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

**OVERVIEW**

- 1 Fonterra wishes to thank the New Zealand Commerce Commission (*Commission*) for the opportunity to contribute to the Commission’s review of competition in dairy markets (*Review*) and in particular to provide a cross-submission on its substantive issues consultation paper.<sup>1</sup>
- 2 In this submission, Fonterra responds to substantive issues regarding the Review that have been identified by other submitters.<sup>2</sup>
- 3 Before setting out those responses in detail, Fonterra makes the following observations:
  - 3.1 Having reviewed concerns raised by other submitters on the Review, Fonterra wishes to emphasise that it has no desire to “turn back the clock” on competition in New Zealand dairy markets. Fonterra understands that competition is a permanent feature of New Zealand dairy markets, and welcomes it as a driver of efficiency. Fonterra’s aim in suggesting the changes to the DIRA pro-competition provisions<sup>3</sup> set out in its substantive

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<sup>1</sup> Commerce Commission, *Consultation on substantive issues – review of competition in the dairy industry* (20 July 2015).

<sup>2</sup> Fonterra has separately responded to the letter from Synlait Milk Limited to the Commission dated 12 August 2015 relating to Fonterra’s proposed offer of co-operative support payments to its share-backed farmers.

<sup>3</sup> Subparts 5 and 5A of Part 2 of DIRA and the provisions of the Dairy Industry Restructuring (Raw Milk) Regulations 2012 (*Raw Milk regulations*), (together, *DIRA’s pro-competition provisions*).

submission,<sup>4</sup> is to capture efficiency gains from adjusting the balance of the regulations to reflect the development of competition in the farm gate and factory gate markets.

- 3.2 The Commission has noted in both of its consultation papers on the Review 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”.<sup>5</sup> In this regard, Fonterra refers to the extensive facts, and analysis of facts, relating to competition in the farm gate and factory gate markets, contained in the expert advice from NERA Economic Consulting (*NERA*).<sup>6</sup> Fonterra considers these form a sound basis for the approach taken in its submission on substantive issues and invites the Commission to take account of them when considering the concerns raised by submitters.
- 3.3 Some submitters have raised concerns that adverse effects might arise from removing certain aspects of the DIRA pro-competition provisions that Fonterra is not suggesting be removed. In summary, Fonterra reiterates that, at this stage, it does not seek removal or amendment of the DIRA pro-competition provisions as they relate to:
- (a) the regulation of the milk price (*Milk Price regime*);<sup>7</sup>
  - (b) Trading Among Farmers (*TAF*);
  - (c) the key components of Fonterra’s obligation to allow suppliers to exit the co-operative freely;<sup>8</sup> and
  - (d) the obligation to supply Goodman Fielder New Zealand Limited (*Goodman Fielder*) and niche independent processors (*IPs*) with raw milk.
- 3.4 Making the changes suggested by Fonterra would not be likely to result in any significant shift in Fonterra’s conduct and hence would not be likely to have a material adverse effect on competition in the farm gate and factory gate markets (and, in Fonterra’s view, these changes would have a positive effect on efficiency). In particular:
- (a) Giving Fonterra greater discretion as to whether, and on what terms, to accept supply from new suppliers is likely to affect Fonterra’s conduct in only a small number of cases,<sup>9</sup> in which Fonterra may choose to decline to accept supply for valid commercial reasons (such as because it would not be efficient due to capacity constraints), or to

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<sup>4</sup> Fonterra Co-operative Group Limited, *Submission on review of the state of competition in the New Zealand dairy industry* (17 August 2015) (*Fonterra’s substantive submission*).

<sup>5</sup> Commerce Commission, *Review of the state of competition in the New Zealand dairy industry: Consultation paper – process and approach* (12 June 2015), paragraph 22; Commerce Commission, above n 1, paragraph 10.

<sup>6</sup> NERA, *Assessment of Competition in Raw Milk Markets and Costs and Benefits of the DIRA provisions* (17 August 2015) (*NERA advice*). The NERA advice is at Appendix A to Fonterra’s substantive submission (above n 4).

<sup>7</sup> The key components of the Milk Price regime are described in Fonterra’s substantive submission, above n 4, paragraph 40.

<sup>8</sup> Including the right to withdraw (DIRA, section 97), 160km rule (DIRA, section 107) and sale of milk vats (DIRA, section 109).

