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Miraka Submission to the Commerce Commission:
Review of the State of Competition in the New Zealand Dairy Industry,
Draft Report (Public Version), 6 November 2015

1.0 Introduction

1.1 The Commerce Commission is completing a review of the state of competition of the dairy industry in New Zealand. Miraka has previously provided to the Commission two submissions on the competition review. These were:

- Miraka submission on the Commission Consultation Paper: Process and Approach – dated 10 July 2015
- Miraka submission on Substantive Issues – dated 17 August 2015

1.2 This latest submission responds to the public version of the Commission’s draft report dated 6 November 2015 (the Report) on its review of the state of competition.

2.0 Summary

2.1 Miraka supports the conclusions and recommendations summarised in paragraph X29 of the Report and which are paraphrased below:

- that the market share thresholds for the independent processors (IPs) share of the farm gate market be increased from 20% to 30%; and
- that a further review of the state of competition in the dairy industry be completed at the earlier of the market share threshold being triggered, and the 2021/22 Season.

2.2 The Commission recommends that the market share thresholds should apply separately to the North and South Islands as is currently the case. Miraka and others had submitted that the market threshold be set on a New Zealand wide basis because the separate Islands do not represent distinct or separate markets. Miraka however accepts the Commissions recommended approach because the overall outcome is likely to be similar: while the review of the state of competition might be triggered by only one of the Island’s meeting the threshold, the review itself would unavoidably be based on a New Zealand wide assessment as has been the case with the current review.

2.3 The Commission’s recommendations are based on its overall conclusion (paragraph X4) that “there is insufficient competition to remove the DIRA regulation at this time”. Miraka agrees with this conclusion.

2.4 Miraka does not however agree in full with the Commission’s assessment of the role the DIRA plays in ensuring contestability in the farm gate market. Miraka considers the DIRA

is more important to ensuring contestability than does the Commission, and Miraka considers Fonterra market power is less benign than the Commission has assessed.

2.5 Miraka also notes that while the Commission recommends changes in the regulatory settings for the relatively minor factory gate market, it does not recommend changes for the farm gate market. At the same time the Commission signals that a substantial increase in the IP share of the farm gate market is needed before a further review of the state of competition is considered. While the next review might alternatively be triggered by the time threshold, that review would still have reference to the market share thresholds now proposed to be established at the increased level of 30%. At a nation-wide level this represents a 100% increase of the current IP market share of some 15%¹. The Commission appears to take the view that the regulatory environment is sufficient to result in this rate of growth in competition. Miraka does not share this view. Miraka submits that changes in regulation are needed, and in particular that Subpart 5A (milk price regulations) should be reformed so that the base milk price can provide a level playing field for competition in the farm gate market.

3.0 Regulatory impact on market efficiency

3.1 At paragraph X18 of the Report, the Commission summarises its view that regulation is needed to prevent Fonterra from raising prices in the factory gate market above competitive levels. This is based on the Commission's view that absent regulation, Fonterra would have both the ability (market power) and incentive (increased margins) to raise prices above competitive levels.

3.2 In relation to the farm gate market, the Commission's assessment of the regulatory impact is quite different. In summary, the Commission concludes:

3.2.1 Fonterra has neither the ability nor the incentive to reduce the milk price below competitive levels. This is due to the co-operative purpose of Fonterra. Refer paragraph X16 of the Report.

3.2.2 Fonterra would not benefit from foreclosing IPs which mainly export because "Fonterra is a price taker and would not be able to raise the price of its own export product" (paragraph X24).

3.2.3 In relation to Fonterra's incentives and ability to foreclose IPs, the Commission considers:

- Fonterra is constrained from inflating the milk price above competitive levels because Fonterra needs "to make TAF work" and inflating the milk price would undermine profits and investor confidence (paragraphs 5.88 to 5.90);

¹ Based on current market shares noted in the Nera report to Fonterra: Assessment of Competition in Raw Milk Markets and Costs and Benefits of the DIRA provisions (17 August 2015). For completeness it is noted the market share increases in relation to each of the North and South Island triggers are 333% and 36% respectively (also based on data in the NERA report).

- Fonterra is unlikely to lock in its own farmers to long term contracts, and in any event locking its own farmers into long term supply contracts would not necessarily prevent IPs from obtaining alternative milk supplies (paragraphs 5.98 to 5.100).

3.3 Miraka does not agree with these conclusions:

3.4 Referring to 3.2.1 above (reducing the milk price below competitive levels to increase profits), the Commission’s conclusion is technically incorrect, and leads to an incorrect assessment of Fonterra competitive advantage (with or without regulation). The purpose of the Fonterra Milk Price Manual is to determine a competitive price for milk in New Zealand. Fonterra is not however obliged to pay that milk price. In the 2013/14 Season Fonterra did in fact pay a milk price lower than the price determined by the Milk Price Manual. This was on the grounds of affordability. Because of its market dominance (it effectively sets the national price for raw milk), Fonterra is the only processor in New Zealand that has this flexibility. This lowers Fonterra’s margin risk relative to other processors and thus confers a market power advantage on Fonterra.

