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**FONTERRA CO-OPERATIVE GROUP LIMITED (*FONTERRA*) – SUBMISSION ON
DRAFT REPORT: REVIEW OF THE STATE OF COMPETITION IN THE
NEW ZEALAND DAIRY INDUSTRY – PUBLIC VERSION**

EXECUTIVE SUMMARY

1 Fonterra welcomes the opportunity to comment on the Commerce Commission's draft report. We acknowledge the competition assessment is an important first step in considering the case for DIRA change.

Fonterra's submission on DIRA reform

2 In Fonterra's previous submission, we set out our support for a staged approach to removing or changing aspects of DIRA.

3 We acknowledged that parts of DIRA continue to benefit the industry and New Zealand. They do this by contributing to a competitive, efficient dairy sector and public confidence – notably, the milk price regime and the obligations to supply Goodman Fielder and small niche processors with milk.

4 However, in light of significant changes to the dairy industry since 2001, particularly the continuing entry of well-resourced competitors, we submitted that other parts of DIRA are no longer necessary or efficient – that part of the Raw Milk regulations that requires us to supply milk to larger processors (other than Goodman Fielder) and our obligation under DIRA to accept all milk. Fonterra is a co-operative and is committed to processing all of the milk produced by its farmer shareholders. But when it comes to new suppliers, Fonterra considers it should have more discretion as to whether, and on what terms, to accept milk from those suppliers.

5 These key points form the underlying basis of this submission on the Commission's draft report. We agree with a number of the Commission's observations and

conclusions in the draft report. Importantly, we agree Fonterra's co-operative structure mitigates risks of anti-competitive behaviour by Fonterra following deregulation. We also strongly agree with the case for removing access to raw milk for large processors, particularly those that are primarily export-oriented.

- 6 On the other hand, we consider the draft report has understated the intensity of competition at the farm gate as well as the efficiency costs of DIRA's open entry and exit provisions. These are the most significant issues addressed in this submission.

Competition at the farm gate

- 7 There has been a great deal of change in the dairy sector since the introduction of DIRA. Many new players have entered the market and Fonterra's market share has fallen substantially. These are developments acknowledged by the Commerce Commission in its draft report. Given the acceleration of these competition trends over the past 5 or so years, Fonterra encourages the Commission to give additional consideration to the significant planned investment and expected expansion of independent processors over the next few years. These are forward trends that Fonterra itself has to factor into its milk supply and infrastructure investment assumptions. They provide a more comprehensive picture of the state and trajectory of competition.
- 8 In addition, we believe the Commission has understated the intensity and significance of competition in key regions such as Canterbury and the Waikato. Competition from longstanding competitors and new entrants in these regions is intense and has been growing year on year, as reflected in market share shifts in those regions. The intensity of this competition, combined with Fonterra's co-operative structure (which drives a national approach to pricing) should mitigate concerns about limited competition in some other regions such as Northland or the Wairarapa. And this local dynamic must also be seen in the context of Fonterra operating in fiercely competitive global markets, which requires a tight focus on efficiency and performance (which the Commission does acknowledge in its draft report).

Balance of DIRA costs and benefits

- 9 The Commission makes an important observation that it believes the benefits of the DIRA regulations as a whole are in the same order of scale as the costs. This is very significant for several reasons.
- 10 First, Fonterra believes the efficiency costs of DIRA (particularly the obligation to accept all new supply) have been materially underestimated. As the Commission rightly points out, the cost and opportunity costs to Fonterra of having to build and maintain additional capacity because of DIRA uncertainty are difficult to calculate. There are a number of factors contributing to milk volume uncertainty. Nevertheless, the inefficiencies related to DIRA (and open entry and exit in particular) are significant and of a magnitude that they shift the overall balance of costs and benefits. As invited by the Commission, Fonterra has provided more information on these costs in the accompanying paper prepared by NERA. The main costs relate to over-investment in capacity, crowding out higher value investments and causing asset stranding. NERA estimates the resulting costs to Fonterra to be millions of dollars each year. Furthermore, NERA provides a case study on a particular investment by Fonterra that highlights the material costs that are incurred by Fonterra as a result of the uncertainty created by Fonterra's obligation to accept all new supply and offer free exit.

- 11 Second, if as is expected, there is a continuation in the growth of competition, arrival of new entrants and shifts in market share, the costs of DIRA will outweigh the benefits in a very short time (even based on the Commission's draft assessment).
- 12 Third, if the costs and benefits of the current regulations are finely balanced it suggests a strong case for changes and improvements to certain DIRA provisions (e.g. open entry and exit, Raw Milk regulations) designed to improve efficiency and reduce costs as interim steps towards full deregulation. This is an approach that Fonterra strongly encourages the Commission to consider. But it is even more importantly considered by policy-makers interested in those DIRA impacts that are outside the scope of the Commission's competition and efficiency focus.