<sup>9</sup> See further Fonterra’s substantive submission, above n 4, paragraph 58.

accept supply on altered terms (such as with a fixed period of commitment to supply Fonterra, to the extent that such a commitment would be consistent with the free exit requirements). Importantly, it would not result in Fonterra declining to accept applications by existing farmer shareholders to increase supply from existing farms. Furthermore, Fonterra would continue to face a strong commercial imperative to accept applications for new supply.

- (b) Removing Fonterra's obligation to make raw milk available to larger IPs<sup>10</sup> would not affect those IPs' ability to enter into commercial arrangements for factory gate supply with Fonterra or other IPs. As noted above, Fonterra does not currently seek the removal of its obligation to supply Goodman Fielder or smaller, niche IPs.
- (c) Fonterra notes that a range of views have been expressed regarding thresholds for deregulation.<sup>11</sup> Fonterra wishes to reiterate its submission that, based on the NERA advice and its own market experience, the current trajectory represents consistent progress towards sustainable and effective competition in both the farm gate and factory gate markets and that it is now appropriate to reassess the costs and benefits of DIRA's pro-competition provisions. Fonterra considers the Review should examine whether some regulation is redundant, or has its purpose served by competition or other regulatory developments, and in the interests of efficiency should be removed or changed now. Fonterra acknowledges that other regulation may for now continue to serve a justifiable purpose, and considers there are some key features of the DIRA pro-competition provisions that should be retained for now, but revisited again in time.

4 In the following sections Fonterra responds to issues raised by other submitters in relation to, first, competition in the farm gate and factory gate markets and, secondly, the key components of the DIRA pro-competition provisions.<sup>12</sup>

### Competition in the farm gate and factory gate markets

5 Fonterra considers the facts and factual analysis put forward by other submitters are generally consistent with Fonterra's substantive submission and the evidence set out in the NERA advice.

6 A number of submitters have observed that Fonterra retains high market shares, and that there are still regions in which no alternative processors to Fonterra exist.<sup>13</sup> However, for the most part, submitters have observed that competition at the farm gate has improved since 2010. Fonterra reiterates its submission that:

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<sup>10</sup> Fonterra's substantive submission, above n 4, paragraph 78.

<sup>11</sup> See, for example, Tatua Co-operative Dairy Company Limited, *Submission on review of the state of competition in the New Zealand dairy industry – substantive issues* (August 2015) (*Tatua (August)*), paragraph 6.1ff; Goodman Fielder, *Re: Commerce Commission consultation paper: review of the state of competition in the New Zealand dairy industry* (10 July 2015), paragraphs 5.1-5.3; Miraka, *Submission to the Commerce Commission: Consultation paper – process and approach: review of the state of competition in the New Zealand dairy industry* (12 June 2015) (10 July 2015) (*Miraka (July)*), paragraph 4.1.3.

<sup>12</sup> In this submission, Fonterra addresses substantive issues raised by other submitters in response to both the process and substantive consultation papers (Commerce Commission, *Review of the state of competition in the New Zealand dairy industry: Consultation paper – process and approach* (12 June 2015); Commerce Commission, *Consultation on substantive issues – review of competition in the dairy industry* (20 July 2015)).

<sup>13</sup> Danone Nutricia, *Re: Consultation on substantive issues – review of competition in the dairy industry* (undated), paragraph 3ff.