3.5 Referring to 3.2.2 and 3.2.3 above, the Commission’s key underlying assumption is that Fonterra is unlikely to engage in anti-competitive behaviour where that would either not increase accounting measures of profit, or would decrease accounting measures of profit. Thus the Commission considers:

- Fonterra is not incentivised to foreclose IPs competing in export markets because this would NOT increase Fonterra selling prices (and margins); and
- Fonterra would not inflate the milk price above competitive levels because this would “increase” its milk cost and REDUCE its margins.

3.6 Miraka considers these observations are not consistent with the economic benefits Fonterra achieves from securing (and increasing) milk supply, and it does not properly assess the priorities of Fonterra stakeholders in assessing and receiving the rewards of Fonterra economic performance.

3.7 It is moot whether Fonterra is a price taker in international commodity markets. For example, Miraka and others have demonstrated that Fonterra management of supply on the GDT auction at least impacts global commodity prices in the short term.² Putting that aside, Fonterra (and all New Zealand dairy processors) gain economic benefit from securing and increasing milk supply in two areas which the Commission seems not to have considered:

3.7.1 Contribution Margin: Milk is the lifeblood of a dairy processor. A substantial and long term investment must be committed to be able to process a NZ seasonal milk supply. That investment is “sized” against the need to process peak seasonal milk. This results

² See for example:

- Tātua Substantive Issues submission (competition review), August 2015: Conduct of GDT Participants (commences at paragraph 3.23)
- Miraka Submission on the 2014/15 Milk Price Calculations (Process and Issues Paper), 28 April 2015: Selling Prices (commences at paragraph 3.1) – this paper was also attached to the Miraka Submission, Consultation Paper: Process and Approach (competition review), 10 July 2015.

in significant redundant capacity during the seasonal shoulders, over the winter months, and at the peak to provide a buffer for the unknowable size of the seasonal peak. Contribution margins are therefore high (a significant portion of both capital and operating costs being fixed costs to maintain redundant capacity). An ongoing and reliable milk supply is crucial to provide a cash flow to service fixed costs. Declining milk supply is a death spiral threat for a dairy processor. It is just as much a strategic priority for Fonterra to maintain and grow its milk supply as it is for the IPs. Furthermore, increasing milk supply to maximise use of installed capacity is highly profitable again because of high contribution margins. It is then not correct to consider Fonterra is not incentivised to foreclose IPs simply because Fonterra is not able to use market power to enhance selling prices (even if that were true).

- 3.7.2 New Zealand dairy products carry an international reputation for pasture fed quality and reliability. This “Brand NZ” provides current and future potential to extract margins above global commodity prices. Fonterra and the IPs are incentivised to secure NZ milk supply to access and manage those “Brand NZ” margins. The growing New Zealand and foreign investment to secure a strategic supply of high quality New Zealand milk to for marketing infant formula into international markets is an example of this. With growth rates in New Zealand milk supply expected to reduce, the motivation to exert market power to secure “Brand NZ” rights is likely to increase.
- 3.8 Contrary to the analysis presented by the Commission, it is then Miraka’s view that Fonterra is significantly incentivised to foreclose IPs because of the economic benefits available.³ Miraka has previously submitted and again emphasises its view that the DIRA regulations are important to ensure Fonterra is not able to exercise market dominance to achieve that outcome.
- 3.9 Turning to the Commission’s conclusion that Fonterra is not able to inflate the farm gate price of milk above competitive levels as a means of foreclosing IPs, this reflects a long standing difference of opinion between Miraka (and others) and the Commission. The Commission considers Fonterra would not inflate the milk price because this would reduce its profits. Miraka however contends that the milk price is the primary measure of Fonterra performance and a “profit imperative” is not sufficiently strong or important to prevent Fonterra inflating that milk price. Miraka has provided information to the Commission on this matter both in its submissions on the annual milk price reviews, and in its submissions on this dairy competition review⁴. In its Report the Commission has not responded to this information other than to cite its view that profit objectives restrain Fonterra from increasing the milk price above competitive levels.

³ Foreclosure here refers to the wider understanding of foreclosure, highlighted in note 38 of the Draft Report, including conditions that “have the potential to prevent, impede, or slow entry **and** expansion” (emphasis not in the original).

⁴ Miraka Submissions on the Consultation Paper (process and approach): refer paragraph 2.3 and the footnoted attached document.

