Open Country Dairy Limited
52 Highbrook Drive, East Tamaki,
Auckland, New Zealand
PO Box 11 159, Ellerslie
Auckland 1542, New Zealand
T: +64 9 589 1372
F: +64 9 525 0347
E: info@opencountry.co.nz

Dear Alex

Submission on the Commerce Commission's Consultation Paper – 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) consultation paper on its process and approach for reviewing the state of competition in the dairy industry.

Open Country welcomes the review of the state of competition in the dairy industry

Open Country welcomes the review, and sees potential for the review to help shape efficient market interactions and regulation. This letter sets out:

- Open Country's views on the state of competition in the dairy industry
- Open Country's preliminary recommendations for the future evolution of the regulatory regime.

In addition, we attach to this letter a report commissioned from Castalia that:

- Comments on how the Commission should implement its proposed approach
- Raises potential outcomes of removing components of the Dairy Industry Restructuring Act 2001 (DIRA) that we urge the Commission to consider in its review.

The New Zealand dairy industry still needs open entry and exit

Open Country firmly believes that while competition between dairy processors is evolving, the industry has not reached the point where it can discipline Fonterra's market power without the open entry and exit regime.

Since the 2010 review, we have seen Fonterra continue to set market prices and hold substantially the same level of market power and influence that led to DIRA being extended in 2010. While independent processors have grown their market share, we have also seen the bankruptcy of New Zealand Dairies Limited (NZDL), and a series of recent and untested investments by new players. While Open Country looks forward to a strengthening presence of independent processors, it will be important to watch how these investments fare. We believe that Fonterra still has the incentive and ability to exercise its market power in a way that harms dairy industry productivity.

DIRA was intended to create the conditions for entry for more efficient firms—with the intention that its transitional arrangements would fall away once they had done their job. Open Country's position is that DIRA's transitional arrangements have not yet finished doing their job and that this issue should be revisited once competitive and contestable dynamics have evolved that are sufficient to put robust competitive pressure on Fonterra.

Competition is strengthening but is not yet sustainable without DIRA's open entry and exit rules

We welcome the Commission's focus on the existing and potential future state of competition as driving the analysis of how the regulatory regime should evolve. Open Country's views on the state of competition at the farm gate[1] since the last review in 2010[2] are that:

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[1] Open Country agrees with the Commission that the two relevant markets to consider are the purchase/sale of milk at the farm gate and at the factory gate, but considers the Commission should focus its review on competition at the farm gate. The factory gate is almost solely supplied by Fonterra through DIRA milk, and the

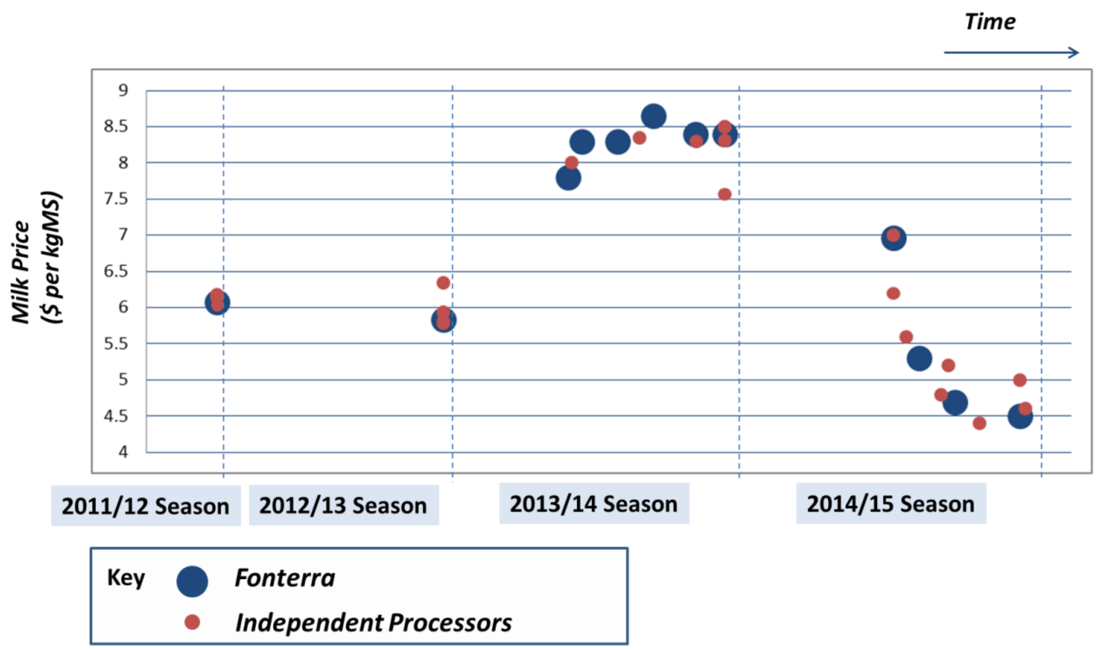
- Fonterra is clearly still setting market prices for milk
- Independent processors have had a mixed success story with market share growth but a series of recent and untested investments, and the bankruptcy of NZDL.

