



Dear Alex

Submission on the Commerce Commission's Draft Report – Review of the State of Competition in the New Zealand Dairy Industry

Open Country Dairy (Open Country) is pleased to make this submission on the Commerce Commission's (Commission) draft report on its review the state of competition in the dairy industry.

Open Country supports the Commission's draft recommendations

Open Country continues to hold the view that there is insufficient competition in the dairy industry, and that the Dairy Industry Restructuring Act 2001 (DIRA) is critical to the success of the New Zealand dairy industry. Open Country is pleased the Commission agrees. Without DIRA, Fonterra would have the ability and incentive to exercise its market power to increase prices and decrease contestability in the market for raw milk.

The Commission now has the opportunity to recommend improvements to the way the dairy industry is regulated. The Commission should take that opportunity and recommend that:

- The scope of the next review should be much broader—it should not look at deregulation as the only option, and extend to consider opportunities to enhance regulatory settings
- The legislative drafting of DIRA be improved by making it clear that any changes to DIRA will only occur after the review of the state of competition is undertaken and Parliament has considered the matter. The way the legislation is currently drafted presupposes that DIRA should be removed, and that this should happen regardless of whether the Minister intends to retain or amend DIRA. This approach makes no sense given everyone agrees a review needs to be undertaken to determine whether at any point the New Zealand dairy industry is ready for deregulation.

We are disappointed that the Commission still considers that Fonterra does not have the incentive to increase the price of raw milk at the farm gate. Open Country (and many others) have consistently stated that Fonterra does have this incentive, and considerable evidence has been presented of Fonterra using this incentive. Further analysis of Fonterra's incentives is provided in the attached report by Castalia.

The scope of the next review should be much broader

The Commission's terms of reference for this review were very limited—they only allowed the Commission to assess whether deregulation was more efficient than the status quo. The Commission has followed these terms of reference, but it is hard to believe that simply assessing the status quo against deregulation will lead to the best outcomes for New Zealand. Many submitters agreed with Open Country on this matter.

While we agree with the Commission's overall conclusions, we recommend it reflect on wider comments received during this review to recommend a wider scope for the next review of the state of dairy industry competition. This should be enshrined within the legislation to ensure that it happens. In particular, the overall objective should be to ensure that regulatory settings maximise efficiency.

To ensure the next review achieves this objective, it must consider both areas where there may be gains from increasing or altering existing regulation in addition to the potential benefits of deregulation. Open Country has already raised the possibility of the Commission setting components in the milk price manual that are notional (such as the cost of capital)—and the next review needs to provide the opportunity to consider these matters in substance, rather than dismiss them as out of scope.

DIRA should not automatically expire on the 70% reset threshold being achieved

The intention of the market share threshold is to reach a point where DIRA is no longer required because Fonterra's market power has been eroded by competition. However, since a simple market share metric is not capable of fully assessing market power, DIRA requires a review of the state of competition. The Commission (and all other submitters) agree that this is sensible.

Given that everyone agrees a review needs to be undertaken before any changes are made to DIRA, it makes no sense for DIRA to then specify that the regulation should expire automatically—and to require further legislative amendment by Parliament to stop this happening. Section 148 of DIRA currently states that regardless of the review’s findings or even the Minister’s response to that review, when the market share threshold is reached, the Governor-General must (by Order in Council) specify a date on which DIRA will expire. This must be at least within the next season. In practice, this means that Parliament will need to pass a law overriding the Order in Council before it takes effect to stop DIRA expiring. This approach makes no sense given everyone agrees a review needs to be undertaken to determine whether at any point the New Zealand dairy industry is ready for deregulation.

A more sensible approach is for DIRA to specify simply that the review be undertaken once the market share thresholds are reached. At that time, the appropriate process can be undertaken to determine the outcome, which should be by a review that feeds into a Parliamentary decision—without a timeframe prejudged by the legislation.

Open Country is disappointed that the Commission still considers Fonterra does not have the incentive to exercise market power at the farm gate

The Commission concludes Fonterra has no incentive to exercise its market power in the farm gate market. We invite the Commission to reconsider its draft conclusion as a result of the findings in the recent case *MacIntyre and Williamson Partnership v Fonterra Co-operative Group Limited* [2015] NZHC 3012. The Judge accepted that Fonterra being able to impose “penalties” on the plaintiffs for essentially internal political purposes when this would not have been possible in a competitive market speaks to why DIRA exists.

Open Country has consistently stated (along with many others) that Fonterra does have the incentive exercise market power at the farm gate. The Court has found that Fonterra is prepared to exercise this market power at the farm gate when it has internal political incentives to do so. Open Country also submits Fonterra has economic incentives to use this power; being to reduce the threat of competition in future by discouraging suppliers from switching to IPs, attracting the lowest cost suppliers, widening the potential market for which it competes internationally (given the internationally integrated nature of some of its domestic rivals), and obtaining any New Zealand brand value in international markets. As Open Country has stated in the past, an example of a circumstance when Fonterra might use a similar power in the future is to punish farmers for leaving and thereby disincentivise farmers from leaving the co-operative. Castalia’s attached report analyses this further and provides additional evidence for this economic incentive.

Conclusion

Like the rest of New Zealand, Open Country wants the New Zealand dairy industry to succeed. Open Country benefits from a ‘New Zealand success story’ for dairy and believes that regulatory settings have a role to play in enabling a vibrant, competitive industry to emerge.

Open Country supports the Commission’s overall recommendations and appreciates the opportunity to suggest a wider scope for the next review of competition and to identify why Fonterra’s incentives to exercise its market power may extend beyond that envisaged by the Commission.

Best regards,

A handwritten signature in blue ink, appearing to read "Steve Koekemoer".

Steve Koekemoer

Chief Executive Officer

Open Country Dairy Ltd