- 3.10 The Commission relies significantly on the TAF to support its position (paragraph 5.98 to 5.100 in the Report). Miraka agrees that the TAF does provide some restraint on Fonterra, but that the Commission has over-estimated this.
- 3.11 The attached Appendix provides further support for Miraka's position. It provides an analysis of the unit prices for the Fonterra Shareholders Fund (FSF) over a 3 year period commencing December 2012. It compares the FSF price to the Global Dairy Trade auction prices for Fonterra Whole Milk Powder (in NZ\$). The WMP price is a leading indicator for milk price expectations and therefore (inversely) for Fonterra profit expectations: As WMP prices rise, milk price expectations rise and profit expectations fall (for Fonterra sales of products sourced from New Zealand milk).
- 3.12 The analysis confirms the FSF price responds directly to profit expectations. The analysis also however shows that the FSF price responds separately and directly (rather than inversely) to Fonterra milk price expectations. Thus for example, the FSF price was at an historic high when WMP prices (and therefore milk price expectations) were at an historic high – by contrast, the Commission's assessment of the importance of profit measures for TAF would expect the FSF price to be at an historic LOW at that time (highest milk price, lowest product margins) – but it was not.
- 3.13 The analysis suggests that milk price expectations not only directly affect the FSF price in their own right, they might have a greater impact on the price than do profit expectations. Thus for example there are extended periods where the FSF price actually rises as milk price expectations rise (i.e. the impact of favourable milk price expectations more than offsets the associated impact of adverse profit expectations on the FSF price).
- 3.14 The behaviour of the FSF price is perhaps not surprising given:
- FSF units are fungible with Fonterra shares on a 1:1 basis
 - The majority holders of rights to Fonterra equity benefits are Fonterra member suppliers
 - Fonterra shares confer BOTH the right to Fonterra dividends AND the right to supply milk to Fonterra
- 3.15 None of this is intended to suggest TAF would not be impacted adversely if the markets considered Fonterra inflated the milk price above competitive levels. It is intended though to demonstrate that the ability of TAF to restrain Fonterra from inflating milk prices is limited. This is fundamentally because the majority holders of Fonterra equity benefits are unaffected by the splitting of returns between milk price and profits, the milk price is the primary measure of the co-operative performance, and the milk price is also considered widely as a key measure of Fonterra performance within the New Zealand economy. These factors highlight the importance of the milk price, and that Fonterra would not necessarily be averse to increasing the milk price simply because profits might be affected.

3.16 Miraka acknowledges that this analysis of the FSF price might be overly simplistic. There are many factors that will influence the unit price. Equally however it provides significant weight to the view that Fonterra profit objectives cannot restrain Fonterra anti-competitive behaviour to the extent the Commission relies on.