Fonterra is clearly still setting market prices for milk

Open Country's experience is that Fonterra is clearly still setting market prices for milk. Independent processors simply cannot attract supply without offering a price that is at or benchmarked against Fonterra's milk price. Even where independent processors compete with a higher quality service offering, such as giving farmers greater certainty on pay-outs, these pay-outs are still benchmarked against Fonterra's pay-outs.

Although public data is limited, Figure 1**Error! Reference source not found.** provides some evidence for this from the pricing announcements of Fonterra and independent processors. Independent processors commonly time announcements of similar milk prices shortly after Fonterra's announcements.

Figure 1: Independent Processors Appear to Generally Follow Fonterra's Price



Source: Public announcements of dairy processors (Fonterra, Synlait, Miraka, Westland, Open Country)

only other substantive but small supply is from processors entering into contingency arrangements (akin to insurance contracts). As a result, this market is unlikely to exist in any material size if the DIRA milk regulations are removed (as noted by economists in the past: see NERA 'An Assessment of the DIRA Triggers: Report to the Ministry of Agriculture and Forestry' 30 March 2010 at p.22).This will leave competition at the farm gate being the only real source of competitive pressure on Fonterra.

[2] See Ministry of Agriculture and Fisheries 'Extension of the Pro-Competition Provisions of the Dairy Industry Restructuring Act 2001—Regulatory Impact Statement' July 2010: http://www.treasury.govt.nz/publications/informationreleases/ris/pdfs/ris-maf-epcpdira-aug10.pdf.

Independent processors have had a mixed success story

While independent processors have grown in the 5 years since the 2010 DIRA review, this growth is not yet at a level that justifies removing DIRA's pro-competition regulation. 5 years ago, the Ministry of Agriculture and Forestry found that:[3]

- There were five main independent processors (Westland, Tatua, Open Country, Synlait and NZDL)
- Two of them would not constrain Fonterra given geographical isolation (Westland) and a policy of not competing for suppliers (Tatua)
- None of the independent processors were large enough to effectively constrain Fonterra
- Fonterra had both the ability and incentive to exercise its market power without DIRA
- It would likely take at least two processors with material market shares (approximately 10 percent) and significant spare processing capacity to consider the state of competition sufficient to remove DIRA.

Since then:

- NZDL went bankrupt and Fonterra acquired its assets (and DIRA was part of the Commission's reasoning for clearing this merger)[4]
- The larger independent processors have grown but over the last seven years Fonterra has increased its milk supply by more than double the amount it has lost to independent processors.[5] In addition, the largest independent processors are still only half the level MAF indicated was necessary for robust competition
- New processors have entered the market, however, they have small market shares and their investments are largely untested. The majority of their investments have been made in the past 2 years—and in value-add rather than commodities processing.

Accordingly, independent processors have had a mixed success story that does not yet demonstrate a robustly competitive market—particularly given MAF's findings that it would likely take at least two independent processors each having 10 percent market share. While it will be important to consider how new investments fare in the coming years, they cannot be relied on yet as imposing competitive pressure on Fonterra.

Open Country views extending DIRA as the most efficient path for the dairy industry to transition to deregulation

Open Country believes there are significant risks that the state of competition is currently insufficient for the Commission to suggest deregulation at this time. In addition, Castalia's report highlights that if Fonterra does have market power, there are potentially harmful inefficiencies that might arise from deregulation. We urge the Commission to consider these carefully. If, as Open Country expects, the Commission finds that Fonterra still has significant market power, and in addition that the potential

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[3] Ministry of Agriculture and Fisheries 'Extension of the Pro-Competition Provisions of the Dairy Industry Restructuring Act 2001—Regulatory Impact Statement' July 2010: http://www.treasury.govt.nz/publications/informationreleases/ris/pdfs/ris-maf-epcpdira-aug10.pdf.

