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Review of the state of competition in the New Zealand Dairy Industry

Draft report

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Executive Summary

Purpose of report

- X1 The purpose of this draft report is to seek interested parties' views on our draft conclusions on the state of competition in the New Zealand dairy industry.
- X2 The final report for the Minister of Primary Industries (the Minister) is due on 1 March 2016. It has been requested by the Minister, in consultation with the Minister of Commerce, under the Dairy Industry Restructuring Act 2001 (DIRA).

Overall Draft Conclusion

- X3 Our primary concern is that competition in the factory gate is very limited. Without the DIRA Regulation, Fonterra would be able to increase the price of raw milk it sells to other domestic processors. This would result in higher prices for dairy products in downstream domestic markets.
- X4 Because of these concerns, we do not think that there is sufficient competition to remove the DIRA Regulation at this time. This is an on-balance assessment of the costs and benefits.
- X5 The pathway to deregulation requires the development of a factory gate market. We recommend that Ministers consider options for changing the regulations in a way that facilitates the development of that market.

Background

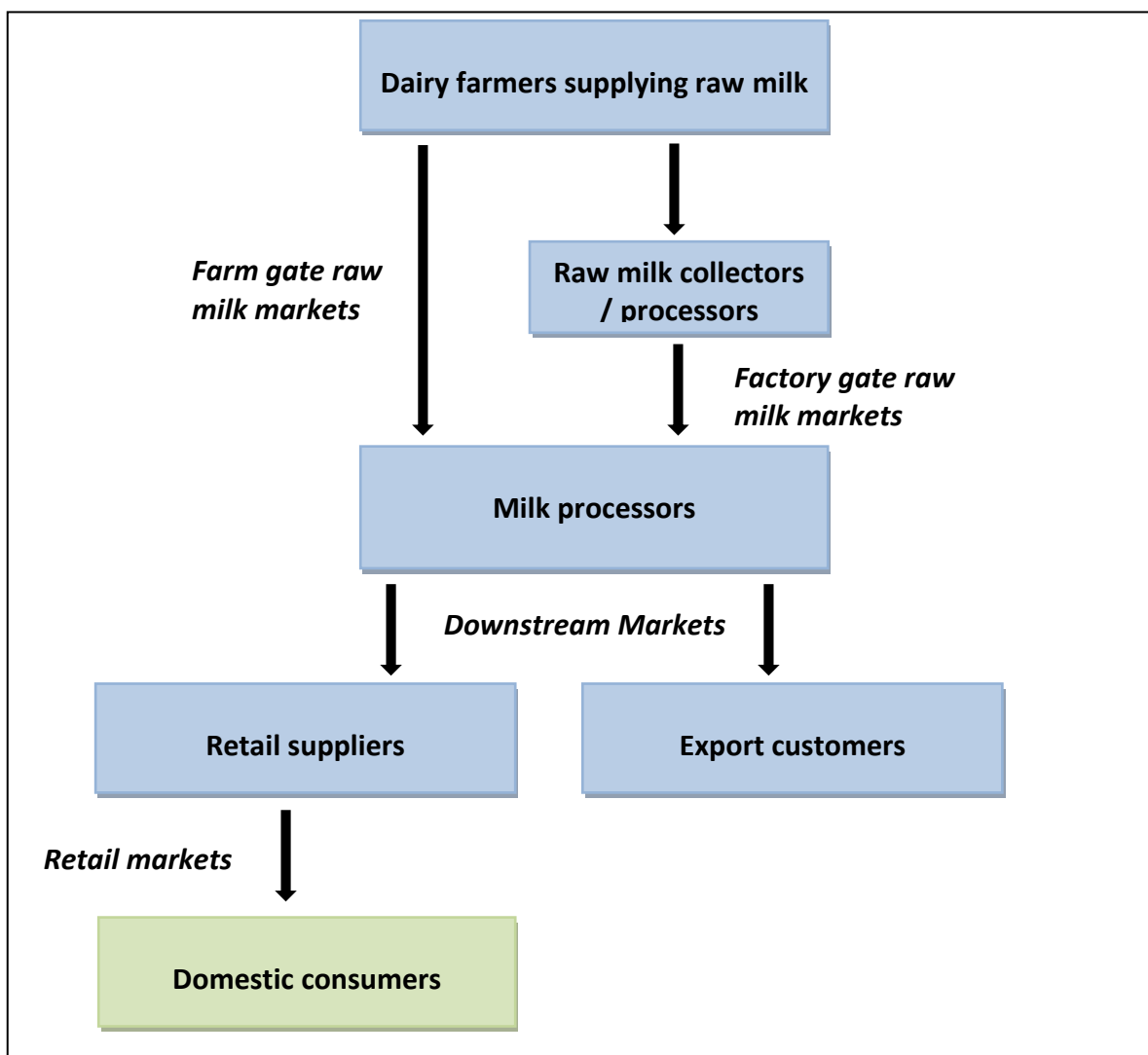
- X6 The DIRA provided for an authorisation under the Commerce Act 1986 to merge the two largest dairy co-operatives at the time (New Zealand Dairy Group and Kiwi Co-operative Dairies) with the New Zealand Dairy Board to form Fonterra—a single co-operative company.
- X7 The DIRA also introduced legislation to promote the efficient operation of dairy markets in New Zealand by regulating the activities of Fonterra. This includes subparts 5, 5A, and Part 2 of the DIRA and the Dairy Industry Restructuring (Raw Milk) Regulations 2012. Collectively these are known as the DIRA Regulation.
- X8 The DIRA Regulation was designed to be temporary with a review scheduled in 2015.

Our review

- X9 As part of this review we assessed the state of competition under the DIRA Regulation. In particular we reviewed two relevant markets:
 - X9.1 the farm gate market, in which processors of raw milk including Fonterra compete to acquire raw milk from farmer suppliers; and
 - X9.2 the factory gate market, in which processors supply raw milk to each other (primarily when they do not collect it direct from farmers themselves).
- X10 We have taken into account the effects of competition in the farm gate and factory gate markets in downstream markets in which processors including Fonterra supply wholesale and retail dairy products.

- X11 Under the Raw Milk Regulations, Fonterra is required to supply raw milk to IPs including separate provision for Goodman Fielder in the factory gate market. We refer to this as 'DIRA milk'.
- X12 Fonterra is the only firm with this obligation, and is the monopoly seller of DIRA milk. The DIRA milk price is specified to be the farm gate milk price plus transport costs.
- X13 Some IPs (Independent Processors) acquire raw milk that is not subject to the Raw Milk Regulations either from Fonterra or from another IP. We refer to this as 'non-DIRA milk'. The price and terms for non-DIRA milk are typically negotiated between the parties.
- X14 The following diagram illustrates the supply chain in the New Zealand dairy market.

Illustrative supply chain of the New Zealand dairy market



Draft conclusions

The state of competition in the New Zealand dairy markets with the DIRA Regulation

- X15 We conclude that Fonterra still has market power in both the farm gate market and the factory gate market.

The farm gate market

- X16 We consider that Fonterra does not have the ability or incentive to exercise market power (by decreasing prices below competitive levels) in the farm gate market. In particular, as a co-operative, Fonterra is owned by its suppliers and would be unlikely to exercise market power against them.
- X17 We also conclude that Fonterra does not have the ability to engage in conduct to prevent or hinder rival processors from accessing raw milk at the farm gate. We consider this is a result of a combination of the DIRA Regulation (which helps ensure contestability), Fonterra's co-operative nature, and constraints from competitors.

The factory gate market

- X18 There is limited competition at the factory gate but the DIRA Regulation prevents Fonterra from raising prices for DIRA milk above competitive levels. The combination of the requirement for Fonterra to supply regulated volumes of milk to IPs at the factory gate, at a price which is also subject to the DIRA Regulation, may be restricting further participation in the factory gate market.

No change from the conclusions in our 2011 report on wholesale and retail milk markets

- X19 In 2011 the Commission considered whether to initiate an inquiry under Part 4 of the Commerce Act 1986 into milk prices. In relation to the wholesale and retail dairy markets, we concluded at that time, that a full pricing enquiry was not warranted. Our current review has found no new information that would alter the conclusions reached in our 2011 inquiry.

What competition would look like without the regulations

- X20 To assess what competition would look like without the DIRA Regulation, we assess whether Fonterra would be likely:
- X20.1 to exercise market power against farmer suppliers at the farm gate in the purchase of milk by decreasing prices below competitive levels;
 - X20.2 to exercise market power against IPs at the factory gate in the sale of milk by increasing prices; and
 - X20.3 to prevent IPs from effectively competing (generally referred to as foreclosure) by:
 - i. restricting IPs from accessing milk from farmers at the farm gate by either increasing the farm gate price, or locking farmers into longer term contracts; and
 - ii. raising prices or restricting access to factory gate milk for IPs who sell to customers in domestic downstream dairy markets (such as milk and cream), which may impact on the amount, quality, and variety of dairy produce available.

The exercise of market power against farmer suppliers

X21 We conclude that the DIRA Regulation places some limit on Fonterra's ability to exercise buyer side market power, such as reducing the farm gate milk price paid to farmers. In the absence of the DIRA Regulation, Fonterra would have greater ability but little or no incentive to use this power to the detriment of its own shareholding farmers.

The exercise of market power at the factory gate

X22 We conclude that without the DIRA Regulation, we would expect the price of factory gate DIRA milk currently supplied to IPs to increase. This will reflect Fonterra's market power in the factory gate market.

X23 The current market price for non-DIRA milk supplied by Fonterra to IPs may indicate what that price increase would likely be.

Fonterra's ability to prevent IPs from effectively competing in the farm gate or factory gate (foreclosure)

X24 Fonterra would gain no benefit from foreclosing IPs who mainly export. This is because such foreclosure would not enhance Fonterra's market power in the export market, where Fonterra is a price-taker and would not be able to raise the price of its own exported product.

X25 Fonterra may have the incentive but not the ability to foreclose some other IPs which produce for the domestic market, because these IPs have alternate sources of raw milk supply.

X26 IPs without alternate sources of supply could be foreclosed by Fonterra but there is minimal incentive for Fonterra to do so as there would be little benefit.

Competition in the farm gate and factory gate markets is insufficient

X27 We do not think there is sufficient competition at the factory gate to conclude that the markets would be more efficient without the DIRA Regulation. The factory gate market also benefits from the regulations at the farm gate, particularly the open entry and exit regulations.

X28 Our assessments of the costs and benefits of removing the DIRA Regulation indicate the costs are similar in size to the benefits. However removing regulation now involves risks, including the risk of disruption to markets during the transition.

Reset both market share thresholds—no need for additional expiry triggers

X29 Our draft recommendations are to:

X29.1 reset the market share thresholds from 20% to 30%, as we found that despite having reached the 20% threshold in the South Island, we consider competition is insufficient. When the 30% threshold is reached in either the North or South Island, this should trigger another report on the state of competition in the New Zealand dairy industry;

- X29.2 reset the time limit provision of the DIRA to the 2021/22 season. This would also require a report on the state of competition, even if the market share thresholds had not been met by that time; and
- X29.3 not add additional or alternative expiry triggers. We consider the current market share thresholds are both suitable and simple measures, sufficient to trigger a future report on the state of competition.

Options for a transition pathway to deregulation

- X30 Our main concern with full deregulation at this time is that competition is not yet sufficient to prevent Fonterra increasing the price of raw milk at the factory gate above the competitive price, and that this has the potential to adversely affect domestic retail markets.
- X31 We believe a staged approach to deregulation is appropriate. The transition path should encourage market participants to depend less on the regulations over time. A staged approach mitigates the risks associated with deregulation. The deregulation process should involve a well-signalled, simple glide path for market participants.
- X32 We considered options for transition pathways for each core element of the DIRA Regulation. At this point we have not identified any subparts to repeal in entirety but we do consider amendments should be made.
- X33 Our draft recommendation is for the Minister to consider amendments to the Raw Milk Regulations that facilitate the development of a more effective and functioning factory gate market.
- X34 Once there is a functioning factory gate market, the risks associated with full deregulation will be significantly lower.
- X35 We consider that the recommended amendments would promote the efficient operation of New Zealand dairy markets.
- X36 We welcome submissions from interested parties, in particular where they can provide evidence on the likely costs and benefits of deregulation and the emergence of a factory gate market.

1. Introduction

Purpose of this draft report

- 1.1 The purpose of this report is to seek interested parties' views on our draft conclusions on the state of competition in the New Zealand dairy industry.
- 1.2 The final report for the Minister is due 1 March 2016. It has been requested by the Minister, in consultation with the Minister of Commerce, as required by the DIRA.
- 1.3 Within 90 days of receiving our report, s 148(3) of the DIRA requires the Minister¹ 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.²
- 1.4 The final report will provide the Minister with our view on the state of competition in the dairy industry, to assist the Minister to make the decision required under s 148(3) of the DIRA.

Structure of this report

- 1.5 In this chapter, we:
 - 1.5.1 explain the scope of the report;
 - 1.5.2 indicate our process for reporting to the Minister;
 - 1.5.3 let you know how interested parties can contribute; and
 - 1.5.4 outline the process for disclosing information from submissions.
- 1.6 In the following chapters, we:
 - 1.6.1 present background information on the DIRA (chapter 2);
 - 1.6.2 explain the evaluation process we followed and describe the framework we used to evaluate the sufficiency of competition (chapter 3);
 - 1.6.3 report on the state of competition in the farm gate market and the factory gate market (chapter 4);

¹ Under s 5 of the DIRA, 'Minister' means the Minister of the Crown who is responsible for the administration of the DIRA. The DIRA is administered by the Ministry for Primary Industries.

² Section 147 of the DIRA sets out market share threshold triggers that specify when the industry-specific regulations relating to Fonterra's conduct will cease to operate in each of the North and South islands.

- 1.6.4 report on what the state of competition in the farm and factory gate markets and the downstream domestic market could be without the DIRA Regulation (chapter 5);
- 1.6.5 report on the efficiencies and inefficiencies created by the DIRA Regulation (chapter 6); and
- 1.6.6 lay out our thoughts on resetting the market share thresholds and potential pathways to deregulation (chapter 7).

Scope of our report

- 1.7 The scope of our report is determined by the terms of reference issued to us by the Minister.³
- 1.8 The objectives of our report under these terms of reference are:
 - 1.8.1 to provide an assessment of the state of competition in the New Zealand dairy industry; and
 - 1.8.2 if the state of competition is insufficient, to ascertain whether the market share thresholds should be reset, the options for a transition pathway to deregulation (if any), and whether particular deregulation options (if any) should be pursued.
- 1.9 Our report addresses specific questions in the terms of reference:
 - 1.9.1 What is the state of competition that exists in the relevant New Zealand dairy markets, in particular the farm gate and factory gate markets?
 - 1.9.2 In relation to the wholesale and retail dairy markets, is there new information that would alter the conclusions reached in the Commission's preliminary inquiry into domestic milk markets in 2011 under Part 4 of the Commerce Act 1986?
 - 1.9.3 In the absence of the provisions of Subparts 5 and 5A of Part 2 of the DIRA and/or the provisions of the Dairy Industry Restructuring (Raw Milk) Regulations 2012 (together referred to as the DIRA Regulation'):
 - 1.9.3.1 Is the current state of competition in the relevant New Zealand dairy markets sufficient to ensure the efficient and contestable operation of these markets?
 - 1.9.3.2 Would Fonterra be likely to have both the ability and the incentive to exercise market power against competitors, suppliers

³ Ministry for Primary Industries "Terms of Reference for a Report on the state of competition in the New Zealand dairy industry" (3 June 2015). Available at: <http://www.comcom.govt.nz/regulated-industries/dairy-industry/report-on-the-state-of-competition-in-the-new-zealand-dairy-industry/>

or purchasers in one or more of the relevant New Zealand dairy markets?

- 1.9.4 If the current state of competition is insufficient in one or more of the relevant New Zealand dairy markets, the Terms of Reference asks us to address these additional questions:
- 1.9.4.1 Should either or both of the market share thresholds specified in s 147 of the DIRA be reset (and, if so, to what new level(s))?
 - 1.9.4.2 Are there other expiry triggers that should be provided for, either in addition to or in place of the market share thresholds?
 - 1.9.4.3 What options there are for a transition pathway to deregulation, and if there are any, which of the options should be pursued?
- 1.10 In undertaking our assessment of whether the state of competition in the relevant New Zealand dairy markets is sufficient or insufficient, we examined the impact of the DIRA Regulation on competition and the efficient operation of those dairy markets.
- 1.11 We have found the state of competition is insufficient. As a result we considered whether markets would be more efficient with or without the regulation. On balance we concluded that the DIRA Regulation should remain. We make suggestions for potential changes to the existing DIRA Regulation as part of transition pathway options that could be pursued.

Next steps: our process for reporting to the Minister

- 1.12 Table 1.1 sets out our process for reporting to the Minister, with indicative dates for each step in the process.

Table 1.1: Process for reporting to the Minister, with indicative dates

Indicative date	Process step
6 November 2015	Draft report published. This includes our findings on the state of competition, and our initial views on pathways to deregulation and resetting of thresholds. We are seeking submissions on our draft report.
4 December 2015	Submissions due on draft report.
18 December 2015	Cross-submissions due.
29 February 2016	Final report published.

How interested parties can contribute

- 1.13 We invite written submissions on this draft report no later than **5pm, Monday, 4 December 2015**.
- 1.14 We invite cross-submissions on this paper no later than **5pm, Monday, 18 December 2015**.

1.15 Submissions on this paper should be addressed to:

Alex Sim

Chief Adviser, Regulation Branch

Email: regulation.branch@comcom.govt.nz

Format for responses

- 1.16 Please include "Submission on the Dairy Competition Review Draft Report, 4 December 2015" in the subject line of your email.
- 1.17 For cross-submissions please include "Cross-submission on the Dairy Competition Review Draft Report, 18 December 2015" in the subject line of your email.
- 1.18 We prefer submissions in both a format suitable for word processing (such as a Microsoft Word doc), and a 'locked' format (such as a PDF) for publication on our website.

Disclosure of your submission

- 1.19 We intend to publish all submissions on our website. We encourage full disclosure of submissions so that all information can be tested in an open and transparent manner.
- 1.20 However, if you wish to provide information in confidence, please note the following:
- 1.20.1 If you include confidential information in your submission, clearly mark it as confidential.
 - 1.20.2 Provide two versions of your submission: one confidential and one public.
 - 1.20.3 You are solely responsible for ensuring confidential information is not included in your public version.
 - 1.20.4 You need to ask us to make an order under s 100 of the Commerce Act 1986 in respect of information you do not wish to be made public.
 - 1.20.5 Your need to make this request when you send your information to us. Include the reasons why the relevant information should not be made public. We will provide further information on s 100 orders if you need it.
- 1.21 Confidential information covered by an s 100 order remains confidential for a limited time only. Once the order expires, we follow our usual process in response to any request for information under the Official Information Act 1982.

2. Background

Purpose of chapter

- 2.1 This chapter gives the history of the DIRA and Raw Milk Regulations and how they have been amended. Note that in this report we refer to the DIRA and Raw Milk Regulations jointly as ‘the DIRA Regulation’.

History and scope of DIRA Regulation

- 2.2 The DIRA provided for an authorisation under the Commerce Act 1986 to merge the two largest dairy co-operatives at the time (New Zealand Dairy Group and Kiwi Co-operative Dairies) with the New Zealand Dairy Board to form Fonterra—a single co-operative company.
- 2.3 The Commerce Act authorisation recognised that Fonterra would have a dominant market position in a number of domestic New Zealand dairy markets as a result of this merger.⁴ The DIRA provides measures designed to reduce the risks associated with that dominant position. One purpose of DIRA is “to promote the efficient operation of dairy markets in New Zealand by regulating the activities of Fonterra⁵ to ensure New Zealand markets for dairy goods and services are contestable”.⁶
- 2.4 Subpart 5 of Part 2 of the DIRA regulates dairy markets and imposes certain obligations on Fonterra. The purpose of the subpart is “to promote the efficient operation of dairy markets in New Zealand” (section 70). The subpart promotes a number of principles under section 71, including:⁷
- 2.4.1 IPs must be able to obtain raw milk and other dairy goods and services necessary for them to compete in dairy markets;
 - 2.4.2 Fonterra must accept applications by new entrants and shareholding farmers to supply it with milk, as shareholding farmers; and
 - 2.4.3 Fonterra must not discriminate between new entrants and shareholding farmers whose circumstances are the same.
- 2.5 To ensure the dairy markets in New Zealand operate efficiently, subpart 5 of the DIRA sets out various rules that govern certain aspects of Fonterra’s behaviour, including:

⁴ Facilitation of the Proposed Dairy Industry Merger: Paper One (9 April 2001), Hon Jim Sutton, Minister of Agriculture, paragraph 19.

⁵ References to ‘new co-op’ in the legislation have been replaced with ‘Fonterra’ in this report.

⁶ Dairy Industry Restructuring Act 2001, s 4(f).

⁷ Dairy Industry Restructuring Act 2001, ss 71(a) to (c).

- 2.5.1 Fonterra’s obligation to accept applications to supply Fonterra with milk⁸, and the right of shareholding farmers to cease or reduce⁹ the supply of milk (the open entry and exit regime);
 - 2.5.2 a rule allowing Fonterra shareholding farmers to supply up to 20% of their weekly production to IPs¹⁰ (the ‘20% rule’);
 - 2.5.3 rules ensuring that, at any time, at least a third of the milk solids produced within a 160km radius¹¹ of any point in New Zealand is supplied either under contracts with IPs, or under short term contracts with Fonterra (the ‘33% rule’); and
 - 2.5.4 a milk price monitoring regime intended to promote greater transparency of Fonterra’s base milk price setting processes. We discuss this further in paragraph 2.8 below.
- 2.6 DIRA also provides for the Dairy Industry Restructuring (Raw Milk) Regulations 2012¹² that include requirements such as currently requiring Fonterra to supply up to 795 million litres of milk to IPs at a regulated price. Individual IPs are limited to 50 million litres per season at the regulated price, except for Goodman Fielder, whose limit is 250 million litres per season.
- 2.7 Between 2008 and 2013, the Ministry of Agriculture & Fisheries (MAF, now Ministry for Primary Industries), in consultation with the dairy industry, undertook a review of the DIRA. This review resulted in legislative amendments designed to refine the existing provisions, including:
- 2.7.1 provisions requiring a report on the state of competition¹³ when IPs reach a market share threshold of 20% or more of milk solids collected in a season in either the North Island or the South Island. Unless legislation is passed to keep aspects of the DIRA Regulation, they will expire after the threshold is triggered;
 - 2.7.2 the requirement that the report to the Minister on the state of competition in the dairy industry could lead to resetting the current thresholds and/or adopting measures to promote a transitional pathway to deregulation; and

⁸ Dairy Industry Restructuring Act 2001, ss 73 to 96.

⁹ Dairy Industry Restructuring Act 2001, ss 97 to 105.

¹⁰ Dairy Industry Restructuring Act 2001, s 108.

¹¹ Dairy Industry Restructuring Act 2001, s 107.

¹² Subject to maximum monthly limits, these are detailed in ss 6 to 8 of the Dairy Industry Restructuring (Raw Milk) Regulations 2012.

¹³ Dairy Industry Restructuring Act 2001, s 148.

- 2.7.3 changes to the DIRA to enable Fonterra to change its capital structure¹⁴ and introduce the Trading Amongst Farmers scheme (TAF).
- 2.8 The provisions under subpart 5 of the DIRA and the Raw Milk Regulations are further supported by the milk price monitoring regime under Part 2, subpart 5A of the DIRA, introduced on 27 July 2012.
- 2.8.1 The milk price monitoring regime is intended to promote greater transparency of Fonterra's base milk price setting processes, and greater confidence in the consistency of Fonterra's base milk price with contestable market outcomes. The regime monitors whether the base milk price that Fonterra chooses to set provides the incentive for Fonterra to operate efficiently but does not preclude efficient processors from potentially competing.
- 2.8.2 Subpart 5A was intended to bolster the existing provisions directed at ensuring contestability and efficiency in New Zealand dairy markets. Like section 4(f) of the DIRA, the new milk price monitoring regime has both efficiency and contestability objectives.
- 2.8.3 The Commission reviews Fonterra's Milk Price Manual and base milk price calculation each dairy season against the efficiency and contestability objectives of the DIRA.

¹⁴ Dairy Industry Restructuring Act 2001, ss 109A to 109N.

3. Framework and approach

Purpose of this chapter

- 3.1 This chapter explains the process we followed and the framework we used to consider and report on the state of competition in the New Zealand dairy industry, as requested by the Minister of Primary Industries (the Minister) under section 148A of the DIRA.
- 3.2 In this chapter we outline:
- 3.2.1 our interpretation of ‘sufficient’ and ‘insufficient’ in the terms of reference and section 148 of the DIRA;
 - 3.2.2 the conceptual framework we used to answer the questions in the terms of reference;
 - 3.2.3 the consultations on our proposed evaluation approach;
 - 3.2.4 our analytical approach to answering the questions in the terms of reference; and
 - 3.2.5 our approach when considering pathways to deregulation.

Our interpretation of ‘sufficient’ and ‘insufficient’

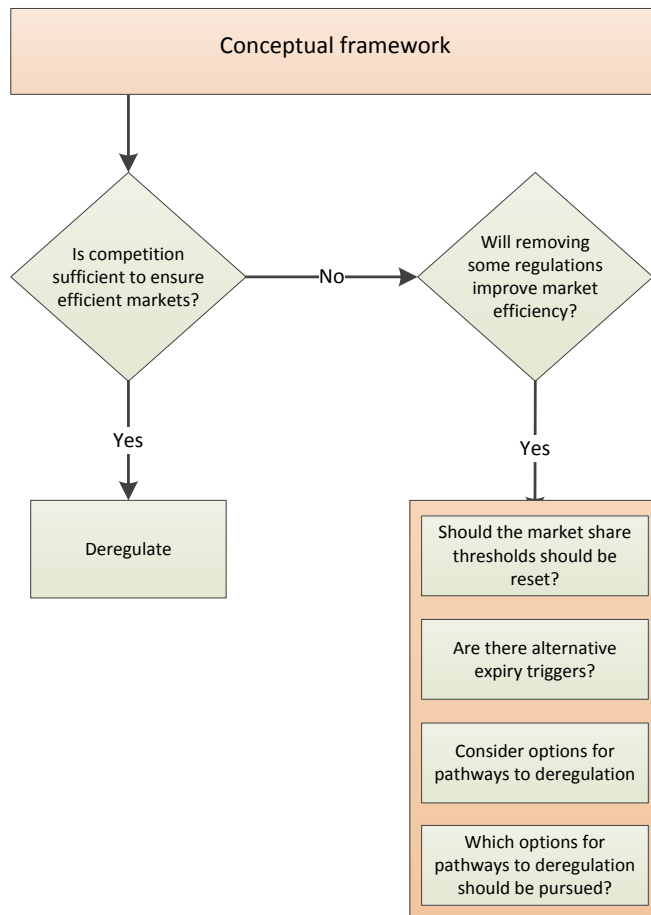
- 3.3 A key question we are required to answer is whether or not the state of competition in the relevant New Zealand dairy markets is sufficient in the absence of the DIRA Regulation.
- 3.4 Under section 148(2)(d)(ii) of the DIRA, we are required to determine whether or not the state of competition in the relevant New Zealand dairy markets is ‘insufficient’.
- 3.5 The terms of reference, however, refer to both efficiency and contestability dimensions. They require us to determine whether:
- 3.5.1 the state of competition in the relevant New Zealand dairy markets is **sufficient** to ensure the efficient and contestable operation of those markets; and
 - 3.5.2 if the state of competition is **insufficient** to consider market share thresholds for deregulation, other potential triggers for deregulation, options for a transition pathway to deregulation, and what options for deregulation should be pursued.
- 3.6 We, therefore, had to decide what the terms ‘sufficient’ and ‘insufficient’ meant before we conducted our review.

- 3.7 We consider that the efficiency purpose is the overriding goal of the DIRA. Our interpretation is therefore driven by the efficiency purpose of the DIRA, and in particular the obligations it imposes upon Fonterra to promote the efficient operation of New Zealand dairy markets.¹⁵
- 3.8 While our review recognises the link between the contestability and the efficiency dimensions, our interpretation is that the state of competition will be sufficient if the relevant New Zealand dairy markets would be more efficient without the DIRA Regulation.
- 3.9 In determining whether the state of competition is sufficient or insufficient we therefore also assessed whether the relevant New Zealand dairy markets would be more efficient with or without the DIRA Regulation.

The conceptual framework for our analysis

3.10 This section describes the conceptual framework we used to carry out our review, see Figure 3.1.

Figure 3.1: Conceptual framework



¹⁵ Refer: Dairy Industry Restructuring Act 2001, s 4(f), s 70, s 71 and s 150A (1).

Is competition sufficient to ensure efficient markets?

- 3.11 We first assessed the relevant markets by analysing their competitiveness and contestability.
- 3.12 We then compared the level of competitiveness and contestability that exists with the DIRA Regulation, with what the level would most likely be without that regulation. In particular, we looked at the extent of Fonterra's ability and incentive to exercise significant market power under both scenarios.
- 3.13 If we had concluded that the degree of competition or contestability would be sufficient to ensure efficient markets without the DIRA Regulation—due to Fonterra not having the ability or incentive to exercise significant market power—we would have recommended removing the DIRA Regulation because the markets would be more efficient without the regulation.

Will removing some or all regulations improve market efficiency?

