Review of the State of Competition in the Dairy Industry

Comments on the Commission's Approach and Potential Outcomes of Deregulation

Report to Open Country Dairy

July
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1 Introduction

The Commerce Commission (Commission) has released its consultation paper in relation to its review of the state of competition in the New Zealand dairy industry.[1] The Commission has set out its proposed approach for reviewing the state of competition and recommending how the Dairy Industry Restructuring Act 2001 (DIRA) should evolve to most efficiently regulate the dairy industry.

Open Country has engaged Castalia to comment on the following aspects of the Commission's consultation paper:

- The Commission's proposed approach
- Potential outcomes of deregulating the dairy industry that the Commission should consider as part of its review.

In summary, we support the Commission's focus on whether deregulation will enhance efficiency in the dairy industry. We consider that a key way to test this is to ask how Fonterra will respond to deregulation scenarios, and whether these responses (and the wider industry impacts of each scenario) will increase or decrease efficiency. Our analysis suggests that while Fonterra has market power, deregulation (in particular, removing open entry and exit) may cause Fonterra to act in ways which reduce efficiency compared to the outcomes expected under DIRA.

Our analysis is preliminary only and we do not comment on the probability of these outcomes occurring—rather, our report intends to highlight conduct and outcomes that we consider the Commission should investigate further as part of its analysis.

2 The Commission's Proposed Approach

We agree with the Commission's approach to determining whether the state of competition is sufficient or insufficient—which involves testing whether New Zealand dairy markets would be more efficient under a 'with or without regulation' scenario-type analysis. In addition, within that approach, **we suggest the Commission should focus particularly on how Fonterra might react to the various deregulation scenarios** the Commission is considering—and the consequences for efficiency. Our view is that how Fonterra is likely to react if it is deregulated will play a dominant role in determining whether deregulation is efficiency-improving.

The Commission proposes to focus on efficiency and argues that this is distinct from analysing workable competition. It is unclear to what extent this entails focusing on the potential competitive interactions between Fonterra and existing and potential dairy processors under deregulation (which features more obviously in analysis of workable competition). As the Commission states, workable competition is not always a necessary or sufficient condition for an efficient or contestable market.[2] However, our view is that in practice the two tests (workable competition on the one hand and efficiency on the other) generally involve assessing the same substance.

Economic efficiency is broken down into:

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1 Commerce Commission 'Consultation Paper – Review of the State of Competition in the New Zealand Dairy Industry' 12 June 2015.

2 Where a market is truly contestable, the threat of competition is sufficient to discipline incumbents and actual competition is unnecessary, and where a market has natural monopoly characteristics (like electricity transmission), it can be most efficient to have a single firm provide the service.

- **Allocative efficiency**—are efficient amounts of resources being allocated to dairy processing in the economy?
- **Productive efficiency**—are dairy products being processed at least cost?
- **Dynamic efficiency**—do firms have incentives to undertake efficient investment in dairy processing?

Workable competition, then, is a state where the actions of competing firms serve to constrain each other such that the outcomes are efficient—as outlined above. As NERA's analysis in 2010 states,[3] workable competition is commonly analysed and understood using the Structure Conduct Performance framework.[4] The Structure Conduct Performance framework provides helpful guidelines to assess whether a market is 'workably competitive'. Using this framework, workable competition typically exhibits:

- Certain market **structures** (e.g. low market concentration and no barriers to entry)
- Efficient **conduct** (e.g. no exclusionary or predatory tactics)
- Efficient **performance** (that is, allocative, productive and dynamic **efficiency**).

Assessing efficiency involves analysing a **market's performance**, and workable competition is often framed around analysing market structure, firm conduct **and market performance**. The two are similar in substance (including that efficiency is influenced by firm conduct), though efficiency places less emphasis on market structure. Given the role of existing and potential firm conduct in driving performance outcomes, we recommend the Commission focus particularly on Fonterra's likely conduct in a deregulated market since this will play a major role in determining whether deregulation is efficiency-improving.

3 Potential Outcomes of Deregulating the Dairy Industry

To help the Commission in its analysis, in this section we highlight how deregulating the dairy industry could potentially affect Fonterra's conduct, and the resulting outcomes for efficiency. Like the Commission, we structure our analysis around DIRA's three core parts:

- Open entry and exit and its associated rules
- The milk price regulatory oversight regime administered by the Commission
- The DIRA milk regulations that require Fonterra to supply raw milk to independent processors.

3.1 Open entry and exit and its associated rules

Open entry and exit is the 'core' of DIRA and the main means by which DIRA encourages efficient entry by independent processors while Fonterra continues to have

3 NERA 'An Assessment of the DIRA Triggers: Report to the Ministry of Agriculture and Forestry' 30 March 2010 at Section 3.1.