[4] Commerce Commission Clearance Register – Fonterra Co-operative Group Limited and New Zealand Dairies Limited: http://www.comcom.govt.nz/business-competition/mergers-and-acquisitions/clearances/clearances-register/detail/758.

[5] Fonterra has increased its milk supply by approximately 390,000 kgMS over the period 2008 to 2014, while independent processors have increased their milk supply by only 190,000 kgMS. Open Country analysis using Fonterra's public reports and New Zealand milk supply data from the Dairy Companies Association of New Zealand: http://www.dcanz.com/statistics.

harmful outcomes highlighted by Castalia are likely to occur, then Open Country believes DIRA should be extended by:

- **Extending open entry and exit**—as this is the core of DIRA
- **Extending the milk price regulatory oversight regime and investigating incremental improvements**—to promote ongoing review of the dairy industry during the transition, and to strengthen the pathway to deregulation.

Extending open entry and exit

Open Country recommends extending open entry and exit as this is the core of DIRA. As noted in Castalia's report attached, it is currently the main means by which:

- Farmers have the confidence and ability to choose to supply an independent processor
- Independent processors have the confidence to invest in efficient plant investments/expansion and ability to attract efficient supply
- Farmers have the confidence to make long-term investments to convert to dairy farming, especially given the need to sell perishable milk at a fair price with significant risk around the seasonality of supply.

Open Country recommends the Commission set a specified date for revisiting whether the dairy industry is sufficiently competitive to progress deregulation.

Open Country agrees with the Commission that a mechanistic approach whereby Fonterra reaching a percentage market share automatically triggers deregulation is not responsible. The task, then, is to create a process for a future for a review—and decide on a trigger for when that will happen. Open Country sees two options: choosing a new market share percentage threshold, or setting a specified date. While Open Country would be comfortable with either approach, we recommend setting a date as this is the simplest approach and it avoids the guesswork in determining at what market share Fonterra might no longer have market power. It also recognises the need to give the industry and investors adequate certainty over major potential regulatory changes. The risks of this approach are also limited given that the Government would always have the power to amend DIRA and accelerate the review process should it be deemed necessary.

Extending the milk price monitoring regime and investigating incremental improvements

If open entry and exit are extended, Open Country sees merit in extending the low cost milk regulatory oversight regime to promote ongoing review of the dairy industry during the transition to deregulation.

Open Country also encourages the Commission's signalling that it may suggest changes to the existing regulation as part of a transition pathway option, and agrees this is part of the scope of the Commission's review. Section 148(4) of DIRA requires the Commission, if it concludes that competition is **insufficient**, to:

- Consider whether the market share thresholds should be reset
- Identify "options for a transition pathway to deregulation (if any)"
- Report on whether a particular option or set of options "should be pursued".

Given the Commission is to report on options **only if competition is insufficient**, "options for a transition pathway..." must be intended to encompass reporting on options for improving the existing regulatory regime.

While Open Country accepts that the choice of how to give effect to DIRA's objectives is ultimately for the Minister to decide, the purpose of the report under Section 148(2) of DIRA is to identify options for the Minister. Accordingly, we encourage the Commission to consider options for how to improve DIRA that will enhance competition and contestability and therefore further DIRA's purpose of creating a transition pathway to deregulation.

As part of the Commission's regular milk price reviews, Open Country has provided suggestions on how that regulation could be made more effective, including:[6]

- Improving the milk price manual to better reflect the risks that an efficient 'real world' processor would face
- Increasing transparency in how the milk price is set
- Reducing Fonterra's discretion in setting the milk price.

We trust the Commission will consider the submissions of Open Country and other industry stakeholders as part of this process.

Conclusion

Like the rest of New Zealand, Open Country wants the New Zealand dairy industry to succeed. Open Country therefore benefits from a 'New Zealand success story' for dairy.

While Open Country continues to suggest recommendations for how to improve DIRA, Open Country firmly believes that extending open entry and exit is the right answer for the dairy industry until competition is sufficiently robust to remove it.

Open Country looks forward to reviewing the Commission's draft report, and the Commission's further analysis of the matters set out in this letter and Castalia's report.

Best regards,

Steve Koekemoer

Chief Executive Officer

Open Country Dairy Ltd

[6] See Open Country submissions on the milk price manual and milk price calculation published on the Commerce Commission's website: http://www.comcom.govt.nz/regulated-industries/dairy-industry/.