- 3.14 Contestability and workable competition are sufficient but not necessary conditions for markets to be more efficient without the DIRA Regulation.
- 3.15 We concluded that the level of competition or contestability would not ensure the efficient operation of the markets in the absence of regulation, because we found that Fonterra would have some ability and incentive to exercise significant market power in the relevant markets. We therefore assessed whether the relevant markets would be more efficient without all or some of the regulation. This assessment involved considering the extent to which the different regulations contributed to efficiency and assessing whether the efficiency gains from the regulation were outweighed by any efficiency losses. This balancing exercise is more important where the level of competition or contestability without the regulation is close to ensuring the efficient operation of the markets in the absence of regulation.
- 3.16 If we had found that the relevant markets would be more efficient without all or some of the regulations, then those regulations would no longer promote the purpose of the DIRA. We would then have recommended removing the relevant regulations. In those circumstances we would have identified the regulation that is not promoting efficiency and explained why the market outcomes would be better without that regulation.
- 3.17 As we found, on balance, that the efficiency of the relevant markets was likely to be enhanced by the DIRA Regulation we went on to analyse the matters set out in paragraphs 3.18.1 to 3.18.4 below.

Options to explore if we conclude that the regulations enhance efficiency

- 3.18 As we concluded, on balance, that the markets would be more efficient with all or some of the DIRA Regulation, we examined:
- 3.18.1 whether or not the market share thresholds should be reset;
- 3.18.2 if there are alternative expiry triggers that may be appropriate (other than the market share thresholds);

- 3.18.3 options for pathways to deregulation;
- 3.18.4 which options for pathways to deregulation should be pursued, including recommendations on which options could be further considered by the Ministry of Primary Industries as part of its review processes on the DIRA Regulation.

Consultation on our evaluation approach

- 3.19 On 12 June 2015 we published a paper for public consultation setting out our proposed approach to the review.¹⁶ The main purpose of this consultation was to obtain feedback from dairy industry stakeholders on our proposed evaluation approach.
- 3.20 We received 11 submissions and two cross-submissions on our proposed approach to evaluating the issues. Submissions came from Fonterra, IPs and Federated Farmers.
- 3.21 We considered all information and submissions we received in finalising our evaluation approach.
- 3.22 Most submitters were supportive of our proposed evaluation approach and our interpretation of sufficiency of competition based on the efficiency purpose of the DIRA.
- 3.23 The key arguments of submitters relating to our evaluation approach are set out below.

Approach to assessing whether the state of competition is 'sufficient'

- 3.24 Fonterra, Westland, Goodman Fielder, Open Country, and Federated Farmers all supported our efficiency approach to assessing the 'sufficiency' of the state of competition.¹⁷ Open Country's submission also noted that in practice the workable competition and efficiency tests generally involve assessing the same substance.¹⁸

¹⁶ Commerce Commission "Review of the state of competition in the New Zealand dairy industry: Consultation paper – process and approach" 12 June 2015.

¹⁷ Fonterra "Review of the state of competition in the New Zealand dairy industry: Consultation paper - process and approach" 10 July 2015, paragraph 22; Westland "Review of the state of competition in the New Zealand dairy industry: Consultation paper - process and approach" 10 July 2015, paragraph 11; Goodman Fielder "Review of the state of competition in the New Zealand dairy industry: Consultation paper - process and approach" 10 July 2015, paragraph 1.4; Castalia Strategic Advisors for Open Country Dairy "Review of the State of Competition in the New Zealand Dairy Industry: Comments on the Commission's Approach and Potential Outcomes of Deregulation" 10 July 2015, p.1; Federated Farmers "Submission on: Review of the state of competition in the New Zealand dairy industry Consultation paper – process and approach" p. 11, paragraphs 10.2 to 10.3.

¹⁸ Castalia Strategic Advisors for Open Country Dairy "Review of the State of Competition in the New Zealand Dairy Industry: Comments on the Commission's Approach and Potential Outcomes of Deregulation" 10 July 2015, p.1.

- 3.25 Miraka disagreed with our approach to assessing the ‘sufficiency’ of the state of competition and our interpretation of the DIRA purpose. Miraka asserted that the primary purpose of the DIRA is to ensure contestable markets and not efficiency.¹⁹
- 3.26 We maintained our focus on efficiency when assessing the ‘sufficiency’ of the state of competition. As discussed in paragraph 3.7 we believe efficiency is the primary purpose of section 4(f) and that contestability is the means to achieving efficient markets in the absence of workable competition.

The scope of the review

- 3.27 Miraka, Tatua, Synlait, and Open Country were all concerned that the scope of our review was too confined.²⁰
- 3.28 Miraka said our review should consider changes to the current regulatory framework to ensure that contestable markets are achieved.²¹
- 3.29 Tatua said our proposed approach was biased towards deregulation and that it should admit the opportunity to improve the competition and efficiency of the market through changes to the DIRA Regulation, apart from as part of pathways to deregulation or resetting thresholds.²²
- 3.30 Synlait said the review should also consider if different regulations would better promote efficient dairy markets.²³
- 3.31 Open Country asked us to consider options to improve the DIRA that would enhance competition and contestability and therefore the DIRA’s purpose of creating a transition pathway to deregulation.²⁴
- 3.32 We have largely maintained our proposed approach to the scope of the review as we believe our approach is underpinned by the efficiency purpose of the DIRA and the

¹⁹ Miraka "Review of the state of competition in the New Zealand dairy industry: Consultation paper - process and approach" 10 July 2015, paragraphs 2.4.1-2.4.2.

²⁰ Miraka "Review of the state of competition in the New Zealand dairy industry: Consultation paper - process and approach" 10 July 2015, paragraph 4.2.2; Tatua "Review of the state of competition in the New Zealand dairy industry: Consultation paper - process and approach" 10 July 2015, paragraph 2.1; Synlait "Review of the state of competition in the New Zealand dairy industry: Consultation paper - process and approach" 13 July 2015, p.1; Castalia Strategic Advisors for Open Country Dairy "Review of the State of Competition in the New Zealand Dairy Industry: Comments on the Commission's Approach and Potential Outcomes of Deregulation" 10 July 2015, p.5.

²¹ Miraka "Review of the state of competition in the New Zealand dairy industry: Consultation paper - process and approach" 10 July 2015, paragraph 2.4.2.

²² Tatua "Review of the state of competition in the New Zealand dairy industry: Consultation paper - process and approach" 10 July 2015, paragraph 4.3.

²³ Synlait "Review of the state of competition in the New Zealand dairy industry: Consultation paper - process and approach" 13 July 2015, p.1.

²⁴ Open Country Dairy "Review of the state of competition in the New Zealand dairy industry: Consultation paper - process and approach" 10 July 2015, p.4.

proper interpretation of section 148 of the DIRA and the terms of reference for our report.

- 3.33 We did not attempt to identify whether or not a specific different set of regulations would better promote efficient New Zealand dairy markets, as this is outside of the scope of the terms of reference for the review.
- 3.34 We have, however, suggested possible changes to the DIRA that would enhance efficiency.
- 3.35 Where specific areas of concern were raised during our review or we have identified aspects of the DIRA Regulation that could be materially improved. We have also noted these so that the Ministry for Primary Industries can consider them as part of its policy processes.

The focus on Fonterra

- 3.36 Tatua asserted that our competition assessment should consider all facets of both domestic and global dairy market competition, rather than just focusing on how Fonterra might or might not react in a deregulated environment.²⁵
- 3.37 In contrast to Tatua, Open Country suggested we should focus particularly on how Fonterra might react to different deregulation scenarios.²⁶
- 3.38 We decided the main focus of our review should remain as proposed, namely: whether Fonterra would be likely to have both the ability and the incentive to exercise market power—or to exercise enhanced market power—against competitors, suppliers or purchasers in the relevant dairy markets in the absence of some, or all regulations.

Support for testing the premise ‘what if there was no DIRA Regulation’

- 3.39 Fonterra, Tatua and Open Country all supported our intention to test ‘what if there was no DIRA Regulation’.²⁷
- 3.40 Fonterra noted the risk that the analysis would become overly complex given the number of permutations of ‘what if there was no DIRA Regulation’, potentially obscuring where the efficiency of regulation could be improved.²⁸

²⁵ Tatua "Review of the state of competition in the New Zealand dairy industry: Consultation paper - process and approach" 10 July 2015, paragraph 5.8.

²⁶ Castalia Strategic Advisors for Open Country Dairy "Review of the State of Competition in the New Zealand Dairy Industry: Comments on the Commission's Approach and Potential Outcomes of Deregulation" 10 July 2015, pp.1-2.

²⁷ Fonterra "Review of the state of competition in the New Zealand dairy industry: Consultation paper - process and approach" 10 July 2015, paragraph 23; Castalia Strategic Advisors for Open Country Dairy "Review of the State of Competition in the New Zealand Dairy Industry: Comments on the Commission's Approach and Potential Outcomes of Deregulation" 10 July 2015, pp.1-2.; Tatua "Review of the state of competition in the New Zealand dairy industry: Consultation paper - process and approach" 10 July 2015, paragraph 5.1.

- 3.41 Tatua and Miraka both sought greater clarity on how we would examine the different counterfactuals given there is no alternate history without the DIRA Regulation.²⁹
- 3.42 Open Country asked us to consider how removing the DIRA's components in combination might exacerbate any inefficiencies of deregulation due to interactive, cumulative effects.³⁰
- 3.43 In assessing the likely state of competition without the DIRA Regulation we focused on those regulations that are most effective in constraining Fonterra's market power. Our evaluation of the likely outcomes if the regulation was removed was based on our judgement of Fonterra's ability and incentive to exercise market power in the absence of the different regulations.

Assessment of regional markets

- 3.44 Fonterra and Talleys both suggested we should assess different regions individually.³¹
- 3.45 Miraka suggested a regional assessment would only be relevant where a comprehensive analysis had found competition to be generally sufficient. Miraka also suggested it might still be appropriate for the DIRA Regulation to be retained in specific regions even though competition was sufficient in most regions.³²
- 3.46 We examined differences in regional competition. However, we did not precisely define the geographic dimensions of the markets, as this level of detail would not affect our conclusions.

How we carried out our analysis

- 3.47 This section describes what we did to answer the questions in the terms of reference.

²⁸ Fonterra "Review of the state of competition in the New Zealand dairy industry: Consultation paper - process and approach" 10 July 2015, paragraph 25.

²⁹ Tatua "Review of the state of competition in the New Zealand dairy industry: Consultation paper - process and approach" 10 July 2015, paragraph 3.4; Miraka "Review of the state of competition in the New Zealand dairy industry: Consultation paper - process and approach" 24 July 2015, paragraph 4.2.

³⁰ Castalia Strategic Advisors for Open Country Dairy "Review of the State of Competition in the New Zealand Dairy Industry: Comments on the Commission's Approach and Potential Outcomes of Deregulation" 10 July 2015, p.5.

³¹ Fonterra "Review of the state of competition in the New Zealand dairy industry: Consultation paper - process and approach" 10 July 2015, paragraph 18.1; Talleys "Review of the state of competition in the New Zealand dairy industry: Consultation paper - process and approach" 22 June 2015, paragraphs 7-8.

³² Miraka "Review of the state of competition in the New Zealand dairy industry: Consultation paper - process and approach" 10 July 2015, paragraph 4.1.4; Miraka "Review of the state of competition in the New Zealand dairy industry: Consultation paper - process and approach" 24 July 2015, paragraph 2.3.

The relevant markets

- 3.48 In order to identify the key competitive constraints faced by Fonterra, we identified the areas of overlap between it and IPs, and then considered what, if any, products and geographic regions constituted close substitutes from a supplier's point of view (farm gate markets) and a customer's point of view (factory gate markets).
- 3.49 We identified the same relevant New Zealand dairy markets as those referred to in the terms of reference, in particular:
- 3.49.1 the **farm gate market** in which dairy farmers supply raw milk to dairy processors and dairy processors compete to secure farmer supply; and
 - 3.49.2 the **factory gate market** in which dairy processors supply raw milk they have collected from farmers to other processors and some food and beverage manufacturers, including the current regulated supply of raw milk by Fonterra to IPs.
- 3.50 Competition in the farm gate and factory gate markets also affects competition in downstream dairy markets. We did not include downstream dairy markets as a detailed analysis of the state of competition in these markets is outside the scope of our review. We did, however, consider generally how the DIRA Regulation and possible deregulation might impact competition at this level of the value chain and whether there were reasons to change our findings in the preliminary inquiry into domestic milk markets in 2011 under Part 4 of the Commerce Act 1986.

How we assessed the current state of competition with the DIRA Regulation

- 3.51 To assess the current state of competition in the farm gate and factory gate markets, we looked at the following market indicators of Fonterra's monopsony (buying) power in the farm gate markets and Fonterra's monopoly (selling) power in the factory gate markets:
- 3.51.1 the conditions faced by dairy processors entering or expanding in the relevant markets;
 - 3.51.2 how the DIRA Regulation has lowered barriers to entry and expansion;
 - 3.51.3 the degree of rivalry between Fonterra and the IPs, as indicated by changes in dairy processors' market shares over time, new entry and expansion by IPs, farmer switching (farm gate markets), and dairy processor switching (factory gate markets), Fonterra's response to competition from IPs (farm gate markets); and
 - 3.51.4 the impact of Fonterra's ownership on its incentives to exercise market power.

What competition would look like without the DIRA Regulation

- 3.52 The central aspect of our review was to compare the likely state of competition that would exist in the absence of the DIRA Regulation with the state of competition where the DIRA Regulation continues.

- 3.53 Our assessment of the state of competition with and without the DIRA Regulation considered the different types of DIRA Regulation that are in place. As part of our analysis, we examined the likely effect of the DIRA Regulation on Fonterra's ability or incentive to exercise market power in the relevant markets. As noted in Chapter 4, this includes the following the DIRA Regulation:
- 3.53.1 subpart 5 of Part 2 of the DIRA (which sets out, amongst other things open entry and exit requirements for Fonterra farmers);³³
 - 3.53.2 subpart 5A of Part 2 of the DIRA (which sets out provisions relating to Fonterra's calculation of the base milk price); and
 - 3.53.3 the Raw Milk Regulations (which provide for the regulated supply of raw milk by Fonterra to IPs).³⁴
- 3.54 To assess what competition in New Zealand's dairy industry would be like without the DIRA Regulation, we analysed whether without regulation Fonterra would have the ability and the incentive to exercise monopsony (buyer) power or monopoly (seller) power in the following ways:
- 3.54.1 exercise market power against farmer suppliers at the farm gate in the purchase of milk by decreasing prices below competitive levels;
 - 3.54.2 exercise market power against IPs at the factory gate in the sale of milk by increasing prices; and
 - 3.54.3 prevent IPs from effectively competing (generally referred to as foreclosure) by:
 - 3.54.3.1 restricting IPs from accessing milk from farmers at the farm gate by either increasing the farm gate price or locking farmers into longer term contracts; and
 - 3.54.3.2 raising prices or restricting access to factory gate milk for IPs who sell to customers in domestic downstream dairy markets (such as milk and cream).

Impact of the DIRA Regulation on efficiency

- 3.55 As part of our assessment we also considered the extent to which the DIRA Regulation may have a positive or negative affect on efficiency in the domestic dairy markets. Our assessment included consideration of:

³³ In examining the impact of the Subpart 5 of Part 2 of the DIRA, we also examined distinct provisions within this Subpart separately (eg, sale of milk vats, 20% rule).

³⁴ In examining the impact on the likely future state of competition of the regulations that require Fonterra to supply raw milk to IPs, we took into account reg 6(3), which provides that from 1 June 2016 IPs that have collected (in three consecutive seasons) 30 million litres or more of raw milk from their own farmer suppliers will no longer be eligible for regulated milk.

- 3.55.1 how the different regulations have aided the development of competition with Fonterra and affected its ability to exercise market power;
- 3.55.2 the potential inefficiencies created by the different parts of the DIRA Regulation, including:
 - 3.55.2.1 whether or not the DIRA Regulation result in Fonterra maintaining excess capacity;
 - 3.55.2.2 what inefficiency is created in the factory gate market as a result of the DIRA Regulation;
 - 3.55.2.3 whether or not the DIRA Regulation has incentivised inefficient dairy conversions; and
 - 3.55.2.4 inefficiencies of the base milk price monitoring regime.

Pathways to deregulation

- 3.56 As part of our review, we considered whether the market share thresholds should be reset, including the potential forms of the thresholds, and whether the thresholds usefully illuminate competition concerns to trigger the timely assessment of these markets.
- 3.57 We also considered whether expiry triggers are best used to trigger a competition review or automatic deregulation, and whether the market share expiry thresholds should be replaced or augmented by additional expiry triggers.
- 3.58 Our analysis considered and identified options for transition pathways to deregulation in relation to each core element of the DIRA Regulation. This included a consideration of whether a staged approach is appropriate.
- 3.59 Our analysis also identified and recommended the most beneficial route for a transition pathway to deregulation.

4. State of competition under the DIRA Regulation

Purpose of this chapter

- 4.1 This chapter provides our assessment of the state of competition in the farm gate and factory gate markets with the DIRA Regulation, including consideration of the factors that would affect Fonterra's ability and incentive to exercise market power with regulation in place. This chapter is divided into following sections:
- 4.1.1 Farm gate market—key findings on the state of competition;
 - 4.1.2 Factory gate market—key findings on the state of competition;
 - 4.1.3 Definitions of the relevant domestic dairy markets;
 - 4.1.4 Farm gate market—entry and expansion;
 - 4.1.5 Farm gate market—independent rivalry;
 - 4.1.6 Farm gate market—Fonterra's co-operative structure;
 - 4.1.7 Factory gate market; and
 - 4.1.8 Wholesale and retail supply of fresh processed milk.

Farm gate market—key findings on the state of competition

- 4.2 The farm gate market is the market in which dairy farmers supply raw milk to dairy processors and dairy processors compete to secure farmer supply.
- 4.3 All farm gate markets for the supply of raw milk are still highly concentrated and Fonterra remains the monopoly purchaser of raw milk in a many regional markets.
- 4.4 There are significant barriers to entry in these markets, but the DIRA Regulation and Fonterra's co-operative nature have succeeded in lowering these substantially.
- 4.5 There are signs that the markets are contestable—new IPs have been entering the markets, and existing processors have expanded their operations in several regions. This has led to increased competition for raw milk in those regions.
- 4.6 The level of competition Fonterra faces varies by region, with the most significant competition in Canterbury, Southland, Taranaki and Waikato, where there has been increased milk production, contributing to growth of rival processors and their ability to compete.
- 4.7 In other areas such as Northland, Wairarapa, Hawke's Bay and other pockets around the country, Fonterra faces little or no competition from other processors.
- 4.8 Given Fonterra's continued high market share in many regions, we consider that effective competition is still in the process of emerging in those regional markets, ie we do not consider that the constraints from Fonterra's competitors are currently sufficient to ensure effective competition in those regional markets.

- 4.9 Overall, we conclude that with the current DIRA Regulation, Fonterra does not have the ability to exercise market power either by lowering the farm gate prices below competitive levels, or engaging in conduct to prevent or hinder rival processors from accessing raw milk at the farm gate. We consider this is a result of a combination of the DIRA Regulation (which helps ensure contestability), Fonterra’s co-operative nature, and constraints from competitors.

Factory gate market—key findings on the state of competition

- 4.10 Fonterra is required to supply raw milk to IPs including Goodman Fielder under the Raw Milk Regulations. We refer to this supply as ‘DIRA milk’. Fonterra is the only firm with this obligation and is therefore the monopoly seller of DIRA milk. However, Fonterra’s market power is constrained because the price of DIRA milk is regulated to reflect the price Fonterra pays farmers for milk plus its average transport costs.
- 4.11 DIRA milk has been successful in supporting entry into and competition in farm gate markets by IPs by ensuring a guaranteed supply of raw milk to supplement their own supply from farmers, and in downstream domestic dairy product markets by helping to ensure that IPs that manufacture dairy products for the domestic markets are able to secure raw milk at low prices.
- 4.12 Some IPs do not source DIRA milk or raw milk from their own farmer suppliers. Instead, they acquire raw milk that is not subject to the Raw Milk Regulations, either from Fonterra or from another IP at the factory gate. We refer to this as ‘non-DIRA milk’ and we consider this to be supplied in a separate factory gate market. The non-DIRA milk market is limited and highly concentrated: only Fonterra and [] supply milk outside the DIRA Regulation in any significant and regular quantities.³⁵
- 4.13 While IPs large enough to source their own raw milk supply at the farm gate are unlikely to face significant barriers to supplying raw milk at the factory gate, these processors are not interested in supplying at the DIRA milk price available to most who wish to buy raw milk at the factory gate.
- 4.14 Where Fonterra (or occasionally IPs) supplies other processors that do not qualify for DIRA milk with non-DIRA milk (for all or part of their factory gate requirements), they do so at a price that is substantially higher than the price of DIRA milk.³⁶ The prices charged by Fonterra for non-DIRA milk [].
- 4.15 Other IPs that are potential entrants to the factory gate market have indicated they would consider supplying that market at the right price.

³⁵ []

³⁶ As noted above, only [] supplies non-DIRA milk on a regular basis.

- 4.16 Given the high concentration levels in the factory gate markets and the limited participation by IPs, we do not think the regional factory gate markets are currently characterised by effective competition.

Definitions of the relevant domestic dairy markets

- 4.17 This section explains how we identified the relevant markets in the domestic dairy industry, in order to assess the current state of competition and how the DIRA Regulation affects them. The relevant markets are:

- 4.17.1 regional farm gate markets for raw milk;
- 4.17.2 regional factory gate markets for DIRA milk; and
- 4.17.3 regional factory gate markets for non-DIRA raw milk.

- 4.18 We defined these markets to help identify and assess the competitive constraints Fonterra faces and would likely face without the DIRA Regulation. A market encompasses actual and potential transactions between sellers and buyers, and market definition seeks to capture the factors that directly shape and constrain rivalry between buyers and sellers.

- 4.19 As the concern is about Fonterra’s market power, we focused our analysis on Fonterra’s market power as a buyer of raw milk from farmers in the farm gate markets, and as a seller of raw milk to other dairy processors in the factory gate markets.

- 4.20 A market is defined in the Commerce Act as “a market in New Zealand for goods and services as well as other goods and services that, as a matter of fact and commercial common sense, are substitutable for them”.³⁷ In general, the more closely substitutable two products are, the closer the competition and the greater the competitive constraint between the products.

- 4.21 We define the markets in a way that best isolates the key competition issues relevant to our enquiry. In many cases this may not require us to precisely define the boundaries of a market. Accordingly, while we considered differences in regional competition, we did not precisely define the geographic dimensions of the markets as this would not affect the conclusions of our analysis.

- 4.22 The DIRA Regulation and competition in the farm gate and factory gate markets also affect downstream domestic dairy markets as well as the strength of export-orientated firms. We did not explicitly define these downstream markets but we considered how the DIRA Regulation might impact competition at those levels of the value chain.

- 4.23 Attachment E sets out our reasons for identifying the above relevant markets.

³⁷ Commerce Act 1986, s 3 (1A).

Farm gate markets

- 4.24 The farm gate markets are the markets in which dairy farmers supply raw milk to dairy processors and dairy processors compete to secure farmer supply.
- 4.25 Competitive pressure can be applied to Fonterra from two sources—IPs competing for farmers to supply them with raw milk and the threat of entry by IPs who may do so.
- 4.26 In order to assess the current extent of competition in the farm gate market we looked at:
- 4.26.1 the conditions of entry and expansion in the market and their role in influencing the likelihood of entry and expansion by existing or new competitors;
 - 4.26.2 the effect of the DIRA Regulation on entry and expansion;
 - 4.26.3 the degree of independent rivalry between Fonterra and other dairy processors as indicated by changes in market shares over time, new entry and expansion, and farmer switching; and
 - 4.26.4 the effect of Fonterra’s co-operative structure on its incentives to exercise market power.

Conditions of entry and expansion

- 4.27 One of the methods we used to assess the current state of competition in the farm gate markets was to look at the conditions faced by dairy processors entering or expanding in these markets.
- 4.28 An effectively competitive market will generally have no significant barriers to entry or expansion.³⁸ Entry or expansion will generally occur when the expected profits from entry or expansion are positive. Certain market conditions, commonly referred to as barriers to entry and expansion, can impact the likelihood of positive profits.
- 4.29 The likelihood of entering or expanding in dairy milk processing in New Zealand may be affected by the following factors:
- 4.29.1 the risk of sunk costs which are not recoverable on exit;
 - 4.29.2 economies of scale—a new entrant needs to have a sufficient share of the market (or a reasonable expectation of reaching such share) to operate efficiently and have low enough costs to compete effectively;

³⁸ While the proposition that a firm’s market power depends substantially on the level of barriers to entry and expansion in the relevant market is well established in New Zealand competition law (see *Southern Cross Medical Care Society v Commerce Commission* (2001) 10 TCLR 25), New Zealand’s courts have subsequently highlighted that the question of whether conditions in a market qualify as a barrier to entry, however defined, is less important than whether those conditions have the potential to prevent, impede, or slow entry and expansion.

- 4.29.3 difficulties in accessing a secure source of raw milk and product distribution channels;
- 4.29.4 the risk (in the absence of the DIRA Regulation) that Fonterra would engage in strategic behaviour to discourage prospective entrants or expansion;³⁹ and
- 4.29.5 regulatory barriers including environmental consents, which are costly and time consuming to secure, and food safety regulations.
- 4.30 While many of these barriers to entry are likely to remain without the DIRA Regulation, in general, new entry into the farm gate is eased by the regulation. For example, as discussed in more detail below, entry, and to a lesser degree expansion, is less likely in the absence of the open entry and exit regulations in Subpart 5 of Part 2 of the DIRA, and, to a somewhat lesser extent, the milk price regime in Subpart 5A of Part 2 of the DIRA and the Raw Milk Regulations.
- 4.31 Processing plants are typically large and capital intensive.⁴⁰ However, these assets are not entirely sunk in that there may be other processors that are likely to be willing to purchase such plants, as demonstrated by Fonterra’s purchase of the NZDL plant in 2012 when it went into liquidation.⁴¹ Where processing plants are based in areas where milk supply is growing, sunk costs are likely to be low. The size of sunk costs is unlikely to be significantly affected by the regulations.
- 4.32 Although we have limited evidence on the minimum viable scale required by entrants, feedback from [] stated that a plant would need to be operating at two-thirds capacity at least by the end of year two to make a case for investment.⁴² A secure source of milk supply may also be required to obtain funding for investment in new production facilities.⁴³
- 4.33 As such, large-scale entry requires secure access to supplies of raw milk—one significant condition for entry is to secure farmer suppliers. Without achieving scale,

³⁹ However, we note that Fonterra’s constitution also contains open entry and exit provisions which may continue if the regulation under the DIRA was removed.

⁴⁰ In 2006 the cost of entry to be an acquirer in the raw milk market was approximately \$12 million for a processing plant of 100,000 litres per day. Fonterra Co-operative Group Limited and Kapiti Fine Foods Limited and United Milk Limited (Commerce Commission Decision 574, 23 February 2006, paragraph 204).
[

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⁴¹ Commerce Commission “Fonterra Limited and New Zealand Dairies Limited (in receivership) [2012] NZCC 21” 6 September 2012.

⁴² []

⁴³ []

a processor is unlikely to be able to operate viably and therefore unlikely to continue to compete for raw milk. As discussed in more detail below, the DIRA Regulation is likely to affect this barrier by easing access to farmers through the open and exit regulations, and access to milk through the Raw Milk Regulations.

- 4.34 However, we note that some of the more recent IP 'new entrants' are part-owned by large international food/dairy companies and this may provide farmers with some comfort about the sustainability of these processors.
- 4.35 Barriers to expansion are generally lower than barriers to entry as farmers are likely to be willing to commit to supply raw milk to an IP that has been established for a number of years and has built up a reputation. Accordingly, while the open entry and exit regulations and, to a lesser extent, the Raw Milk Regulations have facilitated expansion, we do not think they are as important to enabling expansion by IPs that are well established.

The DIRA Regulation has lowered barriers to entry and expansion

- 4.36 The DIRA Regulation has lowered the barriers to entry and assisted IPs to access farmer suppliers and meet the milk requirements for a minimum viable operation on entry and/or expansion. The extent to which each of the key regulations have assisted entry and/or expansion is discussed below.

DIRA milk⁴⁴

- 4.37 As NERA notes, the majority of entrants have used a combination of DIRA milk and direct supply from farmers.⁴⁵ This suggests that DIRA milk is useful in facilitating minimum viable capacity utilisation during the one to three years following entry.
- 4.38 Once an IP's reputation has been built, it is in a better position to attract farmers and increase production to full capacity and DIRA milk is no longer necessary. Although some IPs have told us that DIRA milk was not a necessary requirement to their entry considerations,⁴⁶ others have indicated that it is important for prospective new entrants.⁴⁷ On balance, we consider that DIRA milk has facilitated entry.

⁴⁴ Dairy Industry Restructuring (Raw Milk) Regulations 2012, s 4.

⁴⁵ NERA Economic Consulting for Fonterra "Assessment of Competition in Raw Milk Markets and Costs and Benefits of the DIRA provisions" 17 August 2015, p.38.

