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

Introduction

1 Fonterra welcomes the opportunity to provide a cross-submission in response to the Commerce Commission's (*Commission*) draft report,[1] which forms part of its review of competition in dairy markets (*Review*).[2] In this cross-submission, Fonterra focuses on responses to the draft report that have raised new arguments or analysis, or provided additional supporting evidence. Fonterra has focused in particular on arguments and analysis that Fonterra considers bear most relevance to the scope of the Review.

2 At the outset, Fonterra wishes to reiterate the Commission's observations in earlier consultation papers that "less weight may be given to a statement or submission that a party cannot support with corroborating evidence, than a statement or submission that a party can support with corroborating evidence".[3]

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

[2] 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: Consultation paper – process and approach (12 June 2015), at [22]; Commission, Consultation on substantive issues – review of competition in the dairy industry (20 July 2015) at [10]; see Fonterra's previous comment in its Cross submission on review of the state of competition in the dairy industry, 31 August 2015 at [3.2].

3 Fonterra's submission in response to the draft report[4] contained significant analysis responding to the Commission's draft findings and request for further information. Fonterra's submission was supported by an extensive expert report from NERA.[5] Fonterra considers these, along with the analysis it has submitted previously,[6] form a sound basis for the approach it advocates. Fonterra notes that many submissions do not provide corroborating evidence that would counter its position. As such, Fonterra invites the Commission to take account of its evidence when considering the concerns raised by other submitters.

State of competition – with and without DIRA's pro-competition provisions

Market power at the farm gate

4 Some submitters have expressed concern about Fonterra's market power. In particular, submitters have tended to:[7]

4.1 support the Commission's view that Fonterra has market power at the farm gate; and

4.2 disagree that Fonterra would be constrained from exercising its market power in the absence of DIRA's pro-competition provisions.

5 Fonterra reiterates the evidence it has submitted to show that, while it does continue to hold a significant share of raw milk supply, the Commission has underestimated the extent of competition in the farm gate and given insufficient weight to the ongoing trajectory of increasing competition.[8]

6 Fonterra supports the view of the Commission that Fonterra would not have the ability or incentive to exercise market power against its suppliers or against established IPs. It has provided submissions and evidence in support of this. Central to its evidence are features of Fonterra, as a co-operative, that would constrain its ability to exercise market power, even if it were otherwise in a position to do so. These features include the following:

6.1 The underlying purpose of Fonterra's co-operative structure is to protect supplying shareholders against monopsony pricing.

6.2 Fonterra faces strong incentives to ensure that all of its farmer shareholders are treated fairly (that is, to act in the interests of its farmer shareholders). This includes enabling shareholders to adjust their shareholding as their milk production increases or decreases (which is consistent with ease of entry and exit).[9]

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[4] Fonterra, Submission on draft report: review of the state of competition in the dairy industry, 4 December 2015 (*Fonterra's December submission*).

[5] NERA, Review of Commerce Commission's draft report into dairy competition, 4 December 2015 (*NERA's December advice*).

[6] Fonterra, Submission on review of the state of competition in the New Zealand Dairy Industry, 17 August 2015 (*Fonterra's August submission)*; NERA, Assessment of competition in raw milk market and costs and benefits of the DIRA provisions, 17 August 2015.

[7] See for example Castalia, Review of the state of competition in the dairy industry: comments on the Commerce Commission's draft report, December 2015 at page 3; Danone Nutricia, Submission on the dairy competition review draft report, 4 December 2015 at [3.1]; Miraka, Submission to the Commerce Commission: review of the state of competition in the New Zealand dairy industry, draft report, 4 December 2015 at [2.4].

[8] These views are expressed in more detail in Fonterra's December submission.

