

# Commerce Commission

## Review of the state of competition in New Zealand's dairy markets

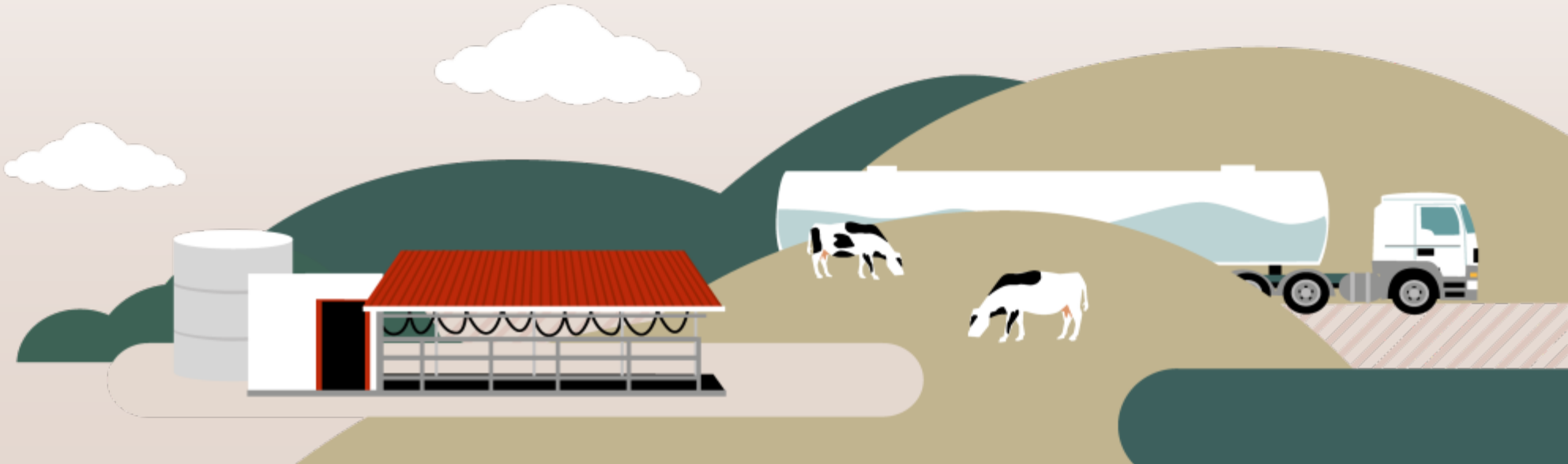
6 November 2015

Sue Begg, Deputy Chair



# Briefing overview

- What the review covers
- Our draft conclusions
- Next steps
- Background



# What the review covers

- The Minister for Primary Industries requested a report on the state of competition in the New Zealand dairy industry.
- The **purpose of the review** is to:
  - provide an assessment on whether the state of competition in the dairy industry is sufficient to justify de-regulation
  - advise the Minister on whether the ‘market share thresholds’ in DIRA should be reset; and
  - the options (if any) for a pathway to deregulation.
- We’re releasing a **draft report for consultation**.

# Summary of draft conclusions (1/2)

- **Competition is very limited in the factory gate market – this is our key concern**
- Some competition has developed in the farm gate market
- The regulations have reduced barriers to entry and constrained Fonterra's market power
- Costs and benefits of removing regulation are same order of magnitude
- On balance, competition is not yet sufficient to deregulate fully

# Summary of draft conclusions (2/2)

## Recommendations

- **The pathway to deregulation requires the development of the factory gate market. We recommend Ministers consider options that facilitate development of that market**
- Staged approach also mitigates the risk associated with deregulation
- Reset the ‘market share’ and ‘time limit’ thresholds to trigger a future report on the state of competition