⁴⁶ [

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⁴⁷ [

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Open entry and exit⁴⁸ and non-discrimination⁴⁹

- 4.39 The open entry and exit rules oblige Fonterra to accept applications to supply it with milk, and provide a right for shareholding farmers to cease or reduce the supply of milk to Fonterra. The non-discrimination rules ensure that Fonterra cannot discriminate between its shareholder farmers that are in the same circumstances.
- 4.40 Therefore, the effect of the open entry and exit provisions of the DIRA has been to ensure that Fonterra cannot lock-in its supplier shareholders through the use of long-term contracts or exclusivity requirements. The non-discrimination rules also mean that Fonterra cannot discriminate between supplier shareholders in ways that discourage switching, for example by discriminating against suppliers who reduced supply or who previously ceased supply.
- 4.41 As discussed above, winning farmer suppliers is important to IP entry and expansion.⁵⁰ It may be difficult for a new entrant to sign up enough farmers to meet their minimum viable capacity utilisation requirements or to achieve 'critical mass' absent the open and entry regulations. This is because farmers will not typically commit to IPs who do not have a track record as the farmers need a guaranteed offtake of their supply. However the processors need guaranteed farmers before they invest in expensive plant. NERA refers to this as the 'catch-22' situation.⁵¹
- 4.42 The open entry and exit and non-discrimination regulations reduce the risk to farmers of switching to an IP that does not have a reputation by assuring that they can return to Fonterra. They therefore appear to have been important in promoting entry and, to a lesser extent, expansion by IPs.
- 4.43 Almost all the IPs emphasised the importance of these provisions in relation to their ability and decisions to enter. A number of the processors noted that the open entry and exit provisions give farmers the confidence to leave Fonterra.⁵² Fonterra also

⁴⁸ Dairy Industry Restructuring Act 2001, s 73 and s 97.

⁴⁹ Dairy Industry Restructuring Act 2001, s 106.

⁵⁰ Although non-DIRA milk supplied at the factory gate could theoretically support entry or expansion, this milk is supplied at higher prices than DIRA milk. DIRA milk may also be more costly than sourcing milk directly from farmers in some cases, because IPs can attract suppliers that are located close to their plants with transport costs that are lower than Fonterra's average transport costs used to calculate the DIRA milk price. As such, factory gate milk might not always be a good alternative to sourcing directly from farmers in the longer term for the larger entrants that can achieve economies of collection. [

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⁵¹ NERA Economic Consulting for Fonterra "Assessment of Competition in Raw Milk Markets and Costs and Benefits of the DIRA provisions" 17 August 2015, p.9. However, we note that some of the more recent independent processor 'new entrants' are part-owned by successful foreign food/dairy companies and this may provide farmers with some comfort about the sustainability of these processors.

⁵² Refer, for example: Open Country Dairy "Cross-submission on consultation on substantive issues - review of the state of competition in the New Zealand dairy industry" 31 August 2015, paragraph 4.4.

stated that exiting suppliers often cite their right to return to Fonterra as a factor in their decision to exit.⁵³

- 4.44 Most of the IPs consider the open entry and exit provisions to be the core of the DIRA regime.

Right to supply IPs: the 20% rule⁵⁴

- 4.45 The 20% rule prevents Fonterra from requiring its supplier shareholders to supply it with all the milk they produce, by allowing a Fonterra supplier shareholder to sell up to 20% of their raw milk production to IPs.
- 4.46 Most of the large IPs told us they do not really use the 20% rule as it is impractical and it requires duplicate testing on the farm and duplicate vats.⁵⁵ However, some large processors do purchase a small amount of milk under this provision.⁵⁶
- 4.47 However, this provision appears to be valuable for a significant number of the small processors who supply dairy products to the domestic market. These include, in particular, smaller cheesemakers.⁵⁷
- 4.48 These small IPs do not typically have access to DIRA milk because they are too small and do not meet Fonterra's minimum volume delivery requirement. In addition, purchasing at the factory gate could lead to lower quality product being produced because the milk may not be as fresh or have the particular characteristics the IP wants. In the absence of this rule, some existing cheesemakers may be excluded from the market or prevented from operating as they would not have access to milk at the factory gate and are not large enough to take all of a small farm's milk.
- 4.49 Without access to milk under the 20% rule, these processors would face significantly higher barriers to entry into the market and/or expansion in the market.

⁵³ Fonterra "Review of the state of competition in the New Zealand dairy industry: Consultation paper - process and approach" 17 August 2015, paragraph 29.6.

⁵⁴ Dairy Industry Restructuring Act 2001, s 108.

⁵⁵ Refer for example: Westland "Review of the state of competition in the New Zealand dairy industry: Consultation paper - process and approach" 10 July 2015; [

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⁵⁷ Refer, for example: Grinning Gecko Cheese "Consultation on substantive issues - review of the state of competition in the New Zealand dairy industry" 14 August 2015, paragraph 3; [] Mercer Cheese "Information request by the Commerce Commission: Review of the state of competition in the New Zealand dairy industry" 13 August 2015; Over the Moon Dairy "Consultation on substantive issues - review of the state of competition in the New Zealand dairy industry" 13 August 2015, pp.1-2.

Regulation of supply contracts for raw milk: the 33% rule⁵⁸

- 4.50 Under the DIRA Regulation, Fonterra is free to arrange milk supply from suppliers outside the open entry and exit regime under normal commercial contracts. This means Fonterra could lock-in farmers who are willing to commit to supply for long terms and that are not supplier shareholders.
- 4.51 This rule ensures that, at any time, at least a third of the milksolids produced within a 160km radius of any point in New Zealand is supplied either under contracts with IPs, or under short-term contracts with Fonterra.⁵⁹ It therefore constrains Fonterra's ability to tie up all regional supply outside the open entry and exit regime for periods longer than one season and ensures that IPs are able to compete with Fonterra for the supply of a significant volume of raw milk on at least an annual basis.
- 4.52 [] noted that this rule is difficult to measure and impractical given that it still allows Fonterra to impose long-term notice provisions on two-thirds of raw milk supply within a 160km radius of its plant.⁶⁰
- 4.53 The value of this rule appears unclear given the relatively low proportion of Fonterra supply from non-shareholder suppliers (currently around 8%) and the open entry and exit provisions discussed above which ensure that IPs are able to compete for supply from Fonterra's supplier shareholders.

Sale of milk vats on supplier exit⁶¹

- 4.54 Since the refrigerated milk storage vats on Fonterra's shareholder suppliers' farms are usually owned by Fonterra, the need to transfer ownership of the vats is a potential barrier to farmers switching from Fonterra to an IP.
- 4.55 This rule therefore provides that a shareholding farmer who withdraws from Fonterra may require Fonterra to sell the vat situated on their farm to either the shareholding farmer or an IP. It also provides a process for determining the price of the vat in the event that the parties cannot agree.
- 4.55.1 Most IPs do not consider this rule to be significant in relation to their ability to obtain raw milk supply as they consider that Fonterra would either sell the vat or the exiting farmers would purchase a new vat.⁶² Only one large IP

⁵⁸ Dairy Industry Restructuring Act 2001, s 107.

⁵⁹ Under s 107 33% or more of the milk solids produced in a region must be supplied to an independent processor or supplied under contract to Fonterra which expires or can be terminated by the farmer supplier at the end of the current season without penalty to the farmer supplier and on expiry or termination all the farmer supplier's obligations to supply milk to Fonterra are extinguished so that they are free to supply to an independent processor.

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⁶¹ Dairy Industry Restructuring Act 2001, s 109.

⁶² []

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considered this to be a valuable provision as it was easier to purchase an existing vat than installing a new vat.⁶³

Milk Price Regime⁶⁴

4.56 These rules which were introduced in 2012 provide for:

- 4.56.1 Fonterra's setting of the base milk price;
- 4.56.2 Fonterra's disclosure obligations in relation to its base milk price setting; and
- 4.56.3 the monitoring of Fonterra's Milk Price Manual and of Fonterra's calculation of the base milk price by the Commission.
- 4.56.4 The base milk price regime creates more certainty about Fonterra's farm gate milk price and increased transparency of information about how the base milk price is set. This transparency of pricing information and increased certainty about the price IPs will have to pay for raw milk (IPs typically peg the price they pay for farm gate milk off the Fonterra price) helps reduce barriers to entry by IPs.
- 4.56.5 The Commission's monitoring of the base milk price calculation provides some disincentive for Fonterra to set the farm gate price of milk too high (and conversely pay a lower dividend) as a way of imposing a margin squeeze on downstream markets.⁶⁵ The monitoring therefore potentially allows processors who are efficient to compete in the dairy markets.
- 4.56.6 On balance, we consider that the transparency of the pricing of raw milk and the Commission's monitoring likely helps to reduce barriers to entry by IPs.

Independent rivalry

4.57 The second area we looked at to assess the current extent of competition in the farm gate markets was the degree of independent rivalry. Independent rivalry refers to

⁶³ []

⁶⁴ Dairy Industry Restructuring Act 2001, Subpart 5A. The level of the farm gate milk price that Fonterra pays its farmers was not originally regulated by the DIRA, although Fonterra adopted separate milk price and dividend payments from the 2009/10 season. The methodology adopted in the DIRA is largely in line with the methodology Fonterra applied prior to the 2012 DIRA Amendment. The Milk Price Regime also has a role to play in the factory gate market as it forms the basis for the price at which raw milk must be supplied under the Raw Milk Regulations.

⁶⁵ We note that Fonterra's ability to manipulate the mix of the farm gate milk price and the dividends paid to farmers is arguably also moderated by farmer-shareholders being able to trade shares with other farmers and external shareholders, under Fonterra's 'trading among farmers' clause.

the extent to which Fonterra and IPs compete with each other to attract supply from farmers.

4.58 Rivalry can lead to lower levels of market concentration over time and can be observed in pricing and other strategies to attract and retain suppliers. We assessed:

4.58.1 changes in market concentration;

4.58.2 entry and expansion in the markets; and

4.58.3 the extent of farmer switching.

Changes in market concentration

4.59 The extent of competition for milk supply varies by region depending on whether or not Fonterra faces competition in its collection areas from rival IPs.

4.60 Nine IPs are currently able to compete with Fonterra for milk supply across different geographic regions.

4.61 Fonterra principally competes for farmer supply with the IPs set out in Table 4.1 which shows their market shares in different regions based on their milk collected for 2015.

Table 4.1: Farm gate market shares – 2014/15 dairy season

[]Source: Commission analysis based on information provided by Fonterra and market participants.

4.62 The market share of the largest firm in the market is an important indicator of market concentration and is also an indicator of possible market power although it is not necessarily conclusive. The number of firms and the relative size of their shares of the market also indicate the level of market concentration.

4.63 It is clear from Table 4.1 that all of the regional markets are dominated by Fonterra (except for the West Coast where Westland is the sole IP and is therefore excluded from our analysis).

4.64 Fonterra's lowest market share is in the Canterbury region where it is still in excess of []%.

4.65 Fonterra faces limited competition in all of these regional markets with only a small number of competing IPs (between one and four) in the different regions that are all of a much smaller scale than Fonterra.

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4.67 Table 4.2 below shows that Fonterra also has the largest share of processing capacity in all regions.

Table 4.2: Farm gate market share of capacity - 2014/15 dairy season

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Source: Commission analysis based on information provided by Fonterra and market participants.

- 4.68 Fonterra is a monopoly purchaser of raw milk in a substantial number of other regional markets. NERA's report attached to Fonterra's submission stated that around 73% of the milk it collects is in catchment areas where competitors also collect milk. This leaves Fonterra as a sole purchaser in the remaining 27% of its catchment areas.⁶⁶

Entry and expansion in the markets

- 4.69 In the absence of the DIRA Regulation, high barriers to entry would have the potential to impede competition, given Fonterra's large market shares.
- 4.70 However, our analysis shows that with the DIRA Regulation, there has been significant new entry, supporting the contestability of the farm gate market under regulation. Since 2010, three large IPs entered the market: Miraka, Oceania and Danone Nutricia.⁶⁷ Large IPs are now well established in particular regions, and are competing to attract and retain supply of raw milk from farmers, including capturing a significant proportion of milk from new farm conversions and winning farmers from Fonterra.
- 4.71 These IPs have focused on entering or expanding in regions of highest milk growth and concentration of milk production.⁶⁸ Most have entered and/or expanded into Canterbury (Synlait, Westland, Oceania), Southland (Open Country, Danone Nutricia), Taranaki (Open Country), and Waikato (Miraka, Open Country).
- 4.72 Table 4.3 shows the changes between 2010 and 2015 in the supply sources, volumes, and capacities of Tatua and Westland, and the processors that have entered the farm gate markets since 2001.

⁶⁶ NERA Economic Consulting for Fonterra "Assessment of Competition in Raw Milk Markets and Costs and Benefits of the DIRA provisions" 17 August 2015, p.11.

⁶⁷ [

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⁶⁸ Tatua "Consultation on substantive issues - review of the state of competition in the New Zealand dairy industry" 17 August 2015, paragraph 2.4.

Table 4.3: Independent processors that source milk directly from farmers – supply sources, volumes, capacity and products, 2010 and 2015⁶⁹

Processor	Entry date	Processing sites		Supplying farms		Volume processed		Capacity	
		2010	2015	2010	2015	2010	2015	2010	2015
		Number		Number		Million litres/year		Million litres/year	
Tatua	1919	1	1	112	[]	138	[]	200	[]
Westland	1937	1	1	380	[]	479	[]	550	[]
Open Country	2004	3	3	510	[]	740	[]	800	[]
Synlait	2008	1	1	60	[]	290	[]	400	[]
Miraka	2011	-	1	-	[]	-	[]	-	[]
Oceania	2014	-	1	-	[]	-	[]	-	[]
Danone Nutricia	2014	-	1	-	[]	-	[]	-	[]

Source: NERA - An assessment of the DIRA triggers (2010) p.15 and Commission analysis based on information provided by Fonterra and market participants.

- 4.73 While the volume of milk Fonterra collects is continuing to increase, Fonterra is growing at a slower rate than its competitors. Fonterra's market shares are therefore gradually reducing as its share is eroded by IPs.
- 4.74 This trend is likely to continue as most of the large IPs are planning to expand their operations and to seek direct farmer supply to meet their increased demand for raw milk.
- 4.75 Table 4.4 sets out the expansion plans of IPs over the next six years.

Table 4.4: Expansion plans of IPs seeking direct farmer supply⁷⁰

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71		72

⁶⁹ NZDL was sold to Fonterra in 2012 and so is excluded from table 4.3.

⁷⁰ This table lists the IPs that seek direct farmer supply rather than expansion through factory gate milk. Further, this table excludes those IPs that seek to expand by purchasing more milk under the 20% rule.

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74		
75		76
77		78
79		80
81		82
83		84

Source: Independent processors' submissions, information request responses and interviews.⁸⁵

71 []	
72 []
73 []	
74 [
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75 [
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76 []
77 [
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78 []
79 []
80 []
81 []	
82 []	
83 []
84 []	

⁸⁵ Note: This table lists the IPs that seek direct farmer supply rather than expansion through factory gate milk. Further, this table excludes those IPs that seek to expand by purchasing more milk under the 20% rule.

4.76 In summary, over the next six years, IPs [] will be looking to add direct farmer supply equivalent to [] farms.⁸⁶ Using the average size of farm, this would equate to just over []% of Fonterra's approximately 10,600 shareholders.⁸⁷ Together, this is just under []% of Fonterra's total current processing capacity.

Extent of rivalry and farmer switching

4.77 We cannot ascertain the extent of competition from simply looking at whether or not Fonterra faces competition in its collection areas from rival IPs. Even where there are rival processors within a common catchment area, the degree of competition may be weak, or, alternatively, the market shares of those rivals may underrepresent their competitive impact.

4.78 Independent processors are likely to compete more weakly with Fonterra for farmer suppliers the further their plants are from farms as this increases their transport costs, which in turn affects the price they can pay suppliers. The competitive constraints on Fonterra will also be lessened where IPs do not have the capacity to compete and are small in comparison to Fonterra.⁸⁸ In contrast, there are likely to be stronger competitive constraints on Fonterra where rival IPs are situated close to supplier farmers and have excess processing capacity.

4.79 Farmer switching is also affected by any costs of switching, despite the existence of the open entry and exit regulations. One such possible switching cost is the interest-free loan scheme Fonterra made available to its farmer suppliers on 1 September 2015.⁸⁹

4.80 We therefore assessed farmer switching—which describes the situation when a farmer shifts their supply of milk from one dairy processor to another—to assess the extent of rivalry between Fonterra and IPs. However, we note that the level of competition may also be understated by switching data if IPs and Fonterra are competing to retain existing suppliers because those that contemplate switching, but choose not to, will not be represented in the data.

⁸⁶ []. According to NERA's estimate, there are 29 farms to every 50 million litres of milk on average. Refer: NERA Economic Consulting for Fonterra "Assessment of Competition in Raw Milk Markets and Costs and Benefits of the DIRA provisions" 17 August 2015, p.31.

⁸⁷ []

⁸⁸ For example, according to Federated Farmers, Westland is not seeking new suppliers as it has enough milk to operate its Canterbury plant efficiently and seeking more suppliers could lead to a greater Fonterra presence damaging its home base. Refer: Federated Farmers "Review of the state of competition in the New Zealand dairy industry: Consultation paper - process and approach" 10 July 2015, paragraph 3.6.1.

⁸⁹ Refer:
<http://www.fonterra.com/nz/en/Hub+Sites/News+and+Media/Media+Releases?keyword=FONTERRA%20FARMERS%20CAN%20NOW%20APPLY%20FOR%20CO-OPERATIVE%20SUPPORT>

4.81 We discuss Fonterra’s response to the rivalry referred to in the previous paragraph, as well as Fonterra’s interest-free loan scheme and its possible impact on rivalry below.

4.82 []

Figure 4.1[]

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4.83 []⁹⁰

4.84 While the IPs have also grown their supply in part from conversions, most suppliers have switched from Fonterra.⁹¹

4.84.1 []⁹²

4.84.2 []⁹³

4.84.3 []⁹⁴

⁹⁰ See <http://www.interest.co.nz/rural-news/59798/fonterra-agrees-buy-nzdl-milk-processing-factory>

⁹¹ In general, we would expect entry to be more difficult if conversions declined. We would also expect Fonterra to be more concerned with switching by its existing suppliers if there were fewer conversions (or increases in milk production by existing farmers declined). As such, as conversions decline, there should be greater competition over existing suppliers.

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4.84.4 [95]

4.84.5 [96]

4.85 Corporate IPs sign farmer suppliers without those suppliers having to purchase shares in the company. NERA maintains that this is a key point of differentiation when competing for new conversions.⁹⁷ [

⁹⁸]Federated
Farmers have noted that switching is attractive for farmers who wish to sell their Fonterra shares and realise their capital.⁹⁹

4.86 The IPs have typically followed Fonterra's lead in paying for milk at the farm gate and absorbing milk transport costs. Fonterra notes that processors that have been successful in contracting farms close to their plants often offer higher farm gate prices where their transport costs are less than Fonterra's national average.¹⁰⁰

4.87 The IPs sometimes pay a premium on the Fonterra price in order to attract farmers.¹⁰¹ Open Country also notes that IPs cannot attract supply from farmers without offering a price that is at or benchmarked against Fonterra's milk price.¹⁰² This suggests that price is a likely a key driver of switching by farmers. Fonterra's response to competition from IPs.

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⁹⁶ []

⁹⁷ NERA Economic Consulting for Fonterra "Assessment of Competition in Raw Milk Markets and Costs and Benefits of the DIRA provisions" 17 August 2015, p.22.

⁹⁸ []

⁹⁹ Federated Farmers "Review of the state of competition in the New Zealand dairy industry: Consultation paper - process and approach", 10 July 2015, paragraphs 3.10 and 3.11.

¹⁰⁰ Fonterra "Review of the state of competition in the New Zealand dairy industry: Consultation paper - process and approach" 17 August 2015, paragraph 29.4.

¹⁰¹ Independent processors might be able to afford to pay a higher price because they have lower transport costs (cherry-picking) and/or because they have higher value product mix and/or are more efficient than Fonterra.

¹⁰² Open Country "Submission on the Commerce Commission's Consultation Paper – Review of the State of Competition in the New Zealand Dairy Industry", page 2.

- 4.88 Fonterra has a national pricing policy for farm gate milk; that is, it pays farmers the same price regardless of location.¹⁰³ This may inhibit its ability to respond to regional competition for farmer supply since a price increase in one region would, according to the national pricing policy, result in a higher price in all regions. This should facilitate entry since the ‘cost’ of an increase in farm gate prices is lower for an IP than Fonterra.¹⁰⁴
- 4.89 Competition by way of non-price incentives offered by Fonterra appears to be similarly non-region specific. National non-price incentives include financial assistance, interest-free loans, and access to support services such as food safety teams.¹⁰⁵ These incentives are offered to all farmers, regardless of location.
- 4.90 Fonterra has, however, responded to regional competition with some non-price incentives in order to limit switching and compete for new dairy conversions. One such incentive is MyMilk, which allows farmers to supply milk to Fonterra for five years without needing to share-up.¹⁰⁶ It is available in regions with strong competitive pressures at the farm gate for conversions— Canterbury, Southland, and Otago.
- 4.91 In addition, as at 1 September 2015, Fonterra announced farmer shareholders could apply for an interest-free loan of 50 cents for each kilogram of share-backed milk solids produced from 1 June to 31 December 2015.¹⁰⁷ While this scheme may not have been developed in response to competition for farmer suppliers, it has the potential to impact on that competition (in any region).¹⁰⁸

¹⁰³ [] We also note that the milk price actually paid to each farmer and farmers in each region varies to reflect the fat/protein content of the milk.

¹⁰⁴ We note that during 2008, Fonterra engaged in tactical pricing to retain supply, but it voluntarily abandoned this practice.

¹⁰⁵ See <https://www.fonterra.com/nz/en/About/Become+a+farmer+shareholder/Supporting+our+farmer+shareholders>

¹⁰⁶ NERA notes that Fonterra finds it difficult to attract new conversions because of its requirement to invest in shares. NERA Economic Consulting for Fonterra “Assessment of Competition in Raw Milk Markets and Costs and Benefits of the DIRA provisions” 17 August 2015, p.24. Fonterra has reacted by allowing farmers to ‘share up’ over time through the MyMilk scheme. The Fonterra constitution only allows 15% of total milks solids to be on a contract supply basis. Refer: NERA Economic Consulting for Fonterra "Assessment of Competition in Raw Milk Markets and Costs and Benefits of the DIRA provisions" 17 August 2015, p.24.

¹⁰⁷ []

¹⁰⁸ In our draft report on the review of Fonterra’s 2015/16 Milk Price Manual (15 October 2015), we stated we would address the competitive aspects of the loan scheme in the report to the Minister on the state of competition in the New Zealand dairy industry.

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4.93 We do not have information on whether the size of this switching cost is material and the number of farmers for which it may be material. We do note, however, that uptake of this interest-free loan was 75% of farmer shareholders (7,800 farmers) by the end of September 2015.¹¹⁰

Conclusion on rivalry for farmers

4.94 The evidence on rivalry suggests that farmers have benefited from rivalry. In keeping with this, [] stated that competition has meant farmers have greater choice and increased competition for service from dairy processors.¹¹¹ We consider that effective competition is starting to emerge in Canterbury, Southland, Taranaki and Waikato in particular, while there is little or no competition in Northland, Wairarapa, and the Hawke’s Bay in particular. However, given the high level of concentration in these markets, we do not consider the existing constraints from competition on their own would be likely sufficient to constrain Fonterra’s ability to exercise market power.

Farm gate markets—Fonterra’s co-operative structure

4.95 Fonterra’s incentive to exercise market power at the farm gate is also limited by its co-operative structure. As a co-operative, Fonterra has little incentive to depress the farm gate prices below competitive levels.

4.96 Due to its co-operative structure, Fonterra has also adopted a national pricing strategy, which may further limit incentive to depress farm gate prices. While Fonterra could, in theory, abandon the national pricing approach, any alternative pricing model is likely to face opposition from disadvantaged shareholder suppliers.

4.97 This is discussed further in Chapter 5 at para 5.7, where we consider Fonterra’s ability and incentive to exercise market power against farmers.

Factory gate markets

4.98 The factory gate markets are the markets in which dairy processors supply raw milk they have collected from farmers to other processors and some food and beverage manufacturers, including the DIRA milk by Fonterra to IPs.

¹⁰⁹ []

¹¹⁰ <http://www.radionz.co.nz/news/rural/285577/75-percent-of-fonterra-farmers-take-interest-free-loan>

¹¹¹ []

4.99 In order to assess the current extent of competition in the factory gate markets we looked at:

4.99.1 factory gate markets and raw milk;

4.99.2 barriers to entry;

4.99.3 independent rivalry between Fonterra and IPs ;and

4.99.4 constraints on Fonterra's market power

Factory gate markets and raw milk

4.100 The factory gate markets are the markets in which Fonterra and (occasionally other processors) supply raw milk they have collected from farmers to other processors and some food and beverage manufacturers.

4.101 The factory gate market is very small compared with the farm gate market. The total volume of milk supplied at the factory gate by Fonterra in the 2014/15 dairy season was [] litres compared with the total collected of 18.1 billion litres. This means that less than []% of the milk Fonterra collected at the farm gate in the 2014/15 season was sold by Fonterra at the factory gate.¹¹²

4.102 There are separate factory gate markets for DIRA milk sold under the Raw Milk Regulations and non-DIRA milk sold outside of the Raw Milk Regulations.

4.103 Under the Raw Milk Regulations, if requested by a qualifying IP, Fonterra is required to supply set quantities of raw milk at a regulated price.¹¹³ The current Raw Milk Regulations require Fonterra to sell up to 50 million litres of raw milk per season to each qualifying IP subject to a total cap of 795 million litres. The volume of DIRA milk in 2014/15 was []% of Fonterra's total factory gate milk.

The current DIRA milk factory gate customers

4.104 There are two distinct types of customers for factory gate milk: large IPs that source their milk directly from farmers ('own-source'), and processors that do not (this includes Goodman Fielder). We discuss both buyer types in more detail in the following paragraphs.

4.105 Table 4.5 provides a summary of the supply of factory gate milk to IPs, excluding the large processors.

¹¹² Fonterra information request response 11 June 2015.

¹¹³ Dairy Industry Restructuring (Raw Milk) Regulations 2012.

Table 4.5: Summary of IPs* that purchase factory gate milk, 2014/15

Region	IP	Alternative factory gate supply	Factory gate milk (litres)	Own farmer supply
Northland	Goodman Fielder	[114		
	Fresha Valley			Yes
AUCKLAND/ WAIKATO/ BAY OF PLENTY	Dairy Goat Co-operative			
	Emerald Foods Group			
	Epicurean Dairy			
	Green Valley			Yes
	Gopals Sweets & Snacks			
GISBORNE/ HAWKE'S BAY/ WAIRARAPA/ MANAWATU	Waimata Cheese			Yes
	Goodman Fielder			
	BioFarm Products			Yes
CANTERBURY	Barrys Bay Cheese			
	Goodman Fielder			
	Karikaas			
	Serra Natural Foods			
	Talbot Forest Cheese			
OTAGO/ SOUTHLAND	Whitestone Cheese			
	Evansdale Cheese			
TASMAN/ MARLBOROUGH	Talleys]	

*Excluding the large processors.

Large IPs that buy DIRA milk to complement their own milk collection

- 4.106 We note that until 2012 there was no restriction on processors accessing DIRA milk irrespective of the volumes they sourced from farmers. Most large IPs that buy DIRA milk to complement their own collection are subject to the sunset clause that will restrict their access to DIRA milk after 1 June 2016.¹¹⁵ DIRA milk is therefore an interim support measure to overcome barriers to entry.
- 4.107 These processors will be required under the sunset provisions to seek to fulfil their milk requirements directly from farmers in the future. This group of processor customers mainly focuses on exports.
- 4.108 If a more robust factory gate market were to emerge in the absence of the Raw Milk Regulations, the IPs that are not likely to buy DIRA milk in the near future would be the most likely processors to enter the market to supply raw milk to other IPs.

Independent processors that rely on DIRA milk for all or most of their milk requirement

- 4.109 The independent processors that buy DIRA milk for all or most of their requirements typically produce dairy products such as cheeses, yoghurt and ice cream for the domestic dairy market. Few fully export. We expect these processors to continue to purchase DIRA milk under the DIRA Regulation.
- 4.110 These processors generally face significant barriers to collecting milk directly from farmers and typically prefer raw milk to other milk products (ie, pasteurised milk and milk powders). They therefore rely on DIRA milk if they qualify for such milk and factory gate milk at market prices otherwise.
- 4.111 The barriers that these processors face to collecting milk directly from farmers include:
- 4.111.1 the milk curve (the uneven seasonal supply of milk, high in spring, less in summer, and often none in autumn)—some IPs, typically smaller ones, cannot take milk along the milk curve as they require a constant volume (a 'flatter' milk supply) in order to use their processing capacity year round;
 - 4.111.2 securing farmer supply—some 'new entrant' processors cannot secure sufficient farmer supply to be able to use their processing capacity efficiently. In addition, some smaller processors are not large enough to take all of a farmer's milk and, even if they are, farmers are reluctant to supply smaller processors because they fear that such processors would not have sufficient demand to collect milk daily;

¹¹⁵ Dairy Industry Restructuring (Raw Milk) Regulations 2012, s 6 (3). Under regulation 6(3) Fonterra does not have an obligation to supply an independent processor (other than Goodman Fielder) with raw milk in relation to a season beginning on or after 1 June 2016 if the independent processor's own supply of raw milk in each of the three consecutive previous seasons was 30 million litres or more.

4.111.3 own-supply costs — costs associated with own-supply (including vats, tankers and testing requirement) are not always viable for smaller IPs.

4.112 Figure 4.2 shows the volumes of DIRA milk purchased by IPs that source their milk from farmers and by those that do not (excluding Goodman Fielder) during the 2014/15 season.