[9] As set out in Fonterra's August submission (at [58.1]), even in the absence of any legislative obligation to accept supply, Fonterra would not be in a position to decline to accept applications by existing farmer shareholders to increase

7 The features described above, among others, have resulted in Fonterra voluntarily adopting extensive rules. For example, the milk price regime was transparent, and codified, well before the milk price regime in DIRA was implemented.[10] In addition, Fonterra has voluntarily imposed limits on contract supply in its constitution.[11]

8 As it has previously submitted, Fonterra would not have the ability or incentive to raise rivals' costs in the absence of DIRA's pro-competition provisions, as Castalia (for Open Country Dairy (*Open Country*)) and Danone Nutricia (*Danone*) suggest. In addition, Fonterra notes:[12]

8.1 Any attempt to introduce new, or alter existing, surcharges or cost allocations in the farm gate milk price (such as for volume or location) would be transparent.

8.2 The construct of the farm gate milk price, which is an aggregate amount after all costs have been taken into account (including transport and logistics costs) means such reallocations would have significant wealth effects that would have a differential effect among Fonterra's farmer shareholders. Accordingly, Fonterra's co-operative structure would likely act as a deterrent to them. At the least, the merits of any such reallocations would likely be closely scrutinised, would need to be compelling (for example, reflecting peak pricing or particular milk qualities) and would need to deal with transitional effects (such as a phased and well-signalled implementation). These represent significant constraints on the ability of Fonterra to act anti-competitively.

9 The two factors above, together with the transparent nature of the rules that allocate the aggregate total farm gate milk price to Fonterra's supplying shareholders would make it difficult for Fonterra to raise costs for IPs.

10 Further, Fonterra is incentivised to operate efficiently (and support an efficient milk price) due to the significant competitive pressures it faces in the global dairy commodities market. Fonterra is also constrained in its ability to increase the milk price by its external investors, who place value in the setting of a transparent and efficient milk price. In any event, Fonterra reiterates that it does not seek removal of the milk price regime in DIRA at this stage, and that in the absence of DIRA's pro-competition provisions, it would retain a milk price regime similar to that which is in place currently.

11 These constraints have been acknowledged to some extent by the Commission and Fonterra does not consider submitters to have provided any material evidence to the contrary.[13]

12 Equally, the underlying factors that shape Fonterra as a co-operative and that are set out above at paragraph 6 also limit its incentive and ability to reduce the farm

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supply from existing farms. Fonterra considers this to be fundamental to its institutional form, and thus that its co-operative structure would constrain it from declining such applications.

[10] See Fonterra's August submission, from [37].

[11] Constitution of Fonterra Co-operative Limited (*Fonterra's constitution*), clause 3.22. See further below at [13.2].

[12] Danone Nutricia, Submission on the dairy competition review draft report, 4 December 2015 at [3.1].

[13] Fonterra's December submission at [12]; Commission's draft report at [5.80].

gate milk price below a competitive level.[14] Even if any increased profit that arose from a contrived lower milk price would flow principally to the same farmers who supplied the milk, Fonterra's shareholders are not indifferent to whether benefits are derived from the farm gate milk price or earnings.[15]

13 In addition, Fonterra responds to the following specific points made by other submitters:

13.1 Miraka's analysis of unit prices for the Fonterra Shareholders' Fund (*FSF*).[16] Fonterra considers that Miraka's analysis is simplistic and misleading. In particular, Fonterra disagrees that the whole milk powder (*WMP*) spot price at a given point in time is indicative of the farm gate milk price. The farm gate milk price, not the WMP, is Fonterra's milk input cost. While the farm gate milk price is a function of the WMP price, the milk price is a) based on a bundle of products, not just WMP and b) is set for a season and thus lags behind WMP (and other) price movements. In Fonterra's view, the FSF unit price is generally negatively correlated to the farm gate milk price. Miraka's analysis also takes the simplistic view that the sole driver of Fonterra's profitability (and therefore the FSF price) is the milk input cost. What Fonterra can sell its value added products for, and changes in cost and production efficiencies, also affect its profits. These factors are largely unrelated to the WMP price. In Fonterra's view, announcements (such as those relating to the farm gate milk price, results, earnings estimates, as well as other material market announcements) are the primary trigger of FSF price changes. Finally, Fonterra notes that Fonterra shares do not confer the right to supply milk.[17] The open entry regime in DIRA confers the right to supply. The requirement to hold shares is a consequence of milk supply.