Thresholds for further review and deregulation

- 13 As stated already, Fonterra considers there is a strong case for changes and improvements to DIRA via this current review.
- 14 In addition, with the market continuing to evolve and change quickly, we think it is important to ensure the next opportunity to review DIRA and deregulate is not set too far out. The Commission has suggested the earlier of the 2021/22 season or when collection of milksolids by IPs reaches at least 30% in either the North or South Island in a season. Fonterra believes neither is appropriate given the speed of change and risk of leaving costs and inefficiencies in place too long – particularly when it is reasonable to expect any review process will take up to two years to be completed and implemented.

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FRAMEWORK AND APPROACH

- 1 As set out in its August submission¹ on the Review,² Fonterra supports a staged approach to removing aspects of DIRA's pro-competition provisions. This appears to align with the Commission's overall views about how any deregulation should take place, as set out in its draft report.³
- 2 Fonterra endorses the goal of achieving efficient markets. The Commission has acknowledged that DIRA's pro-competition provisions currently impose costs (even if it does not ultimately take the view that in every respect they impose net costs).⁴ With this in mind, Fonterra submits that:
 - 2.1 First, a staged approach to deregulation should allow for particular aspects of DIRA's pro-competition provisions to be removed in phases. The Commission acknowledges this in the case of the Raw Milk regulations, by outlining a possible phased approach to their removal.
 - 2.2 Second, concluding that any aspect of the Regulations should not yet be removed is not a sufficient reason to preserve the *status quo* intact. Refining any aspect of DIRA's pro-competition provisions should be considered to the extent it would mitigate costs and improve efficiency (without undermining the benefits the provisions are designed to protect). After 14 years' experience, in Fonterra's view the Review represents an important opportunity to consider changes to these provisions – a rigid approach to deregulation could result in missing opportunities to achieve incremental cost savings and efficiency gains. For example, should the Commission consider it too early to embark on a path of removal of the open entry and exit provisions, there might nevertheless be potential efficiency gains from amendments to those provisions.

¹ Fonterra, Submission on review of the state of competition in the New Zealand dairy industry, 17 August 2015 (*August submission*).

² The review of the state of competition in dairy markets (*Review*). The Review is considering, in particular, Subparts 5 and 5A of Part 2 of the Dairy Industry Restructuring Act (*DIRA*) and the provisions of the Dairy Industry Restructuring (Raw Milk) Regulations 2012 (*Raw Milk regulations*), (together, *DIRA's pro-competition provisions*).

³ Commission, Review of the state of competition in the New Zealand dairy industry: draft report, 6 November 2015 (*Commission's draft report*).

⁴ Fonterra provides additional information on those costs in subsequent sections of this submission. See also Annex A.

STATE OF COMPETITION – WITH AND WITHOUT THE REGULATIONS

- 3 In summary, Fonterra:
 - 3.1 considers the Commission has underestimated the competitive pressure on Fonterra in the farm gate market; and⁵
 - 3.2 disagrees with the Commission's conclusion that Fonterra would have the ability to increase factory gate milk prices above a competitive level (given a number of IPs could enter or expand their supply into that market quickly and at relatively low cost).
- 4 Fonterra provides more detail on these points below but, at the outset, wishes to make two general points about the assessment of the state of competition in the New Zealand dairy industry:
 - 4.1 The Commission is tasked with, and has rightly focused on, assessing the state of competition in domestic dairy markets. But it is worth bearing in mind that domestic competition is not Fonterra's sole focus. Fonterra participates in highly competitive global dairy markets. As such, Fonterra faces strong efficiency drivers regardless of the state of competition in New Zealand domestic markets.⁶
 - 4.2 Fonterra supports the Commission's analytical approach to assessing competition, including considering farm gate and factory gate competition separately. However, Fonterra notes that in reality the factory and farm gate markets are closely linked. The demand side of the farm gate market is the supply side of the factory gate market. The increasingly robust competition in the farm gate market inevitably has implications for the state of competition in the factory gate market, in particular given the low barriers to entering the factory gate market. Fonterra expands on this point below from paragraph 16.
- 5 NERA Economic Consulting (*NERA*) has provided further commentary regarding the state of competition in the New Zealand dairy industry (*NERA advice*, which is attached at Annex A).

Farm gate market

Commission draft conclusions

- 6 In its draft report, the Commission concludes:
 - 6.1 Fonterra has market power in the farm gate market.
 - 6.2 Fonterra has neither the incentive nor the ability to exercise its market power in the farm gate market. As a co-operative, Fonterra is owned by its suppliers and would be unlikely to exercise market power against them.
 - 6.3 Fonterra has no ability to prevent or hinder independent processors (*IPs*) from accessing raw milk at the farm gate as a result of DIRA's pro-competition provisions, Fonterra's co-operative nature and constraints from competitors.

