

SUBMISSION

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To: Ministry of Agriculture and Forestry

Submission on: **REVIEW OF THE RAW MILK REGULATIONS**
Discussion Paper No: 2011/09

From: Federated Farmers of New Zealand

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SUBMISSION

REVIEW OF THE RAW MILK REGULATIONS

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1. FEDERATED FARMERS' VISION OF SETTLED RAW MILK REGULATIONS

- 1.1. Federated Farmers welcomes the opportunity to submit on the Review of the Raw Milk Regulations, Ministry of Agriculture and Forestry (MAF) Discussion Paper No: 2011/09.
- 1.2. The following is premised on milk being allocated on a non price-based criteria allocation system and that those who want it may be excluded.
- 1.3. Federated Farmers submits that the volume of Regulated Raw Milk (RRM) available to each independent processor (IP) should be at a set volume (50 million litres per IP) for three years, and then decreased over time, with zero being available on the fifth year, to encourage independent processors (IPs) to source alternative supplies of milk after getting through the "catch 22" period.
- 1.4. Federated Farmers further submits that IPs in business for five years or longer should not be eligible to use any RRM.
- 1.5. Federated Farmers submits that, for this scenario, only those IPs with facilities to process raw milk should be eligible for RRM.
- 1.6. Federated Farmers submits that IPs should not be discriminated against. Those taking milk at the farm gate must be treated the same as those accessing it at the factory gate market. This will ensure that processors will not switch from the farm gate market to the exclusive use of the factory gate market just to continue to be eligible for RRM. This could help achieve the objective of getting a competitive farm gate market to work for the betterment of all dairy farmers and to reduce demand for RRM.
- 1.7. IPs should not be discriminated against in terms of what markets they sell into. This is because:
 - 1.7.1. Many of New Zealand's IPs produce product for both the domestic and the export markets. A criterion that specifies that one market (for example the domestic market) must be supplied in order to gain eligibility can be easily rorted by supplying a minimum in order to gain accessibility.
 - 1.7.2. Those processors who dedicate their plants to drying milk and who export product will have huge costs imposed on them to supply to the local market.
 - 1.7.3. Requiring an IP to supply dairy product exclusively to the domestic market would rule out Goodman Fielder, the one

processor singled out in the Dairy Industry Restructuring Act (DIRA) to provide competition in the liquid milk domestic market, as it currently exports product. This firm currently has a long term contract with Fonterra under the DIRA and the Raw Milk Regulations (RMR).

- 1.8. Federated Farmers submits that the amount of milk specified in both the Dairy Industry Restructuring Act (DIRA) and the Raw Milk Regulations (RMR) be the same, and be set at 600 million litres.
- 1.9. Federated Farmers submits that the twenty percent rule within the DIRA be dropped or replaced with a secondary volumetric limit to protect the boutique cheese makers and other small IPs who rely on this type of supply.
- 1.10. In order to encourage these outcomes, MAF has many risks to manage, which include:
 - 1.10.1. Unwilling traders
 - 1.10.2. Regular change in name and/or ownership of IPs in order to maintain their eligibility.
 - 1.10.3. Toll processing, given the current definition of independent processors.
- 1.11. Goodman Fielder's position in the dairy industry needs to be considered, as it exports milk, is not a new entrant, has no own supply, and has a long term contract for a fixed volume of milk, all under the RMR.
- 1.12. The Regulations (and the Act if necessary) will also need to be altered to state that restrictions on the use of RRM are allowed and to state what these restrictions are.

2. INTRODUCTION

- 2.1. Federated Farmers has submitted on a number of discussion documents to do with the DIRA and the associated Raw Milk Regulations. While we commend the Ministry for endeavouring to find a win-win situation for the whole dairy industry, we suggest that this Discussion Paper will not provide the outcome of a settled Regulation, something that the Federation desires.
- 2.2. The volume of milk available within the Regulations will always be at risk if it is to be rationed by methods other than price. Setting more Regulations around criteria is adding another regulatory layer over what is already in place. Federated Farmers is against over-regulating if a light hand can be taken by offering sensible solutions.
- 2.3. Federated Farmers agrees that the RMR need updating urgently, given the dairy industry has progressed over the ten years that these Regulations have been in place and that this milk is now being used in ways that may not even have been contemplated.