Figure 4.2: Volumes of DIRA milk purchased by IPs - 2014/15 season^[116]

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[]

Goodman Fielder

4.113 Goodman Fielder supplies fresh milk and other dairy products to downstream markets in competition with Fonterra. It is the largest purchaser of DIRA milk. The total volume of milk supplied to Goodman Fielder at the factory gate by Fonterra in the 2014/15 dairy season was [] litres.

4.114 The DIRA required Fonterra to divest shares in NZDF (New Zealand Dairy Foods). The NZDF business manufactured a number of well-known New Zealand consumer dairy brands and the sale made sure that Fonterra would not monopolise the downstream dairy market in New Zealand. NZDF eventually became the dairy division of Goodman Fielder.

4.115 As part of the negotiations, Fonterra and NZDF agreed commercial contracts allowing NZDF to purchase raw milk subject to the cap of 250 million litres allowed for under the DIRA Regulation. []

4.116 Goodman Fielder stated that it has only implemented minor incremental increases in milk purchases and production since 2011 and its growth has plateaued.¹¹⁷ In submissions to the Commission, Fonterra stated that it “considers the requirement to supply Goodman Fielder remains important for public confidence in downstream wholesale and retail markets”. Goodman Fielder’s DIRA milk purchases are shown in Figure 4.3.

Figure 4.3: Goodman Fielder purchases of DIRA milk between 2005/06 and 2014/15

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Source: Fonterra data from information request by the Commission

¹¹⁶ []

¹¹⁷ Goodman Fielder "Review of the state of competition in the New Zealand dairy industry: Consultation paper - process and approach" 10 July 2015, paragraph 2.1(a).

4.117 [

¹¹⁸]As such, with the DIRA Regulation, Goodman Fielder is unlikely to consider any other source of supply (our assessment of the likely outcomes in the absence of the DIRA Regulation are addressed in Chapter 5 of this report).

Barriers to entry

4.118 Since any new entrant into the factory gate market would need to contract with farmers and invest in infrastructure for the collection of milk for delivery, the only realistic candidates to supply raw milk to the factory gate, in the absence of The Raw Milk Regulations, would be current or future IPs.

4.119 Independent processors that are large enough to source their raw milk from the farm gate for processing are unlikely to face significant barriers to supply at the factory gate in the absence of the Raw Milk Regulations. This is because supply would mainly entail transporting farm gate milk to a purchaser rather than the IP's own processing facility. However, there may be additional transportation costs, as well as transactional costs, including those related to a change in business focus.

4.120 However, it is worth noting that DIRA milk has facilitated farm gate entry by IPs, and having entered the farm gate markets, the barriers to entering the factory gate in a future market are reduced.

Little independent rivalry

4.121 Fonterra is by far the dominant supplier at the factory gate. The only other processor that regularly supplies this market is [

¹¹⁹. [] [¹²⁰] [¹²¹]

¹¹⁸ []

¹¹⁹ []

¹²⁰ []

¹²¹ []

4.122 The market for non-DIRA milk is therefore very small and there is very little competition. Many of the large IPs that could potentially supply the factory gate market do not appear to want to supply small customers, and are unwilling to supply at the DIRA price. (We consider what is likely to happen in this market without the Raw Milk Regulations in Chapter 5.)

Constraints on Fonterra's market power

4.123 The Raw Milk Regulations constrain Fonterra's market power in respect of DIRA milk supplied at the factory gate.

4.124 However, when IPs purchase non-DIRA milk from Fonterra, they are charged a price for that milk that is [] higher than the DIRA price.

4.125 IPs have generally indicated that they would be willing to supply at the factory gate on a regular basis at prices similar to Fonterra's non-DIRA price.¹²² This could suggest that Fonterra may be the price setter in the case of non-DIRA factory gate milk or else that Fonterra and IPs have similar opportunity costs.

4.126 In some instances, the prices charged by Fonterra for non-DIRA milk []

4.127 Given the high concentration levels in the factory gate markets and the limited participation by IPs, we do not think the regional factory gate markets are currently characterised by effective competition.

Wholesale and retail supply of fresh processed milk—any new information on state of competition?¹²³

4.128 We have not obtained any new information that alters our conclusions in the preliminary inquiry into domestic milk markets in 2011 under Part 4 of the Act.

4.129 While we have not specifically sought information on how firms compete in these markets we understand that the competitive dynamics have remained largely unchanged.¹²⁴

4.130 The wholesale market for the supply of fresh processed milk remains highly concentrated with Fonterra and Goodman Fielder still accounting for more than []% of the market in each island. In addition, according to Foodstuffs only Fonterra and

¹²² []

¹²³ The Terms of Reference require us to consider whether there is any new information that would alter the conclusions reached in our preliminary inquiry into domestic milk markets in 2011 under Part 4 of the Commerce Act.

¹²⁴ In its submission of 17 August 2015 "Dairy Competition Review Consultation Paper, 20 July 2015", Foodstuffs noted that there have been no structural or other changes in the retail milk market since 2011 to change this position.

Goodman Fielder are able to compete to supply private label milk which is the key driver of price pressure on other market participants in the retail market for fresh milk.¹²⁵

- 4.131 While there are a number of smaller processors supplying fresh processed milk, the constraints from these suppliers appear to be weak and generally limited to the regions in which they are based.
- 4.132 In relation to the retail supply of fresh milk, there is competition between supermarkets generally and some limited competition from other retailers.

¹²⁵ Foodstuffs “Dairy Competition Review Consultation Paper, 20 July 2015” 7 August 2015.

5. Concerns about deregulation – what competition would look like without the DIRA Regulation

- 5.1 In this chapter we assess what competition would look like in the absence of the DIRA Regulation.
- 5.2 In particular, we assess whether Fonterra would likely:
- 5.2.1 exercise market power against farmer suppliers at the farm gate in the purchase of milk by decreasing prices below competitive levels;
 - 5.2.2 exercise market power against IPs at the factory gate in the sale of milk by increasing prices; and
 - 5.2.3 prevent IPs from effectively competing (generally referred to as foreclosure) by:
 - 5.2.3.1 restricting IPs from accessing milk from farmers at the farm gate by either increasing the farm gate price or locking farmers into longer term contracts;
 - 5.2.3.2 raising prices or restricting access to factory gate milk for IPs who sell to customers in domestic downstream dairy markets (such as milk and cream).

Fonterra's market power in relation to farmers

- 5.3 The base milk price regulations may have some effect in protecting farmers from Fonterra's buyer side market power.¹²⁶
- 5.4 We conclude that although Fonterra would have the ability to exercise some buyer side market power in the absence of the regulations, it would have little or no incentive to use this to the detriment of shareholding farmers.

Fonterra's buyer side market power

- 5.5 The milk market is highly concentrated and in aggregate, Fonterra remains the largest purchaser at the farm gate. This is despite new IPs entering the dairy processing market and expanding their business. Fonterra indicates that it does not face competition at the farm gate in 27% of its catchment areas.¹²⁷ It is therefore the monopsony buyer of milk in these regions. It does, however, face some competition for farm gate milk in other regions.

¹²⁶ They are primarily intended to provide assurance to both farmer suppliers and independent investors that an appropriate allocation of returns is made between the milk price and dividend. This also provides IPs with comfort that the milk price is set at an efficient level.

¹²⁷ NERA Economic Consulting for Fonterra "Assessment of Competition in Raw Milk Markets and Costs and Benefits of the DIRA provisions" 17 August 2015, p.11.

- 5.6 As such, in the absence of relevant regulations, Fonterra would probably have some buyer side market power; although this varies across regions.

Fonterra's ability and incentive to exercise market power against farmers

- 5.7 Although Fonterra may have sufficient market power to be able to reduce prices to a level that would reduce farm gate milk output, we consider that Fonterra is unlikely to do so in the absence of regulation, for the following reasons.¹²⁸

5.7.1 Fonterra is a co-operative owned by its farmer suppliers, where non-supplier shareholders do not have voting rights. Lowering prices to below competitive levels is generally not in farmers' (the supplier owners') interest because it results in retrenchment.

5.7.2 It is likely that some form of independent oversight of the base milk price rules would continue to occur so as to provide assurance to Fonterra's farmer and non-farmer shareholders that the farm gate milk price is set at an efficient level.¹²⁹

5.7.3 The likelihood of such a price decrease being profitable is reduced by the fact that:

5.7.3.1 []% of Fonterra's milk solids are exported and it is largely a price-taker in these markets. As such, any reduced downstream sales consequent upon reduced farm gate purchases would be unlikely to be accompanied by increased downstream prices.

5.7.3.2 Fonterra's buyer side market power varies by region. However, Fonterra has a national price for farm gate milk. If Fonterra lowered prices nationally, it would stand to lose farmer suppliers to competing IPs in at least some regions. This would further decrease the quantity of farm gate milk available to Fonterra.

- 5.8 We have considered whether Fonterra would have the incentive to lower prices below competitive levels, in the absence of the regulations, to only new or returning farmers. Fonterra is required under the regulations to treat new shareholders the same as existing ones. Without the regulations, Fonterra would have little ability to lower prices to new or returning farmers. This is because farmers would only switch to Fonterra if the prices and supply terms they were offered are at or above that which they could get from competing IPs.¹³⁰ This is similarly the case for new

¹²⁸ This finding is consistent with the Commission's findings in the Fonterra/NZDL merger. Refer: Fonterra Limited and New Zealand Dairies Limited (in receivership) [2012] NZCC 21.

¹²⁹ There may, however, be less transparency over how the milk price is set, which could decrease the dairy industry's confidence that the milk price is not set too high. In this discussion, the issue being addressed is the possibility of the price being set too low.

¹³⁰ There may be scenarios where efficient farmers are excluded from supplying milk even though they are efficient. For example, farmers could switch from Fonterra to an independent processor. That processor, the only alternative milk purchaser in a region, could go out of business. If Fonterra in such a case does

conversions. Conversions are not likely to take place unless farmers have the expectation that they will have favourable terms from either Fonterra or an IP. No new entry would be induced where terms are less than competitive levels.

5.9 Another potential concern is that Fonterra could depress prices below the competitive level to contracted suppliers. The regulations limit Fonterra’s ability to use contract suppliers but do not dictate its treatment of them. Therefore whether the regulations are removed or not is unlikely to change Fonterra’s pricing to contract farmers. [

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Fonterra’s market power in relation to IPs

5.10 The open entry and exit provisions in DIRA and the Raw Milk Regulations were put in place to facilitate IPs to enter and to compete against Fonterra at all levels of the market: the farm gate, factory gate, and ultimately downstream domestic dairy markets.

5.11 In this section, we assess what would happen if the Raw Milk Regulations were no longer in place.

5.11.1 Could Fonterra exercise market power at the factory gate and profitability raise its price above competitive levels? This would be a mere exercise of Fonterra’s market power.

5.11.2 Would Fonterra have the incentive and the ability to foreclose IPs from competing so that Fonterra may obtain additional market power either at the farm gate or in downstream domestic markets? This would be achieved by:

5.11.2.1 further raising the factory gate price with the purpose of excluding IPs; and

not accept the return of those efficient farmers (in order to strategically disincentivise farmer switching more broadly), then this might introduce inefficiencies into the market [

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- 5.11.2.2 committing farmers to longer term exclusive contracts to prevent IPs from competing effectively.

Summary of Fonterra's market power in relation to IPs

5.12 In summary, our view is as follows.

5.12.1 Without regulation, Fonterra would likely be able to exercise market power at the factory gate, raising prices above competitive levels. A likely indication of that price is the price at which non-DIRA milk is currently sold at the factory gate. The effect of such a price increase would be that current buyers of that milk would buy less milk, leading to a decrease in their own output. This in turn would likely adversely impact the price, quantity and, potentially, the quality and variety of dairy products sold in domestic downstream markets.¹³⁵ The extent of that adverse impact is unknown but would likely vary by product market with some markets not being as impacted as others.

5.12.2 Having exercised its market power, we consider that Fonterra would not likely be able to restrict its competitors either by further increasing factory gate prices or by holding farmers to longer term exclusive contracts. This is because:

5.12.2.1 At the factory gate, Fonterra would not likely gain much benefit from foreclosing exporters, and it would not have the ability to foreclose those domestic rivals that would have alternative sources of milk. There are few domestic rivals that do not have alternative sources of supply, and Fonterra is unlikely to gain much benefit from their foreclosure.

5.12.2.2 At the farm gate, Fonterra is unlikely to have the incentive to act contrary to its farmer shareholders' interests, and, regardless, it appears unlikely that Fonterra has the ability to prevent its most important rivals for accessing farm gate milk in this way.

Can Fonterra exercise market power at the factory gate?

5.13 To assess whether Fonterra has market power at the factory gate, we considered what would happen to the factory gate milk price without regulation.

5.14 If the factory gate milk price goes up, one possible competitive response to this would be for IPs to try and source their own milk. However, this may be more difficult without the open entry and exit regulations.

5.15 In considering whether there is likely to be an exercise of market power, it is usually sufficient to determine whether prices are likely to increase. However, the non-

¹³⁵ The competitiveness of IPs that rely on DIRA milk to sell in export markets may also be reduced, but the overall exports are unlikely to be impacted since those sales are likely to be replaced by Fonterra sales.

regulated factory gate price may increase relative to the regulated DIRA milk price even without an exercise of market power. This is because the DIRA milk price might not reflect Fonterra's costs of bringing this milk to market (where those costs include opportunity costs).

- 5.16 Therefore before we assessed Fonterra's market power, we considered whether the DIRA milk price is set at a level that covers the associated costs of producing it (where those costs include opportunity cost). If not, then prices are likely to increase in the absence of the regulations for this reason alone.

Is the DIRA price for milk covering its costs?

- 5.17 Without the regulations, we would not expect Fonterra to sell milk at the factory gate to IPs if those sales were less profitable to Fonterra than if Fonterra instead processed those milk volumes itself. That is, without regulation we would expect Fonterra to at least seek to recover its opportunity cost on factory gate sales.
- 5.18 The regulations require Fonterra to supply DIRA milk for the whole of the current season at the most recent quarterly forecast of the farm gate milk price for that season plus the average transport costs Fonterra incurs in the collection of milk from farmers and the delivery of this milk to the purchaser IPs.¹³⁶
- 5.19 The costs of collecting (apart from transportation), processing, and selling milk are not included in the DIRA price for milk. Fonterra does not incur such costs when selling milk at the factory gate.
- 5.20 The DIRA price for milk may not reflect Fonterra's opportunity cost or actual costs of supplying milk at the factory gate. In particular, it may not reflect:
- 5.20.1 the opportunity cost on DIRA milk sales as measured against Fonterra's best alternative to DIRA sales; and
- 5.20.2 any additional costs Fonterra may bear as a result of supplying raw milk at the factory gate.
- 5.21 NERA, in a report commissioned by Fonterra, says that there must be times when the DIRA price for milk is likely to be lower than Fonterra's opportunity cost.¹³⁷ [

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¹³⁶ Dairy Industry Restructuring (Raw Milk) Regulations 2012, sections 4(1), 19(2) and 19(4). Fonterra must offer the fixed quarterly pricing option to IPs that did not source any raw milk in the previous season from its own supply or who sourced raw milk in the previous season from own supply at a quantity less than 30 million litres.

¹³⁷ Fonterra Submission "Consultation on substantive issues - review of the state of competition in the New Zealand dairy industry" 17 August 2015.

¹³⁸ []

5.22 For the following reasons, there may be times when the DIRA price of milk may not reflect the cost, including the opportunity cost, of selling milk under the Raw Milk Regulations. More specifically in regard to opportunity cost, there may be times when the opportunity cost of selling raw milk may exceed the price Fonterra receives for selling DIRA milk, while at other times, the opportunity cost is likely to be less than the DIRA price of milk.

5.22.1 The DIRA price for milk is only updated quarterly but dairy product prices are volatile. They can show large changes within a season and also potentially between updates of the forecast of the farm gate milk price. For example, the forecast of the farm gate milk price for the 2015/16 season for kilograms per milk solids (kg MS) opened at \$5.25 per kg MS (May 2015), fell to \$3.85 in August and then partially recovered to \$4.60 in September 2015.¹³⁹ At any single point in time, the opportunity cost of selling raw milk to IPs may be greater than or less than the price forecast by Fonterra for all of that season.

5.22.2 Fonterra, like other processors, has capacity constraints—its ability to produce products enjoying high prices at any point in time may be constrained by the processing capacity it has available. For example, in times when commodity products like whole milk powder (WMP) or skim milk powder (SMP) make less profit than higher value products, Fonterra would be expected to ‘max-out’ its opportunities to produce those higher value products. However, Fonterra may not have the capacity to produce more of the higher value products, even if it did not have to sell milk to IPs under the regulations.

5.22.3 Conversely, at times WMP and SMP may be significantly more profitable than making and selling other products.¹⁴⁰ For example, in the 2013/14 season when raw milk volumes peaked and WMP and SMP prices were high [] Fonterra was constrained by its diversified range of processing plants from taking full advantage of the volumes and high WMP and SMP prices.¹⁴¹ That is, it had to produce larger volumes of lower-margin product than was desirable. As a result, it had to adjust down the amount of money it could pay to its suppliers by 55 cents per kg MS. In that season, the sale of additional milk to IPs (at a price reflecting the

¹³⁹ Refer: <http://www2.fonterra.com/our-financials/farmgate-milk-prices> .

¹⁴⁰ Refer: Dairy Industry Restructuring Act 2001, s 150C(2). In calculating the farm gate milk price the portfolio of commodities must be determined having regard to the commodities that are likely to be the most profitable over a period not exceeding five years from the time when the portfolio is determined. Fonterra also produces products that are further processed and branded and that would not be considered commodities.

¹⁴¹ The volume of milk Fonterra was required to process was also greater than forecast.

assumed production of that milk into WMP and SMP) may have provided a higher return to Fonterra than Fonterra retaining the milk for processing into (at that time) lower return product.

- 5.22.4 The DIRA price of milk assumes raw milk is turned into WMP and SMP at costs that reflect the performance of a hypothetical efficient processor.¹⁴² If in reality Fonterra cannot match the assumed level of efficiency of that hypothetical processor, then selling raw milk at a price that reflects WMP and SMP selling prices and efficient processing and selling costs, but avoids actually incurring those costs, may be value-enhancing to Fonterra.
- 5.22.5 In the short term, Fonterra's costs are fixed. Having to sell milk to IPs when that milk could have been processed through its own plants may reduce Fonterra's ability to spread the fixed costs of its plants over greater volumes of milk product.¹⁴³
- 5.22.6 However, in the longer term, growth in milk volumes available to Fonterra for processing (as they have been since it was established), would reduce any such above cost by offsetting the loss of milk volumes sold to other processors' plants.¹⁴⁴
- 5.22.7 Fonterra may incur some additional costs from supplying milk to IPs (e.g., administration costs), but the supply of milk to other processors' plants may also yield some efficiencies. For example, the ability to deliver milk to an IP's site may allow Fonterra to reduce collection costs through shorter travel time for some of its tankers.

Goodman Fielder

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¹⁴² We describe the 'notional producer' concept in: Commerce Commission "Review of Fonterra's 2014/15 base milk price calculation: Final report" 15 September 2015, Attachment E.

¹⁴³ We note too that volumes of milk sold under the regulations are small relative to the total quantity of milk processed by Fonterra, and that the need for processing capacity is determined by the amount of milk produced by cow herds in the spring, and inter-season variability in that level of production, rather than uncertainty over the amount of milk that will or will not be purchased by IPs under the regulations. Further, the volume of raw milk sold under those regulations has been falling (and will likely continue to fall as the sunset clauses impact in practice.)

¹⁴⁴ We note also that the volume of milk sold to other processors under the regulations has been falling.

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¹⁴⁵ [

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5.24 We consider the factory gate price to Goodman Fielder without the regulations further in paragraph 5.62.

Conclusion – DIRA milk may not be set at a level that covers costs

5.25 In summary, we agree with NERA (for Fonterra) that there may be times when Fonterra does not recover all its costs, including the opportunity costs, associated with selling DIRA milk. On the other hand, there may be times when the returns from selling DIRA milk more than recover those costs. It is difficult to conclude which scenario occurs more in practice without further information, and we consider this is beyond the scope of this report. We note, however, that without the regulations, there are scenarios under which we would expect the price of DIRA milk to increase to reflect all Fonterra’s costs, including its opportunity costs.

Does Fonterra have market power at the factory gate?

5.26 We now consider whether Fonterra would have market power at the factory gate. Our assessment examines:

- 5.26.1 Fonterra’s current market rate for non-DIRA milk sold at the factory gate to see whether it is likely to inform the price we would observe absent the regulations;
- 5.26.2 whether the competitive constraints Fonterra would face on its factory gate price would likely differ by region; and
- 5.26.3 whether the price would likely vary by customer.

Fonterra’s current factory gate milk market price

5.27 The raw milk that Fonterra sells outside DIRA is considerably higher priced than sales made under the regulations. The difference between the price charged for DIRA milk and non-DIRA milk is [] The non-DIRA milk price, however, is typically for sales of milk that DIRA does not cover, such as the supply of organic milk, a flat supply profile, or volumes over and above the October maximum.

5.28 [¹⁴⁶] [¹⁴⁷] [^{148, 149}]

¹⁴⁶ []

¹⁴⁷ []

¹⁴⁸ []

- 5.29 The difference between the non-DIRA milk price and the DIRA milk price reflects both the products on which the prices are based on ([]), the difference historical prices and actuals,¹⁵⁰ []
- 5.30 [5.22.1 5.22.3 151] Fonterra's prices for factory gate milk outside of DIRA may be above what Fonterra would earn in the export market.
- 5.31 To date, the Fonterra non-DIRA milk price has not had the effect of inducing entry (other than on an ad hoc basis) into any of these markets by any IP [].¹⁵² [] This may be because the non-DIRA volumes are insufficient for processors to be interested.¹⁵³
- 5.32 Based on our analysis of Fonterra's current factory gate milk market price and the fact that Fonterra currently faces little competition in the sale of non-DIRA milk, we consider that Fonterra's current market price for non-DIRA milk likely reflects market power.

The factory gate milk price may vary across regions

- 5.33 We conclude that without the regulations, Fonterra would likely price factory gate milk up to the price of the next best substitute.¹⁵⁴ Whether this is likely to be a price that would otherwise induce entry (or, in the case of Open Country, expansion) into the factory gate market is likely to vary by region.
- 5.34 In Gisborne, Hawke's Bay, and Nelson, there is unlikely to be an IP alternative to Fonterra. In Northland and Otago, it is less clear whether there is likely to be an IP

¹⁴⁹ []

¹⁵⁰ The DIRA milk price is based on the forecasted farm gate price, which is in turn based on historical WMP and SMP product group prices.

¹⁵¹ []

¹⁵² []

¹⁵³ NERA contends that Fonterra is unlikely to exercise market power at the factory gate because the volumes sold at the factory gate are small relative to the total capacity of [own-source] IPs. As such, it would be easy for own-source IPs to undermine an exercise of market power by Fonterra by selling the milk themselves. Refer: NERA Economic Consulting for Fonterra "Assessment of Competition in Raw Milk Markets and Costs and Benefits of the DIRA provisions" 17 August 2015, p.9. This, however, does not mesh with our view that the current market price for non-DIRA milk reflects market power and that this has not resulted in IPs competing the price down to competitive levels despite the fact that volumes of non-DIRA factory gate sales are small. Moreover, IPs have generally indicated that they are unwilling to supply small volumes and their willingness to supply at all will depend on price.

¹⁵⁴ If Fonterra's profit-maximising price increase, given a buyer's elasticity of demand, is less than the price of the buyer's next best substitute, Fonterra will only price up to that price.

alternative to Fonterra. In the remaining regions, [] are most likely to enter and [] is most likely to expand into the factory gate market at a sufficiently high price.

5.35 Without the regulations, we believe some factory gate customers would be unlikely to have an alternative supplier to Fonterra. In such situations, the constraint on Fonterra’s pricing would not be the possibility of entry or expansion, but rather the price that would compel those customers to switch to other inputs (such as direct farmer supply) or otherwise exit the market.

Regions where IPs are more likely to enter the factory gate market

5.36 Independent processors that source milk directly from farmers are the most likely processors to enter into the factory gate market (at the right price).

5.37 Most of these ‘own-source’ IPs are established in areas of high milk growth. Synlait, Oceania, and Westland are located in Canterbury. Danone and Open Country are based in Southland. Miraka, Open Country,¹⁵⁵ Green Valley, and Tatua are based in Waikato. Only Fresha Valley is based in an area of low milk growth—Northland.

5.38 [¹⁵⁶ ¹⁵⁷ ¹⁵⁸ ¹⁵⁹]

Regions where Fonterra is less likely to face a competitor at the factory gate

5.39 Factory gate milk is delivered by the IP directly from the farm to the factory gate customer. Fonterra admits there are no own-source IPs in approximately 30% of its catchment areas.¹⁶⁰

5.40 Our analysis suggests that the catchment areas where Fonterra is the only own-supply processor and where at least one IP purchases DIRA milk are Gisborne, Hawke’s Bay, and Nelson. Our information indicates three IPs collect factory gate milk from Fonterra across these areas and so would have no competitive processor alternative to Fonterra for factory gate milk.

¹⁵⁵ Open Country also has a sites in Taranaki.

¹⁵⁶ []

¹⁵⁷ []

¹⁵⁸ []

¹⁵⁹ []

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¹⁶⁰ Fonterra submission, 17 August 2015 Public Version, paragraph 9.

Gisborne

5.41 Waimata Cheese, in the Gisborne area, collects []% of its milk from its own farmers and therefore could potentially increase its own collection. Otherwise, the next closest own-supply IP to the Gisborne catchment area is Miraka in Waikato.¹⁶¹

5.42 []¹⁶²

Hawke’s Bay

5.43 []¹⁶³

Nelson

5.44 Talleys, located near Nelson, has no options for raw milk other than Fonterra. [
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¹⁶⁵]

5.45 []
¹⁶⁶]

Regions where Fonterra may face a competitive constraint at the factory gate

5.46 We identified Northland (with one processor) and Otago (with two IPs) , as regions where it is uncertain whether there would likely be entry into the supply of factory gate milk.

Northland

5.47 Fresha Valley in Northland is a small operation, collecting just [] million litres per year of milk from its own farmers. [
¹⁶⁷]

5.48 Goodman Fielder’s Puhoi plant is also located in Northland. Puhoi requires over [] million litres of milk per year. This volume would account for over [] of Fresha

¹⁶¹ Waimata Cheese submission of 29 July 2015[]₂.

¹⁶² []

¹⁶³ []

¹⁶⁴ []

¹⁶⁵ []

¹⁶⁶ []

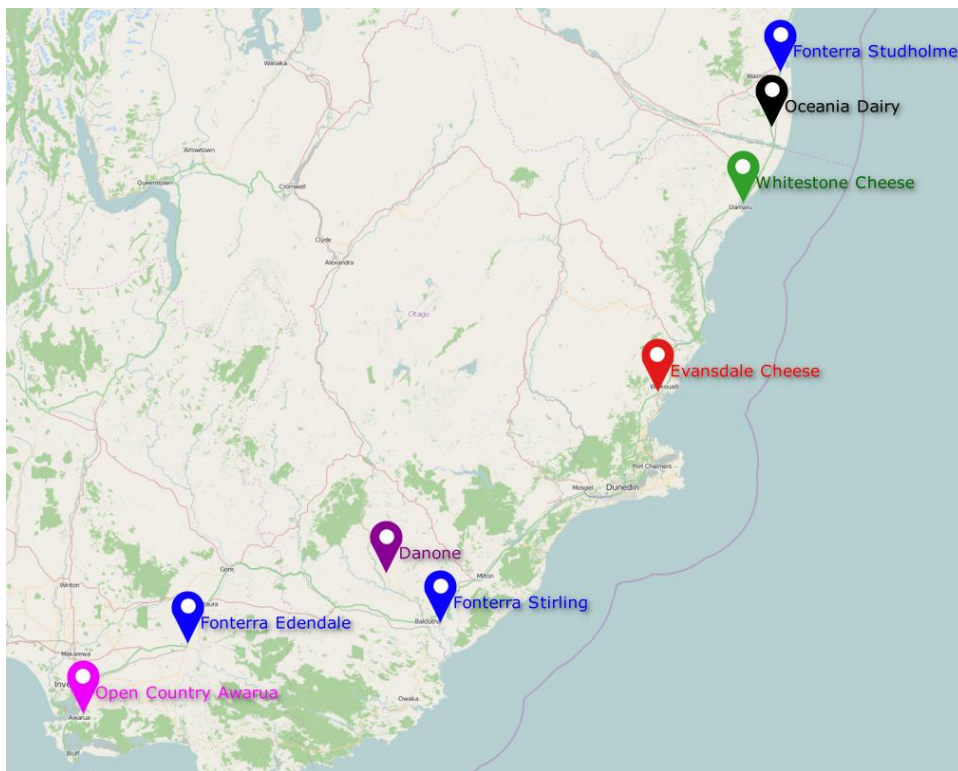
¹⁶⁷ []

Valley’s milk. It is therefore unlikely that Fresha Valley would be able to provide an alternative to Fonterra for all Goodman Fielder’s milk at the factory gate. [168]

Otago

5.49 Cadbury¹⁶⁹ and Evansdale Cheese are both located in Otago. Two own-supply IPs, Danone Nutricia and Oceania, are close to the Cadbury and Evansdale Cheese plants, and therefore one or both of them could possibly supply these customers (see Figure 5.1). []

Figure 5.1: Location of Danone Nutricia and Oceania in relation to Cadbury and Evansdale Cheese, Otago



Source: Commission’s own map

5.50 [] Independent processors might not be interested in supplying small volumes.