⁵ NERA advice at [2.1].

⁶ NERA advice at [2.1].

Market power assessment

- 7 Fonterra acknowledges that it continues to hold a significant share of raw milk supply at the farm gate in New Zealand. However, for the purposes of the Review it is important to place the assessment properly in the context of an ongoing trajectory of increasing competition. It is also important not to assess market power only by reference to simple market shares.
- 8 In Fonterra's view, competition in the New Zealand dairy industry will continue to increase. For example, Fonterra forecasts that every existing IP, other than Tatura (which as a result of its particular business model does not accept new supply), is expanding or planning to expand its capacity.⁷ As NERA points out, it already seems likely these IPs would be sustainable without the DIRA pro-competition provisions.⁸ Fonterra submits that this market context warrants far greater weight than it appears to have been given in the draft report. As a result, the Commission has underestimated the degree of competition in the farm gate market.
- 9 Secondly, the Commission has assessed competition in farm gate markets on a regional basis. In various places in the draft report, the Commission refers to the variability of competition by region and notes that in some regions, and in relation to approximately 30% of supply, Fonterra faces little or no competition from IPs.⁹ The Commission goes on to conclude that Fonterra does not face sufficient constraints to ensure effective competition in those regional markets.
- 10 However, this focus does not give an appropriate picture of the effect of competition, in practice. As the Commission itself acknowledges, uniform pricing and Fonterra's co-operative structure mean that Fonterra must respond to regional competitive pressure on a national basis.¹⁰ To conclude Fonterra holds additional market power in particular regions where Fonterra is the only processor does not reflect the reality of Fonterra's conduct or, importantly, the conduct in which Fonterra could be expected to engage in the absence of DIRA's pro-competition provisions.¹¹ In light of Fonterra's co-operative structure, and uniform pricing, competition in particular regions necessarily has, and will continue to have, competitive benefits nationally with or without the DIRA pro-competition provisions. In this respect, the Commission has further underestimated the degree of competition in the farm gate market.

Exercise of market power

- 11 To the extent it has any degree of market power at the farm gate, Fonterra supports the Commission's conclusion that it would not have the ability or the incentive to exercise any market power against its suppliers. As the Commission has previously acknowledged, Fonterra's co-operative structure by itself largely eliminates the prospect of exercising market power against farmers.¹² In addition, the milk price regime and Fonterra's constitution (which incorporates key elements

⁷ See NERA, Assessment of Competition in Raw Milk Markets and Costs and Benefits of the DIRA provisions, 17 August 2015 at [3.3.2] and Figure 8.

⁸ NERA advice at [2.2].

⁹ See, for example, the Commission's draft report at [4.6] and [4.7].

¹⁰ Commission's draft report at [4.96].

¹¹ See Fonterra, submission on review of the state of competition in the New Zealand dairy industry, 17 August 2015 (*Fonterra's August submission*) at [30.1].

¹² See Fonterra's August submission at [43]; *Fonterra Limited and New Zealand Dairies Limited (in receivership)* [2012] NZCC 21 at [26]-[27] and [81]-[88]; NERA, Assessment of Competition in Raw Milk Markets and Costs and Benefits of the DIRA provisions, 17 August 2015 at [2.1].

of the milk price regime and would likely be retained regardless of the regime) as well as Trading Among Farmers provide for increased certainty and transparency regarding the milk price and dividends.¹³

- 12 Fonterra also supports the Commission's conclusion that it would not have any material ability to prevent or hinder IPs from accessing raw milk at the farm gate.¹⁴ Even in the absence of oversight by the Commission of the basis on which Fonterra determines its milk price, Fonterra is likely to calculate its farm gate milk price under a regime similar to that which prevails now.¹⁵ In addition, Fonterra's co-operative structure, which requires it to treat similarly placed shareholders equally, would limit its ability to lock in a substantial proportion of its farmers to long-term contracts. Fonterra would have little incentive and/or ability to foreclose IPs at the farm gate.
- 13 In further support of this conclusion, Fonterra notes:
- 13.1 A significant number of IPs are now collecting milk at the farm gate. They do so in areas where Fonterra collects approximately 73% of its farm gate milk, which illustrates their ability to compete effectively for supply.
- 13.2 Once established, barriers to expansion are low, particularly where IPs have scope to co-ordinate to share transport costs.
- 13.3 Barriers to entry have also decreased over time, with IPs having ready access to:
- (a) export markets in which to market products; and
 - (b) expertise in relation to processing infrastructure.
- 13.4 Milk is generally a relatively homogenous product, which means sources of farm gate supply are highly substitutable.¹⁶
- 13.5 Farmers' switching costs are low.
- 13.6 A number of competitors are now well established and have been operating in the market for many years.
- 13.7 A number of the competitors that have entered the market over the last 5 years are linked to global dairy businesses.