- 2.4. Currently, international companies wishing to have food certainty in their own countries are using the Regulations to source milk in New Zealand and are then sending it back to the home country, with all the profits staying off-shore. While Federated Farmers has no issue with what these companies are doing, we ask if this is the intention of the Regulations.
- 2.5. As things stand, we currently have companies who do not possess even basic milk processing facilities taking this milk, asking others to process it into a form it can use. Is this toll processing what the government intended?
- 2.6. Now we have IPs taking this milk even though they are obviously not in the set-up phase. Is this what was intended when the Regulations were set?
- 2.7. The intention by government in 2001 was that all those who wanted milk at a regulated price would be able to have it. A quantity was set aside that was thought to be 'enough' to satisfy the few who were thought to contribute to the dairy industry in New Zealand, and this volume was increased to manage increased demand.
- 2.8. In 2011, demand is such that the Ministry of Agriculture and Fisheries (MAF) has decided that new objectives may need to be set which in turn may alter the intention of the Regulations.
- 2.9. Federated Farmers sees a number of caveats in this discussion document, and fails to see how the objectives will be met, given the difficulty in choosing categories and criteria and the intention of the Act and Regulations. This is exacerbated by the fact that MAF intends that this milk be rationed by quantity and not by price.
- 2.10. The other major principle that makes choosing criteria and categories difficult is that the intention of the Raw Milk Regulations is to make this milk available to all who wish to take it.
- 2.11. Indeed, this is cemented into the purpose of Subpart 5 of the DIRA, s 70, which states that the purpose of the subpart is to "promote the efficient operation of dairy markets in New Zealand" and s 71(a) specifies that "independent processors must be able to obtain raw milk, and other dairy goods and services, necessary for them to compete in dairy markets". While MAF may wish to ignore these points, it should be factored into this discussion, and quite frankly it is hard to submit on this document without recourse.
- 2.12. Federated Farmers submits that a way forward could be by including in the DIRA a statement that states clearly that the RMR apply to all those IPs that wish to take it but for a specified period of time only. This would make it clear to both regulators and dairy processors.
- 2.13. However, this will run the risk of IPs being short lived or 'creative' as it will incentivise change of ownership when the time limit runs out.
- 2.14. Any change will also require yet another consultation round.

- 2.15. While we understand there has been a decision made on the definition of an independent processor and that this decision is being contested before the Courts, having a narrow definition will help if criteria are to be used as this will reduce demand on this milk to a certain extent. Having a broader definition will help should an auction system be decided upon.
- 2.16. Because Federated Farmers is aware that the quantity of milk available in the Regulations is at the discretion of the Minister, very real and transparent pressure must be put onto moving all IPs off the use of RRM. Only then will the total volume allocated remain contained.
- 2.17. Federated Farmers is concerned that Fonterra (and other IPs who may be in the business of supplying milk to other processors to process at the factory gate) could charge anti-competitive prices or apply some other anti-competitive condition in order to force competitors out of business. .

3. RESPONSES TO QUESTIONS

- 3.1. The Federation's responses to questions posed in the discussion document follow. Because of the way the discussion document is written, Federated Farmers submits that its answers are only valid if the RRM is rationed by criteria that does not include price and that those who want it may be excluded from using it.
- 3.2. **Question one: What objectives of the Raw Milk Regulations outlined in this document do you agree/disagree with, and for what reasons?**
- 3.3. Federated Farmers **agrees** with the objective that the Regulations should actively encourage IPs to source milk at the farm gate, directly from farmers. This gives farmers a choice of processor which may suit their philosophy, cash flow or relationships. It may also provide farmers with competitive returns for their milk.
- 3.4. It also provides an incentive to Fonterra to act in the best interests of its farmer shareholders.
- 3.5. The Regulations, however, have nothing to do with providing farmers with fair entry and exit from the co-operative as these are dealt with in the DIRA itself
- 3.6. Federated Farmers **agrees** with the objective of providing new IPs a pathway into the industry by addressing the "catch 22" situation.
- 3.7. Federated Farmers **agrees** that the Regulations should support the domestic dairy product market. In order to better target supporting dairy product availability for New Zealand consumers, it could be suggested that the objective be one of supporting the domestic **consumer** dairy product market.
- 3.8. This would encourage those IPs who wish to take advantage of the Regulations the incentive to supply some dairy product onto the New Zealand domestic market. This could be in the form of supplying finished dairy products (for example, liquid milk, cheese) to the consumer or raw milk at the factory gate for other IPs to process.

- 3.9. However for those IPs who dry all their product, forcing them to produce a percentage of their capacity for sale on the domestic market will have huge costs imposed on them. Dryers only work efficiently when fully loaded and asking them to forgo this efficiency is unfair. It would also be unfair to the smaller IPs who maximise their profits by exporting all their product: the opportunity cost of forcing them to dedicate, say, five percent of a small quantity to the domestic market could cripple their business.
- 3.10. On the basis of the above argument, Federated Farmers submits that requiring the Regulations to support the domestic consumer dairy product market would be unfair.
- 3.11. It is interesting to note that the objective of supplying milk 'to anyone who wanted it', as Cabinet agreed on the formation of New Co-op in 2000 and consequently included in the DIRA (see paragraph 2.11), has not been included here. Federated Farmers asks if this is still one of the intentions of the Regulations as some clarification is required in order to move forward.
- 3.12. **Question 2: What additional objectives, if any, do you think should be considered for the Raw Milk Regulations, and for what reasons?**
- 3.13. Federated Farmers submits that the suggested objectives are sufficient.
- 3.14. **Question 3: What regulatory design characteristics for the Raw Milk Regulations do you agree/disagree with, and for what reasons?**
- 3.15. Federated Farmers **agrees** with all the design characteristics outlined. They are substantially the same as those that are in place at the moment and while all parties complain about them, IPs continue to use the Regulations to their advantage and Fonterra is obliged to provide milk. If the Regulations were so onerous, IPs would source milk from elsewhere. This is illustrated by some IPs, well able to do without this milk, still choosing to take it and even those who have done without it in the past (for example Westland Milk Products) now taking advantage of it.
- 3.16. **Question 4: Do you consider that some of the above regulatory design characteristics are not desirable? If so, which ones and why?**
- 3.17. No
- 3.18. **Question 5: What additional regulatory design characteristics, if any, do you think should be considered for the Raw Milk Regulations, and for what reasons?**
- 3.19. Federated Farmers understands that the design characteristics are necessarily broad and not prescriptive. However, the options selected for analysis is incomplete and should include an auction system (see paragraph 3.42).
- 3.20. **Question 6: Do you agree/disagree with the proposition that the key issue to consider is whether the Raw Milk Regulations are providing an efficient pathway to the farm gate milk market?**

