



**The Tatua Co-operative Dairy Company Limited
Submission on**

**REVIEW OF THE STATE OF COMPETITION IN THE
NEW ZEALAND DAIRY INDUSTRY**

July 2015

1. SUBMITTER

- 1.1 Formed in 1914, The Tatua Co-operative Dairy Company Ltd (Tatua) is one of the few dairy companies in New Zealand that has remained unchanged by merger or take-over. The Company operates as a co-operative, with 114 supplying shareholders and concentrates its business activities in the added value and higher technology sectors. The Tatua business model can be considered as being part dairy processor and part food company.
- 1.2 Having had a long history of trading dairy materials, including raw milk, with other New Zealand based dairy companies as part of its normal business activities Tatua continues to take a keen interest in all milk markets. We are therefore grateful for the opportunity to consider the Commerce Commission's proposed process and approach to review the state of competition in the New Zealand dairy market.

2. INTRODUCTORY COMMENTS

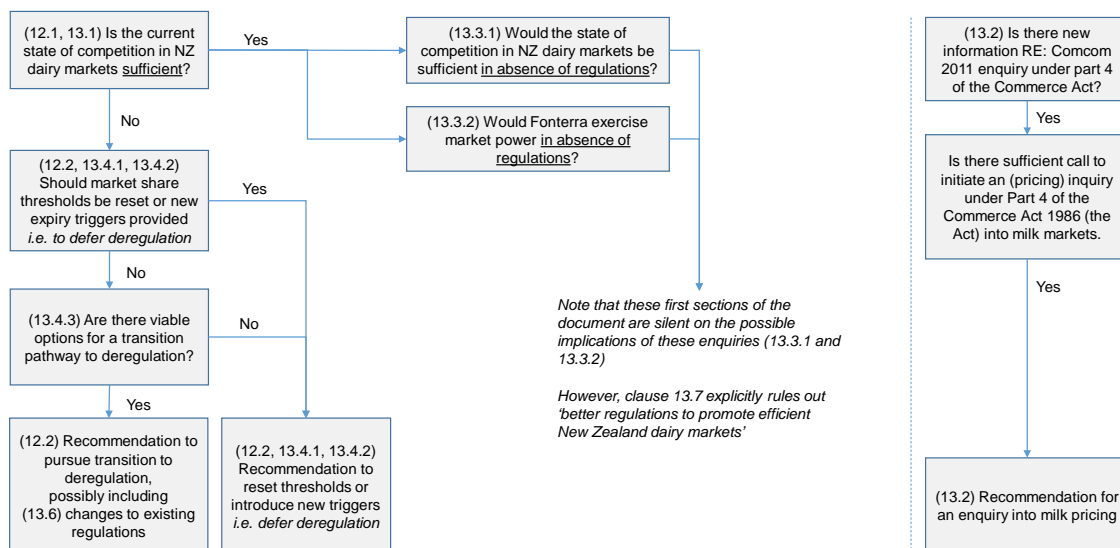
- 2.1 First and foremost we must acknowledge some reservations regarding the proposed scope of the review. As a requirement of the DIRA, we had anticipated that a review would be forthcoming, and welcomed it as an opportunity for government and officials to critically examine the operation of New Zealand milk markets as a means to confirm that the DIRA and Milk Regulation remain fit for purpose.
- 2.2 What has emerged however is a proposed review that, in our view, may lead to an outcome which is sub optimal for New Zealand. We recognise that this outcome is in part at least, a function of the Terms of Reference promulgated by the Minister of Primary Industries (and we intend to take the matter up with him directly). With this in mind, we have attempted to restrain our comments to the proposed Review process and approach, but note that there will inevitably be overlap, with some observations also being applicable to the Terms of Reference.
- 2.3 In respect of the consultation paper we make the following observations:
- The review logic described under scope does not appear to provide for a full consideration of the questions, nor does it permit the possibility of "better regulations to promote efficient New Zealand dairy markets" except as part of a pathway to deregulation.
 - The review's proposed approach only considers whether competition and the efficiency of markets, including the exercise of market power by Fonterra, would be any worse in a deregulated market.
 - The approach does not admit the opportunity to improve the competition and efficiency of the market through changes to regulation, at best it offers to simply defer deregulation.