Factory gate market

Commission's draft conclusions

- 14 The Commission concludes in its draft report that there is limited competition in the factory gate market and that DIRA's pro-competition provisions prevent Fonterra from raising prices for DIRA milk above competitive levels. In particular, the Commission concludes that Fonterra's obligation to supply DIRA milk, and to supply

¹³ See Fonterra's August submission at [43].

¹⁴ Commission's draft report at [5.80.1].

¹⁵ Principal aspects of the regime by which the farm gate milk price is set by Fonterra were in place well before the Commission assumed its oversight role.

¹⁶ Fonterra acknowledges there may be an exception to this in the case of niche IPs such as producers of gourmet cheeses.

at a regulated price, may be restricting further participation in the factory gate market.

Competition at the factory gate

- 15 Fonterra agrees the factory gate market is relatively immature. That said, Fonterra submits that it is important to bear in mind the close relationship between this market and the farm gate market (in which competition is relatively developed and sustainable). The development of competition in the demand side of the farm gate market represents the strengthening of competition in the supply side of the factory gate market.
- 16 As discussed in the NERA advice,¹⁷ this relationship is particularly significant given very low barriers to entry to the factory gate market. The key condition is collection infrastructure; essentially, participation requires the diversion of a tanker. Transport costs would commonly result in factory gate supply being only slightly more expensive, and in some cases slightly less expensive, than supply to a processor's own factory.¹⁸
- 17 Given the relatively developed and sustainable nature of competition in the farm gate market, there are already several IPs with the means to participate in the factory gate market without significant expenditure.¹⁹ There is no valid reason why at least the large exporting IPs would not do so at an appropriate price. As is the case for Fonterra, if the margin such IPs could obtain by selling through the factory gate market rose above the opportunity cost of selling in overseas markets, they would switch production into the factory gate market.²⁰ Consistent with this, the Commission notes in its draft report that "other IPs that are potential entrants to the factory gate market have indicated they would consider supplying that market at the right price".²¹
- 18 IPs are individually developing extensive transport infrastructures, which Fonterra estimates now collect approximately 15% of all milk at the farm gate. Moreover, Fonterra understands IPs to be competing to provide collection services to new entrant processors, such as Yashili.²² This infrastructure provides scale and scope that could be exploited to supply at the factory gate, meaning relevant IPs' costs of supplying at the factory gate should be relatively low. Their costs should also be comparable to Fonterra's own costs to supply at the factory gate.

The price of DIRA milk

- 19 Overall, the Commission appears to acknowledge that the DIRA price may be too low at least in some circumstances, and thus potentially crowding out competition. Fonterra agrees the DIRA price is generally lower than its opportunity cost and that this may be materially detrimental to competition in the factory gate market. Further information about the implications for efficiency is provided from paragraph 27 below, and in the NERA advice at Annex A.

¹⁷ NERA advice at [2.1].

¹⁸ See Commission's draft report at [4.119].

¹⁹ Such IPs can be considered poised to enter – they are already not likely to buy DIRA milk in the near future (Commission's draft report at [4.108]).

²⁰ See NERA advice at [2.1].

²¹ Commission's draft report at [4.15]; see also [4.125].

²² Fonterra's August submission at [33.4]; NERA, Assessment of Competition in Raw Milk Markets and Costs and Benefits of the DIRA provisions, 17 August 2015 at [4.3].

The price of non-DIRA milk

- 20 The Commission suggests Fonterra is setting a price for non-DIRA milk that is too high, based on its analysis of Fonterra's current prices and the fact that Fonterra currently faces little competition in the sale of non-DIRA milk.²³ The Commission has estimated that, absent regulation, Fonterra would likely be able to exercise market power at the factory gate, raising prices 25% above competitive levels.²⁴
- 21 Fonterra considers the price at which it supplies non-DIRA milk does not represent a use of market power and thus does not in itself stifle factory gate competition. Rather, the price is based on what Fonterra considers to be an appropriate measure of its opportunity cost and would not be above competitive levels. Further information about the efficiency implications is provided below from paragraph 30.

Wholesale and retail supply of fresh processed milk

- 22 The Commission in its draft report notes that it has not obtained any new information that alters its conclusions in the 2011 preliminary inquiry into domestic milk markets under Part 4 of the Commerce Act 1986. Fonterra welcomes this view.

²³ Commission's draft report at [5.32].

²⁴ Commission's draft report at [6.31] - [6.36].