- 3.21. It is **one** of the key issues; the other is providing a pathway for those IPs who wish to partake in the wider dairy industry without actually going to the farm gate, away from relying on RRM and into normal contractual relationships at the factory gate.
- 3.22. This factory gate market is growing, with both domestic and international companies taking this milk. As more international companies enter this market, wishing to gain certainty of dairy product supply in their own countries, excess demand will occur.
- 3.23. If these IPs who chose the factory gate market over the farm gate market continue to have full access to this milk, more will chose this business structure over others, to the detriment of farmers and competition at the farm gate.
- 3.24. Federated Farmers submits that IPs sourcing milk at the factory gate should come under the same rules as those who are able to source milk at the farm gate. While they may not wish to enter the farm gate market, there is no reason to not incentivise them to enter into normal contractual arrangements with any dairy processor. Federated Farmers submits that the same rules apply to both the farm gate and the factory gate market.
- 3.25. **Question 7: Do you agree with the proposition that independent processors who are no longer new entrants to the farm gate milk market should not have access to regulated milk?**
- 3.26. Yes, in the long run. It will be necessary to have a transition period to enable those IPs who are no longer regarded as new entrants to make suitable milk supply arrangements over time.
- 3.27. Federated Farmers also submits that those processors who do not plan to source milk at the farm gate must also have access to RRM restricted and encouraged into usual business contractual arrangements, with a similar period of transition (see the response to question 6).
- 3.28. **Question 8: Do you believe that removing access to regulated milk for independent processors with their own established farm gate milk supply will drive more competition at the farm gate market?**
- 3.29. It should. Those IPs who are good at relationship management and negotiating will manage in areas where farmers are willing to switch processors. This could increase prices for farmers.
- 3.30. Something similar should happen for those IPs who source milk at the factory gate and this could promote competition at the factory gate as processors move to make normal contractual arrangements with other processors.
- 3.31. However, Federated Farmers is concerned that anti-competitive behaviour may cause some difficulties where a willing seller of milk may not exist.
- 3.32. The Federation is also concerned that Fonterra will endeavour to squeeze competitors out of the farm gate market by offering its suppliers very good contracts in certain areas. This happened in 2007/08 where

Fonterra introduced tactical milk pricing on contract milk supply in Canterbury and Waikato¹.

- 3.33. However, these difficulties should not be used as an excuse to not restrict access to RRM for these IPs.
- 3.34. **Question 9: Do you agree that the issues identified as being within the scope of this document all need to be addressed?**
- 3.35. Yes. In particular, the “total volume cap” of 600 ML is sufficient and must be transferred into the DIRA, replacing the current 5 percent. This is addressed in the Federations’ answer to question 24.
- 3.36. **Question 10: Do you believe there are any additional issues with the current Raw Milk Regulations that should be considered for review? If so what are they and why?**
- 3.37. Federated Farmers submits that the reason of “end-use” discrimination not being considered due to trade policy concerns is the wrong reason. It was ruled out in the past because the intention of the DIRA was to provide a certain quantity of milk to all those who wanted it, regardless of who they were and what they wanted it for. Federated Farmers asks that the intention of the Regulation should be adhered to and if issues are unclear they should be negotiated to get clarification.
- 3.38. This premise is important and needs to be addressed before any decisions are made with regard to the Regulations as it influences the outcome.
- 3.39. If the reason of “end-use” restrictions is based on trade policy and this is used to prevent MAF from including it in the current review, MAF should be aware that its use is prevalent in international trade and is not prohibited by international trade law per se. For example, end-use restrictions or conditions can be used to determine eligibility for tariff preferences or quota access or determine eligibility for consumption subsidies.
- 3.40. However, Federated Farmers submits that restricting RRM to IPs on the basis of “end use” discrimination would be unworkable due to some IPs supplying both the domestic and export markets, and the ability to shift product around internally in order to fit the system.
- 3.41. As argued in the answers to question 6, the factory gate market needs to be brought into this review due to IPs choosing to not source milk at the farm gate as part of their whole business plan.
- 3.42. In order to help those IPs who are unable to source milk through the Regulations and who consequently will need to source milk at the factory gate under normal contractual conditions (given that their business plan does not include farm gate sourcing), there needs to be a tool to prevent those processors who have the ability to supply milk, from price gouging

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<http://www.fonterra.com/wps/wcm/connect/fonterra.com/fonterra.com/our+business/news/media+release+archive/fonterra+to+introduce+tactical+milk+pricing>

or even from refusing to trade. MAF needs to encourage a “willing seller willing buyer” scenario.