- 6.1 Its high shares at the national or Island level understate the competitive impact of IPs (for example, because they have significant shares in their collection zone).
  - 6.2 Fonterra's uniform pricing means Fonterra suppliers who do not have a choice of processor benefit from competition from IPs in other geographic areas. For this reason, it is also not necessary or appropriate for the Commission to consider markets based on a regional geographic scope in the context of the Review.<sup>14</sup>
- 7 Submissions concerning the contestability of the factory gate market have been mixed, from indicating that the factory gate market is competitive or capable of functioning without regulation,<sup>15</sup> to indicating the regime has not yet delivered effective competition.<sup>16</sup> Based on its own experience of this market, Fonterra considers it to be relatively immature.<sup>17</sup> However, on balance, the evidence available to Fonterra suggests that:
- 7.1 IPs appear to be easily capable of constraining Fonterra's ability to raise price in this market above competitive levels; and
  - 7.2 The ability of competitors to supply at the factory gate has reached a point where the structure of the regulatory requirements on Fonterra can be reconsidered.
- 8 The NERA advice suggests that sustainable competition in the farm gate market has increased materially since 2010 but is not yet at the point where full deregulation can be recommended.<sup>18</sup> Fonterra wishes to re-emphasise that, in its view, there are some key features of DIRA that should be retained for now, and notes that it is not seeking complete deregulation at this stage.
- 9 Fonterra also wishes to make the following factual corrections in response to certain matters raised that have been raised in submissions:
- 9.1 Some submitters have suggested that tactical pricing by Fonterra would amount, and has in the past amounted to, anticompetitive behaviour.<sup>19</sup> Fonterra has engaged in "tactical pricing" in a limited way – by offering some farmers in specific areas who were considering leaving, or were at risk of leaving, a bespoke contract, which was non-shareholding. This occurred some time ago (between 2007 and 2009); it was not favoured by shareholders and Fonterra has not subsequently engaged in any tactical pricing. In any event, and as noted by Tatua Co-operative Dairy Company Limited (*Tatua*), the Commission investigated claims levelled against Fonterra concerning tactical pricing in 2008 and concluded that it was not

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<sup>14</sup> See for example Talley's, *RE: Commerce Commission review of the state of competition in the New Zealand dairy industry – July 2015* (22 June 2015), paragraphs 7 and 8.

<sup>15</sup> Westland Milk Products, *Submission on the dairy competition review consultation paper, 12 June 2015* (10 July 2015), paragraph 24ff.

<sup>16</sup> See for example Goodman Fielder, above n 11, paragraph 2.1ff; Danone Nutricia, above n 13, paragraph 3.1ff; Tatua Co-operative Dairy Company Limited (August), above n 11, paragraph 2.5.

<sup>17</sup> See Fonterra's substantive submission, above n 4, paragraph 34.2; NERA advice, above n 6, paragraph 4.2.

<sup>18</sup> NERA advice, above n 6, paragraph 3.6.

<sup>19</sup> Tatua Co-operative Dairy Company Limited (August), above n 11, paragraph 3.36; Talley's, above n 14, paragraphs 7 and 8.

anti-competitive. The Commission concluded that tactical pricing is a legitimate response to vigorous competition, and identified that Fonterra's behaviour was consistent with what could be expected in competitive markets.<sup>20</sup>

- 9.2 Tatua has suggested that Fonterra's guaranteed milk price scheme (*GMP*), which allows farmers to lock in a milk price for a proportion of their milk supply, is anti-competitive. This offering was developed in response to farmers seeking greater certainty of their milk price to enable them better to plan, manage and invest in their farming business. All farmer shareholders are eligible to apply for *GMP*, with limited exceptions.<sup>21</sup> In essence, this provides an opportunity to farmers to obtain a fixed milk price for part of their milk supply. That fixed price is determined by reference to the opening forecast farm gate milk price for the relevant season and may end up being less, or more, than the final farm gate milk price. *GMP* in turn benefits Fonterra by allowing it greater pricing certainty on which to base its relationships with key customers.

### Milk Price regime and TAF

- 10 A number of submitters have indicated that they wish to see the Milk Price regime retained.<sup>22</sup> As set out in its submission on substantive issues, Fonterra recognises that the Milk Price regime and TAF continue to support market efficiency and transparency, as well as public confidence, and does not seek any changes to them at this time.
- 11 Some submitters have expressed concern about the Milk Price methodology and the incentives acting on Fonterra to generate a price that is truly reflective of market rates.<sup>23</sup> Fonterra notes that objections of this nature have been (and continue to be) taken into account in the context of the consultation processes concerning the calculation of the milk price.<sup>24</sup> Most recently, the Commission concluded in its draft report that the calculation of the 2014/15 base milk price was largely consistent with both the efficiency and contestability purposes of the DIRA, and also approved Fonterra's direction of travel with respect to calculating the base milk price (noting the quality of information Fonterra provided had improved and that Fonterra has made a significant effort to improve the transparency of its calculations).<sup>25</sup> Similarly, in its most recent review of the Milk Price Manual, the Commission concluded not only that the 2014/15 Milk Price Manual is largely consistent with the efficiency and contestability objectives of DIRA, but also that amendments made

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<sup>20</sup> Commerce Commission, *Fonterra did not breach Commerce Act*, press release, 24 December 2008.