168 []

169 We refer to Mondelez New Zealand as Cadbury throughout our report.

- 5.51 Another consideration is that Danone Nutricia and Oceania's transportation costs may be relatively higher because IPs typically have smaller catchment areas than those of Fonterra. So, while their plants may be close to these customers, they might not have a farmer supplier as close to these factory gate customers as Fonterra has.
- 5.52 Cadbury, meanwhile, seeks much larger quantities (over [] million litres in the 2014/15 season) and therefore it may be more attractive for factory gate suppliers in the absence of regulations. [¹⁷⁰]

Price increase by type of buyer

- 5.53 Prices may also vary by type of buyer. In particular it will likely vary by buyers' ability to access or increase their own supply of milk cost effectively. That ability will in turn depend in part on whether, without open entry and exit regulations, Fonterra would be able to limit such access. This is more fully considered in the discussion below in relation to foreclosure of IPs at paragraph 5.76 below. For purposes to this section, we assume that access to farmers would remain as under the regulations.
- 5.54 Factory gate prices by buyers will likely differ across:
- 5.54.1 large independent processors that are subject to the sunset provisions;
 - 5.54.2 IPs that source milk from farmers, and therefore are not subject to the sunset provision; and
 - 5.54.3 IPs for whom own-supply is not an option.
- 5.55 Since Fonterra might be able to set different prices for different factory gate customers, we consider each group in turn. We also comment on Goodman Fielder's claims that it would have no alternative to Fonterra.¹⁷¹
- 5.56 The factory gate price increase that different buyers would likely face without the regulations may differ based on ability to sustain a price increase. Once having sold milk to those buyers with the highest willingness to pay, should Fonterra have milk left over, it would be profitable for it to sell that milk to the remaining buyers at a lower price as long as that price is at least as great as Fonterra's opportunity cost.

Large IPs subject to the sunset provisions

- 5.57 Independent processors that will be subject to the sunset provisions, and so will no longer have access to DIRA milk by mid-2016, are already seeking to increase their own-supply of milk directly from farmers. Therefore, these processors are unlikely to

¹⁷⁰ []

¹⁷¹ The alternative of using powdered milk instead of sourcing raw milk is not considered. []

rely on factory gate milk except while they transition to exclusively supplying themselves or if they happen to fall short in that supply.

Own-supply IPs not subject to the sunset provisions

5.58 Own-supply IPs that are not facing the sunset provisions are largely located in regions with higher milk growth.¹⁷² Similarly, entrants that would seek their own supply from farmers are likely to establish plants in these regions. These processors are therefore likely to be in a better position to increase their own-supply, without regulations.

5.59 [173

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IPs for whom own-supply is not an option

5.60 For many small IPs, own-supply is not an option owing to the volumes and consistent uptake that farmers require. Sourcing milk from farmers under the 20% rule is also impractical for many IPs, given the requirement to maintain separate vats.

5.61 For these processor, not only are competitive alternatives reduced as a result of not being able to take milk directly from farmers, there is also some uncertainty as to whether they would be supplied even if a factory gate market were to emerge, given their small volume purchases (at least in certain regions). Independent processors have told us they are not interested in supplying small volumes. However, Fonterra currently supplies small volumes to small IPs at the market rate. It is not clear why, at the right price, IPs that enter or expand in the factory gate market would not be willing to do the same. That said, processors for whom own-supply is not option are more likely to have only Fonterra as their factory gate supply option.

Goodman Fielder

5.62 Goodman Fielder, based in Auckland, Canterbury, and Manawatu, told us that no processor other than Fonterra can guarantee year round supply of milk on the scale it requires, and nor is any processor likely to develop this scale within a reasonable timeframe.¹⁷⁵

5.63 However, it is not clear why an own-supply IP would not supply factory gate milk, if that price was high enough. This includes supplying Goodman Fielder. It is possible

¹⁷² The main exceptions are []

¹⁷³ []

¹⁷⁴ []

¹⁷⁵ Goodman Fielder purchases some raw milk from Westland on an ad-hoc basis when Westland has excess supply. This amounts to approximately 8% of the total volume of raw milk Goodman Fielder procures. Goodman Fielder "Review of the state of competition in the New Zealand dairy industry: Consultation paper - process and approach" 10 July 2015, paragraph 2.4.

there would be a transition period before all Goodman Fielder's supply requirements could be met by such suppliers. If Goodman Fielder purchased even a portion of its milk volumes from alternative suppliers, it might constrain Fonterra's pricing to some degree.¹⁷⁶

Price sensitivity by classes of buyer

- 5.64 The price increase faced by buyers is also likely to differ based on their price sensitivity. Buyers who face vigorously competitive downstream markets¹⁷⁷ or are otherwise low-margin businesses are less well placed to sustain a factory gate milk price increase.
- 5.65 Dairy exporters are, for the most part, price takers. This limits their ability to pass through any cost increase since such a cost increase would not be industry wide (given that the export market is international). The competitiveness of the export market also suggests that, after having paid a factory gate price that reflects opportunity cost, exporters are likely to have low margins. The consequent sensitivity to factory gate price increases (meaning that a small price increase is likely to result in a large decrease in demand) would limit Fonterra's profit maximising price to such buyers.
- 5.66 The IPs Auscow Dairies, Envictus Dairies, and the Dairy Goat Co-operative do not own-supply and are focused mainly on export markets.
- 5.67 Small IPs that do not collect their own milk are in a similar situation. They are likely to be quite price sensitive because they tend to be relatively high cost and they face competitive downstream markets.
- 5.68 If Fonterra can effectively price discriminate across customer types, the factory gate price increase that different buyers would face in the absence of regulations may differ based on the differing ability to sustain a price increase. Should Fonterra have milk left over after having sold milk to those buyers with the highest willingness to pay, it would be profitable for Fonterra to sell that milk to the remaining buyers at a lower price, as long as that price was at least as great as Fonterra's opportunity cost.
- 5.69 The implications of this type of pricing is that those buyers with few or no alternatives to Fonterra and with little ability to sustain a price increase, would not necessarily face a market foreclosing price increase but rather a price increase that they could just afford.

¹⁷⁶ Although there may be efficiencies associated with having a single supply contract for a plant it is clear that Goodman Fielder has sourced milk from other IPs in the past [].

¹⁷⁷ Downstream markets may be more competitive than upstream supply markets. Downstream markets for dairy products are more likely to be national and so have more market participants.

Price increase by type of buyer—summary

- 5.70 In summary, it appears likely that buyers who currently source milk directly from farmers would be less vulnerable to a factory gate price increase without the Raw Milk Regulations (assuming that such buyers would be able to access farmers as under the open and exit regulations). Buyers who do not have such an option, on the other hand, would be more reliant on Fonterra or other IPs that may enter the factory gate market, if prices in that market were high enough to attract such entry (or expansion).
- 5.71 Prices may also differ depending on buyers' price sensitivity. Buyers who are more price sensitive would pay lower prices (but still above Fonterra's opportunity cost) if there is milk left over after the buyers who are less price sensitive have made their purchases.

Summary—Fonterra can exercise market power at the factory gate

- 5.72 Without the regulation, the price that Fonterra charges for DIRA milk would likely rise. In many instances it would likely rise to the level of the buyers' next best alternatives, which may be the price that just induces entry or expansion by certain e IPs that source milk directly from farmers. Fonterra's current market rate price for non-DIRA factory gate milk provides an indication of what that price increase would likely be.
- 5.73 Independent processors with access to their own sources of raw milk would likely be less affected if there were no regulations, assuming access to farmers similar to that historically provided by the open entry and exit provisions.
- 5.74 In the case of price sensitive buyers, should there be milk left over after factory gate milk is sold to those buyers with a higher willingness to pay, the price increase may be lower (but at least still as high as opportunity cost).
- 5.75 An increase in factory gate prices has the following implications:
- 5.75.1 Increased downstream domestic producers' cost would likely adversely affect downstream domestic prices, quantities, and, potentially, quality and variety. The extent of that adverse effect is unknown.
 - 5.75.2 Buyers that cannot afford a factory gate price that fully reflects all related costs (including opportunity cost) will be unable to compete in the market.¹⁷⁸
 - 5.75.3 Other buyers may be foreclosed if they cannot afford the price increase that reflects market power; however, any such foreclosing effect may be restricted by Fonterra's (and other IPs that enter into the factory gate

¹⁷⁸ IPs that can only remain in the market at below competitive pricing would not be considered efficient. We consider in Chapter 6 whether the DIRA price may have incentivised inefficient independent processor entry.

market) ability to price discriminate across price sensitive customers. The incentive to price discriminate in this way would depend on the availability of milk.

Fonterra's incentive and ability to foreclose independent processors

- 5.76 This section examines whether Fonterra would be likely to have the incentive and ability to seek to foreclose IPs in order to ultimately further increase Fonterra's profits by dampening competition at the farm gate or by raising prices downstream. By foreclosure we mean forcing the exit of processors or otherwise rendering them less competitively effective. Foreclosure strategies could include:
- 5.76.1 restricting IPs' access to farmers at the farm gate by –
 - 5.76.1.1 increasing the farm gate price; and
 - 5.76.1.2 locking farmers into long-term contracts; and
 - 5.76.2 restricting access to milk at the factory gate, where this includes further increasing its price.
- 5.77 This conduct would not likely be profit maximising for Fonterra in the short term. This is because it would require Fonterra, in the case of farmers, to increase the farm gate prices to levels that are likely higher than that which can be justified based on downstream prices or provide concessions to farmers for taking on longer term contracts. In the case of the factory gate, the price would be above profit maximising levels and would thus forego profitable sales. Fonterra would only engage in such conduct if in the long term it allowed Fonterra to prevent the development of more vigorous competition for farmer suppliers, or it allowed Fonterra to gain additional, compensatory market power in downstream markets.
- 5.78 We separately consider the incentive and ability to foreclose at the farm gate and the factory gate. In the case of the factory gate, we separately examine the incentive and ability to foreclose by two types of buyer: exporters and IPs that supply the domestic market.
- 5.79 Whether Fonterra has the incentive and ability to foreclose is considered in the context of the regulations no longer being in place. This means we assume Fonterra would have already raised its factory gate prices to the point where it covers its opportunity cost plus a margin to reflect its market power. It also means we assume the open entry and exit rules are no longer in place.
- 5.80 In summary:
- 5.80.1 At the farm gate we consider that the removal of the milk price monitoring regime would likely not result in significant changes to how the farm gate price is set, and so Fonterra is not likely to raise the farm gate price. Fonterra's co-operative structure would likely limit its ability to lock its farmer suppliers into long-term contracts. Further, Fonterra's ability to foreclose IPs would also be likely to be limited in the case of well-established IPs. Fonterra may be in a better position to foreclose new IPs or those still building their reputations and financial stability.

- 5.80.2 At the factory gate, Fonterra would not likely have a significant incentive to foreclose exporters, and it would not be able to foreclose those domestic downstream buyers that would have alternative sources of raw milk (either by sourcing milk directly from farmers or from IPs that enter the factory gate market as result of higher prices). Some IPs would not have such alternatives but there are likely insufficient in number for Fonterra to gain much benefit from their foreclosure.

Does Fonterra have the incentive and ability to foreclose IPs to soften competition at the farm gate?

- 5.81 We examine here whether, absent the regulations, Fonterra would likely have an incentive to foreclose independent processors that source milk directly from farmers, in order to reduce competition for access to farmer suppliers. Fonterra may benefit from reduced competition by retaining milk supply.

Incentive to foreclose IPs that source milk from the farm gate market

- 5.82 In order to assess the extent to which Fonterra may have an incentive to foreclose its upstream rivals, to soften farm gate competition in the farm gate market, we examined the extent to which IPs provide competition for farmers.
- 5.83 We identified that Fonterra was somewhat constrained by its national pricing policy and could not compete vigorously with ‘own-source’ IPs in Fonterra’s attempt to maintain and grow its farmer suppliers. However, we noted Fonterra reacted to farm-gate competition by improving the range and quality of services it offers and easing farmers’ conditions of sharing up.
- 5.84 Fonterra principally competes for farmer supply with the IPs set out in Table 4.3 in Chapter 4. The biggest of these are Open Country and Synlait. []
- 5.85 Fonterra competes with these IPs both for additional farmer suppliers and to retain their existing farmers.
- 5.86 Given the sizes of these various ‘own-source’ IPs in certain geographic areas, we consider that Fonterra may have an incentive to foreclose processors that compete at the farm gate, to soften the competition for farmer suppliers.

Ability to foreclose ‘own-source’ IPs from the farm gate market

- 5.87 We considered whether Fonterra would be able to foreclose its upstream rivals absent the regulations. This was considered through two mechanisms:

- 5.87.1 Without the Milk Price Monitoring regime, Fonterra would generally raise the price of farm gate milk so that IPs would no longer be able to afford farm gate milk,¹⁷⁹ and
- 5.87.2 Without the open entry and exit regulations, Fonterra would seek longer term contracts with famers and so make them unavailable to rival processors. Under the current regulations, Fonterra cannot lock-in suppliers for one more than year.^{180, 181}

Foreclosure by raising the farm gate price

- 5.88 Without the Milk Price Monitoring regime, Fonterra would technically have greater than its current level of discretion to raise the price of farm gate milk. However, we do not consider that Fonterra would, without the regime, make significant changes to how the milk price is set.
- 5.89 We consider that Fonterra is constrained from raising the farm gate milk price by the need to make TAF work. It has been important to Fonterra to remove redemption risk, which it has achieved through TAF.
- 5.90 To be successful at attracting outside capital, Fonterra needs to assure investors that it will set an efficient farm gate milk price and that it will not reduce the dividend to increase prices to its shareholder suppliers.
- 5.91 A number of parties seek information and transparency over the farm gate milk price (including farmers, TAF investors and analysts). Absent regulation, we consider that Fonterra would have a continued incentive to provide milk price information to such parties and to ensure there is effective monitoring of that price. Without this, the attractiveness of investing in TAF units in particular would likely be reduced.
- 5.92 Our review provides the benefit of greater transparency and has resulted in Fonterra disclosing more information on how its model for calculating the milk price works. Fonterra has also adjusted aspects of its approach in response to our analysis. However, the overall changes to the milk price as a result of our monitoring have

¹⁷⁹ Rather than seeking to raise farm gate prices generally, Fonterra may seek to raise prices to only those farmers who would otherwise exit Fonterra to sell their milk to an independent processor. Such farmers would essentially become contract suppliers. Fonterra could potentially pay such farmers a higher price than the price it pays its shareholder farmers so as to deny these farmers to its rival processors. Any potential for such targeted pricing is not impacted by the regulations. The limit on the number of contract suppliers Fonterra may retain is, rather, contained in Fonterra's constitution. We do not, thus, consider the possibility of such targeted pricing herein. We note, however, our understanding that Fonterra generally pays its contract suppliers a lower price than its farmer shareholders.

¹⁸⁰ Except where 33% or more of milk solids produced within a 160 km radius of any point in New Zealand is supplied under contract with IPs. Fonterra locks in contract suppliers that are sharing up under growth contracts (this is seven years for the former NZDL farmers).

¹⁸¹ As discussed in Chapter 4 (see paragraphs 4.72 – 4.74), it is possible that Fonterra's interest free loan scheme may be raising the costs of a farmer switching to an IP. Such a switching cost is present both with and without the regulations.

been small. As a result, we do not think removal of the regulation would result in a significant increase in the farm gate milk price.

- 5.93 We therefore think that Fonterra would retain most aspects of the milk price setting process, including its Milk Price Manual, even if regulation was removed. Fonterra's incentives to raise the farm gate milk price are therefore constrained with and without regulation.

Foreclosure through longer term contracts

- 5.94 If the open entry and exit provisions are no longer critical to own-source IP entry and growth, Fonterra increasing the length of its contracts with farmers would not have an adverse effect on these processors since they would nonetheless be able to cost-effectively attract and maintain farmers. Whether this is likely to depend on the type of IP affected: whether it is a new entrant or, if already in the market, how well-established it is in regard to its reputation and financial stability.

- 5.95 The concept of open entry and exit is not just part of the DIRA regulation, it may also relate to Fonterra's cooperative nature. This means that farmers are unlikely to see it as being in their best interests to have these terms changed. [

182]

- 5.96 The majority of IPs raised concerns that Fonterra would lock-in farmers to impede entry in the first place and to preclude growing processors from acquiring new sources of milk supply.¹⁸³

- 5.97 They are concerned that, in face of the choice of longer term contracts with Fonterra or staying with an IP (even a well-established one), farmers, who tend to be conservative in their business decisions, would switch to Fonterra. That is, conservative farmers see Fonterra as a 'sure thing' given its size and co-operative structure. Moreover, should sufficient switching away from IPs occur, this could weaken the processors as ongoing business and in turn further drive farmers back to Fonterra. We have been cautioned that this negative feedback loop could result in a 'mass exodus' of farmers from IPs to Fonterra.¹⁸⁴

- 5.98 We consider Fonterra could limit the development of new or newer 'own-source' IPs, but a number of factors mitigate Fonterra's ability to adversely impact established IPs:

182 []

183 Danone Nutricia submission, 17 August 2015; Westland submission, 10 July 2015, at paragraph 35. []; Talleys submission, 29 June 2015; []

].

184 []

5.98.1 []¹⁸⁵

5.98.2 The processors typically pay a premium for milk at the farm gate and most do not require sharing up, potentially making them more appealing for certain farmers; and

5.98.3 certain own-source IPs, in particular Westland¹⁸⁶ and Tatua,¹⁸⁷ are well established and unlikely to lose farmers if Fonterra were to change the terms of its farmer contracts.

5.99 Even after the liquidation of NZ Dairy Ltd in 2012, farmers continued to switch away from Fonterra to Oceania, Synlait, and Westland. Although this occurred at a time when farmers were assured they could switch back to Fonterra, it still indicates that not all farmers are so risk averse that they are unwilling to switch.

5.100 An additional consideration is whether longer term supply contracts are not anti-competitive, despite any foreclosing effect they may have, but instead are an efficient response to mitigating the risk of uncertain supply. Security of supply can give a processor the confidence to invest in risky processing assets.

5.101 []

5.102 Fonterra may face lower investment risk than its competitors, in the event of no regulations, and so should not require as lengthy contracts as them although it is also exposed to the risk of underutilising capacity. However, on the face of it, there does not appear to be good reason why Fonterra would have farmer supplier contracts that are longer or shorter than those of its competitors.

Conclusion on the incentive and ability to foreclose own-supply IPs from the farm gate market

5.103 We consider that while Fonterra may have an incentive to prevent IPs from competing for farmers, it is nonetheless unlikely to do so either by changing the method by which it sets the farm gate milk price absent the Milk Price Monitoring Regime, or by locking farmers into longer contracts absent the open entry and exit regulations.

Incentive and ability to foreclose IPs to enhance market power downstream

5.104 This section examines the question of Fonterra's incentive and ability to foreclose IPs to enhance its market power downstream. We separately consider this for IPs that principally export and for those that sell in downstream domestic markets.

¹⁸⁵ []

¹⁸⁶ Fonterra has not found it profitable to sign farmers from the Westland region.

¹⁸⁷ Tatua is a closed co-operative that predates Fonterra. []

Incentive to foreclose IPs from the export market

5.105 It is not clear that Fonterra would obtain much benefit from excluding rival exporters by raising the price of factory gate to them (or foreclosing their access to such milk altogether) as long as Fonterra was otherwise selling factory gate milk at a price that at least covered its opportunity cost. This is because the export market is generally understood to be a competitive, international market in which Fonterra, while being a large player, does not have significant market power. In this situation, Fonterra would have little or nothing to gain from foreclosure.

5.106 This is because Fonterra tends to compete with either global dairy players or local IPs in international consumer markets. Fonterra's key competitors in export markets are global players and so IP entry in New Zealand would not significantly change the competitive dynamic in those markets.¹⁸⁸

5.107 [189]

5.108 [

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¹⁸⁸ Fonterra's Europe and US Roadshow – June 2015.

¹⁸⁹ []

¹⁹⁰ []

Figure 5.2: New Zealand exporter's whole milk powder prices in China, 2014/15 season

[]

[]

5.109 [] if Fonterra is recovering its opportunity cost in factory gate sales, we do not consider it to have a strong additional incentive to foreclose domestically based exporters through further increases of the factory gate price. Given this, we do not further consider Fonterra's ability to foreclose competitors in order to gain additional market power in export markets.

Incentive to foreclose IPs in domestic downstream markets

5.110 We considered Fonterra's incentive to foreclose IPs that participate in the domestic downstream market by further raising the factory gate market price.¹⁹¹ We also considered this incentive in the context of the 20% rule. That is, whether without the regulations, Fonterra would prevent IPs that rely on this rule from accessing Fonterra's farmers. Independent processors that rely on this rule participate almost entirely in the domestic market.

5.111 Fonterra would have an incentive to foreclose downstream competitors if they had or are likely to have a significant effect on the competitiveness and the dynamism of domestic dairy markets. We consider they have affected certain dairy markets and that there is the possibility for increased effect, and so Fonterra would likely have an incentive to foreclose, in the absence of the regulations.

5.112 The domestic downstream dairy markets are almost entirely supplied by New Zealand dairy processors. Fresh dairy products are difficult to transport given their relatively short shelf lives so domestic dairy markets face few, if any, import constraints; although, product is transported around the country. Hard cheeses and very small quantities of artisan cheeses are sometimes imported and tend to be premium products.

5.113 The strength of competition that Fonterra faces in domestic downstream markets from IPs varies by product market; however, Goodman Fielder is its most significant competitor in all of the main markets. Private label brands also have significant market share in certain product markets but all private label products are produced by Fonterra and Goodman Fielder, and so are not considered further in our assessment of foreclosure incentives outside our consideration of any incentive to foreclose Goodman Fielder.

¹⁹¹ Fonterra could also attempt to foreclose downstream IPs by reducing their access to farmer supply by way of change to the open entry and exit rules. As we addressed this previously, we do not consider it any further.

5.114 The main domestic dairy processors after Goodman Fielder are Green Valley¹⁹²,¹⁹³, Fresha Valley, and Tatura.^{194, 195}

5.115 Independent processors (apart from Goodman Fielder) typically specialise in cheese, yoghurt, or ice cream. The collective market share of IPs, other than Goodman Fielder, is particularly significant in cream cheese and dips ([]), followed by yoghurt and chilled desserts ([]). Their collective market shares range are [] in cheese, butter, and margarine, and [] in UHT flavoured milk. The only product categories where their market shares are less than [] are UHT white milk ([]) and fresh milk and cream ([]).

Table 5.1 Market share in main domestic product categories, August 2015								
	Fresh milk and cream	UHT flavoured milk	UHT white milk	Cream cheese and dips	Yoghurt and chilled desserts	Butter and margarine	Cheese	Ice cream
[
196								

Source: []

Note: Figures are rounded, so do not sum to 100%.

5.116 We understand that this competitive dynamic has been quite stable for a while.¹⁹⁷

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194 []

195 []

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197 []

5.117 We consider the particular competitive role played by Goodman Fielder, and smaller cheese, yoghurt and ice cream makers in the following sections.

Goodman Fielder

5.118 [

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5.119 [

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]

Cheesemakers

5.120 Independent processors indicated they generally cannot compete against Fonterra in bulk products such as 1kg cheeses, as Fonterra and Goodman Fielder have lower cost bases.²⁰⁰ [²⁰¹]

5.121 This, however, does not mean that Fonterra is not in competition with such cheesemakers. There is some price competition²⁰² and they exert pressure on Fonterra's quality.²⁰³ As noted in Table 5.1 smaller cheesemakers have collectively in this way gained about [] market share as at August 2015.

Yoghurt and chilled dessert makers

5.122 As noted in Table 5.1 producers other than Fonterra and Goodman Fielder collectively account for almost [] of the yoghurt and chilled dessert product category. Lion,²⁰⁴ which on its own accounted for about [] market share as at August 2015, is one of these IPs. There has been steady growth by the remaining players, gaining market share from [] in early 2012 to [] in August 2015.

198 []

199 []

200 Grinning Gecko Cheese submission of 14 August 2015.

201 []

202 []

203 []

204 Lion, registered as 'Lion - Beer, Spirits & Wine NZ', sell Yoplait Yoghurt.

5.123 [

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Ice cream makers

5.124 As noted in Table 5.1, Fonterra accounts for []the ice cream category, which independent producers have made in-roads into. Based on Fonterra’s analysis of market shares at Foodstuffs’ South Island outlets, ‘other manufacturers’ (excluding Goodman Fielder) account for about [] of market share[]²⁰⁶.

Conclusion on incentive to foreclose in domestic downstream markets

5.125 Fonterra remains the dominant player in domestic downstream markets, particularly for fresh milk and cream (typically supplied indirectly through private label toll manufacturing). However, smaller IPs have made significant in-roads in certain product categories. There appears to have been some consequent price pressure on Fonterra (although this may be limited since most of the smaller independent producers products are premium products), as well as a quality pressure.

5.126 We consider that Fonterra would have an incentive to foreclose smaller IPs in event of no regulations. Whether this incentive extends to Goodman Fielder is less clear given its observed ability to negotiate a discount off the DIRA price for its milk supply.

Ability to foreclose IPs in domestic downstream markets

5.127 Given our view that Fonterra would have some incentive to foreclose downstream domestic competitors, we now consider whether Fonterra would be able to foreclose. This outcome appears likely only for the IPs that do not have competitive alternatives to Fonterra either because they are not in a good position to self-supply or no other IP is geographically positioned to supply milk to them at the factory gate. There does not appear to be sufficient of the latter for Fonterra to consider a strategy of exclusion. Fonterra would have little to gain in the downstream market from their exclusion.

IPs that use Fonterra factory gate milk

5.128 indicates by geographic area whether downstream competing IPs that use Fonterra factory gate milk are likely to have a competitive alternative should Fonterra further raise factory gate milk prices above levels that reflect its opportunity cost and market power. The identified alternatives assume that Fonterra has not otherwise successfully foreclosed own-supply IPs or precluded new access to farmer suppliers by effectively locking in farmer suppliers to Fonterra.

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- 5.129 We identified 14 domestically focused IPs that use Fonterra factory gate milk. Of these, it appears that six may have alternatives to Fonterra, including by way of increasing their sourcing from farmers. These include Goodman Fielder's Manawatu and Canterbury plants. In terms of the possible cost effectiveness of these alternatives, as discussed in our assessment of the likelihood of Fonterra raising the factory gate price to reflect its market power, it seems likely that these processors would be willing to supply at Fonterra's current market rate and that price may be an indication of the factory gate price that would induce entry or expansion in that market.
- 5.130 The remaining nine IPs (including Goodman Fielders' Puhoi plant in Northland) that do not appear to have alternatives currently account for approximately [] of total DIRA milk purchases in the 2014/15 season. They principally sell specialty cheeses, gourmet yoghurts and ice cream.

Table 5.2: Summary of IPs that rely on factory gate milk, 2014/15

Region	Independent processor	Alternative factory gate supply	Factory gate milk (litres)	Own farmer supply	Compete against Fonterra	Products
Northland	Goodman Fielder	[207			Yes	Domestic dairy
				Yes	Yes	Domestic dairy
Northland AUCKLAND/ WAIKATO/ BAY OF PLENTY	Goodman Fielder				Yes	Infant Milk Formula export
	Fresha Valley				Yes	Domestic ice cream
	Dairy Goat Co-operative				Yes	Domestic yoghurt
	Emerald Foods Group			Yes	Yes	Domestic dairy
	Epicurean Dairy				Yes	Domestic yoghurt
GISBORNE/ HAWKE'S BAY/ WAIRARAPA/ MANAWATU	Green Valley			Yes	Yes	Domestic specialty cheese
	Gopals Sweets & Snacks				Yes	Domestic dairy
	Waimata Cheese			Yes	Yes	Domestic yoghurt
CANTERBURY	Goodman Fielder				Yes	Domestic specialty cheese
	BioFarm Products				Yes	Domestic dairy
	Barrys Bay Cheese				Yes	Domestic specialty cheese
	Goodman Fielder				Yes	Domestic yoghurt
	Karikaas				Yes	Domestic specialty cheese
	Serra Natural Foods				Yes	Domestic Specialty cheese
	Talbot Forest Cheese				Yes	Domestic specialty cheese
OTAGO/ SOUTHLAND	Whitestone Cheese]		Yes	Domestic ice cream
	Evansdale Cheese					
TASMAN/ MARLBOROUGH	Talleys					

Independent processors that rely on the 20% rule

5.131 We found smaller cheesemakers tend to purchase milk under the 20% rule. Without access to milk under the 20% rule, these cheesemakers would face higher barriers to entry and expansion, and so otherwise competitively effective entry might not occur. Further, some existing cheesemakers may be foreclosed as they do not have access

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to milk at the factory gate and are not large enough to take all the milk from a small farm.