- 3.43. Another criterion that could be considered is the consideration of ‘own processing’ facilities. Federated Farmers submits that this should be narrowed to include only those who have liquid milk processing facilities. This would exclude toll processing. However, this requires a settlement on what the definition of an independent milk processor is and whether toll processing is allowed.
- 3.44. **Note:** The potential options presented by MAF are incomplete. Federated Farmers submits that a system where the total volume available within the Regulations is fixed but the price is not, for example, an auction system, should be considered in the analysis to find a solution to a difficult issue. While it may not be the solution, it deserves to be considered so that the merits of each system can be weighed.
- 3.45. **Question 11: Do you agree that access to regulated milk should not be provided to independent processors with their own established supply of milk from farmers?**
- 3.46. If RRM is to be rationed by quantity, then all those who use this milk should be made to discontinue its use by some mechanism.
- 3.47. Federated Farmers submits that **all** IPs should be encouraged to source milk on a normal contractual basis from the farm gate (or from the factory gate if they do not wish to source milk directly from the farm gate). Again, we point out the difficulties that could exist without a willing seller being present.
- 3.48. Federated Farmers agrees that encouraging IPs to source milk from the farm or the factory gate is sensible as this will decrease pressure on the total volume of RRM available.
- 3.49. We do flag the possibility that Fonterra may make sourcing milk at the farm gate difficult by offering farmers in targeted areas contractual arrangements that IPs will find difficult to match (see paragraph 3.32).
- 3.50. If the RRM is to be rationed by quantity then there must be some system to ration it by some sort of criteria so that a set amount of milk is available to those who want it. Without this pressure, IPs will continue to want the milk which will mean that the Minister will have to continually increase the amount. Federated Farmers submits that continuing to have a system where Fonterra is required to provide more milk is unfair. We want an end to this continual adjustment of the Regulations.
- 3.51. **Question 12: What, in your opinion, are the pros and cons of introducing time bound limits to those independent processors with some degree of own farmer supply?**
- 3.52. The following answers will be appropriate for both those IPs who collect milk at the farm gate and those who collect milk at the factory gate. There should be no discretion.
- 3.53. The advantage of a phase out period on the use of RRM will give the IPs:

- 3.53.1. the opportunity to develop relationships with their suppliers and gain new suppliers
 - 3.53.2. the opportunity to develop relationships with other processors to allow them to buy milk under normal contractual obligations at the factory gate
 - 3.53.3. the opportunity to develop a strategy to allow them to market their milk as being a complete “gate to table” product, which is a clear market advantage, if they chose to take milk at the farm gate
 - 3.53.4. a reality check, as some IPs will have to learn how to manage the shoulders of the season and suppliers (be they farmers or other IPs) to keep their factories full
 - 3.53.5. certainty, as they will then understand that they will no longer be able to rely on RRM.
- 3.54. The disadvantage of having a time limit whether it is phased or abrupt could encourage IPs to change ownership, (and possibly just the registered name) regularly, in order to remain eligible for RRM. This will lead to excess demand and is one of the problems with rationing by criteria and not by price.
- 3.55. **Question 13: What, in your opinion, are the pros and cons of introducing a certain quantity of own supply (“established own supply” rule) after which independent processors would no longer have access to regulated milk?**
- 3.56. Federated Farmers submits **against** the introduction of a “certain quantity of own supply” into the Regulations.
- 3.57. If MAF does not consider that IPs who source RRM at the factory gate need to be restricted from taking this milk, then establishing an “own supply” rule would discourage IPs to source milk at the farm gate: none would choose to have “own supply”. It would not increase competition at the farm gate.
- 3.58. For those IPs who already source milk at the farm gate, it will encourage farm gate supply only up to the threshold. Having a certain quantity of own supply will actually be a disincentive to source more milk at the farm gate.
- 3.59. **Question 14: If the option of “time bound limits for those with own farmer supply” were to be implemented, what in your opinion, is the optimal period of time that access to regulated milk should be limited to, e.g. 2, 3 or 5 seasons? Please explain your reasons.**
- 3.60. Federated Farmers submits that, upon implementation of the new Regulations, **all** current IPs (regardless of what gate they take it from) should have full access to RRM for three years. After this time the amount of RRM able to be taken by each IP should be scaled down so that, by the fifth year, no RRM would be available for that IP.