- The review proposes to consider the various possible combinations of regulation / deregulation, but is silent on both how the (seven or more) hypothetical cases will be considered and on how historical evidence will be balanced with relevant contextual information.
- The review appears to be premised on a view that the regulations were not intended to last indefinitely. While some parties may have anticipated their ‘falling away’, that is not a universal view and should not be presumed by the Review.
- The 80% thresholds to trigger a review of the state of competition and/or deregulation are an important facet of the regulations. We suggest that it is unwise to assume that such a review would necessarily occur without such triggers, or at least some alternative provision.
- The inherent purpose of the threshold in triggering deregulation may create a moral hazard around the level at which the threshold is set. This could be mitigated by changing that purpose to one of simply triggering a review, but only if deregulation is not presumed.
- There appears to be a clear bias evident towards deregulation. This bias could be corrected by inclusion of options to enhance the regulation, entertaining the possibility that milk markets may remain regulated for the foreseeable future.

3.0 SCOPE

3.1 To assist in our analysis and understanding of the scope of the review, the logic of each paragraph in the scope section has been mapped out in the figure below:

Review Logic – As Presented in Document Sections 12 and 13



3.2 This logic is broadly consistent with the terms of reference provided by the Minister, but is constrained by not considering the possibility of simply retaining and improving the current regulation.

3.3 The Review appears to be missing some important questions relating to present market performance, in particular whether in the current regulated environment does Fonterra exercise market power, and/or are markets efficient and contestable? In the event that the regulations are not found to be working as well as intended then we suggest it would be useful for consideration to be given to improving these regulations.

3.4 At present, the only remedy being considered seems to be either resetting the triggers (deferring the issue) or setting down a path to remove regulation altogether. We suggest that consideration be given to reviewing the investigation /decision logic, as illustrated in the above figure, with a view to improving clarity of both scope and process.

- 3.5 We note that separate consideration is given to milk pricing in asking whether there is any new information that would have changed the outcome of a preliminary enquiry made in 2011. This would then trigger an enquiry into milk pricing. Our concern here is that Part 4 of the Commerce Act does not usefully apply to the milk markets in question.
- 3.6 Given that milk pricing is fundamental to the operation of both farm gate and factory gate markets, we consider that it should be considered an integral part of this review, and not limited to Part 4 of the Commerce Act. While we are aware of a separate process looking at milk pricing application, that does not detract from this requirement.
- 3.7 **Tatua submits that the review logic described under scope (paragraphs 12 – 13) does not provide for a full consideration of the questions, nor does it permit the possibility of “better regulations to promote efficient New Zealand dairy markets” [13.7] except as part of a pathway to deregulation.**

4.0 OVERVIEW OF APPROACH

- 4.1 From paragraphs 36 to 52 of the consultation document we understand that the Commerce Commission is essentially limiting its consideration of “sufficient competition” in milk market operations to whether or not the situation would be any worse if they were deregulated. In particular, whether Fonterra could and would exercise more market power. In the absence of conclusive evidence that that state of competition would be worsened, then the state of competition will be deemed “sufficient” and the recommendation will be for deregulation.
- 4.2 Even in the case that competition is not deemed sufficient (by the preceding logic), the proposed remedies are limited to resetting the thresholds (presumably to defer matters) or setting out a pathway to deregulation.
- 4.3 In all of this approach, there is an apparent bias towards the presumed inevitability of deregulation. We consider that this approach is inappropriate on the basis that it is inconsistent with the reality of the market, i.e. that there is a dominant entity comprising approximately 87% of the industry. Furthermore, cannot foresee a scenario that is beneficial to the interests of New Zealand under which this dominant entity will cease to be dominant. However, there is likely to be a circumstance where the improved regulation of that dominant entity would result in more efficient and contestable milk markets.
- 4.4 **The review’s proposed approach only considers whether competition and the efficiency of markets, including the exercise of market power by Fonterra, would be any worse in a deregulated market. Tatua submits that the approach should admit the opportunity to improve the competition and efficiency of the market through changes to regulation.**