- 5.132 About half the Specialty Cheesemakers Association members use the 20% rule.²⁰⁸ They typically source milk from a single farm as three-quarters of them take less than 100,000 litres per season. These companies are unlikely to have another realistic source of milk. Fonterra generally restricts its deliveries to above 3,000 litres. Based on our view that IPs that enter the factory gate market are expected to do so on terms similar to Fonterra, we expect these IPs may also restrict deliveries to above 3,000 litres (although, we note that whether processor selling at the factory gate would be able to do so cost-effectively would likely be affected by the location of buyers relative to the factory gate seller's collection routes). If this happened, the IPs that rely on the 20% rule would still not likely gain access to raw milk, even if new processors entered the factory gate market.
- 5.133 Cheesemakers prefer to know where their milk comes from, and so tend to source milk from farms close to them. Being able to trace the milk to that farm is important. As such, some cheesemakers opt to purchase milk under the 20% rule from more than one farm rather than purchase milk at the factory gate. Three companies currently take milk from more than one farm, and at least one company planning to take milk under the 20% rule in the future will require milk from more than one farm.
- 5.134 Further, IPs that purchase milk directly from farmers under the 20% rule are concerned that Fonterra would foreclose access to those farmers. A representative of the Specialty Cheesemakers Association, Karikaas, noted that generally and historically dairy companies and co-operatives do not like, and therefore contractually prohibit, a farmer from dual supply. The Specialty Cheesemakers Association understands that there may be a drive to do away with 20% rule, which would be a concern for these processors.²⁰⁹ Two cheesemakers claim that their businesses would not survive without access to this milk.^{210, 211}
- 5.135 Self-supply also appears to be an unlikely alternative to most cheesemakers as this would require significant investment in farms and they take a very small proportion of a farm's milk.
- 5.136 We consider it likely that Fonterra would be able to foreclose independent processors that rely on the 20% rule. However, while Fonterra may generally have an

²⁰⁸ Thirty seven members of NZSCA are currently making cheese for sale. Of these, eight companies do not use cow's milk, three use cow's milk exclusively from their own animals, and three companies are very large (Goodman Fielder, Open Country, and Fonterra) and so do not find the 20% rule useful. Of the remaining 23 cheese makers, 16 members currently take milk from farms under the 20 % rule. Another four companies are planning to do so.

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incentive to foreclose downstream competitors, the amount of competition provided by those cheesemakers that rely strictly on the 20% rule may be so small that Fonterra's incentive would be much reduced.

Conclusion on incentive and ability to foreclose in domestic downstream markets

5.137 Our analysis suggests that while Fonterra may have an incentive to foreclose downstream competitors, its ability to do so would be limited because many such IPs would likely face alternatives at the factory gate or be able to increase their own supply. However, processors that rely on the 20% rule, plus some factory gate users, would not be likely to have an alternative to Fonterra. Fonterra would probably be able to foreclose these processors. However, given the small market share such processors collectively account for, Fonterra may not get a benefit from their foreclosure.

6. Balancing efficiencies and inefficiencies of the DIRA Regulation

Purpose of this chapter

- 6.1 This chapter states our recommendation on the DIRA Regulation and assesses the sufficiency of competition in the dairy industry. To reach our recommendation, we analysed:
- 6.1.1 the efficiency benefits that accrue from the DIRA Regulation; and
 - 6.1.2 the efficiency costs that accrue from the DIRA Regulation including:
 - 6.1.2.1 the DIRA Regulation and Fonterra maintaining excess capacity;
 - 6.1.2.2 what inefficiency is created in the factory gate market as a result of DIRA Regulation;
 - 6.1.2.3 if the DIRA Regulation incentivising inefficient dairy conversions; and
 - 6.1.2.4 inefficiencies of the base milk price monitoring regime.

The sufficiency of competition in the dairy industry

- 6.2 Question 2 of the Terms of Reference asks [emphasis added].²¹²

Is the current state of competition in the relevant New Zealand dairy markets **sufficient to ensure the efficient and contestable operation of these markets in the absence of the provisions of Subparts 5 and 5A of Part 2 of the DIRA and/or the provisions of the DIRA Raw Milk Regulations**? In particular, would Fonterra (given its market shares, nationwide collection and processing networks, and ownership and capital structure arrangements) be likely to have both the ability and the incentives to exercise market power against competitors, suppliers or purchasers in one or more of the relevant New Zealand dairy markets (in the North and/or the South Island), in the absence of the provisions of Subparts 5 and 5A of Part 2 of the DIRA and/or the provisions of the DIRA Raw Milk Regulations?

- 6.3 In Chapter 3, Framework and approach, we stated why we consider that the efficiency purpose is the overriding goal of the DIRA. Accordingly, in order to determine whether the state of competition is sufficient or insufficient we assessed whether the relevant New Zealand dairy markets would be more efficient with or without the DIRA Regulation.
- 6.4 Table 6.1 summarises our main findings on the efficiencies and inefficiencies of the DIRA Regulation:

²¹² Minister for Primary Industries "Terms of Reference for a report on the state of competition in the New Zealand dairy industry" 3 June 2015, p.2.

Table 6.1: High level assessment of the efficiencies and inefficiencies of the DIRA Regulation

<i>Efficiencies</i>	<i>Inefficiencies</i>
<ul style="list-style-type: none"> • Open entry and exit, and Raw Milk Regulations: • Provide for own-supply IPs entry and expansion. • These regulations mitigate Fonterra’s ability to exercise market power against new and recently established IPs at the farm gate which could limit efficient entry and expansion. • These regulations may facilitate entry by own-source IPs that may provide for more competition in the factory gate market in the future. • Open entry and exit, particularly the 20% rule, has fostered downstream domestic competition particularly in yoghurt and cheese. Fonterra responded to this competition in its domestic product offerings. • The Raw Milk Regulations constrain Fonterra from exercising market power to raise its prices in the factory gate market. Indicative estimates imply efficiencies may be in the order of \$3.5m to over \$13m. • The base milk price disclosure and monitoring rules improve the credibility of the farm gate milk price and provide a source of flexibility in the scope of our review, particularly in improving the transparency of disclosures over time. 	<ul style="list-style-type: none"> • Open entry and exit, and Raw Milk Regulations, may both cause Fonterra to maintain excess capacity: • Our estimate is that the capacity cost of catering for DIRA milk uncertainty is in the region of \$6 million per year. This reflects the volume risk on DIRA milk. • The costs to Fonterra of free exit have been limited because milk growth has replaced milk lost to IPs, so Fonterra’s capacity has not been stranded. Further, some form of entry and exit may be retained in any case. • Open entry and exit may incentivise inefficient dairy conversions: • We have no evidence that this is significant. Fonterra would not often reject in the absence of regulation. • Raw milk regulations could lead to inefficiency so far as Fonterra is prevented from recouping its opportunity costs at the DIRA price. We have no reason to believe that any inefficiency is material. • The Raw Milk Regulations may hinder the development of a functioning factory gate market. Even if the DIRA price reflects Fonterra’s opportunity cost, the tolerance limits and certainty of supply may reduce incentives for IPs to seek milk outside of the regulations.

Our recommendation

6.5 On balance, we found competition is currently not sufficient to warrant deregulation.

- 6.6 Chapter 5, Concerns about deregulation—what competition would look like without the DIRA Regulation, outlined our conclusion that competition at either the farm gate or factory gate could not ensure the efficient and contestable operation of these markets in the absence of the DIRA Regulation. We also concluded Fonterra would be able to exercise market power in the factory gate market in the absence of the DIRA Regulation.
- 6.7 Our assessments of the costs and benefits of removing the DIRA Regulation indicate the benefits of the regulations are in the order of scale as the costs. However there exist risks involved with removal at this time which may harm the growth of competition to date which offer potentially significant future benefits.
- 6.8 Therefore, on balance, we conclude that it is not clear that efficiency will be improved with the removal of subparts 5 (open entry and exit), 5A (base milk price disclosure and monitoring rules) of the Dairy Industry Restructuring (Raw Milk Regulations) 2012 and it could be reduced by the removal of the DIRA Regulation. We acknowledge our decision to not recommend deregulation is an ‘on balance’ one, based on our analysis and the current evidence before us. We seek further information from stakeholders on the relative efficiencies and inefficiencies of regulation.
- 6.9 As discussed in Chapter 5, we consider the main potential concern from full deregulation is Fonterra increasing the price of raw milk at the factory gate to a level above the competitive price. This would be expected to have a consequential end impact on domestic retail markets.
- 6.10 The Raw Milk Regulations are potentially beneficial in encouraging some IPs to enter the farm gate market. Although those that might be encouraged to enter this market largely serve international markets, they would be well placed to supply into the factory gate market and thereby support the IPs that serve domestic markets and that are not well placed to directly contract with farmers.
- 6.11 We found that the Raw Milk Regulations are also potentially hindering the development of a factory gate market. A lack of robust competition in this market increases the risks associated with full deregulation. Lack of competition could lead to price increases which reflect market power feeding through to the final prices for goods such as fresh milk and yoghurt.
- 6.12 Subpart 5 of the regulations which concern the 20% rule and open entry and exit provisions assist those IPs and food processors which want to access raw milk direct from farmers. As we discuss in Chapter 5, we are less concerned about the prospect of Fonterra attempting to foreclose access to farmers. However, this does not mean there is no prospect of that occurring or that there are no benefits accruing from the regulations acting as a safeguard. These regulations have also assisted niche producers, who compete downstream in domestic markets, to source raw milk for production. Given the low cost of these regulations, and their assistance to the growth of IPs and therefore their ability to compete at the factory gate, we believe these should be retained.
- 6.13 Finally we have also considered Subpart 5A of the regulations which govern the Milk Price Manual monitoring. It costs between \$0.5m and \$1m per annum for us to

review the milk price. We note there are some additional benefits from the Commission's role. In this respect the monitoring of the Milk Price Manual serves to highlight issues with the base milk price, if it were to occur. We also note the widespread support for the Milk Price Manual and on balance believe this should also be retained.²¹³

- 6.14 In the following sections, we lay out the question we are addressing, our assessment of the efficiency benefits promoted by these regulations and what inefficiencies may be caused by them. Based on the evidence before us, we have attempted to gauge the size of these impacts where possible.

The efficiency benefits that accrue from the DIRA Regulation

- 6.15 In Chapter 5, Concerns about deregulation—what competition would look like without the DIRA Regulation, we assessed the market power that Fonterra would have, and Fonterra's incentive and ability to exercise that power. Our main concern is that, without regulation, Fonterra would be likely to have the ability to exercise market power in the factory gate market. The exercise of market power by Fonterra would result in higher than competitive prices in the supply of raw milk to IPs, which would ultimately feed through to retail prices of domestic dairy products. The DIRA Regulation has prevented this from occurring.
- 6.16 The regulations have also resulted in increased competition in the farm gate market. Removing the regulations may slow the rate of increase in competition. This could result in Fonterra foregoing some further productive and possibly dynamic efficiency gains that might result from competition.
- 6.17 Fonterra faces competition in export markets, which would not be affected by removing the regulations. This competition would continue to provide incentives for Fonterra to achieve dynamic and productive efficiencies.
- 6.18 In our analysis, the efficiencies from the regulation are considered to result from restraining Fonterra from being able to fully exercise its market power. The following section draws upon the theories of harm to gauge the extent of efficiencies which may accrue.

Regulations aid the development of competition with Fonterra

- 6.19 Fonterra faces some competition at the farm gate and potentially at the factory gate but this varies by region. It also faces competition in downstream domestic markets and export markets.

²¹³ We recognise several submitters expressed concerns about the operation of the Milk Price Manual and who carries should carry out the calculations. For example see: Open Country Dairy 4 "Cross-submission on consultation on substantive issues - review of the state of competition in the New Zealand dairy industry" 31 August 2015; Synlait "Consultation on substantive issues - review of the state of competition in the New Zealand dairy industry" 12 August 2015.

- 6.20 Overall we found that, without regulation, while Fonterra is likely to hold some buyer side market power, it would have little or no incentive to use this to the detriment of shareholding farmers. Consequently we do not believe the regulations contribute to material efficiencies in this respect although we recognise the regulations act as a safeguard against such conduct.²¹⁴
- 6.21 The principal constraint Fonterra faces in farm gate markets is from own-source IPs. These processors are the ones also likely to compete with Fonterra at the factory gate, should a functioning factory gate market emerge outside of DIRA. The most significant constraint Fonterra faces in domestic downstream markets is from Goodman Fielder and private label brands.²¹⁵ Goodman Fielder [] is afforded protected access by the regulations.²¹⁶
- 6.22 In most domestic downstream markets, niche IPs²¹⁷ use the regulations to enter, compete and expand. For many of these IPs, own-supply is not a feasible option owing to the volumes and consistent uptake that farmers require. While these IPs make up a small portion of competitors, the DIRA Regulation facilitates entry and these smaller players may impose a collective constraint on Fonterra. Where the DIRA Regulation allows for greater entry and expansion, the resulting constraint on Fonterra's market power is likely to generate efficiencies in downstream domestic markets.²¹⁸
- 6.23 While we assessed what competition would look like without the DIRA Regulation, we found that an increase in factory gate prices is likely to increase downstream domestic producers' cost. An increase in price due to Fonterra's market power is likely to adversely affect domestic prices, quantities, and potentially, quality and variety. Given these are significant markets in New Zealand we would expect the efficiencies generated are potentially substantial.²¹⁹
- 6.24 The principal constraint Fonterra faces in export markets is from global players. We did not see evidence to suggest the export market is not workably competitive so we did not consider it further.

²¹⁴ There were some concerns with contract farmers; however we found DIRA Regulation is not likely to impact on these concerns. See Chapter 5.

²¹⁵ Fonterra and Goodman Fielder are the principal competitors for these private label contracts.

²¹⁶ Dairy Industry Restructuring (Raw Milk) Regulations 2012 s 7 and s 20.

²¹⁷ Niche IPs target a specific market such as bio nutrients.

²¹⁸ This is discussed at greater depth in the previous chapter 5.

²¹⁹ Annual retail sales (through supermarkets only) across the major dairy categories are approximately:

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Fonterra has a greater ability to exercise market power at the factory gate without the DIRA Regulation

- 6.25 We have found in Chapter 5 that the main role the DIRA Regulation plays is to constrain the factory gate market price in the absence of effective competition. There are two aspects to this:
- 6.25.1 regulations which aid the development of IPs who may compete in the factory gate market; and
 - 6.25.2 regulations that aid the IPs that directly serve the downstream domestic markets by providing access to raw milk at the DIRA milk price.
- 6.26 Ultimately we are concerned about the impact in these downstream markets. All the regulations under DIRA have a role within this:
- 6.26.1 While it is possible that Fonterra would retain an open entry and exit policy in the absence of the DIRA Regulation, it is certain the open entry and exit provisions of the DIRA Regulation make it easier for existing and new IPs that source milk directly from farmers to contest the farm gate market. Should these IPs produce differentiated products or operate more efficiently than Fonterra, they may be able to pay a premium for raw milk and compete for sufficient raw milk at the farm gate. Fonterra may need to respond to this competition by improving its own processes and product mix which may drive productive and dynamic efficiencies.
 - 6.26.2 Domestic competition, particularly in yoghurt and cheese, has been fostered by the Raw Milk Regulations and the 20% rule. Fonterra has responded to this competition in its domestic product offerings. Speciality cheese makers [] may provide a competitive constraint on Fonterra.

The base milk price disclosure and monitoring rules

- 6.27 We consider that the requirement for Fonterra disclosure its methodology for calculating the farm gate milk price, and our annual statutory reviews of Fonterra's Milk Price Manual and calculation of the base milk price, has had some influence on how Fonterra sets its base milk price.
- 6.28 As we discuss in Chapter 5, we do not consider the removal of the regime would necessarily result in significant changes to how the milk price is set or the level it is set at. The process also incurs costs both for the Commission and other parties to the process.
- 6.29 If the regulations were to be removed we would expect some independent audit to continue and consequently not all these costs are likely to be avoided. There are some benefits which accrue from the monitoring process under the regulations including additional transparency across a complicated price setting process. A benefit in having the Commission (as a regulator) review the base milk price calculation is that we can be more flexible in the scope of our review (such as calling

for improved transparency of information from Fonterra) than another independent party such as a financial auditor who might generally be tasked to review the accuracy of the calculation rather than taking a broad view of how Fonterra could best comply with the rules. This may enhance the role of highlighting issues with the base milk price that might occur.

- 6.30 We also recognise the widespread support for the milk price monitoring regime which indicates all parties find some value from the Commission's role in milk price monitoring. On balance we do not recommend removing this safeguard at this time.

Estimating the potential size of the efficiencies created by the DIRA Regulation

- 6.31 We have estimated the potential impact of Fonterra using its position of market power in the factory gate market to increase price were it to be de-regulated now. To estimate this we attempted to isolate the impact of the volumes of milk that might be priced out of the market. Such estimates of inefficiency can only be indicative and are used to show the potential order of scale of the impact.
- 6.32 We have gained a view of the order of scale by the following assumptions:
- 6.32.1 We have estimated the size of this potential market using factory gate volumes in 2014/15.²²⁰ We then added in volumes of milk Fonterra supplied for the domestic market within Fonterra. These Fonterra volumes are incorporated because a market-wide cost increase is likely to increase all prices in those downstream markets including Fonterra prices.²²¹
- 6.32.2 We then used the [] as an estimate of the likely price increase. While this figure can fluctuate significantly, we used a 25% mark-up as an approximation.²²²

²²⁰ We have the volumes of milk supplied by Fonterra from which we excluded the larger IPs: Synlait, Miraka and Oceania who primarily serve international markets. []

²²¹ We have estimated the volumes internal to Fonterra from data supplied by Fonterra on milk delivered to their Fonterra Brand plants and Kapiti Fine Foods. This is only an approximation given some of these sales may be for export. We do not believe this will be material and note the overall shares of milk volumes for Fonterra broadly approximates their downstream market share. []

²²² The estimates are affected not only by the estimated mark-up but also by the base DIRA price. []

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- 6.32.3 To isolate the efficiency impact, we took a range of potential changes in volume that might result from the increase in the factory gate milk price.²²³
- 6.33 These estimates provide a very rough guide and are very sensitive to the assumptions that underlie them, and to the DIRA milk price, which can vary significantly. Based on a 25% price increase, the cost can range from \$3.5 million to over \$13 million a year.
- 6.34 There are several other factors that can significantly affect this estimate:
- 6.34.1 The analysis assumes that the DIRA milk price includes all opportunity costs of the on-sale of raw milk. As we discuss within para 5.22, this may not be the case.
- 6.34.2 Our estimates are based on a price mark-up of 25%. If other large IPs did not prove a constraint on the ultimate factory gate price; this could underestimate the price effect whereas if they are a more effective constraint, the price rise may be over-estimated.²²⁴
- 6.34.3 These benefits are based on ‘static’ efficiency losses by which we mean these do not capture the full efficiencies and benefits that competitive rivalry can bring over time. Typically we give more weight to these dynamic efficiencies as they bring important benefits such as more efficient investment, which can easily outweigh static measures of efficiency.
- 6.34.4 This last category of benefit could be significant. In chapter 5, Concerns about deregulation—what competition would be like without the DIRA Regulation, we noted how a price increase could, in particular, impact on smaller producers who cumulatively represent a material competitive dynamic. Such costs, while very difficult to estimate, can be significant over the long run.
- 6.35 Ultimately such factory gate price increases should be passed through downstream so understanding the size of these markets can test the reasonableness of our estimates. There are two conflicting factors here:
- 6.35.1 Given that raw milk only makes up a proportion of the costs of the downstream products, any price increase is diluted. We have previously estimated that raw milk comprises a quarter of the retail price of a 2 litre

²²³ Technically this is the price elasticity of demand. We have used a range of between -0.5 to -1.0. As this is a derived demand from retail markets for dairy products, we do not expect this to be highly elastic at this level. However, again the results are highly sensitive to these assumptions. We note that while a lower elasticity implies a lower volume impact, it also implies a higher price rise from the exercise of market power.

²²⁴ The price mark-up has a non-linear impact on the estimated deadweight loss. If we doubled the price mark-up, the estimated deadweight loss increases to the range of \$14 to \$50 million.

bottle of processed milk.²²⁵ Consequently a 25% price increase at the factory gate could translate into a smaller price impact, an up to 6.25% increase in the retail price.²²⁶

6.35.2 Downstream market purchases are likely to be more sensitive to price increases than the intermediate markets. As such the volume impact and hence the economic efficiency impacts are likely to be larger.²²⁷

6.36 Overall we consider the likely efficiency impacts to New Zealand of a factory gate price increase to be fairly modest in the context of the overall industry. This reflects the efficiency concerns being limited to the impact on the domestic markets because international markets remain competitive.

Efficiency costs that accrue from the DIRA Regulation

6.37 In our view, the 2012 amendments to the Raw Milk Regulations successfully mitigated material inefficiencies created by the DIRA Regulation.²²⁸ Nonetheless the current regulations either require or restrain Fonterra's behaviour in ways that may cause inefficiency. These areas in turn have assisted us in identifying potential inefficiencies caused by the DIRA Regulation.

6.38 Fonterra is constrained in how it secures farmer supply for its investment in plant. For example, the right to withdraw provisions mean that Fonterra cannot secure supply on more restrictive terms. This results in Fonterra bearing milk volume risk it otherwise might not.

6.39 Under subpart 5 (open entry and exit) Fonterra must accept milk from farmers who apply. This might lead Fonterra to maintain spare capacity in excess of what it optimally would.²²⁹

6.40 Fonterra cannot refuse to supply raw milk to IPs under the Raw Milk Regulations at a higher price or on more restrictive terms than those specified in the DIRA Regulation. On this Fonterra bears the risk of IPs not taking DIRA milk according to the allowed tolerances on IPs' forecasts.²³⁰ Fonterra may have to invest in capacity in excess of

²²⁵ Commerce Commission "Consideration of whether to initiate a Commerce Act Part 4 Inquiry into Milk Prices" August 2011, paragraph 43.

²²⁶ This will depend on what proportion of the cost increased is passed on to consumers and what is absorbed by the company.

²²⁷ If we are correctly measuring the deadweight loss impacts in the immediately impacted market (the factory gate), this should capture the overall costs.

²²⁸ For example, the amendments to the Raw Milk Regulations address specific efficiency concerns with Fonterra investing in excess capacity. Broadly the 'October rule' addressed concerns on taking DIRA milk along the milk curve, the sunset clauses mitigated dependence on the DIRA Regulation by large own-source IPs.

²²⁹ Fonterra can issue a capacity constraint notice for one year, [].

²³⁰ The DIRA Regulations require IPs taking raw milk under the Raw Milk Regulations to provide forecasts of their requirements to Fonterra (s 9 – 11, DIRA). For milk other than winter milk an IP must provide a quantity forecast at least three months before the delivery date and must again provide a forecast one

what it would otherwise have and bear additional transaction costs in terms of managing milk.²³¹

- 6.41 In chapter 5, Concerns about deregulation—what competition would look like without the DIRA Regulation, we noted there may be times when Fonterra might not be recovering all of its costs associated with selling DIRA milk, including its opportunity cost. If this occurs regularly, it could cause:
- 6.41.1 inefficient entry by IPs reliant on access to DIRA milk at a price that does not fully incorporate opportunity cost.²³²
 - 6.41.2 inefficient site choice upon entry as the IP might not necessarily take into account non-DIRA factory gate market conditions (in the absence of DIRA Regulation). This could result in supply costs which are higher than at an efficient location and could impede a functioning factory gate market from emerging.
 - 6.41.3 the factory gate market outside of the regulations may not develop effectively, with the effect of prolonging the regulations. This may occur because of the security of raw milk supply the Raw Milk Regulations provide which may dis-incentivise IPs from seeking alternate supply whether or not the DIRA price reflects Fonterra’s opportunity cost.
- 6.42 Fonterra is required to supply Goodman Fielder a maximum of 250 million litres of raw milk per season.²³³ Under the Raw Milk Regulations, Fonterra must either negotiate a price for this supply, or, if a price cannot be agreed,²³⁴ Fonterra is required to charge the default milk price.²³⁵ This regulation may prevent IPs that source their own milk from competing to supply some or all of Goodman Fielder

week before the delivery date. This second forecast may vary by up to 40% from the first forecast. Likewise, for winter milk a forecast must be provided to Fonterra 18 months before the delivery date and must again provide a forecast one week before the delivery date. This second forecast may vary by up to 40% from the first forecast.

²³¹ For example, Fonterra may keep a drier on when it otherwise could have been off, or it builds capacity earlier.

²³² There is also inefficiency in that Fonterra could make more profit without the DIRA Regulation without exercising market power.

²³³ Dairy Industry Restructuring (Raw Milk) Regulations 2012, s 7. In addition, supply to Goodman Fielder is also subject to monthly limits, supply for August, September, November, December, January, February, March, April, or May, is limited to 110% of the amount taken by Goodman Fielder in October.

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²³⁵ Dairy Industry Restructuring (Raw Milk) Regulations 2012, s 20.

The default milk price means the farm gate milk price for that season plus:

- (a) the reasonable cost of transporting the raw milk to the independent processor; and
- (b) for winter milk, the additional cost of winter milk in the island in which the milk is supplied; and
- (c) for organic milk, the reasonable additional costs to new co-op of procuring and supplying the organic milk.

requirements at the factory gate. This could hamper the development of the factory gate market without DIRA Regulation.

6.43 As far as the information we have allows, we considered the following questions to identify the potential inefficiencies created by the regulation:

6.43.1 Do the regulations result in Fonterra maintaining excess capacity?

6.43.2 What inefficiency is created in the factory gate market as a result of DIRA Regulation?

6.43.3 Has DIRA Regulation incentivised inefficient dairy conversions?

6.43.4 What inefficiency is created by the base milk price and disclosure rules?

DIRA Regulation and Fonterra maintaining excess capacity

6.44 We have estimated the economic efficiency costs of Fonterra maintaining excess capacity as a result of DIRA Regulation. This has led us to estimate a modest direct cost to Fonterra from maintaining this additional capacity in the region of \$6 million per year. There is a great deal of uncertainty in future milk volumes and it appears that the regulations are not the primary driver of capacity. It is difficult to isolate the effect of DIRA Regulation from other drivers of milk volume uncertainty although it is likely to have some impact. We note however that the direct costs to Fonterra of \$6 million are not the same as the cost to economic efficiency from maintaining this capacity. It is not necessarily the case that such capacity would not exist, or that the costs would not be incurred by another industry participant in some other form absent the regulations. There would, however, be likely to be better incentives to manage this risk and price it appropriately. As such we consider \$6 million as an upper bound on the costs.

6.45 Fonterra's planning and capacity investments are complex. [
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6.46 The DIRA Regulations have the potential to require Fonterra to maintain excess capacity as:

6.46.1 Fonterra must accept farmers switching back from IPs and from new conversions (with limited exceptions). The switching occurs in a shorter time period than the period required for Fonterra to adjust capacity; and

6.46.2 Fonterra must manage the tolerances or cancellation of DIRA milk provided to the IPs on the regulated factory gate market.

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6.47 On balance, we consider the costs to Fonterra of maintaining capacity in excess of what it otherwise would (in the absence of DIRA Regulation) are likely to be in the order of \$6 million to \$12 million per year.²³⁷ We consider these are fairly modest costs in the context of the overall dairy market.²³⁸

Forecasting milk volumes is complex and uncertain

6.48 Forecasting future milk volumes is important for making optimal investment decisions, and this is challenging given the range of variables and uncertainties that influence the value of different products and volume of milk supply. Fonterra tells us that, [²³⁹]

6.49 [²⁴⁰]

6.50 [²⁴¹] Figure 6.1 below illustrates Fonterra’s milk volume forecast accuracy over the past few years.

6.51 The challenge with uncertain milk volumes is that it is hard to react quickly to the need for new capacity, as it can take as long to set up a new processing plant (a ‘greenfield investment’) as it would to expand an existing plant ([²⁴² ²⁴³]) because expansion often involves duplicating plant. [

Figure 6.1: Fonterra’s Milk Volume Forecast Performance

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²³⁷ Normally when we compare costs and benefits we would look only at the costs which are incurred because of those parts of the regulations which give rise to the benefits. In the case of the additional capacity costs which Fonterra incurs, part of this is from supplying raw milk to IPs who primarily serve international markets and consequently are excluded from our calculation of the benefits. We note that our terms of reference request we examine the question of the state of competition in the absence of Subpart 5 and 5A of the DIRA and/or the provisions of the DIRA Raw Milk Regulations. The regulations as they currently exist therefore would imply examining the full costs from additional capacity including due to supplying IPs serving international markets. We do however recognise that these IPs are also the most likely potential competitors to Fonterra in the factory gate market and are currently subject to sunset provisions which limit the time over which they have rights under the Raw Milk Regulations.

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²⁴³ []

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6.52 []^{244, 245} This competition also complicates Fonterra’s forecasting of capacity requirements.

6.53 Overall, DIRA Regulation appears to be only one of several factors driving uncertainty in required capacity. It is not the main driver.

The evidence before us does not suggest DIRA Regulation has a large impact

6.54 []²⁴⁶

6.54.1 []

6.54.2 []

6.54.3 []

Figure 6.2: Fonterra’s capacity forecasts

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²⁴⁴ []

²⁴⁵ []

²⁴⁶ []

[

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6.55 [

].²⁴⁷ This evidence again points to the DIRA Regulation being a small component of overall capacity risk as these measures can mitigate, but not totally avoid, costs.

It is [

] in the absence of DIRA Regulation

6.56 [

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²⁴⁹]

6.57 [

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²⁵¹] We note that the other IPs that source their own milk are generally at or near capacity.

6.58 Fonterra calculates [

²⁵²]

6.58.1 []; and

6.58.2 [].

6.59 [

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²⁴⁷ [

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²⁴⁸ [

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²⁴⁹ [

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²⁵⁰ [

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²⁵¹ [

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²⁵² [

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6.59.1 [253 254]and

6.59.2 [255]

6.59.2.1 [];

6.59.2.2 []; and

6.59.2.3 [].

6.60 [].