<sup>21</sup> With the exception of Fonterra directors (and associated persons), and shareholders who have given notice of their intention to cease supply.

<sup>22</sup> See for example Danone Nutricia, above n 13, paragraph 4.3; Open Country Dairy, *Submission on the Commerce Commission's Consultation Paper – Review of the State of Competition in the New Zealand Dairy Industry* (10 July 2015); Westland Milk Products, above n 15, paragraph 30, Federated Farmers, *Review of the state of competition in the New Zealand dairy industry: Consultation paper – process and approach* (10 July 2015), paragraphs 9.1-9.4.

<sup>23</sup> In particular, Miraka (July), above n 11, at 3.2; Miraka, *Submission to the Commerce Commission: Consultation on substantive issues (20 June 2015) (17 August 2015) (Miraka (August))*, at 2; Tatua Co-operative Dairy Company Limited (August), above n 11, at 3; Open Country Dairy, above n 22, page 5. Westland also notes that Fonterra is able to depart from the Milk Price Manual (Westland Milk Products, above n 15, paragraph 19.3) – in that regard, see Fonterra's substantive submission, above n 4, paragraph 40.4.

<sup>24</sup> For example, Miraka has attached submissions raised during reviews of the Milk Price calculation in April 2015 and Milk Price methodology in February 2012.

<sup>25</sup> Commerce Commission, *Review of Fonterra's 2014/15 base milk price calculation – draft report* (17 August 2015), paragraph 2.5ff, and paragraph 3.9ff.

since the previous review represent a step towards greater consistency with those objectives.<sup>26</sup>

- 12 Fonterra remains of the view that its Milk Price methodology and the governance framework around the operation of the methodology are sound and generate a price that is consistent with the statutory objectives enshrined in DIRA. That has also been the view of the Commission in its statutory reviews to date, in which context it takes into account a range of views.<sup>27</sup>

### Open entry and exit

- 13 Fonterra acknowledges that many submissions have emphasised the importance of the open entry and exit provisions of DIRA. This is clearly an issue of concern for both established and new entrant IPs.
- 14 Fonterra reiterates that the changes it proposes to the obligation to accept supply will not substantially alter the way Fonterra operates. For example, Fonterra does not seek any changes to core aspects of its obligation to maintain open exit. Furthermore, if granted more discretion regarding whether and on what terms to accept new supply, Fonterra would retain commercial and structural incentives to accept supply and treat farmers equally in all but the most marginal of cases. In those marginal cases, Fonterra submits that the proposed changes will not cause material detriment to contestability and will benefit efficiency.
- 15 Fonterra also re-emphasises that there has been significant movement in the farm gate market since the enactment of DIRA in 2001. IPs have been highly successful in contracting suppliers and Fonterra expects them to continue to expand market share.<sup>28</sup> Fonterra's market share is now below the statutory threshold for triggering deregulation in the South Island.<sup>29</sup> Fonterra submits that the market can readily operate competitively if Fonterra's proposals are adopted.

### Open entry

- 16 A number of submitters have observed that open entry provides comfort to farmers switching to untested IPs<sup>30</sup> and there is suggestion that Fonterra might take advantage of relaxed regulation to refuse re-entry.<sup>31</sup> Some concern has been expressed that removal of these provisions will dampen competition from IPs.<sup>32</sup>
- 17 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.

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<sup>26</sup> Commerce Commission, *Review of Fonterra's 2014/15 milk price manual – final report* (15 December 2014), chapter 2.

<sup>27</sup> Commerce Commission, *Review of Fonterra's 2014/15 Milk Price Manual: Final report* (15 December 2014), paragraph 2.2; Commerce Commission, *Review of Fonterra's 2013/14 Milk Price Manual: Final report* (16 December 2013), paragraph 2.1; *Review of Fonterra's 2012/13 Milk Price Manual: Final report*, above n 38, paragraph 3.7.

<sup>28</sup> NERA advice, above n 6, paragraph 3.3.1.

<sup>29</sup> DIRA, section 147; Nathan Guy press release, *Independent dairy processors collecting more milk* (13 August 2015).

<sup>30</sup> Tatua Co-operative Dairy Company Limited (August), above n 11, paragraph 4.4.