5.0 APPROACH TO POSSIBLE SCENARIOS FOR DEREGULATION

- 5.1 The approach suggests that the assessment of the state of competition with and without competition will consider “all the regulations referred to in paragraphs 42.1 to 42.3, or different combinations thereof”. This implies the possibility of eight combinations as per the table below (or considerably more if separate island or regional scenarios are included). Creating and investigating up to eight scenarios will be an extensive exercise, but one that we see as vital to understanding whether competition in milk markets could be improved through better regulation.

		Scenarios							
		A <small>(status quo)</small>	B	C	D	E	F	G	H
42.1 Subpart 5 of Part 2 of the DIRA (which sets out, amongst other things open entry and exit requirements for Fonterra farmers)	Regulated farmer exit & entry to Fonterra	✓	✓	✓	✓				
	Unregulated entry/exit for Fonterra farmers					✓	✓	✓	✓
42.2 Subpart 5A of Part 2 of the DIRA (which sets out provisions around Fonterra's base milk price)	Regulated base milk price	✓	✓			✓	✓		
	Unregulated base milk price			✓	✓			✓	✓
42.3 the provisions of the DIRA Raw Milk Regulations (which provide for the regulated supply of raw milk by Fonterra to independent processors)	Regulated raw milk supply to independents	✓		✓		✓		✓	
	Unregulated raw milk supply		✓		✓		✓		✓

- 5.2 The approach states that the Commerce Commission “intend to evaluate the state of competition by examining both how competition has developed since Fonterra was established and how competition may develop in the future. In examining how competition has developed, we intend to focus on what has changed in the five years since the Government’s 2010 review of competition in the dairy industry” [para 44].
- 5.3 We are concerned that this historical approach can only practically consider the situation under which the actual market and regulations were operating. As there is no alternate history, we request that the Commission clarify how it will examine up to seven hypothetical cases as outlined above.
- 5.4 New Zealand’s dairy industry regulation has seen significant developments since 2010, of which Trading Amongst Farmers and the associated changes in 2012 are most relevant. These changes altered the rules and operation of the market, and their consequences are still emerging. It is unclear on what basis the whole 5-year history will be considered in light of these developments.
- 5.5 Also relevant are the changes in the fortunes of the sector, and the consequent effects on both the operation of domestic milk markets and the entry or exit of participants in the processing industry (i.e. factory gate). The time period being considered has mostly been positive, reaching an unprecedented market peak in 2014. The current state of depressed prices is relatively recent. The consequences of this latter phase have not yet played out, and so the timeframe excludes the performance of the current regulation through a whole cycle of rise, fall and recovery.
- 5.6 The New Zealand milk market is relatively small on a global scale, but highly exposed to global market dynamics. Immediately following the 2008 San Lu scandal in China, New Zealand benefitted from high Chinese demand for foreign milk powder. However, the EU and US also saw the opportunity and began seriously developing their dairy export capability. Unfortunately, New Zealand then suffered a series of mishaps including DCD contamination and Fonterra’s suspected botulism incident in 2013. China has now emerged since 2014 with a renewed sense of purpose and direction, and imposed new rules on the dairy trade. These factors have all had a material impact on New Zealand’s relative competitiveness and export market performance. It is absolutely vital that any evidence of competition be understood in the global context, and with an appreciation of the wider objectives for the New Zealand industry.
- 5.7 In the specific case of new entrants to the New Zealand dairy processing industry over the past five years, there are additional external factors that should be considered. Not least among these are the ambitions of those parties to secure supply of New Zealand dairy products in light of an expectation that long-term global demand for high-quality dairy products will increase strongly in populous regions such as Asia.