Figure 6.3: Fonterra’s capacity buffers

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6.61 Figure 6.3 [

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6.62 [].

DIRA Regulation contributes toward general uncertainty which Fonterra must manage

6.63 NERA contends that []²⁵⁶ []

²⁵³ []

²⁵⁴ []

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²⁵⁵ []

²⁵⁶ []

[
257]

6.64 NERA argues [].

6.65 [258]

6.66 [].

6.67 However, if Fonterra had more discretion on open entry and exit and the Raw Milk Regulations we believe this could have some effect on Fonterra’s investments.

6.68 While around [] of Fonterra’s milk collection is allocated as DIRA milk, [
259]

6.69 This cost does not necessarily represent a cost inefficiency imposed on the industry. Uncertainty of volume implies a cost whether or not DIRA Regulation requires Fonterra to bear this cost. It appears more likely that purchasers may have better incentives to manage that risk if they faced the costs of capacity risk. The Fonterra forecast evidence suggests [].

6.70 One way this could occur is if suppliers to the factory gate market priced milk to reflect agreed tolerances to trade off the managing and bearing of this risk.

6.71 Overall, on the evidence before us, the costs associated with the additional capacity generated by the regulations appears modest and below \$6 million.

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] 259 []

What inefficiency is created in the factory gate market as a result of DIRA Regulation?

- 6.72 In chapter 5, Concerns about deregulation—what competition would look like without DIRA Regulation, we noted there may be times when Fonterra might not recover all of its costs associated with selling DIRA milk, including its opportunity cost. While DIRA Regulation protects Fonterra’s prices reflecting market power, in setting a price which may not be recouping opportunity costs it also contains potential inefficiency.
- 6.73 Given we have found it difficult to conclude whether over- or under-recovery of opportunity costs would occur more often under the current DIRA Regulation, than without DIRA Regulation, we have no reason to believe that any inefficiencies are material.

The DIRA price may be adversely affected the factory gate market

- 6.74 An important inefficiency that may accrue is if the DIRA price acts as a hindrance to the development of the factory gate market. While IPs have indicated they do not have an appetite to supply the small volumes some customers would require, this may relate to the current prices.
- 6.75 If the largest single customer, Goodman Fielder, were to seek at least some of its volumes outside the DIRA Regulation, this may help encourage the development of this market.
- 6.76 Even where the DIRA price fully reflects opportunity cost the DIRA price may not fully reflect the costs imposed on Fonterra, or the benefits IPs receive, eg, given the tolerance limits available under DIRA and the guaranteed supply. This may reduce incentives for customers of factory gate milk to seek supply outside the DIRA, which in turn can affect the viability of a factory gate market.

If DIRA Regulation incentivised inefficient dairy conversions

- 6.77 There is a risk that the open entry and exit provisions, even with the exception clauses provided for in the DIRA,²⁶⁰ mean that Fonterra must take on dairy conversions it otherwise would not. This could lead to inefficiency because:
- 6.77.1 it may require Fonterra to incur costs (eg, expanding capacity, transport costs) that exceed the benefit of taking the milk. These conversions are likely neutral in making the farm gate market more efficient and contestable; and
 - 6.77.2 the land may not be put to its most efficient use.
- 6.78 While we recognise this possibility, we have so far seen no evidence to suggest this is a material inefficiency. It seems unlikely that there are a significant number of farms affected by these policies.²⁶¹

²⁶⁰ Dairy Industry Restructuring Act, ss 94-96.

6.79 The evidence we have on collection costs suggests that these costs are not material to the overall price. [

] ²⁶² Synlait has noted this could easily be outweighed by other economies of scale generated by the greater volume of raw milk collection: ²⁶³

6.79.1 Fonterra benefits from some economies of scale generated by its larger size. The notional producer’s fixed administrative costs of \$251 million in 2013/14 equates to 16 cents per kgMS. A 25% reduction in volume would increase this by 5 cents per kgMS.

6.79.2 There would be additional rising average costs from fixed components of the supply chain costs and unscalable fixed manufacturing costs.

6.80 Fonterra informed us [²⁶⁴]

6.81 Data on total conversions is difficult to come by, though Fonterra’s NERA report has some details. ²⁶⁵ Figure 6.4 indicates the key trends in dry farm dairy conversions.

Figure 6.4: Fonterra’s estimated dry farm conversions

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6.82 Fonterra forecasts [²⁶⁶]

6.83 There has been a concern raised about the price for raw milk paid to farmers being too high and that the price at the farm gate leads to an inefficiently high level of milk

²⁶¹ This is different to whether Fonterra’s market power has allowed the price paid to farmers to increase, this would not be an inefficiency caused by the DIRA Regulation.

²⁶² []

²⁶³ Synlait “Submission on the Commerce Commission’s 2014/15 Base Milk Price Calculation Review Draft Report” 1 September 2015, paragraph 28(iii)

²⁶⁴ []

²⁶⁵ NERA Economic Consulting for Fonterra "Assessment of Competition in Raw Milk Markets and Costs and Benefits of the DIRA provisions" 17 August 2015.

²⁶⁶ []

production by farmers, and inefficient conversions. While the price paid by Fonterra to farmers is overseen by the Milk Price Manual, it does not appear likely that deregulation would lead to a lower price (see Chapter 5). Consequently we do not consider this is an efficiency cost due to the regulations.

Inefficiencies of the base milk price disclosure and monitoring rules

- 6.84 In the absence of DIRA Regulation, Fonterra would need to retain a milk price setting process similar to the one in DIRA Regulation, in order to assure its supplier shareholders and outside investors that the milk pay-out is appropriately divided between dividend and a supplier payment. As long as Fonterra seeks an independent audit of its process such a process would incur costs similar to those it incurs with the DIRA Regulation, this does not affect our balancing exercise.

On balance—competition is not sufficient to warrant deregulation

- 6.85 On balance, we conclude that it is not clear that efficiency will be improved with the removal of subparts 5 (open entry and exit), 5A (base milk price disclosure and monitoring rules) of the Dairy Industry Restructuring (Raw Milk Regulations) 2012 and it could be reduced by the removal of the DIRA Regulation.
- 6.86 We have made a conservative decision to not recommend deregulation based on our analysis at this point in time.
- 6.87 Given the degree of market power held by Fonterra, as discussed in chapter 5, we consider there may be a risk to long-term efficiency caused by complete deregulation.
- 6.88 We estimated the static efficiency benefits of DIRA Regulation to be in the order of \$3.5 - \$13m per year. These figures are indicative of the potential scale of the efficiency impacts arising from an increase in the factory gate milk price. We compared this with the likely efficiency costs of retaining the regulations as being in the order of \$6m per year. These efficiency costs are largely associated with the impact on Fonterra's capacity. Consequently, on the evidence before us, we believe the static efficiency costs and benefits are of the same order of magnitude.
- 6.89 We consider that competition is not sufficient in the factory gate and farm gate markets to conclude that these markets would be more efficient without regulation. In particular, the risk of early deregulation while competition with Fonterra is still developing carries with it the loss of potential dynamic efficiencies. This provides a large upside to the potential benefits to regulation whereas the main expected efficiency costs of regulation, maintaining excess capacity, appear modest based on the information from Fonterra.
- 6.90 We would welcome further evidence on these points, given the limited evidence we have on the scale of these effects.
- 6.91 We do also have concerns that aspects of these regulations may act to hamper the development of competition within the factory gate market. Without effective competition at the factory gate, deregulation carries significant risks given that at least some of the IPs who compete downstream with Fonterra in domestic markets

may be dependent on access to raw milk thought this market in the absence of DIRA milk. We discuss this in more depth in Chapter 7, Pathways to deregulation.

7. Pathways to deregulation

Purpose of this chapter

- 7.1 In this chapter we analyse options for transition pathways to deregulation. We considered:
- 7.2 the approach that could be taken to resetting the market share thresholds, including the potential to introduce new or alternative expiry triggers; and
- 7.3 options for transition pathways to deregulation.

Our recommendations

- 7.4 We recommend resetting the market share thresholds in the North and South islands to 30%. We do not recommend including any additional or alternative expiry triggers. However, we do recommend resetting the time limited provisions of the DIRA to the 2021/22 season.
- 7.5 As discussed in Chapter 5, Concerns about deregulation, we consider the main potential concern from full deregulation now is Fonterra increasing the price of raw milk at the factory gate to a level above the competitive price. We are primarily concerned about the end impact on domestic retail markets where manufacturers are dependent on access to raw milk at the factory gate.
- 7.6 We consider that the domestic dairy markets could benefit from a better functioning factory gate market. We recommend that the Minister consider options to facilitate the development of a functioning factory gate market as a transition pathway to deregulation. A functioning factory gate market would allow for fuller de-regulation in the future.
- 7.7 We have drawn upon our investigation of the sufficiency of competition to identify options for transition pathways to deregulation, but we have not evaluated any of the options in detail.²⁶⁷ These options for a transition pathway to deregulation include: The amendment or removal of the Raw Milk Regulations, consideration of the Goodman Fielder provisions in the Raw Milk Regulations, amendments to the DIRA Regulation open entry and exit provisions particularly around the 20% rule, and regional deregulation.
- 7.8 Detailed policy issues and choices on how to best give effect to the objectives of the DIRA are outside the scope of this report.
- 7.9 Question three in the Terms of Reference asks:

²⁶⁷ While we have encouraged interested parties to provide their views on how the current the DIRA Regulation could be improved; any consideration of options for different regulation proposed by interested parties will be limited to highlighting these for consideration by the Minister as part of his processes after receiving our report.

If the research determines that the current state of competition in the relevant New Zealand dairy markets is insufficient in one or more of the relevant dairy markets, so far as the available information allows the provider of the report to reach a conclusion:

- i. Should either or both of the market share thresholds specified in s 147 of the DIRA be reset (and, if so, to what new level(s))?
- ii. Are there any other expiry triggers that should be provided for, either in addition to or in place of the market share thresholds?
- iii. What options, if any, are there for a transition pathway to deregulation?
- iv. Are there any options (or sets of options) for a transition pathway to deregulation that should be pursued?

DIRA Regulation is temporary measure designed to achieve sufficient competition

- 7.10 Under the DIRA, deregulation cannot occur before an expiry threshold or a provided date is triggered (and after the resulting competition review is reported to the Minister).
- 7.11 DIRA Regulation was designed to facilitate efficient entry by IPs and facilitate efficient growth and expansion. It was hoped that eventually, it would be possible to remove DIRA Regulation, as the IPs became able to effectively compete with Fonterra in farm and factory gate markets (as well as downstream domestic dairy markets).
- 7.12 Economically inefficient outcomes can occur both by retaining DIRA Regulation too long, or removing it too soon. Our views on the potential error costs associated with each of these outcomes may help inform views on the expiry thresholds.
- 7.13 Removing DIRA Regulation too soon could harm efficiency and structural competition gains achieved through regulation. In particular, Fonterra may raise raw milk prices in the factory gate above competitive levels to earn higher profits. This could result in:
 - 7.13.1 a loss of innovation in the domestic markets, including the evolution of new and higher value products, through insufficient diversity and competition in the production and marketing of New Zealand dairy products;
 - 7.13.2 a reduced level of contestability and competition in the farm, factory and retail markets; and
 - 7.13.3 wider economic risks of 'putting all your eggs in one basket'.
- 7.14 Keeping DIRA Regulation in place for too long could risk other types of inefficiency, such as:
 - 7.14.1 an over-reliance on access regulations, in particular the Raw Milk Regulations, where these are no longer needed, can weaken incentives for IPs to enter the factory gate market thereby dampening competition;
 - 7.14.2 the cost to Fonterra of having to invest in excess capacity to take on unexpected milk volumes from either returning farmers or variances in

regulated milk deliveries (at the expense of more long-term profitable investments),²⁶⁸ and

7.14.3 inefficient entry by IPs who may not be economic without the regulations.

7.15 We note that in the absence of regulation, Fonterra remains subject to the provisions in the Commerce Act which restrict anti-competitive behaviour (see Chapter 5, Concerns about deregulation).²⁶⁹

Reset the market share thresholds of the DIRA

7.16 This section discusses our draft recommendation on how the market share thresholds in the North and South islands should be reset. Our draft recommendation is to reset the market share thresholds to 30% in the North and South islands.

7.17 We consider that triggering of either of these market share thresholds should continue to result in a competition review of the dairy industry.²⁷⁰

7.18 In coming to this view we have noted:

7.18.1 The market share thresholds are simple but imperfect proxies for competition and there is no specific number at which we can be sure competition will be sufficient. The market share thresholds however trigger a competition review rather than automatic de-regulation;

7.18.2 Our current review suggests the current market share thresholds are too low; and

7.18.3 We have had regard to wider factors in coming to our view that 30% is appropriate.

Market share thresholds are simple but imperfect proxies of competition

7.19 We consider that the best expiry trigger is one that is simple and well understood.

²⁶⁸ Although that risk is in turn offset by other factors such as Fonterra's large network providing processing flexibility, its ability to temporarily refuse to take new supply through the use of capacity constraint notices, its ability to flex its product set depending on the volume of milk it is receiving (including for example producing non-standardised product).

²⁶⁹ In particular, section 36 of the Commerce Act makes it illegal for any business with a substantial degree of market power to take advantage of that power to deter or prevent rival businesses from competing effectively. Section 27 of the Commerce Act makes it illegal to enter into or give effect to an agreement that has the purpose or effect of substantially lessening competition.

²⁷⁰ Submitters support a review process, rather than a trigger leading to full deregulation. For example: Tatura "Submission on review of the state of competition in the New Zealand Dairy Industry" July 2015, paragraph 6.5. Open Country "Submission on consultation paper" 10 July 2015, page 4. Miraka "Submission on consultation paper" 10 July 2015, paragraph 4.1.4.

- 7.20 Market share measures do not necessarily provide a meaningful representation of the level of competition in the industry as these thresholds are not, for example, based on the relevant geographic markets, nor do they indicate the level of market concentration in the relevant markets.²⁷¹
- 7.21 However, the current expiry triggers trigger a competition review, not automatic deregulation as was the case before the last review in 2011, which in our view addresses this limitation of the market share thresholds.²⁷²
- 7.22 The expiry triggers should provide sufficient regulatory predictability for existing IPs, future new entrants in dairy processing and, potentially, new dairy conversions such that they can benefit from DIRA Regulation for a period of time, and enter or expand accordingly. On this we note following the 2012 amendments of the Raw Milk Regulations, the market share thresholds were augmented with a time limit, as competition could potentially evolve in the markets without necessarily triggering the market share thresholds.²⁷³

This review of competition in dairy markets has guided our view

- 7.23 The market share thresholds are an average over the different geographic farm gate markets in each island. The Canterbury region has a relatively competitive farm gate market, with IPs holding approximately [] market share in the 2014/15 season. In chapter 5, Concerns about deregulation we have found that the ability to exercise market power may be more muted in certain regions, such as Canterbury. However, there is nonetheless likely some ability to exercise market power in Canterbury even with an IP market share of [].
- 7.24 Therefore, we consider that setting the market share thresholds closer to 25% would likely be too low to reasonably expect a finding of sufficient competition in the relevant dairy markets, based on our draft findings.²⁷⁴ The next increment in share is 30% and is our starting point for considering the appropriate trigger for another competition review.

There are other factors which have informed our view

- 7.25 We have also had regard to broader factors that may be informative to resetting the market share thresholds, including:

²⁷¹ The level of market concentration depends on the market shares and the number of firms active in the relevant markets.

²⁷² But, where a trigger has been met deregulation will occur in the relevant island(s) unless enactments are passed to reset the market share thresholds and/or extend the DIRA Regulation.

²⁷³ Stakeholders expressed concern generally around uncertainty caused by the deregulation/competition review process so a 365 day time limit on the competition review was also included in the DIRA (s 148(2)(a)).

²⁷⁴ For example, in Canterbury which is characterised by a relatively competitive farm gate market the market collective IP market share in 2014/15 was approximately [].

- 7.25.1 Fonterra's co-operative structure (which all else equal may support lower market share thresholds). The market share thresholds should not be reset 'too high' as while Fonterra is likely to dominate at the farm gate in some regions (eg, Northland) for the foreseeable future its co-operative structure might also mitigate some of the adverse efficiency effects of its market power;
- 7.25.2 competing IPs are operating at or near capacity (which all else equal may support higher market share thresholds). For example, a market share of 30% may overstate actual contestability as some IPs are at capacity and not able to increase farmer supply. This may be a feature of the landscape as an IP that is underutilising its plant would likely bear additional costs;
- 7.25.3 expected strong growth of the industry (which all else equal may support lower market share thresholds). This reveals the dynamism in the market including the size of the IPs that can provide a competitive constraint on Fonterra; and
- 7.25.4 overseas use of market share thresholds (which all else equal may support higher market share thresholds). Though there is no precise threshold, Competition authorities worldwide generally consider large market share is required to establish significant market power. A 30% market share threshold would be viewed as low in foreign contexts.²⁷⁵
- 7.26 We consider that conservative lower market share thresholds are appropriate for triggering a competition review. We consider that in terms of selecting a specific market share threshold:
- 7.26.1 Relying on market share thresholds alone to trigger deregulation carries a risk of regulating for 'too long' if we wait for imperfect triggers to be met, albeit the costs of this occurring are likely relatively low. The risk of this is also low if the triggers are not set too high or a time limit is retained;
- 7.26.2 On the other hand, triggers set very low that result in a more frequent review and potential DIRA amendment may deter investment through a perceived uncertainty in future regulations; and
- 7.26.3 Therefore, we consider that a market share threshold trigger should be adopted at the lower end of a range that is most likely to be indicative of sufficient competition.
- 7.27 In 2021/22 our projections, which we describe in the next section, suggest neither the North Island nor the South Island IPs will collectively have a market share of

²⁷⁵ We note in passing a 2008 European Commission merger decision required the merged company to effectively reduce its market share of farm gate raw milk, ensuring 30-40% farm gate raw milk is available to IPs. *Commission of the European Communities* [17/12/2008] Case No COMP/M.5046 – Friesland Foods / Campina.

more than 30%. This suggests that setting the expiry triggers at 30% market share thresholds for the North and South islands is conservative in terms of the time to the next trigger based on current trends.

- 7.28 We note that there is significant uncertainty inherent in projecting market outcomes years in advance. In particular developments in the factory gate market could bring forward the time at which an inquiry could be triggered. That, in turn, would also reflect increased competition which would suggest an inquiry is appropriate.
- 7.29 Future competition reviews are likely to be triggered by the South Island market share threshold being met. On this we note:
- 7.29.1 future findings might find that the South Island should be deregulated while leaving the regulations in place in the North Island, and
- 7.29.2 regional deregulation within the South Island might be difficult to administer and result in perverse factory gate outcomes.²⁷⁶ We consider regional deregulation later in this chapter.

Historic observation and judgement on the future to project market shares

- 7.30 As a starting point for estimating how the market shares might evolve, we used the past evolution of market shares.
- 7.31 In the last five years to the 2014/15 season we observe that:²⁷⁷
- 7.31.1 the total New Zealand milk pool grew at around 6% compound average growth rate (CAGR);
- 7.31.2 IP milk collection grew at around []% CAGR; and
- 7.31.3 Fonterra milk collections grew at around []% CAGR.
- 7.32 We also looked at forward projections of milk pool growth based on assumptions used by Fonterra and reference to other projections.²⁷⁸
- 7.33 We used a higher growth rate for the total New Zealand milk pool to maintain the observation that IP milk collections will grow faster than Fonterra, albeit from a much lower base. In particular:

²⁷⁶ For example, DIRA factory gate dependant IPs may choose geographically inefficient sites in a regional deregulation within an island potentially creating further barriers to a functioning factory gate market with the complete absence of the DIRA Regulation.

²⁷⁷ Commission analysis of Dairy NZ data and provided by IPs and Fonterra. There was a high level of milk growth observed in the past 5-10 years, []. Fonterra has a range from low to high []. We have used a combination of low and medium growth to simulate a scenario where the growth continues, but at a slower rate than in the recent past and where IPs are growing faster than Fonterra.

²⁷⁸ For example, Ministry for Primary Industries "Situation and Outlook for Primary Industries 2015" page 21., forecasts milk solids growth of 1.7% CAGR 2015 to 2019.

7.33.1 the total milk pool is assumed to grow at around [] CAGR in the 6 years to 2020/21 season.^{279, 280} This growth is based on Fonterra’s own ‘medium’ growth scenario;

7.33.2 IP milk collections grow around []CAGR;²⁸¹ and

7.33.3 Fonterra collections grow at less than [] CAGR in the six years to the 2020/21 season. []²⁸²

IP market shares in the North and South islands could reach [] and [] within six years

7.34 Figures 7.1 and 7.2 show how IP market share at the farm gate might evolve over the next six years.

Figure 7.1: North Island projected market share of Fonterra and the IPs, 2015/16 – 2021/22

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Figure 7.2: South Island projected market share of Fonterra and the IPs, 2015/16 – 2021/22

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[]

7.35 Our projections suggest that the North Island IP market share could reach []%, and that of the South Island []% by the 2021/22 season, respectively.

7.36 The North Island IP market share growth may continue to lag behind that of the South Island. This is consistent with the experience of farm conversions in the Canterbury, Otago and Southland regions.

²⁷⁹ []

²⁸⁰ Six years chosen to proxy any new legislation coming into effect during the 2016/17 season with a 5 year competition review trigger.

²⁸¹ The choice of different growth scenarios is to simulate a situation where IPs are able to capture a higher proportion of the milk pool in the future. This scenario []

²⁸² []

7.37 The North Island will likely remain the largest milk pool, but based on our projections, the split between the North Island and the South Island could decline from 75:25²⁸³ in 2001/02 to almost []²⁸⁴ in 2021/22.

A time limit provision is appropriate to augment the market share thresholds

7.38 The time limit provision requires the Minister to request a report on the state of competition by a certain date (currently 1 July 2015) in the event that the market share thresholds have not been triggered.

7.39 With a time limit provision, the market share thresholds might be viewed as a simple mechanism to bring forward a competition review in case sufficient competition emerges more quickly than anticipated by the market share measures.

7.40 We are doubtful that sufficient competition could develop without first triggering the market share thresholds we are recommending, but likewise see low cost to including a reasonable time limit provision.

7.41 We note that as the expiry date currently triggers a competition review and not automatic deregulation removing the time limit provisions would not risk automatic deregulation when competition is insufficient.²⁸⁵

7.42 The time limit provision was included as a result of the 2010 review as it was considered competition could potentially evolve in the markets without triggering the expiry triggers.²⁸⁶

7.43 Given inherent uncertainty on the future market and a preference for simplicity, we recommend retaining and amending the time limit provisions in the DIRA to 2021/22.²⁸⁷

Additional or alternative expiry triggers are not necessary

7.44 This section discusses our draft recommendation on whether there are additional expiry triggers that should be provided for, either in addition to or in place of the market share thresholds.

²⁸³ Source: New Zealand Dairy Statistics 2013-2014 LIC and Dairy NZ accessible at <http://www.dairynz.co.nz/publications/dairy-industry/>

²⁸⁴ []

²⁸⁵ As mentioned, if the Minister does not promote a new enactment to reset the market share thresholds and/or extend the regulation then it will be revoked, ie, the Minister is forced to respond to the report because if he does not, the DIRA will be revoked in the island(s) where the threshold has been met.

²⁸⁶ The DIRA (s 148A) requires the Minister to request and respond to a completion review if the market share thresholds have not been met by 1 June 2015. Stakeholders expressed concern generally around uncertainty caused by the deregulation/competitor review process so a 365 day time limit on the competition review was also included in the DIRA (s 148(2)(a)).

²⁸⁷ Dairy Industry Restructuring Act, s 148A.

- 7.45 Our draft recommendation is to not introduce any expiry thresholds in place of or in addition to the market share thresholds.

Alternative or additional triggers should only be adopted if they add value to the regulations

- 7.46 The current expiry triggers trigger a competition review and no longer trigger automatic deregulation in either or both islands.²⁸⁸ Additional expiry triggers could trigger automatic deregulation or a competition review.
- 7.47 Additional or alternative expiry triggers to the market share thresholds should capture new or more information to assist in justifying a competition review or, with a necessarily higher standard, automatic deregulation.

We considered options for additional or alternative expiry triggers

- 7.48 We have not identified suitable additional or alternative expiry triggers to the market share thresholds that provide better information than the market share thresholds.
- 7.49 While different measures have relative advantages, there is no perfect measure, and they would likely introduce additional complexity with limited timing benefits in triggering a competition review or automatic deregulation.
- 7.50 Measures which we considered as expiry triggers might instead be more appropriate in informing a future competition review. This includes measures of:
- 7.50.1 The factory gate market. The current market share thresholds focus on the farm gate. However, if the farm gate market is efficient we might assume the downstream the factory gate market would be as well if the regulations were removed.
 - 7.50.2 Industry concentration. This could use established measures, such as Herfindahl indices, or policy specific such as ‘two IPs with 20% market share’.
 - 7.50.3 Industry dynamics. This could include measures such as the proportion of new supply going to Fonterra, proportion of capacity owned by Fonterra, Fonterra’s farmer churn, and rates of change in other measures over a period of time (eg, percentage change in market share over three years).
- 7.51 An expiry trigger should be based on a geographic area that we consider could be deregulated independently of the rest of New Zealand. In addition to the North and South islands, we considered triggers covering:
- 7.51.1 New Zealand. An appropriate national trigger could be used as a sufficient condition for automatic deregulation, and

²⁸⁸ However, as noted previously, if a market share threshold has been met deregulation will occur unless enactments are passed to reset the market share thresholds and/or extend the DIRA Regulation.

- 7.51.2 sub-island regions. Deregulating regional areas of sufficient competition may be an appropriate transition pathway to deregulation. We discuss regional deregulation in paras 7.90 to 7.94 below.

Options for transition pathways to deregulation

- 7.52 This section discusses our draft recommendations on the options for transitional pathways to deregulation.
- 7.53 Our draft recommendations are:
- 7.53.1 a staged approach to transition pathways to deregulation is appropriate at this time, and
- 7.53.2 that the Minister consider the options we have outlined on potential amendments to the Raw Milk Regulations that have the potential to incentivise additional demand and supply in the factory gate market outside of the regulations.

Staged deregulation is simple and promotes certainty

- 7.54 If competition was sufficient, we would recommend the regulations be removed.²⁸⁹ As we have concluded that competition is insufficient we consider what options there are for transitional pathways to deregulation.²⁹⁰ We consider that there are opportunities to better promote the efficiency purpose of the DIRA.
- 7.55 Transition pathways to deregulation should:
- 7.55.1 not encourage a dependency on the regulations. Transition pathways should allow for efficient market participants to stand on their own two feet, facilitating a future sufficiency of competition in the relevant dairy markets, and
- 7.55.2 maintain confidence in the direction of the regulatory regime. The regulations are temporary and the deregulation process should allow a well signalled, simple glide path to market participants.
- 7.56 We recommend a staged approach as the most appropriate means of achieving a transition pathway to deregulation. This approach is the same approach taken in the 2012 amendments to DIRA. Our view is that the 2012 amendments to the DIRA (particularly around the Raw Milk Regulations) were successful in removing the most material inefficiencies created by the DIRA.²⁹¹ We discuss the 2012 Raw Milk amendments in Attachment C.

²⁸⁹ See Chapter 3.

²⁹⁰ See Chapter 6.

²⁹¹ In particular, the sunset provisions added to the Raw Milk Regulations, ie, if an IP collects more than 30 million litres of raw milk from its own farmer suppliers for the past three years it no longer has access to

- 7.57 As competition in the relevant dairy markets strengthens and becomes clearly sufficient policy makers should consider a staged repeal of subparts as the most appropriate transitional pathway. At this point we have not identified any subparts to repeal in entirety but we do consider amendments should be made.
- 7.58 A staged approach to repealing subparts might involve first repealing the regulation that contributes least to efficiency and contestability. Depending on the state of competition this might involve removing, the Raw Milk Regulations first, base milk price disclosure and monitoring rules second, and lastly the open entry and exit provisions.

Our analysis has identified options for transition pathways to deregulation

- 7.59 At a high level, Chapter 5 and Chapter 6 support the view that:
- 7.59.1 the open entry and exit provisions may still be important for entry and expansion by own-source IPs.²⁹² These regulations impose modest costs. Fonterra's constitution currently includes open entry and exit provisions which can only be changed with 70% support of its shareholders
 - 7.59.2 the own-source IPs will be the most likely potential future suppliers in a deregulated factory gate market, and
 - 7.59.3 the Raw Milk Regulations are the most appropriate to repeal in a staged repeal of DIRA subparts. The Raw Milk Regulations may be distorting the development of a factory gate market. They result in Fonterra having to invest in additional capacity. They may involve a subsidy from Fonterra to the entrant which may be encouraging inefficient entry.
- 7.60 We consider options for transition pathways for each core provision of the DIRA. We also draw attention to other potential amendments that have arisen as part of our review.

The Raw Milk Regulations and the factory gate market

- 7.61 An option for a transition pathway to deregulation is to reduce the dependency of factory gate dependant IPs on the Raw Milk Regulations.
- 7.62 The analysis in Chapter 5 suggest that the Raw Milk Regulations in their current form may be setting prices below competitive levels which may be preventing the development of a functioning factory gate market.²⁹³

regulated milk, the adoption of a fixed quarterly price rather than an annual price with wash-up price for regulated milk, the quantity of raw milk an IP has access to following the milk curve.

²⁹² The sunset clauses on DIRA milk may make the Raw Milk Regulations less of a critical factor for new entry by own-supply IPs. However, the three-year clause likely addresses a key entry concern of filling capacity just after entry into the market.