- 3.61. Federated Farmers submits that a time bound limit on taking RRM, regardless of where the milk is sourced, would encourage some IPs to source milk (or source more milk) at the farm gate and others to make normal contractual obligations at the factory gate.
- 3.62. A decreasing volume makes this milk less reliable and will encourage alternative sourcing.
- 3.63. A time limit would allow IPs to make arrangements to source milk outside of the RMR.
- 3.64. Those IPs who choose to come in after the implementation of the new Regulations should have the same access rules as stated in paragraph 3.60
- 3.65. Again, this obligation should apply to both those who choose to source milk at the farm gate and those who choose to source milk at the factory gate, as otherwise it could incentivise IPs to never source milk at the farm gate.
- 3.66. **Note:** IPs may choose to change ownership or just the registered name in order to remain eligible for RRM to manage this obligation.
- 3.67. **Question 15: If “established own farmer supply” rule was to be implemented, what, in your opinion, is the appropriate level of farmer supply that would ensure access to sufficient volume of regulated milk to enable an effective entry pathway while preventing some of the perverse incentives that may arise with this rule?**
- 3.68. Federated Farmers **submits** against an “own supply” rule.
- 3.69. Federated Farmers submits that IPs with and without own supply should not be treated differently as it will not increase the farm gate market, but will instead drive more IPs to take milk at the factory gate market. It will not increase competition at the farm gate.
- 3.70. **Question 16: Are there any other options that should be considered to address the issue of independent processors with their own established supply of milk from farmers continuing to access regulated milk?**
- 3.71. Federated Farmers submits that the twenty percent rule within the DIRA (s 108) be dropped or replaced with a secondary volumetric limit to protect the boutique cheese makers and other small IPs who rely on this type of supply.
- 3.72. This rule allows Fonterra farmer suppliers to divert up to twenty percent of their milk to an IP on a weekly basis, without renegeing on their obligations to Fonterra.
- 3.73. Today, many farms are large holdings and twenty percent of a weekly supply is a large volume that could compromise Fonterra’s business plans. Also, farmers are now able to hold more shares than that required to support their milking platform and this “dry share” holding will increase to 200 percent on the full realisation of Trading Among Farmers (TAF).

This “twenty percent rule” will make it very attractive for those shareholders with large holdings to divert large quantities of milk to other processors, to the detriment of Fonterra.

- 3.74. IPs who use this rule to gain supply tend to only offer this opportunity close to their factory gate and to square up their curve at both ends of the season.
- 3.75. Making these changes would mean that Fonterra would have greater certainty of milk supply, while allowing niche processors the opportunity to take small quantities of milk.
- 3.76. **Question 17: What volume of regulated milk do you consider to be sufficient to provide for the critical mass needed to overcome the initial “catch 22” entry barrier faced by the new entrants to the farm gate milk market?**
- 3.77. Federated Farmers submits there is no reason to change this for the first three years as the current volume limit of 50ML per IP seems to have been sufficient in the past. After three years, decreasing volumes should be made available to these IPs so that by five years, the amount available is zero. This will encourage IPs to source milk at either the farm gate or the factory gate.
- 3.78. There is no reason to discriminate between the farm gate and factory gate markets.
- 3.79. **Question 18: What do you consider to be the pros and cons of allowing access to the same volume of regulated milk in each of the seasons that independent processors have access to regulated milk?**
- 3.80. A guaranteed supply which is sufficient to manufacture enough product for their start-up phase will give IPs certainty. This has been proven over the last ten years.
- 3.81. It also allows IPs to perfect a stable business plan.
- 3.82. Federated Farmers submits that having access to this milk cut abruptly may be too difficult for some IPs who have had difficulty sourcing alternative supply (either at the farm or factory gate), regardless of the fact that this would be well signalled.
- 3.83. **Question 19: What do you consider to be the pros and cons of introducing a gradual reduction in volume over the access period?**
- 3.84. Federated Farmers **agrees** with this strategy.
- 3.85. A gradual reduction will give IPs time to build up business relations and a supply base.
- 3.86. **Question 20: Do you believe that introducing a smaller volume cap for independent processors without own farmer supply is desirable?**

- 3.87. Federated Farmers **disagrees** with this strategy. IPs, regardless of whether they source milk at the farm or factory gates, should be treated the same. Those IPs who do not need to take the full amount during the access period, are not required to take the full 50ML allocated to each processor. What they will need to do however, is move to get their own supply base through normal contractual practice.
- 3.88. The current size has not hindered IPs from using this milk; therefore it must be correct or, at least, IPs have managed the quantity available.
- 3.89. **Question 21: What would be the impact of introducing smaller volume caps for independent processors without their own farmer supply?**
- 3.90. Federated Farmers **disagrees** with this strategy. Any milk not taken via the RMR would remain available for other processors or simply processed by Fonterra.
- 3.91. Limiting the volume would limit expansion should business plans change. It also requires that MAF would need knowledge of each IPs intentions. Federated Farmers submits that this would be an imposition on IPs and difficult to manage.
- 3.92. Limiting the volume would make no change to those IPs who source milk at the factory gate. Instead it would encourage the creation of more IPs who would be limited by a smaller volume.
- 3.93. As stated before, limiting the time that all IPs have access to RRM will force all IPs to source their milk either at the farm gate or the factory gate. This would be good for farmers if the farm gate were chosen and will reduce demand for RRM.
- 3.94. **Question 22: Are there any other options relating to how much regulated milk each independent processors should have access to that you think should be considered?**
- 3.95. No. 50ML is sufficient.
- 3.96. **Note:** For the following set of questions, the volume of milk available within the Regulations will always be at risk if it is to be rationed by methods other than price. Setting more Regulations around criteria is just that: over regulating. Federated Farmers is against over regulating if a light hand can be taken by offering sensible solutions.
- 3.97. **Question 23: Do you have a preference for a static amount of the “total volume” of regulated milk versus one that moves with Fonterra’s own milk supply volumes? Please explain your preference.**
- 3.98. This section refers to the percentage of milk set aside for use in the RMR in the DIRA (up to five percent of Fonterra’s New Zealand supply), and the actual volume set aside in the Regulations (600ML). Five percent of Fonterra’s New Zealand supply is currently around 750ML.

