binding on Panel members).
- C.37 Section 150E does not indicate the requisite number of Panel members, appropriate qualifications/experience pre-requisites for selection or tenure duration. Is it intended that these matters be reserved to Fonterra?

Offences provisions

- C.38 As noted in the previous paragraphs, Fonterra must establish the Panel (s 150D(1)), set terms of reference for the Panel and make those terms of reference publicly available (s 150D). Under s 150D(6):

If new co-op contravenes subsection (1), (2) or (5), it commits an offence and is liable on summary conviction to a fine not exceeding \$200,000 and a fine of \$10,000 for each day that the offence continues

- C.39 Section 150D does not include any dates by when Fonterra must do the things listed in ss 150D(1), (2) or (5). It is therefore unclear when any offence would have been committed under s 150D(6), or when the period "for each day that the offence continues" begins to run.
- C.40 The same is true of other sections that create offences, for example, ss 150E, 150F, 150G and 150N.
- C.41 Further, it is unclear who is intended to be the prosecuting agency for these offences. A summary offence is commenced by the laying of an information.⁶⁷
- C.42 Under s 13 of the Summary Proceedings Act 1957 (SPA), any person can lay an information. An information must be laid within 6 months from the time when the offence occurred (under s 14 of SPA), which is a further reason for the need to specify the dates upon which the various offences under DIRA occur.

Application of Commerce Act provisions

- C.43 Section 150V imports the application of certain provisions of the Commerce Act to the Commission's reviews of the Milk Price Manual and of Fonterra's application of assumptions, inputs and processes in setting the base milk price.
- C.44 Several of these sections will be affected by the Search and Surveillance Bill 2009 which is currently before Parliament. The Commission submits that the application

⁶⁷ *Mapa v Dept of Labour* [1980] 2 NZLR 21 (CA).

of these sections to the DIRA regime should be revisited following the enactment of that legislation.

Fair market value

C.45 Section 77A(2) values assets as “the aggregate fair market value of [Fonterra’s] assets taking into account the value of the forecast free cash flows expected to be generated from the operation of those assets”, which potentially conflates the valuation of Fonterra’s assets as part of an ongoing business with the valuation of Fonterra’s assets viewed individually.

C.46 We **recommend** changing the definition of ‘assets’ in s 77A(2) to:

assets means the present value of the forecast free cash flows expected to be generated from the operation of new co-op’s assets

C.47 Further, as currently drafted, section 77A(2) only deducts interest-bearing debt and does not take non-interest bearing current liabilities into account when determining the fair market value of a co-operative share.

C.48 We **recommend** changing the definition of ‘debts’ in s 77A(2) to:

debts means the aggregate fair market value of new co-op’s interest-bearing and non-interest-bearing debt