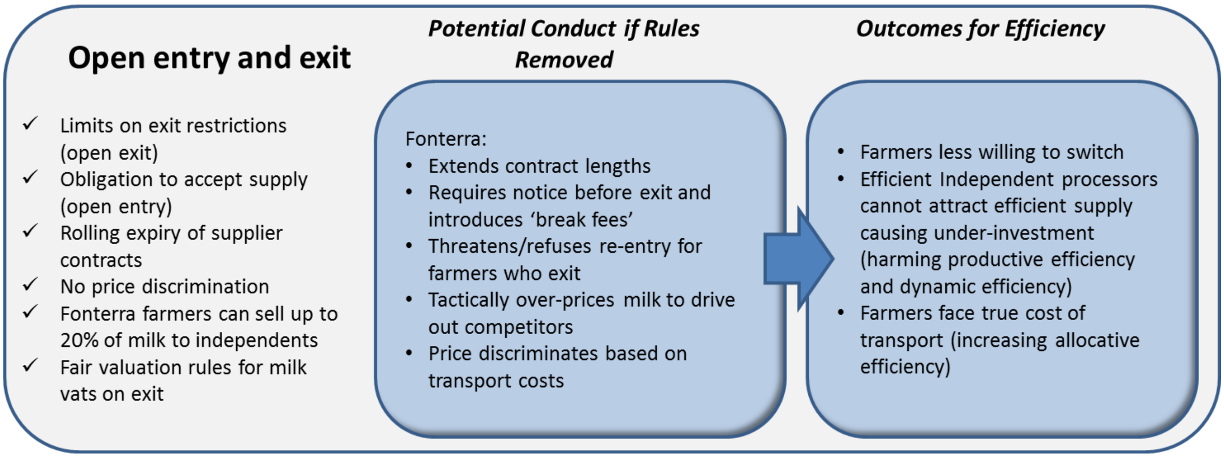
4 See Scherer, Frederic and Ross, David (1990) Industrial Market Structure and Economic Performance, Third Edition, Houghton Mifflin Company.

market power. It helps ensure that Fonterra does not put in place barriers to switching which harm productive and dynamic efficiency by:

- **Restricting farmers' ability to leave Fonterra** and supply an independent processor
- **Reducing confidence for existing and potential independent processors** that they can attract supply and therefore invest in efficient plant investments/expansions.
- **Reducing confidence for farmers looking to make long-term investments to convert to dairy farming** that they will be able to sell perishable milk at a fair price—and to processors with the capacity to accept the large milk quantities necessary at peak season.

Figure 3.1 shows the main ways in which Fonterra might respond if open entry and exit is removed, and what this would mean for efficiency.

Figure 3.1: Potential Conduct and Efficiency Outcomes from Removing Open Entry and Exit



Generally these outcomes are harmful for efficiency, although there may be limited offsetting benefits of deregulation. In particular, if Fonterra moved to price discriminating between suppliers based on the cost of collecting their milk it would provide more efficient price signals for dairy farm conversion. Currently DIRA prohibits Fonterra from price discriminating—so removing this element from open entry and exit might be beneficial. However, this would likely come at the substantial cost of harming productive and dynamic efficiency, and the Government may well have public policy reasons for limiting price discrimination.

The Commission will need to form a view on the likelihood of Fonterra undertaking the conduct in Figure 3.1, and what role the Commerce Act 1986 might play in restricting it (particularly section 36). While the Commerce Act prohibits the misuse of market power and this may go some way to restricting Fonterra's conduct, we agree with the comments of MAF[5] and NERA[6] in the 2010 review that:

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[5] See Ministry of Agriculture and Fisheries 'Extension of the Pro-Competition Provisions of the Dairy Industry Restructuring Act 2001—Regulatory Impact Statement' July 2010: http://www.treasury.govt.nz/publications/informationreleases/ris/pdfs/ris-maf-epcpdira-aug10.pdf.

[6] NERA 'An Assessment of the DIRA Triggers: Report to the Ministry of Agriculture and Forestry' 30 March 2010.

- It is both difficult to detect and prove strategic behaviour in contravention of section 36 of the Commerce Act
- It is costly and time consuming to pursue such litigation.

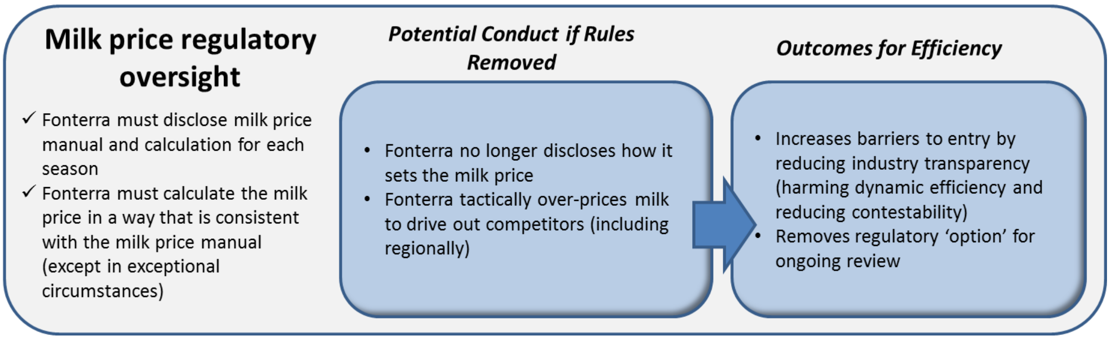
This calls into question the efficiency in relying on the Commerce Act when there is an existing regulatory regime which achieves the same outcome ex ante at low cost—which was NERA's conclusion in 2010.[7] These views are also relevant to Sections 3.2 and 3.3 below.