- 3.99. Federated Farmers submits that the amount of milk set aside in both the DIRA and the RMR should be the same, and must be set at a volume rather than a percentage of Fonterra's total New Zealand milk supply. This is because as the dairy industry becomes more competitive, Fonterra will be picking up less milk as a proportion of all New Zealand milk, which means that it will need to 'give up' a greater proportion of its milk to the Regulations if it is tied to a percentage. Federated Farmers submits that this would be unfair to Fonterra and is not the intent of the DIRA.
- 3.100. Federated Farmers submits that the percentage set within the DIRA to be made available for the RMR should be substituted by a fixed total volume and that this volume be 600ML.
- 3.101. Federated Farmers is concerned that every time the amount of milk available in the Regulations is changed another round of consultation is required which is wasteful of both time and money.
- 3.102. **Question 24: If the "total quantity" of regulated milk was to continue to be set below 5 percent of Fonterra's milk supply, what do you consider the optimal level for the "total volume" provision to be and why?**
- 3.103. As stated in the response to Question 23, tying the amount available for the RMR to a percentage of total milk supplied to Fonterra is unfair. As the dairy industry becomes more competitive, Fonterra will be picking up less milk as a proportion of all New Zealand milk, which means that it will need to 'give up' a greater proportion of its milk to the Regulations. The amount set within the DIRA to be made available for the RMR should be substituted by a fixed total volume (600ML).
- 3.104. If MAF can solve the issue of over demand for RRM, then this volume (600ML) is ample to satisfy new entrants.
- 3.105. **Question 25: Do you consider the option of gradual reduction in the "total volume" of regulated milk to be desirable? Please explain why.**
- 3.106. A gradual reduction will be unnecessary. Any milk not taken can be processed by Fonterra. It has the capacity to do this.
- 3.107. **Question 26: Are there any other options relating to the total volume of regulated milk that you think should be considered?**
- 3.108. The necessary phasing in of new regulations will lead to up to five years of over-demand for this milk which must be managed (see paragraph 3.60).
- 3.109. **Question 27: Do you consider the current pro rata rationing rule to be an adequate mechanism for managing excess demand for regulated milk?**
- 3.110. Federated Farmers **disagrees** with the current pro-rata rationing rule.

- 3.111. Federated Farmers submits that this is an imperfect rationing mechanism as Goodman Fielder (who takes 250ML) has a contract with Fonterra that takes it into at least 2020 and is therefore ineligible for this rationing system.
- 3.112. Furthermore, it allows for lobbying and favouritism of the other IPs and will consequently be unfair. Those IPs who can least afford to have any volume change will be the ones most affected.
- 3.113. **Question 28: Which of the alternative mechanisms do you consider to be most effective in managing excess demand? Please explain why.**
- 3.114. Federated Farmers agrees that a suitable system to deal with over-demand must be found that will cover the Regulations until a new system is bedded in.
- 3.115. Federated Farmers submits that an auction system is the only way to manage excess demand for RRM. Those who need it most will be able to pay what it will be worth to them. Those who think that the price is too high can make normal contractual arrangements at either the farm or the factory gates.
- 3.116. Federated Farmers submits that retaining the status quo is unacceptable and is explained in response to question 27.
- 3.117. Federated Farmers submits that priority ranking is unacceptable due to the reasons given in response to question 27. Given that there would be lobbying by IPs to make sure their own needs were met, it is doubtful that the supply would be settled in time for those who would be short of RRM to make other arrangements.
- 3.118. **Question 29: Are there any other options relating to managing excess demand that you think should be considered?**
- 3.119. Currently (s 5C of the Regulations) the Chief Executive of Fonterra must verify the final forecasts of raw milk requirements by mid November for the coming season. Federated Farmers asks if this forecasting obligation will still stand.
- 3.120. If this will still stand, excess demand will be known well before the start of the season due to forecasting obligations in the Regulations.
- 3.121. This therefore means that an auction will have to be held for all the available milk (350ML) and that this will be known before the start of the season.
- 3.122. As Goodman Fielder has already been allocated its 250ML in a separate contract with Fonterra and is therefore not a participant in any discussion around decreasing its allocation or altering its contract price, there is only 350ML available to auction.
- 3.123. Federated Farmers further submits that if MAF is going to use an auction system to deal with excess demand, then the system could be used to deal with any demand (not just excess demand), and could solve any

difficulty in trying to fit IPs into categories of eligibility. This will allow all those who value the milk most, to pay what it is worth to them.

3.124. There are some issues to be discussed when contemplating an auction. These are:

3.124.1. **Predatory over-bidding** by larger processors in order to starve the smaller processors of milk:

3.124.2. This is unlikely to occur. Small niche processors will have a much higher willingness to pay for milk than bigger processors. This is because the former has a high margin product whereas the latter produces a commodity with wafer thin returns. This makes the probability of big processors being able to outbid the small ones a remote one.

3.124.3. It's ineffective due to the 50ML volume limit allocated to each processor, and that the auction will probably be split into tranches. If any of the bigger processors do overbid, they will get their respective 50M litres but will pay a high price. They are then unable to take up the rest of the milk available. This leaves the smaller processors who will bid what they are able to afford.