13.2 Danone's suggestion that in the absence of DIRA's pro-competition provisions there is a real risk that Fonterra could seek to contract with farmers for long periods, particularly in areas where it considers competition is likely.[18] DIRA's pro-competition provisions currently allow for such contracts, subject to the 160km rule.[19] However, in the absence of the DIRA

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[14] Miraka suggests that Fonterra would have incentives to do this: Miraka, Submission to the Commerce Commission: review of the state of competition in the New Zealand dairy industry, draft report, 4 December 2015 at [3.4]. Fonterra notes that, elsewhere, Miraka appears to suggest Fonterra would do the opposite, and increase the farm gate milk price (see [3.4]-[3.6]).

[15] In particular, a contrived lower farm gate milk price would:

(a) be contrary to the requirement in Fonterra's constitution for Fonterra to pay the maximum sustainable milk price (Annexure 1);

(b) be unfair to some suppliers due to the absence of full alignment between supply and shareholding;

(c) limit the ability of shareholders to grow production and encourage suppliers to exit; and

(d) substantially weaken long-term performance incentives that Fonterra faces.

In addition, if Fonterra were to lower the farm gate milk price there is every reason to expect IPs to follow suit. Alternatively, if IPs were able to hold a higher milk price they could be expected to gain farmer suppliers from Fonterra.

[16] Miraka, Submission to the Commerce Commission: review of the state of competition in the New Zealand dairy industry, draft report, 4 December 2015 at [3.11]-[3.15].

[17] Ibid, at [3.14].

[18] Danone Nutricia, Submission on the dairy competition review draft report, 4 December 2015 at [3.2].

[19] DIRA, s 107: Fonterra may offer new entrants and existing shareholders supply contracts with terms greater than one year subject to ensuring that, at all times, 33% or more of milksolids produced within a 160km radius of any point in New Zealand is either:

- supplied to IPs; or

pro-competition provisions, Fonterra would continue to be constrained in the extent to which it could offer long-term supply contracts. The Commission has correctly acknowledged the material limits that Fonterra's co-operative structure places on its ability to lock its farmer suppliers into long-term contracts.[20] In particular, Fonterra's constitution provides that the aggregate amount of milksolids obtained from shareholders in a season on contract supply cannot exceed 15% of the total milksolids supplied by shareholders in the preceding 12 months.[21]

13.3 Castalia's view is that Fonterra could seek to foreclose IPs from vertically integrating in New Zealand.[22] For the reasons given in paragraphs 6 and 7, there is no basis for the view that Fonterra would have any ability to foreclose IPs in those circumstances.

Milk price regime

14 Fonterra reiterates that it is not seeking the alteration or removal of the milk price regime at this stage. However, in response to the comments of several submitters,[23] Fonterra repeats its position that, in the absence of DIRA's pro-competition provisions, it would retain a milk price regime similar to that which is in place currently. Fonterra's external investors will continue to have an interest in a transparent and efficient price that will maximise returns. Fonterra has provided reasoning and evidence to support this in its previous submissions.[24]

15 Furthermore, Fonterra considers it would not be possible to reduce the current level of transparency in relation to the farm gate milk price in any material way, since this would be likely to cause discontent among FSF unit investors as well as its farmer shareholders. Fonterra notes Castalia's conclusion that Fonterra would be unlikely to maintain the same level of transparency without the Commission playing a role under DIRA.[25] This is not the case and nor is there any objective basis for the assertion. Weakening the transparency of the milk price regime would directly undermine investor confidence in the FSF, given the way the farm gate milk price is set has the potential directly to affect the dividends paid by Fonterra and therefore the returns earned by unit investors.