BALANCING EFFICIENCIES AND INEFFICIENCIES OF THE REGULATIONS

Overview

- 23 As noted above, Fonterra considers the Commission has underestimated the degree and scale of the detriment of DIRA's pro-competition provisions to competition and efficiency. This is particularly significant given the Commission's view that the costs and benefits are finely balanced.
- 24 The Commission has indicated it would benefit from additional information on efficiency costs, particularly in relation to the provisions supporting open entry and exit, and Fonterra's obligations under the Raw Milk regulations. Fonterra has worked with NERA to prepare this additional information, the results of which are set out in the NERA advice at Annex A.

Open entry and exit

- 25 NERA has estimated the costs of the open entry and exit provisions by analysing historical milk collection data. NERA's analysis indicates that the costs of the open entry and exit provisions are materially higher than the Commission has identified in the draft report. In addition, in Fonterra's experience these provisions have a material impact on its planning and decision making. Based on that experience, Fonterra believes that NERA's estimates are conservative. NERA breaks these efficiency costs down into three broad categories, which add to Fonterra's previous submissions on the costs of these provisions:²⁵

25.1 *Excess capacity due to uncertainty*: Fonterra builds capacity for farms that may or may not supply Fonterra; Fonterra is forced to assume they will supply it due to the obligation to accept supply.²⁶ NERA has quantified the cost to Fonterra of this additional investment in capacity at around [REDACTED] in addition to the Commission's estimated \$6 million.²⁷

25.2 *Investment in higher value producing plant is "crowded out"*: Fonterra faces capital constraints, which require it to plan investment commitments over a 2-3 year rolling horizon. However, the obligation to accept supply means that Fonterra has limited ability to phase supply growth to match its medium term investment programme.²⁸ As a consequence, it is prudent for Fonterra to invest in low-cost, low-value capacity to a greater extent than is optimal, thereby using up scarce capital.²⁹ Based on a simplified calculation, assuming that 5% of base capital expenditure was instead invested in value added plant each year, the cost to Fonterra in terms of limiting investment in higher value producing plants is on average an additional [REDACTED].³⁰ Fonterra considers this estimate conservative, and notes NERA's point that even a reallocation of 10% would not be surprising, which would result in a cost [REDACTED].

²⁵ Fonterra's August submission at [57].

²⁶ NERA advice at [3.1]; this inefficiency is also outlined in Fonterra's August submission ([57.2]).

²⁷ NERA advice at [3.2.1].

²⁸ Fonterra is obliged to accept new milk, including from conversions, without having any material ability to manage timing.

²⁹ NERA advice at [3.1].

³⁰ NERA advice at [3.2.2.3].

25.3 *Asset stranding due to free exit*: Capacity becomes stranded when Fonterra is obliged to build capacity for new farms that subsequently leave Fonterra.³¹
[REDACTED]

].

25.4 While [REDACTED] is an easily identifiable example, it is not an isolated one. The potential for stranded capacity exists in relation to all of Fonterra's processing plants, and does, in fact, take place as farmers move elsewhere (for example, in response to IPs entering a region). IPs themselves are able to reduce stranding risk, for example through the use of longer term contracts. The costs identified by NERA in relation to [REDACTED] can and should be extrapolated more broadly.

26 Thus, open entry and exit result in significant costs. The implications of these costs for "pathways to deregulation" are addressed below from paragraph 48.

Raw milk regulations

27 The Commission states that there may be times when the opportunity cost is higher or lower than the DIRA price.³² But NERA concludes that the evidence suggests that, in general, the DIRA price will be lower than Fonterra's opportunity cost. Factors identified by NERA as relevant to the price representing opportunity cost include:

27.1 World commodity prices are volatile. Fonterra is able to respond to that by either producing different proportions of WMP and SMP than the milk price formula assumes, or by producing more commodity products from outside of the reference commodities. Put another way, the marginal value of a unit of milk is not the bundle assumed in the milk price calculation, but instead the highest value product stream at the time the IP takes the milk.

27.2 The time at which DIRA milk is taken by IPs. Fonterra's opportunity cost is particularly sensitive in shoulder periods when milk is scarcer and the availability of greater capacity provides a wider range of processing options.

27.3 The location at which the IP takes milk. For example, if milk is diverted from an area housing value-added plants (such as the Waikato), there is greater likelihood that the milk would have been used to create higher value products.

³¹ NERA advice at [3.1].

³² See also NERA advice at [4].