4.0 Changes in DIRA regulation of the farm gate market

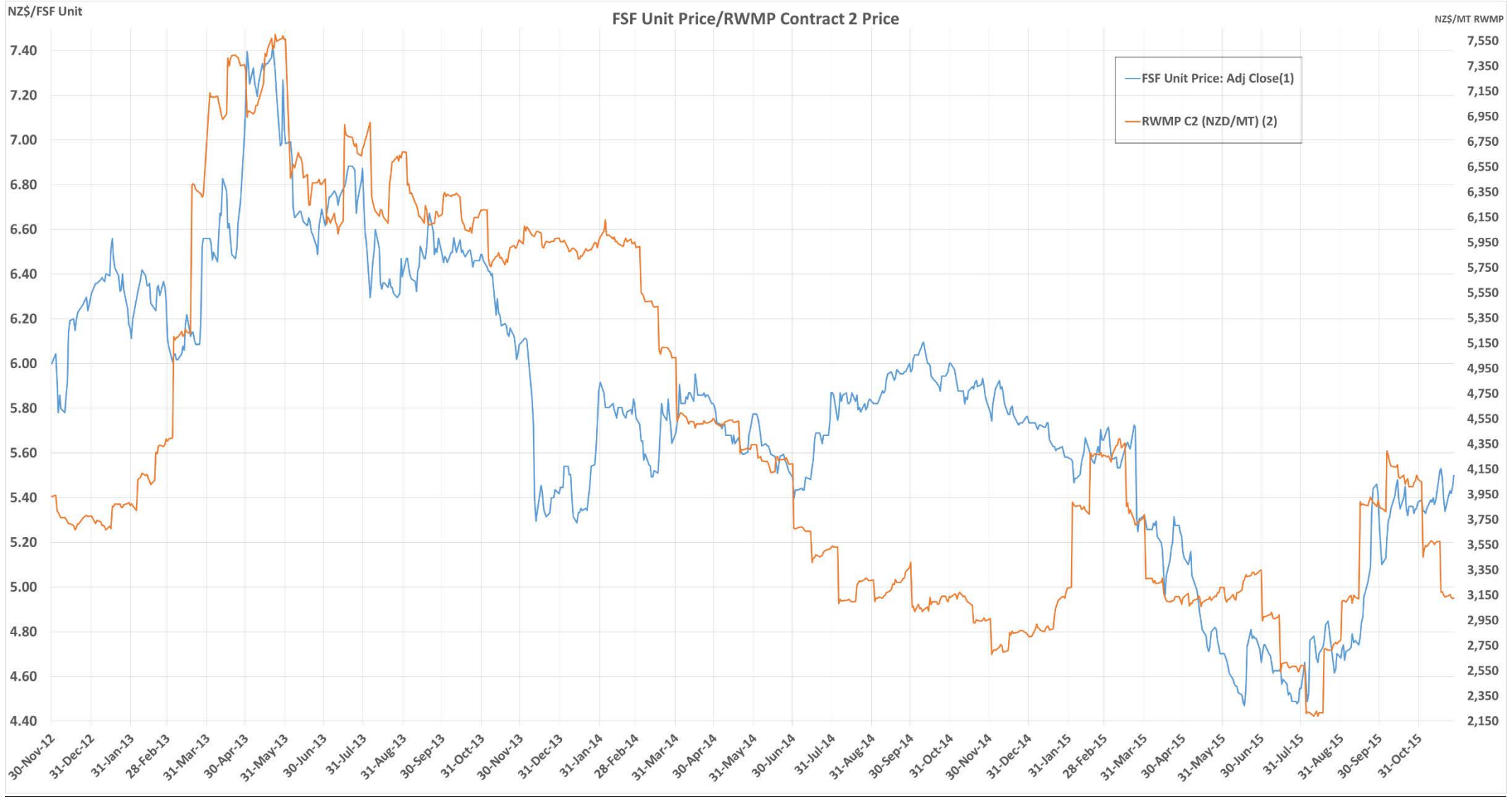
4.1 The Commission has recommended changes in the DIRA regulations to increase competition in the factory gate market as a pathway to deregulation. The Commission has not recommended changes to the regulations to increase competition in the farm gate market. This is presumably because the Commission considers the current regulatory settings are sufficient to achieve the increase in competition contemplated by the increase in the market share thresholds. Given the Commission also considers that the regulatory settings are not especially significant in discouraging Fonterra anti-competitive behaviour, it seems the Commission considers that only time is needed for the increase in competition to the recommended 30% market share thresholds. Miraka does not agree that increase in competition will be achieved under the current regulatory settings. This is not least because the rate of increase in competition has already been slow under the DIRA.

4.2 In section 4.2.5 of its submission to the Commission dated 10 July 2015 (Consultation - process and approach), Miraka explained its view that Subpart 5A perpetuates uncompetitive pricing and that the milk price regulations should be reformed to ensure a level playing field in the farm gate market. In its second submission (Substantive Issues) Miraka reinforced this position and provided evidence that the milk price based on a hypothetically efficient competitor (the model adopted in the Fonterra Milk Price Manual) was anti-competitive. The Commission has not responded to these submissions other than to confirm its view that Fonterra would not increase the milk price above a competitive milk price because of the previously discussed profit imperatives.

4.3 Miraka again submits that the milk price regulations should be reformed to achieve a level playing field in the farm gate market, and that this is a necessary requirement for a pathway to deregulation. Noting the further information Miraka has provided in this submission, Miraka requests the Commission now reconsider this matter.

Richard Wyeth
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Appendix: Unit Price of Fonterra Shareholders Fund Compared to Global Dairy Trade Regular Whole Milk Powder Price



(1) Source: Yahoo New Zealand Business and Finance

(<https://nz.finance.yahoo.com/q/hp?s=FSF.NZ&a=10&b=30&c=2012&d=10&e=9&f=2015&g=d>). Prices are as at close of day, adjusted (by Yahoo NZ Business and Finance) for historical dividends and splits.

(2) Source: Relevant most recent Global Dairy Trade Contract 2 US\$ selling price for RWMP, converted to NZ\$ at daily spot rate published by the Reserve Bank of New Zealand.

The chart compares the FSF unit price to the prevailing spot price for Fonterra Regular WMP sold on GDT. The RWMP selling price is the lead indicator for changes in the Fonterra Farm Gate Milk Price. It is accordingly also the lead indicator for changes in Fonterra product margins (for product manufactured from New Zealand milk:

- Fonterra Milk price (and thus Fonterra production cost) expectations vary directly with the NZ\$ WMP price changes.
- Fonterra margin and profit expectations vary inversely with the NZ\$ WMP Price changes.