16 More generally, Miraka and Castalia[26] appear to underestimate the importance of the FSF to the liquidity of Trading Among Farmers. In this regard, it is inappropriate

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- supplied to Fonterra on contracts that expire or are terminable by the supplier at the end of the current season (without penalty) and on expiry or termination end all the supplier's obligations to supply milk to Fonterra.

[20] Commission's draft report at [5.80.1].

[21] Fonterra's constitution, clause 3.22. Further, Part A of Fonterra's constitution (which contains this restriction) can only be amended by at least 75% of Fonterra's eligible and voting shareholders, with the support of least 50% of Fonterra's Shareholders' Council (clause 18.1).

[22] Castalia, Review of the state of competition in the dairy industry: comments on the Commerce Commission's draft report, December 2015 at page 4.

[23] See for example Castalia, Review of the state of competition in the dairy industry: comments on the Commerce Commission's draft report, December 2015 at page 5; Tatua Cooperative Dairy Company Limited, Submission on review of the state of competition in the New Zealand Dairy Industry, 4 December 2015 at [2]; Miraka, Submission to the Commerce Commission: review of the state of competition in the New Zealand dairy industry, draft report, 4 December 2015 from [3].

[24] Fonterra's December submission at [10]-[12]; Fonterra's August submission at [43]; NERA's August submission at [2.1].

[25] Castalia, Review of the state of competition in the dairy industry: comments on the Commerce Commission's draft report, December 2015 at page 5-6.

[26] Castalia, Review of the state of competition in the dairy industry: comments on the Commerce Commission's draft report, December 2015 at page 5-6; Miraka, Submission to the Commerce Commission: review of the state of competition in the New Zealand dairy industry, draft report, 4 December 2015 at [3.10].

to focus on the small proportion of share capital in Fonterra that the FSF represents. A more relevant focus is on Fonterra's imperative to retain investors' confidence in in the FSF. If investors perceive Fonterra to be "favouring" the farm gate milk price, or not to be transparent in relation to setting the farm gate milk price, their departure would result in a drop in liquidity in the market for Fonterra's shares and FSF units and a fall in their value.

17 Although Fonterra has not sought deregulation of the DIRA milk price regime,[27] the considerable costs imposed by the regime[28] are particularly notable given that Fonterra's conduct would be unlikely to be materially different in the absence of the regime.

The presence of a regulatory framework

18 Federated Farmers makes a practical point in favour of DIRA's pro-competition provisions, which appears to be that regulation provides a more certain context for Fonterra to operate within.[29] In fact, Fonterra suggests that greater regulatory flexibility would enhance its ability to pursue and execute a clear business strategy. There is no basis on which to suggest that the presence of regulatory restrictions on Fonterra's options assists Fonterra's strategic decision making. In particular, Fonterra's ability to make decisions about the timing of incremental capacity is hampered under the current regime. The regulatory framework imposes significant administrative and transaction costs in other ways as well. Fonterra itself continues to face strong commercial incentives to operate efficiently and grow long-term wealth for its stakeholders regardless of the regulatory environment.

Pathways to deregulation

19 Fonterra has responded to a number of specific comments made by Castalia in the preceding sections. More generally, it is important to note that in its analysis Castalia does not contemplate a pathway to deregulation. Rather, it assumes an environment in which DIRA's pro-competition provisions do not operate at all.[30] Fonterra has not advocated for, and the Commission has not recommended, the immediate and wholesale removal of DIRA's pro-competition provisions, including those protecting open entry and exit. Castalia has not engaged with the pathways to deregulation discussed by the Commission and Fonterra.

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[27] See in particular Fonterra's August submission at [47].

[28] The Commission has observed that it costs between $0.5m and $1m per annum for it to review the milk price. See Commission's draft report at [6.13].

[29] Federated Farmers, Submission on the dairy competition review draft report, 4 December 2015 at [3.11.1].

[30] Castalia, Review of the state of competition in the dairy industry: comments on the Commerce Commission's draft report, December 2015 from page 3.

20 In previous submissions, Fonterra has provided evidence to support its views on a pathway to deregulation that would not facilitate an incentive or ability to exercise market power.

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