<sup>31</sup> Castalia, *Review of the state of competition in the dairy industry: report to Open Country Dairy* (July 2015), figure 3.1; Miraka (August), above n 23, 3.1.1.

<sup>32</sup> Miraka (July), above n 11, paragraph 3.1.1; Open Country Dairy, above n 22, pages 1-2.

- 18 Fonterra notes that so long as incremental revenue from milk exceeds the incremental cost, it will retain a strong commercial incentive to accept milk from new suppliers.<sup>33</sup> Fonterra would elect not to accept supply only in marginal cases – for example, due to capacity constraints, or where farms are particularly difficult to reach or supply only minimal quantities of milk. The existing limit<sup>34</sup> and exceptions<sup>35</sup> to the obligation to accept supply represent a clear concession that it is not efficient for Fonterra to accept supply in some such cases. The further changes sought to the obligation to accept supply would not be likely, in practice, significantly to impact open entry and exit. But they would significantly benefit efficiency.
- 19 Fonterra notes that the same principles apply to farmers who have previously supplied milk to IPs (irrespective of whether these farmers have previously also supplied Fonterra). In fact, these farmers are likely to operate in competitive areas and so the incentives on Fonterra to accept supply (including returning supply) are likely to be greater.
- 20 Finally, for the most part Fonterra does not perceive that its proposed change to the obligation to accept supply will generate discrimination among farmers, particularly among existing Fonterra farmer shareholders. Fonterra’s co-operative structure is a genuine barrier to its ability (and potential desire) to discriminate.<sup>36</sup> Accordingly, differentiated treatment is likely only in the context of marginal new suppliers. In these circumstances, it is possible Fonterra would consider supply on different terms, particularly where the rational alternative would be to reject supply entirely. This approach incentivises efficiency, without entirely foreclosing the opportunity to supply Fonterra for marginal new suppliers. Differentiated treatment in these cases would also ensure an efficient price for the majority of farmer shareholders, who would not bear the additional cost of marginal suppliers.<sup>37</sup>

### *Open exit*

- 21 Open exit appears to be a key concern for IPs, over and above the other aspects of the entry and exit regime. Fonterra reiterates that it does not seek any changes to core aspects of the obligation to maintain open exit, including the right of withdrawal, the 160km rule and the sale of milk vats. Fonterra anticipates that this will be of comfort to submitters, who have expressed concern that Fonterra might make it difficult for farmers to exit Fonterra, for example by extending contract lengths or requiring farmers to give an extended period of notice in advance of withdrawal.<sup>38</sup>
- 22 Fonterra notes that some submitters have expressed doubt about the consistency of some of Fonterra’s innovations with the open exit provisions of DIRA, including:

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<sup>33</sup> Fonterra’s substantive submission, above n 4, paragraph 58.2; NERA advice, above n 6, paragraph 5.3.2

<sup>34</sup> DIRA, section 86.

<sup>35</sup> DIRA, sections 94 and 95.

<sup>36</sup> Fonterra’s substantive submission, above n 4, paragraphs 43.3 and 64; NERA advice, above n 6, paragraph 2.1.

<sup>37</sup> See also Federated Farmers, above n 22, paragraph 5.4.

<sup>38</sup> Castalia, above n 31, paragraph 3.1; Tatua Co-operative Dairy Company Limited (August), above n 11, paragraph 4.9.; Westland Milk Products, above n 15, paragraph 19ff; Danone Nutricia, above n 13, paragraph 4.3; Miraka (July), above n 11, paragraph 3.1; Talley’s, above n 14, paragraphs 5 and 6.

22.1 MyMilk: This has been addressed in Fonterra’s substantive submission,<sup>39</sup> but it is worth reiterating here that supply to MyMilk is on an annual basis – suppliers may leave at the end of any season; and

22.2 “locking in” milk supply for periods of up to 10 years.<sup>40</sup> Fonterra has no supply contracts that lock a farmer into supplying Fonterra for 10 years.<sup>41</sup> In addition, Fonterra has no evidence that its ‘share-up over time’ supply contracts have resulted in material difficulties for IPs in sourcing their own supply at the farm gate.<sup>42</sup> As noted previously, Fonterra has offered suppliers options to “share up” (in other words, purchase sufficient Fonterra shares to support their volume of milksolids supply) over longer periods, including three, 6 or 10 years. These offers entail some degree of commitment to supplying Fonterra for the share up period.<sup>43</sup> Allowing farmers to share up over time represents an attempt by Fonterra to present attractive options to suppliers who may be unable to share up immediately, and meet competition from IPs.