3.124.4. While the bigger processors do have a better ability to carry higher costs/debt for longer, it is not likely that the amount that the smaller independents take and then produce for sale would be an issue that needs considering. These smaller processors are not a threat to the bigger processors.

3.124.5. **Collusion**, with larger processors joining forces to bring the price down. This is unlikely given the Commerce Commission's Cartel Leniency Policy. Market surveillance by the platform provider would also prevent this from happening.

3.124.6. **Thin auction**: This could happen if Fonterra contracts privately with some processors. In this case the auction will not clear and those in the auction will get milk close to the reserve price. This is good for all: some get milk at a contract (and therefore negotiated price), the rest get milk at close to the reserve price and any left over Fonterra is able to process itself.

3.124.7. **Thick auction**: Those in support of Fonterra could set up paper companies to bid for the milk and then get Fonterra to toll process it. The auction will clear and if the phantom bidders win lots of milk, starving the bigger processors, then bigger processors with own supply will recruit more farmers. This will lead to Fonterra losing supply. It also means they lose the farmer and the farmer's capital. Those without own supply will have to manage using the factory gate market. It is also unlikely this would go unnoticed by the regulators.

3.125. **Question 30: Do you consider the current simple averaging out approach to be acceptable? If so, do you believe that the current average margin of \$0.10 per kilogram of milksolids is adequate to**

compensate Fonterra for the cost of flattening the regulated milk supply curve? If not, what average margin would you recommend and why?

- 3.126. IPs are required to take RRM throughout the year, based on the amount of milk they take in October. So while they are allowed 50ML each in total, they cannot take it all at once. Because of the peak shaped curve of seasonal milk supply and the set margin of 10c/Kg of milk solids (MS), the milk they have to take around the peak is really expensive even though there is an excess supply of milk and very little demand for it. The milk they really want, taken on the shoulders of the season, is under-priced even though there is a shortage of supply and increased demand. It is a “swings and roundabouts” scenario. IPs have to pay the same margin on the peak as at the shoulders and they have to pay this through the year. It should be near cost neutral for farmers and Fonterra.
- 3.127. Federated Farmers understand that the margin of 10c/KgMS is the value Fonterra provided MAF with when asked to consider what a reasonable flat margin would be.
- 3.128. Federated Farmers submits that having a simple averaging out approach is unfair and does not reflect the true value of this milk to either Fonterra or IPs. Milk, by its seasonal nature, is more valuable at some times than it is at others, and the price should reflect this seasonality. Ideally, the margin would be the amount someone would be willing to pay for it.
- 3.129. However, Federated Farmers also submits that trying to reflect this seasonality will overly complicate the issues and may not be necessary. If the revised RMR contain conditions that limit the amount of time all IPs can continue to take RRM, then the issue will be insignificant. Having a constant price does give new start-ups certainty of both pricing and volume throughout the whole year.
- 3.130. If, however, the RMR do not allow for this decreasing take of RRM, and that MAF feels that seasonality must be taken account of, then:
- 3.130.1. Federated Farmers submits that the margin of 10c is adequate if the base price (Fonterra farm gate price) is tailored to fit seasonality. Conversely, if the base price is fixed, the margin should be altered to reflect seasonality.
- 3.130.2. MAF will need to work out a model that calculates what margin would make this milk cost neutral to Fonterra, based on Fonterra’s farm gate price.
- 3.131. **Question 31: If a price schedule for different points of the season was introduced, what level of the margin would you consider to be appropriate to be set for the peak supply, mid-season and shoulder months supply?**
- 3.132. Federated Farmers submits the same reasoning as given in the previous answer.
- 3.133. If IPs are required to take milk on a seasonal curve basis, then the margin should remain unchanged throughout the season.

- 3.134. If the current “Raw milk estimates” (s 6) remain within the Regulations, then the Federation submits that a much higher margin is required on the shoulders. However, calculating this margin will be difficult, as discussed in the response to question 30, above.
- 3.135. However, we do suggest that two options could be considered when setting the level of margin, by taking:
- 3.135.1. A percentage of current farm gate price of Fonterra plus increases as Fonterra changes its milk price or normal increments as Fonterra suppliers receive increments
 - 3.135.2. A percentage of the final predicted Fonterra milk price, fixed and final. This will create the obligation for Fonterra to calculate the milk price more accurately than is current.
- 3.136. **Question 32: Are there any other options relating to the seasonal supply curve that you think should be considered?**
- 3.137. The pricing formula developed for RRM should be tied to Fonterra’s North Island and the South Island supply curves. This is because the security of taking this milk is of differing value throughout the season.
- 3.138. However, Federated Farmers is unsure how this would affect the smaller IPs who, while they could contract directly at the factory gate with what could be an unwilling seller, just want the same quantity on a monthly, assured basis.
- 3.139. **Question 33: Do you think flexibility provisions of some sort are necessary? If so, do you think the current level or a reduced degree of flexibility would be appropriate?**
- 3.140. Federated Farmers submits that the current flexibility is unfair to Fonterra. Fonterra has to keep stainless steel available at a considerable cost to accommodate the current system, at little cost to IPs. This high degree of flexibility also takes away the obligation on IPs to forecast their short term business model more accurately.
- 3.141. Federated Farmers submits that the current 40 percent margin be reduced to 10 percent, and the later 20 percent (closer to delivery) margin be reduced to 5 percent.
- 3.142. **Question 34: What flexibility arrangements are likely to prevail in standard commercial contracts?**
- 3.143. Arable contracts used in the agriculture sector have an over and under provision, normally at 5 -10 percent, with discount for prompt payment and bulk delivery. These are set price contracts.
- 3.144. **Question 35: If “pricing the option” was to be introduced, what do you think the premium should be?**
- 3.145. Federated Farmers submits that the premium should be the average cost of collection plus delivery to a specific site, with some risk management cost (for example accidents, collection mistakes) built in. This could be

turned into a model then indexed per half year on fuel cost, depreciation, wages and so forth.