28 The Commission observes:

- 28.1 The DIRA price for milk is updated quarterly but dairy product prices are volatile, so at any single point in time the opportunity cost for selling raw milk to IPs may be greater or less than the price forecast by Fonterra for all of that season.³³ Fonterra considers this is unlikely – see Figure 3 of the attached NERA report.
- 28.2 Capacity constraints might prevent Fonterra from maximising its opportunities to produce higher-value products even if it did not have to sell milk to IPs under the Raw Milk regulations.³⁴ Again, Fonterra considers this unlikely to arise in practice particularly to the extent it had the ability to plan its capacity with greater certainty. Fonterra notes the DIRA pro-competition provisions themselves would be a contributing factor in any such capacity constraint, to the extent they “crowd out” investment by Fonterra in plant that can produce value added products.³⁵
- 28.3 At times, commodity products might be more profitable than making and selling other products. As a result sales of DIRA milk might provide a higher return than processing the milk into lower returning products.³⁶ Again, Fonterra considers this is unlikely – see Figure 3 of the attached NERA report.
- 28.4 If in reality Fonterra does not match the efficiency of a hypothetical efficient processor then sales of DIRA milk might be value enhancing.³⁷ Fonterra considers this to be a largely theoretical possibility, and refers again to NERA’s conclusion that the DIRA price is more likely lower than Fonterra’s opportunity cost.
- 28.5 Having to sell milk to IPs may reduce Fonterra’s ability to spread the fixed costs of its plants over greater milk volumes.³⁸ Assuming Fonterra has correctly understood the Commission’s intended meaning, Fonterra disagrees that spreading fixed costs affects opportunity cost.³⁹
- 28.6 The supply of milk to other processors’ plants may yield efficiencies, for example, reduced collection costs through shorter travel time for some of its tankers.⁴⁰ **[REDACTED]**

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³³ Commission’s draft report at [5.22.1].

³⁴ Commission’s draft report at [5.22.2].

³⁵ NERA advice at [3.2.2].

³⁶ Commission’s draft report at [5.22.3].

³⁷ Commission’s draft report at [5.22.4].

³⁸ Commission’s draft report at [5.22.5] and [5.22.6].

³⁹ See NERA advice, footnote 11.

⁴⁰ Commission’s draft report at [5.22.7].

[REDACTED]

- 29 Fonterra also notes additional costs of the Raw Milk regulations, which it has identified previously:⁴²
- 29.1 The tolerances in the Raw Milk regulations for IPs' estimates of the required quantity of raw milk can lead to inefficiencies. Fonterra faces significant costs in coping with excess milk arising from failure by IPs to take forecasted volumes of milk, particularly during "peak" months.
- 29.2 The current notice period of 18 months for winter supply can force Fonterra to divert milk that it intended for other purposes, as Fonterra has insufficient time to source new winter milk supply in that time. The potential consequences for Fonterra are particularly acute because there are no monthly maximum limits for winter milk.
- 29.3 Tolerances for winter milk can generate costs for Fonterra, as Fonterra must pay a premium to suppliers for winter milk irrespective of whether IPs actually take the estimated volumes of milk. Although Fonterra may process the milk, it cannot recover the premium.
- 30 The Commission also appears to consider that Fonterra's price for non-DIRA milk represents a use of market power and bases its efficiency analysis on this assumption. **[REDACTED]**
- ⁴³] Further, Fonterra does not consider an assumption that it could process factory gate milk into SMP, BMP and butter at the margin represents an inappropriate measure of opportunity cost. Fonterra does not consider there to be any reason to believe that these products are systematically more profitable than others and thus that using them as a basis for prices imposes any systematic bias. Consistent with this, NERA concludes that the evidence suggests Fonterra sets non-DIRA factory gate milk prices at opportunity cost, not at a market power level.⁴⁴ In particular, Fonterra sets its prices in accordance with ECPR-type models.
- 31 The challenge suggested by the foregoing analysis is to reduce dependency by IPs on regulated raw milk supply in order to foster competitive conditions in the factory gate market. This should be done in a way that avoids jeopardising competition gains that might continue to be made from supply under the Raw Milk regulations. This challenge is addressed in relation to "pathways to deregulation", below from paragraph 33.

⁴² Fonterra's August submission at [91]

[REDACTED]

⁴⁴ NERA advice at [4].

PATHWAYS TO DEREGULATION

Overview

32 Fonterra appreciates the thought the Commission has invested into identifying workable options for deregulation. However, the Commission's conclusion that it would not yet be appropriate to commence removal of an aspect of the DIRA pro-competition provisions should not prevent due consideration of amendments to these provisions that would improve efficiency.⁴⁵ If policy options can be developed that would result in reducing the costs of regulation, without harming the benefits to competition, it would be appropriate to consider those options.

Raw Milk regulations

33 To address its concern (discussed above, from paragraph 14) that the Raw Milk regulations are restricting the development of the factory gate market, the Commission has identified a number of possible reforms. The primary options for reform discussed are: limiting IPs' access to regulated milk, reducing Goodman Fielder's entitlement to regulated milk, and reviewing the price at which Fonterra may sell regulated milk.

34 Fonterra agrees that, in general, it is efficient to incentivise self-supply or competitive factory gate supply above dependency on regulated milk. The current scheme may have facilitated IP entry, but has not resulted in much factory gate activity.