23 These offers are consistent with the DIRA pro-competition provisions, and Fonterra strongly disputes submissions that they are intended to circumvent open exit.<sup>44</sup>

### Raw Milk regulations

24 In Fonterra’s view, the requirement to supply Goodman Fielder remains important for public confidence in downstream wholesale and retail markets and there is still a case for smaller, niche IPs that do not have their own milk supply having access to Fonterra raw milk (although we note that it appears a number of these IPs are utilising the 20% rule to meet their demand). Fonterra seeks the removal only of its obligation to make raw milk available to larger IPs (other than Goodman Fielder). These larger IPs either have their own supply or are capable of obtaining their own supply and therefore regulated milk is no longer necessary to provide a beach head into the farm gate market. Furthermore, Fonterra considers the regulated price for factory gate milk should reflect Fonterra’s opportunity cost. Finally, Fonterra seeks the amendment of aspects of the Raw Milk regulations that give rise to particular inefficiency, or ambiguity.<sup>45</sup>

25 It follows that Fonterra also disagrees with extending the 3 year limit for partially self-supplied IPs to 5 years.<sup>46</sup> Such IPs should be in a position to obtain their own raw milk supply, rather than relying on the provisions of DIRA. Fonterra supports

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<sup>39</sup> Fonterra’s substantive submission, above n 4, paragraph 72; see also Fonterra Co-operative Group Limited, *Cross submission on review of the state of competition in the New Zealand dairy industry – process and approach*, 24 July 2015, paragraphs 4-7.

<sup>40</sup> Westland Milk Products, above n 15, paragraph 31.

<sup>41</sup> The “10 year contract” is for a fixed term of 6 years, prior to the end of which the farmer can elect whether to continue to supply under the contract.

<sup>42</sup> See generally the evidence of increasing competition set out in the NERA advice, above n 6, at paragraph 3.3.

<sup>43</sup> Fonterra’s substantive submission, above n 4, paragraph 71.

<sup>44</sup> As noted in Fonterra’s substantive submission (above n 4, paragraph 70), the right to withdraw in combination with the 160km rule allows Fonterra some flexibility in its supply contracts, and in particular to present more attractive options to suppliers in order to meet competition.

<sup>45</sup> Fonterra’s substantive submission, above n 4, paragraphs 93-94.

<sup>46</sup> See Danone Nutricia, above n 13, paragraph 4.5.



the view of Foodstuffs that the regulation should aim to reduce the dependency of IPs on regulated milk.<sup>47</sup>

- 26 Fonterra supports Tatua's observation that the regulatory period to date has been characterised by rapidly growing milk production, and that observed growth is likely to slow over the next five years.<sup>48</sup> Fonterra submits in that context the trade-off between scale and competition becomes more important, as it increases the cost of inefficient entry. This supports Fonterra's proposed changes to the Raw Milk regulations.
- 27 A number of submitters have registered concern that amendment to the Raw Milk regulations would result in Fonterra withdrawing from, or reducing its participation in, the factory gate market.<sup>49</sup> This concern appears to have arisen as a result of difficulties experienced in obtaining supply from other IPs. Submitters have observed that IP factory gate supply tends to only occur where IPs have excess volumes of raw milk.<sup>50</sup> Fonterra notes in this context that the immaturity of the factory gate market may in part be due to the Raw Milk regulations "crowding out" others from entering.<sup>51</sup> Fonterra and other IPs would have no incentive to withdraw from the factory gate market so long as the price is sufficient to compensate for the opportunity cost in supplying.<sup>52</sup>
- 28 Fonterra has observed that well established IPs with their own supply base, including Tatua<sup>53</sup> and Open Country Dairy<sup>54</sup> were supportive of retaining the Raw Milk regulations. This position is advanced despite the fact that these entities will soon no longer have regulated access to Fonterra's raw milk.<sup>55</sup> For this reason the point being made by these IPs must be one of market design. In Fonterra's view a number of factors need to be considered: the Raw Milk regulations provide an avenue for a *new entrant* processor, but at the expense of dampening competition at the farm gate, and at the factory gate (since incumbent IPs have no incentive to compete in the factory gate markets if milk is available from Fonterra at the regulated price). The Raw Milk regulations also risk stimulating inefficient levels of entry, given there must at least be times when the regulated raw milk price is below opportunity cost to Fonterra,<sup>56</sup> and buyers can vary their take.<sup>57</sup> As explained in Fonterra's submission and in the NERA advice, given the current levels of

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<sup>47</sup> Foodstuffs NZ, *Dairy competition review consultation paper, 20 July 2015* (17 August 2015), paragraph 7.