3.146. **Question 36: If a “take or pay” provision was to be introduced, what in your opinion are the key risks to independent processors and how these could these be managed?**

3.147. If an IP did not want the milk ordered it could:

3.147.1. Take the milk and on-sell it if there was no capacity to process it

3.147.2. Take the milk and ask another processors to toll process it for them if they had no capacity to process it themselves

3.147.3. Dump the milk if it did not have the capacity to process it

3.147.4. Process the milk but make little margin on it because the market could be saturated at that time.

3.147.5. It could pay Fonterra for not taking the milk

3.148. These are all reasonable business decisions that IPs need to make for themselves. It will encourage them to better forecast their needs.

3.149. **Question 37: Are there any other options relating to the flexibility provisions that you think should be considered?**

3.150. Another option could be for the IP to sell back the milk to Fonterra, at a negotiated price. However, there is a risk that Fonterra would be an unwilling buyer. This could be mitigated if there was a regulated buy-back clause. However, Federated Farmers is against this as it would prefer to let the markets work without regulation.

3.151. **Question 38: Do you believe the option of introducing a “November” rule would add a great deal of complexity in administering both “October” and “November” rules? If so, how do you believe this could be managed?**

3.152. Federated Farmers submits that the October Rule could be continued for the North Island and a November Rule could be used for the South Island if it is found that these periods, on average, better reflect peak milk supply.

3.153. However, given the ease of transport this may prove problematic and not worth changing.

3.154. **Question 39: Are there any other options relating to peak supply that you think should be considered?**

3.155. The peak milk season can vary year to year, depending on climatic conditions. To accommodate this, payment for milk ordered during this period could be based on a ‘take or pay’ basis and periods outside of this could be on a negotiated basis.

- 3.156. **Question 40: Do you think the option of price certainty should be provided for in Regulations, or should it be a negotiated commercial solution?**
- 3.157. The status quo is difficult for IPs to manage. However, they have managed with it so far, and farmers have to deal with the same system. It is difficult for all during periods of volatility.
- 3.158. Federated Farmers submits that price certainty should be provided for in the Regulation and this could be via the forecasted final milk price plus adjustments at the end of the season and the margin. This would give clarity around supply and costs for both Fonterra and IPs
- 3.159. A negotiated commercial solution could be time consuming and contentious for some.
- 3.160. An option could be a choice, where the milk price is determined as the forecasted component with adjustments made at the end of the season, plus a margin; OR the status quo. This would be elected at the beginning of the season.
- 3.161. **Question 41: If you do consider it should be provided for in the Regulation, do you think that quarterly is the appropriate timing for set pricing?**
- 3.162. Fonterra makes adjustments to the forecasted payment quarterly and these could be factored in to the model as suggested in response to question 40.
- 3.163. **Question 42: If a risk management margin were to be introduced, what do you consider would be an appropriate margin?**
- 3.164. Federated Farmers submits that the choices given in Question 40 should cover off any risk as IPs choose what risk they can take.
- 3.165. **Question 43: Are there any other options relating to payment scheduling that you think should be considered?**
- 3.166. There could be a mix of the suggestion as given in question 40. For instance, a third could be based on the final forecasted component while two thirds are based on the final milk price.
- 3.167. **Question 44: Do you agree that the peak for milk supply in the South Island is more likely to fall in November than in October?**
- 3.168. Yes, but as explained in response to question 38, it may not be worth changing.
- 3.169. **Question 45: Do you consider introducing the “November rule” for the South Island to be of critical importance? If so, please explain why.**
- 3.170. No, due to ease of transport.

- 3.171. While it would be good to match the North Island IPs to North Island supply and South Island IPs to South Island supply, ease of transport makes this difficult to justify.
- 3.172. **Note:** The cost of transport is included within the Regulations (s 8 (5) where it must be 'reasonable'. The Federation is unsure if the cost of transport is the cost from the nearest Fonterra processing plant or the point of milk pick-up, to the IP's factory. This is critical as there are times when this RRM has to travel between the islands.

4. ABOUT FEDERATED FARMERS

- 4.1. Federated Farmers of New Zealand is a primary sector organisation that represents farming and other rural businesses. Federated Farmers has a long and proud history of representing the needs and interests of New Zealand farmers.
- 4.2. The Federation aims to add value to its members' farming business. Our key strategic outcomes include the need for New Zealand to provide an economic and social environment within which:
- Our members may operate their business in a fair and flexible commercial environment;
 - Our members' families and their staff have access to services essential to the needs of the rural community; and
 - Our members adopt responsible management and environmental practices.