# Questions we looked at in the review



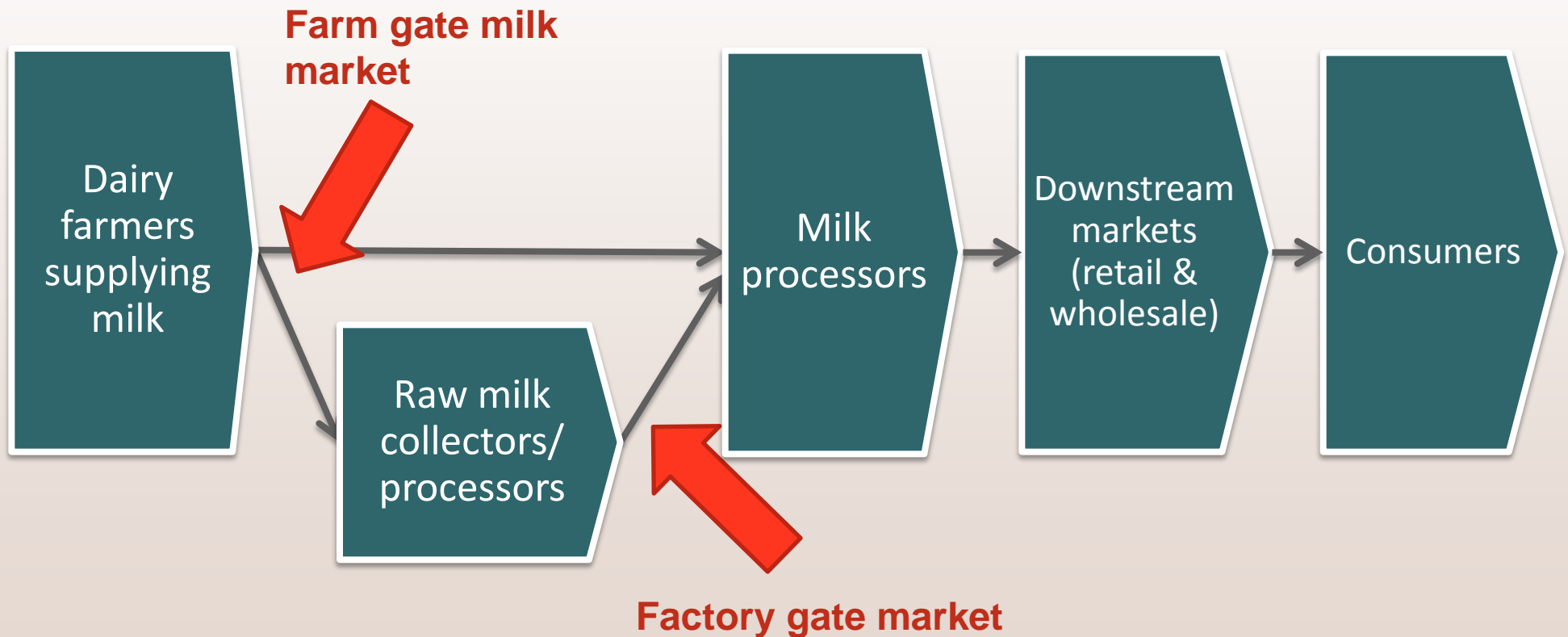
1. What is the **state of competition** with the current DIRA regulations?
2. Is the current **state of competition sufficient** to ensure efficient and contestable markets **without the DIRA regulations**?
3. If the state of competition is insufficient:
  - should the **market share thresholds** be reset?
  - **options** for a transition **pathway to deregulation**

# The markets we've focused on

## Terms of Reference

- Focus on the state of competition and whether we should deregulate:
  - **The farm gate market**
  - **The factory gate market**
- Any new information that would change the findings of our 2011 preliminary inquiry into domestic wholesale and retail dairy markets?

# Farm gate and factory gate markets





# Farm gate market

- **The market for purchasing raw milk from farmers**
- Dairy processors compete with each other to purchase milk from farmers – beneficial to farmers
- DIRA aims to achieve efficient markets via:
  - ‘Open entry and exit’ rules
  - Raw milk regulations
  - Milk price monitoring regime

# Factory gate market

- **The wholesale market where dairy processors trade raw milk:**
  - DIRA milk
  - Non-DIRA milk
- Demand at wholesale level from
  - Emerging dairy processors looking to supplement own supply
  - Food and beverage manufacturers

# State of competition with DIRA – farm gate market

## Farm gate market

- Concern is possible depression of the farm gate milk price
- Market still highly concentrated
- Significant barriers to entry to these markets
- These issues are addressed by:
  - DIRA regulation
  - Fonterra's co-operative nature

# State of competition with DIRA – factory gate market

## Factory gate market

- Regional factory gate markets not characterised by effective competition
- Customers have access to milk under raw milk regulations, so have little incentive to seek supply elsewhere
- Fonterra's price for non-DIRA milk substantially higher than for DIRA milk

# Insufficient competition without DIRA regulations

- **We don't think there is sufficient competition** in the farm gate and factory gate markets for them to be more efficient without the regulations.
- We've considered:
  - **What competition would look like** without the DIRA regulations
  - The **costs and benefits** created by the DIRA regulations

# How markets would operate without the regulations

## Would Fonterra be likely to:

- Exercise market power against farmer suppliers at the farm gate?
- Exercise market power to increase prices at the factory gate?
- Prevent independent processors from effectively competing?