5.8 The review proposes to consider the various possible combinations of regulation / deregulation, but is silent on both how the (seven or more) hypothetical cases will be considered and on how historical evidence will be balanced with relevant contextual information. Tatua submits that the process for examining the level of competition in milk markets should consider all facets of both domestic and global dairy market competition, rather than focusing on how Fonterra might or might not react in a deregulated environment.

6.0 MARKET SHARE THRESHOLDS

6.1 The review appears to assume that the regulation of milk markets was only ever intended to be temporary:

[55] *“The provisions in the regulations directed at ensuring contestability were not intended to last for an indefinite period of time and it was anticipated that they would fall away when a sufficient level of competition had been reached.”*

6.2 In Tatua’s view, the regulations contain provisions for their expiry only as a possible eventuality, not an inevitability. We do not believe that there is reasonable basis for presuming that deregulation is a necessary good, nor a foregone conclusion. As such, we suggest that it is incumbent on the Commerce Commission to entertain the possibility that regulation of domestic milk markets may be required indefinitely and that this represents an acceptable outcome. Indeed, insofar as Fonterra remains a strong and therefore dominant power in the industry, this could be considered a positive outcome for the New Zealand dairy industry.

6.3 The review then asks ‘Do interested parties agree that it would be more appropriate to base the removal of the regulations on a more comprehensive competition analysis, rather than the current threshold triggers?’ Tatua considers the inclusion of triggers as a fundamental design feature of the regulations. We support the continued inclusion of triggers as a means to ensure that the regulatory structure remains appropriate over time and/or in response to changes in market conditions.

6.4 Finally, this part of the review consultation paper asks:

[63] *Do interested parties think that the current triggers set at 80% are at an appropriate level to trigger either the removal of the regulations, or to trigger a more comprehensive competition analysis? If not, what do interested parties consider to be more appropriate?*

6.5 This is an important question, and one which requires consideration of both the market reality and the underlying motivations of the parties concerned. It is clear that any party that would benefit from deregulation will lobby for a relaxation of the current trigger (i.e. a reset above 80%) or for an alternative that would accelerate deregulation. Similar, parties with an opposite motivation will lobby the reverse. The moral hazard is clear and obvious, but would be largely mitigated by revising the purpose of the trigger such that all it triggers is a review process, and does not presume to lead to deregulation.

6.6 **The review asserts that the regulations were not intended to last indefinitely. While some parties may have anticipated their ‘falling away’, Tatua submits that this is not a universal view and should not be presumed by the Review.**

6.7 **The 80% thresholds to trigger a review of the state of competition and/or deregulation are an important facet of the regulations. Tatua supports the retention of such triggers, or an equivalent alternative provision.**

6.8 **The inherent purpose of the threshold in triggering deregulation creates a moral hazard around the level at which the threshold is set. Tatua submits that this should be mitigated by changing that purpose to one of simply triggering a review where deregulation is not a presumed outcome.**

7.0 TRANSITION PATHWAY TO DEREGULATION

7.1 As stated in the preceding sections, the review appears to take a view that the regulation of milk markets was only ever intended to be temporary. Instead of considering how regulation might be improved in the case where there is insufficient competition, the review process instead looks to deregulate as a solution:

[64] *'If we determine that there is insufficient competition in any of the relevant New Zealand dairy markets, the Terms of Reference asks us what options, if any, there are for a transition pathway to deregulation.'*

7.2 We see this as similar to suggesting that if the current medication being prescribed for a patient has not resulted in good health, then the only option is to withdraw the medication. In reality, a responsible medical professional would of course consider what alternative therapies might be applied instead, of which 'doing nothing' would only be one option. In our view, the Commerce commission should take a similar approach in terms of the New Zealand milk market operation.

7.3 **There is an apparent bias evident towards deregulation. Tatua submits that this bias should be corrected by inclusion of options to enhance the regulation, entertaining the possibility that milk markets may remain regulated for the foreseeable future.**

The above comments are provided in the spirit of co-operation which has characterised all dealing between Tatua and the New Zealand Government. We genuinely want to engage on these important issues and hope our comments are helpful for securing the optimal approach to this review.



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