<sup>48</sup> Tatua Co-operative Dairy Company Limited (August), above n 11, paragraph 2.2ff.

<sup>49</sup> See Danone Nutricia, above n 13, Miraka (July and August), above n 11 and 23, at paragraphs 4.2.4.2 and 2.8.2 respectively; Castalia above n 31, figure 3.3, Tatua Co-operative Dairy Company Limited (August), above n 11, paragraph 5.5; Open Country Dairy, above n 22, footnote 1.

<sup>50</sup> See for example NZ Specialist Cheesemakers, *Commerce Commission – submission on the dairy competition review consultation paper, 12 June 2015*; Goodman Fielder, above n 11, paragraph 2.2.

<sup>51</sup> NERA advice, above n 6, at 4.2.

<sup>52</sup> Karikaas' submission (see Karikaas Natural Dairy Products Ltd, *Commerce Commission – Submission on the Dairy competition Review Consultation Paper 12 June 2015* (undated)) that the price appears high does not appear to be borne out – see NERA advice, above n 6, footnote 85.

<sup>53</sup> Tatua Co-operative Dairy Company Limited (August), above n 11, paragraphs 5.1-5.7.

<sup>54</sup> Open Country Dairy, above n 22, footnote 1.

<sup>55</sup> As a result of a change introduced in 2012, the obligation to supply under the Raw Milk regulations ceases for IPs whose own supply of raw milk is 30 million litres or more for three consecutive seasons (provided for in new regulation 6(3)).

<sup>56</sup> The regulated milk price is effectively equal to the raw milk price determined by the Milk Price Manual. This assumes the milk is processed and sold as a commodity, whereas there will be times when the milk could be processed and sold as a higher value product, providing higher returns. See NERA advice, paragraphs 5.2.2 and 5.2.3.

<sup>57</sup> See NERA advice, above n 6, paragraph 5.2.3.

sustainable competition at the factory gate and farm gate a different balance is now more likely to be efficient.

- 29 In this context, the same design question might be raised regarding Goodman Fielder's regulated access to raw milk (which Fonterra is proposing should not change). That is, in the absence of having regulated access to Fonterra's milk supply, Goodman Fielder may need to enter the farm gate market and this would further increase the contestability of that market. Fonterra acknowledges this scenario is credible. Nevertheless, this is not determinative of the balance to be struck when considering Goodman Fielder's access to raw milk. Fundamentally and most importantly, the policy balance should recognise that the requirement to supply Goodman Fielder remains important for public confidence in downstream wholesale and retail markets in New Zealand – and it is not at this stage an issue worth opening up.

### 20% rule

- 30 In its substantive submission, Fonterra sought the removal of the 20% rule<sup>58</sup> on the basis that it is largely redundant. This reflected Fonterra's understanding that the 20% rule is not widely used.
- 31 Fonterra acknowledges the submissions of Danone Nutricia, Grinning Gecko, Karikaas, Mercer Cheese and Over the Moon Dairy. Fonterra was not aware of the extent of use of the 20% rule.
- 32 Fonterra considers that, in general, the IPs that currently use the 20% rule could replace their supply with supply through the factory gate market (and, given the 20% rule appears typically to be used by "niche" IPs, this would not be likely to change were Fonterra's changes to the Raw Milk regulations adopted).
- 33 Nevertheless, as set out in its substantive submission, Fonterra does not consider the 20% rule a priority for change and, given it now understands the 20% rule to be highly valued by certain IPs, no longer seeks its removal at this time.



**Andrew Cordner**  
**Group General Counsel**

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<sup>58</sup> Farmer shareholders are entitled to allocate to IPs up to 20% of their weekly production throughout the season without exiting Fonterra (DIRA, section 108).