35 In response to the particular options for reform identified by the Commission, Fonterra:

35.1 agrees that obliging Fonterra to make raw milk available at the regulated price does not incentivise trading of non-DIRA milk. Fonterra submits the price regime governing factory gate milk prices generates inefficiency and that the price should reflect Fonterra's opportunity cost;

35.2 acknowledges the Commission's support for removing the entitlements of IPs that primarily export. Fonterra considers it should no longer be obliged to make milk available to larger IPs, including those looking to establish a foothold in the New Zealand market; and

35.3 acknowledges the Commission's views but considers there is a case for the retention of entitlements for Goodman Fielder and for niche processors.

36 Fonterra reiterates its view, expressed above at paragraph 16, that the barriers to entry in the factory gate market are low. The lack of interest in the factory gate market on the part of particularly larger exporting IPs is largely attributable to insufficient incentives rather than any other identifiable factor. Fonterra considers that if the Raw Milk regulations are altered to generate incentives to participate in the factory gate market, competition would be in a position to respond in relatively short order.

37 Fonterra notes that it wishes to continue to supply milk at the factory gate, regardless of the regulatory position, and that it would have an incentive to do so to the extent the price reflects its opportunity cost. Fonterra also reiterates that it does

⁴⁵ See further above at paragraph 2.

not consider the current prices for non-DIRA milk represent a use of market power. Fonterra would welcome further engagement on the appropriate price level.

- 38 **Fonterra agrees that the price regime governing factory gate milk prices generates inefficiency and that the price should reflect Fonterra's opportunity cost.**

Larger and exporting IPs

- 39 Fonterra welcomes the Commission's support for the need to reduce dependency on the Raw Milk regulations. Fonterra considers that competition has already reached the point where it should no longer be obliged to make raw milk available to larger IPs (other than Goodman Fielder), including those looking to establish a foothold in the New Zealand market for the collection or processing of milk.

- 40 The role of the Raw Milk regulations in facilitating contestability at the farm gate has been achieved with the advent of IPs that have secured their own supply and present a sustainable competitive force in the farm gate market. As Fonterra noted in its August submission, many IPs are now self-sustaining.⁴⁶ In addition, IPs are able to secure factory gate supply on commercial terms from Fonterra and, Fonterra believes, from other IPs.

- 41 There is little justification for continuing to require the supply of regulated milk, particularly for already established IPs and IPs with little or no participation in domestic markets and thus no benefits for downstream competition in New Zealand.

- 42 **Fonterra remains of the view that it should not be obliged to make raw milk available to larger IPs (other than Goodman Fielder), including those looking to establish a foothold in the New Zealand market.**

Goodman Fielder

- 43 The Commission has suggested that reducing Goodman Fielder's entitlement to access DIRA milk could spur a factory gate market outside of DIRA. The Commission has identified options for reform that include limiting entitlements either on a national or on a regional basis.

Fonterra believes that the raw milk regulations as they relate to Goodman Fielder should remain unchanged.⁴⁷ Goodman Fielder's entitlement to raw milk under these regulations supports public confidence in the domestic markets through securing availability of raw milk for a key competitor in those markets. This is also further supported by Fonterra's long term commercial contract with Goodman Fielder for the supply of milk.

- 44 **Fonterra remains of the view that the requirement to supply Goodman Fielder is important for public confidence.**

⁴⁶ Fonterra's August submission from [78]-[85].

Milk price calculation

- 45 The Commission has determined that reopening the milk price calculation and/or process falls outside the scope of its mandate in this process.⁴⁸ Fonterra agrees.
- 46 Fonterra also endorses the Commission's observations that:
- 46.1 The milk price regime creates more certainty about the farm gate milk price, and more transparency with respect to how that price is set. This assists to reduce barriers to entry for IPs, because it increases their certainty about the price they will have to pay for milk (since they typically peg the price they pay for milk to Fonterra's farm gate milk price).⁴⁹
- 46.2 Fonterra would retain most aspects of the milk price setting process, including its Milk Price Manual, even if regulation was removed. "Fonterra's incentives to raise the farm gate milk price are therefore constrained with and without regulation."⁵⁰
- 47 **Fonterra agrees that a detailed review of the milk price regime is outside the scope of the current process.**

Provisions protecting entry and exit

- 48 The Commission has not recommended any alterations to the open entry and exit provisions of DIRA in its draft report, preferring to obtain further information about the costs of the provisions, at this stage.
- 49 Fonterra considers there have been significant changes to the dairy industry since 2001, particularly the continuing entry of well-resourced competitors. Further information is provided above,⁵¹ in the August submission⁵² and in the NERA advice.⁵³ Fonterra also considers the provisions protecting entry and exit to result in material costs, which the Commission has underestimated.⁵⁴ As a consequence, Fonterra considers there is a case for change to the open entry and exit provisions in the context of the Review.
- 50 As a co-operative, Fonterra is committed to processing all of the milk produced by its existing farmer shareholders. But to assist Fonterra to invest and operate more efficiently, the co-operative should have more discretion to manage new entry to enable it to better optimise the phasing of new supply.⁵⁵ This would improve efficiency by reducing the cost of the provisions, without undermining competition.
- 51 **Fonterra remains of the view that discretion should be granted to Fonterra to better manage new entry to enable it to better optimise the phasing of new supply.**

⁴⁸ Commission's draft report at [7.88].