The Commission will also need to consider whether the existence of the Fonterra Shareholders' Fund (FSF) places additional discipline on Fonterra's management that would lead Fonterra to replicate the outcomes of open entry and exit. However, regardless of what theoretical discipline this might place on Fonterra, the FSF only provides approximately 6 percent of Fonterra's equity, and unitholders have no voting rights in Fonterra. Accordingly, it is unlikely the FSF places discipline on Fonterra's management sufficient to 'override' the outcomes discussed above.

3.2 The milk price regulatory oversight regime

The milk price regulatory regime increases transparency around the way Fonterra sets the milk price, and enhances the industry's confidence that it is being set in an efficient way. As Open Country has noted in the past,[8] while Fonterra continues to set market prices for raw milk, the robustness of competition is enhanced by existing and potential independent processors having transparency over how that market price is being set. Figure 3.2 shows how Fonterra is likely to respond and how this would affect efficiency.

Figure 3.2: Potential Conduct and Efficiency Outcomes from Removing Regulatory Oversight of the Milk Price



The potential conduct change is predictable—Fonterra is likely to stop disclosing how it sets the milk price. If this happened, two potential inefficiencies might arise:

- It could raise barriers to entry for potential processors by increasing uncertainty in the price they will have to pay for raw milk (without the substantial time and cost necessary to fully understand the complexities of the milk processing business)
- It removes the Commission's main option for ongoing review of the operation of the dairy industry, and neither the Commission nor the industry

[7] NERA 'An Assessment of the DIRA Triggers: Report to the Ministry of Agriculture and Forestry' 30 March 2010 at p.19.

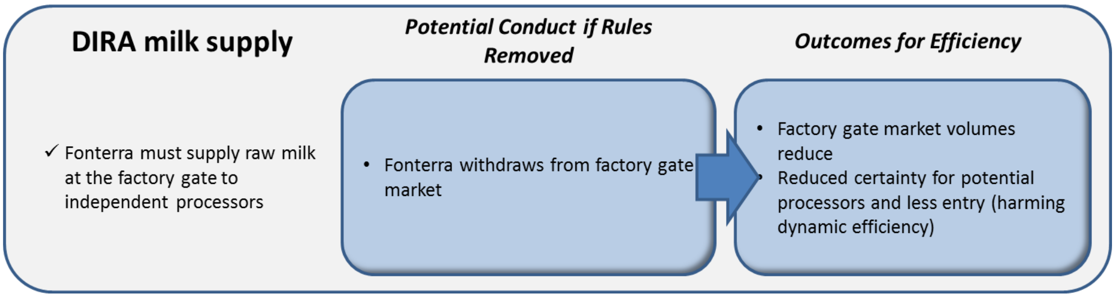
[8] Open Country 'Submission on the Commerce Commission's Draft Report – Review of Fonterra's 2014/15 Milk Price Manual' May 2015.

will have a ready way of knowing if Fonterra is paying inefficiently high milk prices.

3.3 The DIRA milk regulations

The DIRA milk regulations require Fonterra to make available up to 5 percent of its milk supply to independent processors at a regulation-determined price.[9] The regulations were intended to provide start-up processors with certainty that they could access at least 50 million litres of milk per year and therefore the confidence to make initial capital investments in milk processing. Figure 3.3 shows how Fonterra might respond to the removal of the DIRA regulations, and how this might affect efficiency.

Figure 3.3: Potential Conduct and Efficiency Outcomes from Removing DIRA Milk



The main potential outcome is that existing and potential processors must move to solely sourcing milk directly from farmers at the farm gate. While for existing processors in sufficiently competitive areas this may not be harmful to efficiency, it may reduce certainty for potential processors when deciding whether to invest and build processing plant.

4 Conclusion

Our analysis suggests that there is a range of conduct Fonterra might engage in under various deregulation scenarios, and if they were to occur, would likely reduce productive and dynamic efficiency. While there may be some offsetting efficiency benefits (in particular better price signals for dairy conversion), we would expect these to be limited. We request the Commission consider the conduct and efficiency outcomes highlighted in this report and look forward to reviewing the Commission's draft report on how DIRA should evolve.

We have sought to highlight the specific potential conduct and performance outcomes if each of DIRA's components were removed. However, we would also expect that removing two or all three of DIRA's core components might have interactive, cumulative effects (for example in reducing confidence for processors to make efficient plant investments). Accordingly, we request the Commission consider as an additional point how removing DIRA's components in combination might exacerbate any inefficiencies of deregulation.

[9] Dairy Industry Restructuring (Raw Milk) Regulations 2012.

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