# How markets would operate without the regulations

## Farm gate market

- Removing regulations would not have a big impact on the farm gate market
- Fonterra would still have significant market power, but little or no incentive to use it to the detriment of its shareholder farmers

# What competition would look like without DIRA regulations

## Factory gate market

- Removing regulations would increase the price of previously-regulated 'DIRA' milk
- Increase in factory gate prices has flow-on implications (e.g. increase in the retail price of fresh milk, cheese and yoghurt)
- Some portion of likely price increase reflects Fonterra's market power



# What competition would look like without DIRA regulations

## Restricting competition

- We have considered Fonterra's ability to restrict competition in the absence of regulation
- It is unlikely Fonterra would:
  - Raise prices at the farm gate in order to exclude competitors
  - Commit farmer suppliers to longer term exclusive contracts to shut out competing processors
  - Raise prices at the factory gate in order to exclude downstream competitors

# Efficiency would not be enhanced by removing DIRA regulations



**On balance, we found competition is not sufficient to warrant deregulation at this point**

- Cannot conclude that markets would be more efficient without regulations
- Static efficiency costs and benefits in the same order of magnitude

# Efficiency would not be enhanced by removing DIRA regulations

- **Benefits of the regulations:**

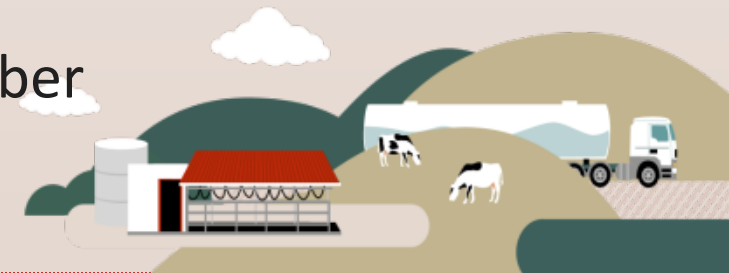
- Facilitate independents being able to source milk from farmers – these are the potential entrants to the factory gate market
- Reduce Fonterra’s ability to exercise market power at the factory gate and prevent consequential impacts on the retail market (i.e. the price of fresh milk, yoghurt and cheese)

- **Costs of the regulations**

- Costs to Fonterra of maintaining excess capacity
- No evidence that the regulations have incentivised inefficient dairy conversions
- However, raw milk regulations may be impeding development of factory gate market

# Draft recommendations

- **The pathway to deregulation requires the development of the factory gate market. We recommend Ministers consider options that facilitate development of that market**
- Staged approach also mitigates the risk associated with deregulation
- Competition review when non-Fonterra market share of 30% is achieved in either North Island or South Island, or if threshold not met in five years
- Recommended thresholds not a magic number



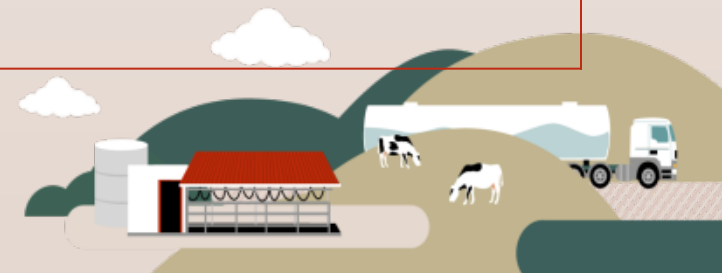
# Options for transition pathways to deregulation

- **The factory gate market is our key concern**
- A **staged approach** is the most appropriate transition pathway to deregulation
- Pathways to a functioning factory gate market potentially offer the biggest benefits:
  - 1) Changes to the raw milk regulations
- Later, consider the other regulations
  - 2) Base milk price disclosure and monitoring rules
  - 3) Open entry and exit provisions



# Review steps

Indicative date	Process step
2 June 2015	<i>Review requested by Minister</i>
6 November 2015	Draft report published
4 December 2015	Submissions due on draft report
18 December 2015	Cross-submissions due
29 February 2016	Final report published



# Questions?



# Contact us

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# Background

- Trigger for the review
- DIRA regulations
- Consultation process

# Trigger for the review

- DIRA requires the Minister of Primary Industries, in consultation with the Minister of Commerce, to request a report on the state of competition in the New Zealand dairy industry:
  - When **market share thresholds** are met;
  - If the market share thresholds haven't been met **by 1 June 2015**, as soon as practicable after that date.
- The review was triggered by the 1 June 2015 time limit.

# DIRA regulations

- Enacted when Fonterra was created in 2001 because Fonterra's creation lessened competition in NZ dairy markets
- Key elements are:
  - Open entry into and exit from Fonterra
  - Raw milk regulations (obligations to collect and supply)
  - Milk price monitoring regime
- Intended to be transitional

# Consultation process

- We are releasing a draft report for consultation on our draft findings
- We have already consulted with interested parties via:
  - A process and approach paper
  - A consultation paper on substantive issues
  - Opportunities for cross-submissions
- Engagement with Fonterra, farmers and independent processors (IPs)

# Next steps

- Consultation period for the next 6 weeks
- Final report to be published 29 February 2016
- Within 90 days of receiving our report, DIRA requires Minister to give notice of whether the Minister:

*“...intends to promote the enactment of legislation that resets either or both of the market share thresholds specified in s 147 or to promote the adoption of measures that provide a transition pathway to deregulation, or to promote both.” – s 148(3) DIRA*