⁴⁹ Commission's draft report at [4.56.4]

⁵⁰ Commission's draft report at [5.92] and [5.93].

⁵¹ From paragraph 3.

⁵² Fonterra's August submission from [29].

⁵³ NERA advice at [2.2].

⁵⁴ See above from paragraph 25, and NERA advice from [3].

⁵⁵ Fonterra notes there might also be reasons other than those related directly to competition that support the need to review and alter these provisions. Fonterra also observes that the Commission has already noted that amending the transport cost exception might contribute toward mitigating potential inefficiency (see [7.81]). However, the Commission does not appear to have carried this observation forward to its recommendations.

Thresholds for further review

- 52 The Commission has proposed resetting the market share thresholds in DIRA to trigger a further competition review of the dairy industry. The Commission's proposed thresholds are the earlier of:
- 52.1 the 2021/22 season;⁵⁶ or
 - 52.2 following collection by IPs of 30% of total milksolids in either the North or South Island in a season.⁵⁷
- 53 Fonterra agrees that a further review will be necessary in order to sensibly implement a staged approach to deregulation.
- 54 Fonterra considers the industry is changing rapidly, as evidenced by the particularly significant development of competition over the last five years and forecasts for coming seasons. It is important there is another opportunity to consider DIRA's pro-competition provisions within reasonably short order.
- 55 Fonterra suggests a further review should commence sooner than the Commission proposes. In reaching that view, Fonterra has taken into account the following factors:
- 55.1 The Commission has acknowledged that its draft decision not to recommend deregulation in this review is conservative,⁵⁸ and that the costs and efficiencies of DIRA's pro-competition provisions are finely balanced.⁵⁹
 - 55.2 If the Commission's new thresholds were adopted, it is unlikely that any recommended changes to the Regulations would be effected before the 2023/24 season (assuming, as the Commission does, that the market share threshold is not triggered before 2021). Fonterra considers this to be an overly conservative approach.
- 56 **Fonterra suggests that it would be appropriate to commence a further review of competition in the New Zealand dairy industry sooner than the Commission has proposed.**



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⁵⁶ Commission's draft report at [7.43].

⁵⁷ Commission's draft report at [7.16].

⁵⁸ Commission's draft report at [6.86].

⁵⁹ Commission's draft report at [6.88].

APPENDIX: ADDITIONAL COMMENTS

Draft report reference	Draft report statement	Fonterra's response
4.79	Fonterra's farmer loan scheme is identified as a possible switching cost.	<p>This incorrectly characterises the Co-operative Support. In particular, participation is voluntary, the loan may be repaid at any time, and it does not restrict suppliers from entering or exiting Fonterra in any other respect.</p> <p>For share-backed farmers who receive Co-operative Support, it will simply provide assistance to manage their cashflows during an extremely difficult and challenging season. While farmer suppliers will be required to repay the Co-operative Support upon ceasing to supply Fonterra, Fonterra does not consider that this will materially affect the decision to cease supply. First, it will not impact upon the key drivers of that decision. Secondly, Fonterra expects that repayment will be able to be made out of the proceeds of the required sale of Fonterra shares held by that farmer or out of the payments made for their milk which are paid following the end of the season.</p>
4.90	The Commission acknowledges that many of Fonterra's price and non-price competitive responses have been applied on a national basis. However, the Commission goes on to note that Fonterra has responded to regional competition with some non-price incentives. It gives the example of MyMilk, which is available in Canterbury, Southland and Otago.	MyMilk does evidence a geographically confined offering (which is only temporarily available to suppliers), which was in part a response to particularly vigorous competition. A key feature of this offering is that it defers the obligation to back production with shares, thereby better matching the terms offered by competitors. Notably though, Fonterra has undertaken that MyMilk will not pay more for milk than the farm gate milk price Fonterra pays nationally on share-backed supply. Thus, MyMilk underlines the relevance of Fonterra's co-operative structure, which results in competition in particular regions benefiting competition nationally.
6.13	The Commission notes that it costs between \$0.5m and \$1m per annum for it to review the milk price.	Fonterra wishes to make clear that it pays these costs.

ANNEX: NERA ADVICE