²⁹³ However, on the other hand we note the regulations have facilitated entry by IPs who are now potential entrants into a future factory gate market.

- 7.63 Currently, there is uncertainty on the ability of IPs who compete in downstream markets to efficiently source their full factory gate raw milk requirements to meet domestic demand in the absence of DIRA Regulation. It is this domestic market such as fresh processed milk on supermarket shelves, where the regulations main benefits are potentially felt. To reduce the risk of de-regulation, a viable source of supply other than directly contracting with farmers may be needed. A competitive factory gate market outside of DIRA would achieve this. Hence it is important to consider how refining the regulations may aid the growth of such a market.
- 7.64 The regional options for factory gate suppliers vary given the location of the large own-source IPs. These large own-source IPs compete in the international markets and are best placed to contract directly with farmers and potentially supply the factory gate market as competitors to Fonterra in the absence of DIRA Regulation.²⁹⁴
- 7.65 Currently, we have not observed a functioning factory gate market outside DIRA Regulation. We consider this may reflect:
- 7.65.1 The DIRA entitlements affecting the demand for raw milk outside DIRA Regulation. For example, the Goodman Fielder provisions allow for its total raw milk requirements.
- 7.65.2 In Chapter 5, Concerns about deregulation, we suggested the DIRA price for raw milk at the factory gate may not cover Fonterra's opportunity cost at some points in time. This may affect incentives on own-source IPs to supply factory gate milk if this price is also below their opportunity cost.
- 7.66 This combination of incentives created by the Raw Milk Regulations may be acting to crowd out a functioning factory gate markets from developing.
- 7.67 We have considered potential options to help facilitate the development of a functioning factory gate market as a transition pathway to deregulation which we discuss. A gradual removal of the Raw Milk Regulations would assist in mitigating the potential risks associated with de-regulation. It can take a period of time for a factory gate market to be established and the small scale of the current market outside of DIRA may mask other factors which could hinder its development. A gradual shift may also mitigate transitional costs to the industry.
- 7.68 An option is to allow the DIRA raw milk entitlements to expire. Signalling the expiry of the raw milk entitlements now may cause DIRA milk dependant IPs to explore their alternative options now and hence create greater demand for raw milk outside DIRA Regulation. This could include considering further the following options:

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- 7.68.1 The sunset clauses introduced for larger own-supply IPs in 2012 have worked well to reduce dependence on DIRA Regulation.²⁹⁵
- 7.68.2 There appear to be diminishing marginal benefits from further entry in some regions and at least the potential for existing IPs to expand into other regions. In this context an option could be to remove DIRA entitlements, particularly for IPs who are largely serving the competitive international markets.
- 7.68.3 Sunset clauses may be extended to IPs that collect some of their own-supply. This may create incentives for factory gate dependant IPs to demand raw milk from a factory gate market outside DIRA Regulation.
- 7.68.4 Sunset clauses could be introduced for factory gate dependant IPs that do not have their own-supply. Providing for these IPs to consider their factory gate alternatives and make necessary adjustments to their business (eg, location, whether to accept own-supply) may require longer sunset clauses.
- 7.69 An option is to investigate further whether Fonterra is recovering its opportunity cost through the DIRA price. A DIRA price that reflects Fonterra's opportunity cost may address potential economic barriers to other own-source IPs from entering the factory gate market. We note that potentially setting a glide path from the current DIRA price to a higher price may be appropriate to avoid a price shock.
- 7.70 An option is to consider whether DIRA raw milk entitlements should be allowed to be traded. In particular:
- 7.70.1 The ability to trade the DIRA raw milk entitlements may act as a signalling mechanism about the 'correctness' of the DIRA price while allowing for the raw milk volumes to flow to the most valued 'use',
- 7.70.2 However, consideration should be given to the practical implications of trading the raw milk entitlements in that significant volumes can switch regions potentially creating increased risk and costs of managing milk on Fonterra.
- 7.71 An option is to grandfather the rights of IPs currently taking DIRA milk under the Raw Milk Regulations based on previous volumes. In particular:
- 7.71.1 This would require new marginal entrants to operate outside the DIRA Regulation. They would have to obtain raw milk in the unregulated factory gate,
- 7.71.2 It would mean, though, that incumbent IPs face an efficient price for any additional milk they demand. This could potentially give the incumbent IPs a material advantage in downstream domestic markets.

²⁹⁵ For details, see Attachment C.

Goodman Fielder and the factory gate market

- 7.72 The creation of DIRA required that Fonterra divest shares in NZDF (New Zealand Dairy Foods) The NZDF business manufactured a number of well known New Zealand consumer dairy brands and the sale made sure that Fonterra would not monopolise the downstream dairy market in New Zealand. NZDF is now the dairy division of Goodman Fielder New Zealand Limited.
- 7.73 Fonterra was also required to provide NZDF with access up to 250 million litres of regulated raw milk per season. [²⁹⁶] In submissions to the Commission Fonterra stated that it "considers the requirement to supply Goodman Fielder remains important for public confidence in downstream wholesale and retail markets"²⁹⁷
- 7.74 An advantage of deregulating Goodman Fielder may be in spurring a factory gate market outside of the DIRA earlier on account of Goodman Fielder's large volume requirements.
- 7.75 A disadvantage of deregulating Goodman Fielder at this time could be the risk that Fonterra will exercise market power []. We discussed this in chapter 5, Concerns about deregulation.
- 7.76 A further potential disadvantage of deregulating Goodman Fielder is the risk of Fonterra foreclosing Goodman Fielder in order to increase market power in downstream markets against its largest domestic rival. In chapter 5, Concerns about deregulation we considered this as less likely to occur.
- 7.77 An option to transition pathway to deregulate the Goodman Fielder provisions on its access to factory gate milk might include:
- 7.77.1 [] Removing the Goodman Fielder provisions, or reducing Goodman Fielder's entitlement over time, may provide sufficient incentive for Goodman Fielder to consider its alternative options for own-supply and factory gate supply outside DIRA Regulation.
- 7.77.2 Regional deregulation may be an appropriate option for Goodman Fielder. At least two of its plants (ie, Canterbury, Manawatu) out of its three plants

²⁹⁶ [

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²⁹⁷ Fonterra "Review of the state of competition in the New Zealand dairy industry: Consultation paper - process and approach" 17 August 2015, paragraph 17.

(ie, Northland) appear to have factory gate alternatives to Fonterra.²⁹⁸ Reducing rather than eliminating their entitlement can afford Goodman Fielder protection in those areas where Fonterra is the only option. A good transition time and certainty will likely be important for Goodman Fielder to adjust its source and terms of supply.²⁹⁹

The open entry and exit provisions

- 7.78 The open entry and exit provisions ease farmer switching and as such potentially facilitate the enhancement of competition in both the farm gate and factory gate markets.
- 7.79 In chapter 6, Balancing efficiencies and inefficiencies of regulations, we reported little evidence that the open entry and exit provisions contribute materially to costs on Fonterra or to inefficiency more generally in the domestic dairy markets.
- 7.80 While we recognise there are potentially efficiency grounds for relaxing these provisions, in particular potentially in relation to open entry, we consider that Fonterra should provide evidence of the costs of these provisions before any further consideration of amendment or removal of these provisions.
- 7.81 We note that relaxing the open entry provisions as proposed by Fonterra may have practical issues as to what constitutes a new entrant.³⁰⁰ Considering amendments to the transport costs exceptions to open entry may contribute toward mitigating any potential inefficiency caused by the open entry and exit provisions.³⁰¹
- 7.82 The 20% rule is used by many small IPs, particularly artesian cheese makers. It is uncertain how effective this rule is going to be in the future; as Fonterra submitted it was not aware the 20% rule was being used so widely.³⁰²
- 7.83 In chapter 5, Concerns about deregulation, we noted that the 20% rule is potentially important into creating a collective constraint on Fonterra in downstream domestic markets.
- 7.84 We consider that the 20% rule is still important for small IPs to access milk and is an important pathway for them to grow.³⁰³ Until a factory gate market has developed, the 20% rule should be maintained, potentially with improvements being made.

²⁹⁸ We note that in the 2014/15 season Goodman Fielder processes approximately [] of its raw milk in Canterbury, [] in the Manawatu and [] in Northland, respectively. Goodman Fielder has potential options for factory gate raw milk in 1) Canterbury: Westland, Synlait and Oceania, 2) Manawatu: Miraka and Open Country.

²⁹⁹ We note the likely increase in factory gate and downstream prices.

³⁰⁰ Fonterra "Assessment of Competition in Raw Milk Markets and Costs and Benefits of the DIRA provisions, Public Version" 17 August 2015, paragraphs 53 to 62.

³⁰¹ Dairy Industry Restructuring Act, s 95.

³⁰² Fonterra "Cross-submission on review of the state of competition in the New Zealand dairy industry" 31 August 2015, paragraph 31.

- 7.85 The 20% rule makes it difficult for small IPs to access milk, as the rule requires the use of separate vats. The Ministry for Primary Industries might consider how to amend this rule to remove unnecessary administrative and regulatory burden. This would have to balance any legitimate concern Fonterra had about the IPs in accessing their vats any food safety concerns.

The base milk price disclosure and monitoring rules

- 7.86 It is likely that some form of independent oversight of the base milk price rules would occur in the absence of DIRA Regulation, in order to provide assurance to Fonterra's farmer shareholders and external investors that the farm gate milk price is set at an efficient level.
- 7.87 It appears the Commission base milk price reviews are valued by industry stakeholders³⁰⁴ and those parties would be less comfortable with a process controlled by Fonterra.³⁰⁵
- 7.88 We have received a number of submissions asking for the Milk Price Manual process to be changed or parts it off handed over to the Commission³⁰⁶ and for the efficiency standard employed in the Milk price Manual to be changed and that the price is too high.³⁰⁷ We note that the detailed implementation of the Milk Price Manual regulations are outside the scope of this report which is examining options for broad transition pathways to de-regulation.
- 7.89 We also note that our findings on the raw milk price is that it may not always reflect opportunity costs and that there are other pressures such as from investors that mitigate the risk of the Milk Price Manual being used by Fonterra to set a price that harms competition.

Regional deregulation as a transition pathway to deregulation

- 7.90 We considered whether the Raw Milk Regulations and the open entry and exit provisions could be removed in particular regions.

³⁰³ Karikaas considers that the 20% rule is an important pathway for cheesemakers to become established and grow. Karikaas "Submission on the dairy competition review substantive issues" 17 August 2015, page 2. Grinning Gecko and Over the Moon Dairy submits it would not be able to access any milk without the 20% rule. Grinning Gecko "Submission on "14 August 2015 and Over the Moon Dairy "Submission on " 13 July 2015.

³⁰⁴ For example: Open Country "Review of the state of competition in the New Zealand dairy industry: Consultation paper - process and approach" 10 July 2015.

³⁰⁵ For example: see Tatua "Consultation on substantive issues - review of the state of competition in the New Zealand dairy industry" 17 August 2015, paragraphs 3.12 to 3.15.

³⁰⁶ For example: Castalia Strategic Advisors for Open Country Dairy "Review of the State of Competition in the New Zealand Dairy Industry: Comments following submissions on substantive issues" 31 August 2015, section 3.

³⁰⁷ For example see Tatua "Consultation on substantive issues - review of the state of competition in the New Zealand dairy industry" 17 August 2015, paragraph 3.18, and Miraka "Review of the state of competition in the New Zealand dairy industry: Consultation paper - process and approach" 17 August 2015, paragraph 2.1 to 2.20.1.

- 7.91 Repealing the Raw Milk Regulations in particular regions may result in sub-optimal factory gate outcomes overall later in time. For example:
- 7.91.1 it is likely that when the farm gate market is sufficient, the factory gate market could be considered sufficient, though it may be thinly traded,
 - 7.91.2 the regions where DIRA Regulation would most likely be repealed are also areas of strong milk growth, and entry and expansion of self-source IPs (eg, Canterbury). Removing the Raw Milk Regulations in these areas, but not others in the same island, could incentivise IPs reliant on the factory gate market to locate in regions further away from the milk growth and the self-supply IPs,³⁰⁸ and
 - 7.91.3 in eventual absence of DIRA Regulation island-wide the IPs reliant on the factory gate market might be inefficiently located, or not make up the critical mass required to even achieve a functioning factory gate market. This could encourage IPs to be dependent on DIRA Regulation when they otherwise might not have been.
- 7.92 Repealing the open entry and exit provisions regionally now may risk Fonterra exercising some market power at the farm gate to prevent farmers from switching in those regions. This might risk a foreclosing effect on existing own-source IPs, hampering the development of a functioning factory gate market once DIRA Regulation is completely removed.
- 7.93 On the other hand, the benefits of regional deregulation include:
- 7.93.1 Removing unnecessary regulation in areas of sufficient competition where and when it develops,³⁰⁹ and
 - 7.93.2 Providing an opportunity for experimentation in transition pathways to deregulation before adopting the preferred pathway nationwide. For example, discovering more about how a functioning factory gate market would develop in the absence of DIRA Regulation may be prudent.
- 7.94 We recognise the practicalities of regional deregulation might be problematic. For example, oversight and enforcement of region specific Raw Milk Regulations might be difficult to administer and costly for Fonterra and/or the enforcement agency.

³⁰⁸ This might be particularly true if the DIRA price of raw milk at the factory gate is below the market price that might emerge absent regulation. This could be limited by allowing a price increase on DIRA milk and signalling the temporary nature of the regulations.

³⁰⁹ At this time we have not identified a region of New Zealand where competition might be considered sufficient. The Canterbury region, for example, has an IP market share of approximately [] in the 2014/15 season.

Options for transition pathways to deregulation that should be pursued

- 7.95 So far as the available information allows we consider that a transition pathway to deregulation that should be pursued is to explore amendments to the Raw Milk Regulations in order to facilitate better functioning factory gate markets.
- 7.96 We recommend the Minister consider the options we have outlined on potential amendments to the Raw Milk Regulations that have the potential to incentivise additional demand and supply in the factory gate market outside DIRA Regulation.

Attachment A: Terms of Reference for a report on the state of competition in the New Zealand dairy industry

Purpose

- A1 The Dairy Industry Restructuring Act 2001 (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:
- A1.1 when market share thresholds are met; or
 - A1.2 in the event that they have not been met by 1 June 2015, as soon as practicable after that date.
- A2 The report must provide an assessment of the state of competition in the dairy industry and advise the Minister as to whether the market share thresholds should be reset, and options for a pathway to deregulation (if any).

Context

- A3 The creation of Fonterra resulted in a lessening of competition in the New Zealand dairy industry. As a result, DIRA imposed regulatory requirements on Fonterra to promote contestability and efficiency in New Zealand dairy markets. Specifically, s4(f) of DIRA stipulates the purpose of the DIRA regulatory requirements is to “promote the efficient operation of dairy markets in New Zealand by regulating the activities of Fonterra to ensure New Zealand markets for dairy goods and services are contestable”.
- A4 The DIRA regulatory requirements are aimed at the following two dairy markets:
- A4.1 The market for milk at the farm gate, which is a market for the purchase of raw milk from farmers. Dairy processors compete with each other to purchase raw milk from farmers and this rivalry is beneficial to dairy farmers.
 - A4.2 The factory gate milk market, which is a wholesale market where dairy processors trade raw milk among themselves prior to processing. There is demand at the wholesale level for unprocessed raw milk, from:
 - A4.2.1 dairy processors who are in the early stages of their operations looking to supplement their own inputs of raw milk to improve the capacity utilisation of their processing plants; and
 - A4.2.2 food and beverage manufacturers, which require unprocessed raw milk as an input for their manufacturing processes.

- A5 To ensure the contestability of the farm gate milk market, the DIRA contains ‘open entry and exit’ provisions, as well as the farm gate milk price monitoring regime (as set out in Subparts 5 and 5A of Part 2 of DIRA). The requirement for Fonterra to on-sell a small proportion of its raw milk to other dairy processors (as specified in the Dairy Industry Restructuring (Raw Milk) Regulations of 2012 (DIRA Raw Milk Regulations) further promotes the contestability of the farm gate milk market by providing newly established dairy processors with temporary access to wholesale raw milk supply. The DIRA Raw Milk Regulations also provide access to wholesale raw milk for food and beverage manufacturers that choose not to have access to their own farm gate milk supply.
- A6 Critically, the DIRA regulatory requirements were designed to be transitional in nature. The regulatory regime is designed to expire if and when the New Zealand dairy markets are considered to be sufficiently competitive, so that industry-specific regulation is no longer required over and above the normal application of general competition law.
- A7 The process to expire these requirements begins when IPs have collected 20% or more of milk solids in either the North or the South Island of New Zealand in a dairy season. If this market share threshold is not met by 1 June 2015, the DIRA sets out a process to ascertain the state of competition in the New Zealand dairy industry (pursuant to section 148A).
- A8 The first step in the process requires a report to be produced on the state of competition in the New Zealand dairy industry. This document sets out the requirements for that report.

Objectives and scope

- A9 The provider of the report (the provider) must ascertain:
- (i) the state of competition that exists in the New Zealand dairy industry; and
 - (ii) if the provider determines that the state of competition in the New Zealand dairy industry or any specified New Zealand dairy market or markets is insufficient,—
 - (A) whether either or both of the market share thresholds specified in section 147 should be reset; and
 - (B) the options for a transition pathway to deregulation (if any) and whether a particular option or a set of options (if any) should be pursued.
- A10 In addressing the objectives above, the report should address the following questions:
- A10.1 What is the state of competition that exists in the relevant New Zealand dairy markets, in particular, in the farm gate and factory gate markets? In relation to the wholesale and retail dairy markets, is there any new information that would alter the conclusions reached in the Commerce

Commission's preliminary inquiry into domestic milk markets in 2011 under Part 4 of the Commerce Act 1986?

- A10.2 Is the current state of competition in the relevant New Zealand dairy markets sufficient to ensure the efficient and contestable operation of these markets in the absence of the provisions of Subparts 5 and 5A of Part 2 of the DIRA and/or the provisions of the DIRA Raw Milk Regulations? In particular, would Fonterra (given its market shares, nationwide collection and processing networks, and ownership and capital structure arrangements) be likely to have both the ability and the incentives to exercise market power against competitors, suppliers or purchasers in one or more of the relevant New Zealand dairy markets (in the North and/or the South Island), in the absence of the provisions of Subparts 5 and 5A of Part 2 of the DIRA and/or the provisions of the DIRA Raw Milk Regulations?
- A10.3 If the research determines that the current state of competition in the relevant New Zealand dairy markets is insufficient in one or more of the relevant New Zealand dairy markets, so far as the available information allows the provider of the report to reach a conclusion:
- i. Should either or both of the market share thresholds specified in s 147 of the DIRA be reset (and, if so, to what new level(s))?
 - ii. Are there other expiry triggers that should be provided for, either in addition to or in place of the market share thresholds?
 - iii. What options, if any, are there for a transition pathway to deregulation?
 - iv. Are there any options (or sets of options) for a transition pathway to deregulation that should be pursued?

Stakeholder consultation

A11 The provider of the report must consult at least once with the following on each of Questions 1-3 above before providing its final report:

A11.1 New Zealand dairy farmers through the following representative groups;

- DairyNZ
- Federated Farmers

A11.2 Fonterra; and

A11.3 Independent dairy processors.

A12 The method of consultation may include:

A12.1 Providing a draft report for written submissions;

A12.2 Facilitating a workshop, following which participants may provide written submissions.

Attachment B: Summary of the key provisions of the DIRA Regulations and the Raw Milk Regulations³¹⁰

Open entry and exit provisions under Subpart 5 which assist farmer switching and access to raw milk by processors at the farm gate

Section 73

Subject to a limited number of exceptions, Fonterra must accept an application by a new entrant to become a shareholding farmer and must also accept applications by shareholding farmers to increase volumes of milk supplied.^{311 312}

Section 97

A shareholding farmer who wants to cease or reduce their supply of milk as a shareholding farmer to Fonterra may give a notice of withdrawal.

Section 106

Fonterra may not discriminate in the terms of supply between its suppliers (new entrants and shareholding farmers), and the terms of supply that apply to a new entrant must be the same as the terms that apply to a shareholding farmer in the same circumstance.

Fonterra must also not treat a shareholding farmer who exercises an entitlement under Subpart 5 of the DIRA any less favourably than a shareholding farmer who does not do so.

Section 109

A shareholding farmer who withdraws totally from Fonterra may require Fonterra to sell a milk vat situated on the withdrawing shareholding farmer's farm to the shareholding farmer or an IP.

³¹⁰ The full title of the Raw Milk Regulations is the Dairy Industry Restructuring (Raw Milk) Regulations 2012.

³¹¹ Section 5 of the DIRA defines a new entrant as "a dairy farmer who is not a shareholding farmer who applies to become a shareholding farmer under section 73".

³¹² Section 94 of the DIRA provides that Fonterra may reject an application by a new entrant or a shareholding farmer if the supply of milksolids obtainable from milk to be supplied by the applicant in a season is less than 10 000 kilograms. Section 95 of the DIRA further provides that Fonterra may reject an application by a new entrant if the cost of transporting the milk of the new entrant exceeds the highest cost of transporting another shareholding farmer's milk.

Restrictions on long term contracts and exclusive supply contracts under Subpart 5 which promote contestability and access to raw milk by processors at the farm gate*Section 107*

Fonterra may only offer new entrants and shareholding farmers contracts for milk supply for more than one season if it ensures that, at all times 33% or more of the milksolids produced within a 160 kilometre radius of any point in New Zealand is –

- supplied under contracts with IPs; or
- supplied under contracts with Fonterra that expire or may be terminated by the supplier at the end of the current season without penalty to the supplier; and on expiry or termination, end all the supplier's obligations to supply milk to Fonterra.

Section 108

Fonterra shareholding farmers are entitled to allocate up to 20% of their weekly production to IPs throughout the season; this may not be a higher percentage of their weekly production than their average weekly allocation to IPs in October.³¹³

³¹³ A shareholding farmer who exercises this entitlement must give Fonterra 20 working days' notice of the arrangements for the collection of this milk and may require storage in separate milk vats.

The base milk price regime under Subpart 5A which promotes contestability at the farm gate

Sections 150A to 150C

Fonterra's base milk price setting:

- Sets out the purpose of subpart 5A, which is to promote the setting of a base milk price that provides an incentive for Fonterra to operate efficiently while providing for contestability in the market for the purchase of milk from farmers.³¹⁴ (section 150A)
- Fonterra can choose to use certain assumptions in setting the base milk price. (section 150B)
- Fonterra must set the base milk price in a way that is consistent with certain principles. (section 150C)

Sections 150D to 150G and 150N

Fonterra must establish a Milk Price Panel (panel) and maintain a Milk Price Manual (manual):

- Fonterra must establish a panel, where the majority of its members and the chair are independent, and set the publicly available terms of reference for the panel. (sections 150D and 150E)
- Fonterra must maintain a manual that sets out how the milk price is calculated, and make it public, including any amendments. (Section 150F)
- For each season, the panel must: supervise the calculation of the base milk price; advise Fonterra on the application of the manual; and recommend the base milk price to Fonterra. (section 150D)
- If Fonterra does not accept a recommendation of the panel, or amends the manual without a recommendation, it must make its reasons for doing so publicly available. (section 150G)
- If Fonterra does not accept the recommendation of the panel when setting the base milk price or sets the base milk price without a recommendation by the panel, it must make its reasons for doing so publicly available. (section 150N)³¹⁵

Sections 150H to 150M

The Commission must review the manual and report on the extent to which the manual is consistent with the Subpart 5A purpose, namely "to promote the setting of a base milk price that provides an incentive to new co-op to operate efficiently while providing for contestability in the market for the purchase of milk from farmers."

³¹⁴ Under section 150A(2) of the DIRA, the setting of a base milk price provides for contestability if any notional costs, revenues or other assumptions taken into account in calculating the base milk price are practically feasible for an efficient processor.

³¹⁵ The effect of these provisions is limited as Fonterra is remains free to deviate from the milk price produced by the calculation under the manual.

Sections 150O to 150U

The Commission must review Fonterra's base milk price calculation and report on the extent to which the assumptions adopted and the inputs and process used in the milk price calculation are consistent with the Subpart 5A purpose, namely "to promote the setting of a base milk price that provides an incentive to new co-op to operate efficiently while providing for contestability in the market for the purchase of milk from farmers."³¹⁶

Raw milk regulations which regulates the prices Fonterra can charge for raw milk at the factory gate and promotes access to raw milk by processors at the factory gate

2012 Raw Milk Regulations

Fonterra is required to:

- supply IPs (including Goodman Fielder) with up to 795 million litres per season (regulation 4 and 5(1))
- supply each IP (other than Goodman Fielder) with up to 50 million litres per season, subject to both maximum monthly limits and, for months other than October, 110% of the amount taken in October³¹⁷ (regulation 6(1)).
- supply Goodman Fielder with up to 250 million litres per season, subject to a monthly limit in August, September, November, December, January, February, March, April, or May, of 110% of the amount taken in October (regulation 7(1)).
- offer to supply the raw milk required by the IP (other than Goodman Fielder) for the whole of the current season at the most recent forecast of the farm gate milk price for that season (fixed quarterly price) subject to that IP having own supplied less than 30 million litres in the previous season³¹⁸ (regulation 19).

³¹⁶ The DIRA limits the extent of our review as section 150P(3) states that we must not state the amount of the base milk price according to our own calculations. We are further not required to calculate the costs of an IP.

³¹⁷ The maximum monthly limits are: August, 3 million litres; September, 6 million litres; October, 7 million litres; November, 7 million litres; December, 6 million litres; January, 6 million litres; February, 5 million litres; March, 4 million litres; April, 4 million litres; May, 2 million litres.

³¹⁸ Under regulation 19(4) the most recent forecast of the farm gate milk price means the forecast published under regulation 24(1)(c) plus the reasonable cost of transporting the raw milk to the independent processor, plus an additional amount for winter milk (milk supplied in June or July) and/or organic milk. Regulation 3(1) defines own supply as "raw milk collected from dairy farmers by or on behalf of an independent processor".

- supply an IP (other than Goodman Fielder) whose own supply of raw milk exceeded 30 million litres in the previous season at the default milk price³¹⁹ (regulation 20).

Under regulation 6(3) Fonterra does not have an obligation to supply an IP (other than Goodman Fielder) in a season beginning on or after 1 June 2016, if the IP's own supply of raw milk in each of the three consecutive previous seasons was 30 million litres or more.

Fonterra may also require that a contract for supply includes terms that are reasonable having regard to industry practice before the commencement of the regulations.

³¹⁹ Under regulation 20(2) the independent processor and Fonterra may also agree on the price for the supply of the raw milk. Under regulation 20(1) an independent processor whose own supply of raw milk was less than 30 million litres in the previous season may also choose to obtain raw milk at the default price rather than at the fixed quarterly price. Under regulation 20(4) the default milk price means the farm gate milk price for that season plus the reasonable cost of transporting the raw milk to the independent processor, plus an additional amount for winter milk and/or organic milk.

Attachment C: 2012 Raw Milk Regulations amendments

Purpose

- C1 The purpose of this attachment is to:
- C1.1 outline what has happened in the dairy markets as a result of the Ministry Agriculture and Fisheries' (MAF) 2012 amendments to the Raw Milk Regulations, and
 - C1.2 comment on the how the amendments have performed.

The 2012 DIRA amendments focused on the Raw Milk Regulations

- C2 Table C1 below summarises the amendments to the Raw Milk Regulations and the reasons for amendment.
- C3 Overall we consider these amendments have improved efficiency through reducing dependence on the regulations, improvements in administering the pricing of regulated milk, and ensuring IPs face the reality of the New Zealand milk curve when making investment and production decisions under the regulations.

Table C1: The 2012 DIRA amendments to the Raw Milk Regulations

Regulation as at 2001	Amendment to the regulation	Reason for amendment
All IPs, including those with their own established farmer supply, would have access to regulated milk for as long the Regulations are in place.	A processor would be ineligible for DIRA milk if it collected a minimum of 30 million litres of milk for three consecutive seasons. They are considered to have their own farmer supply.	To create stronger incentives for IPs to grow the amount of their own farmer supply sooner. Ensure that access to regulated milk is targeted to IPs seeking an entrance pathway into the farm gate market and those with minimal or none of their own farmer supply, rather than established processors with their own-supply.
600 million litre cap on DIRA Milk supplied by Fonterra	The maximum quantity of raw milk that Fonterra must supply to all IPs is 795 million litres per season which is equivalent to 5% of the total raw milk collected by Fonterra The 5 percent gap is based on the average quantity of milk Fonterra received over the previous three seasons and would be reviewed at	To provide greater flexibility, allowing the total regulated milk quantity to move in line with the total quantity of milk Fonterra collects.

	<p>a minimum every three seasons to ensure that it continues to represent approximately 5% of Fonterra's total milk supply.</p> <p>Goodman Fielder entitled to up to 250 million litres per season (with seasonal restrictions on winter milk and does not include the above cap).</p>	
<p>October rule – A processor can only take up to 110% of what they took in October.</p>	<p>Monthly maximum volume limits to reflect the seasonal supply curve and retention the 'October rule'.</p>	<p>Conditions more closely reflective of those in a competitive farm gate market.</p> <p>Does not disadvantage processors who need to be able to flatten the curve (such as town milk suppliers) as the quantities generally fall below the monthly limits.</p> <p>To mitigate risk that a processor would use the regulations purely to access milk in the shoulder months and not any other month.</p>
<p>Price for DIRA milk was 'Fonterra's farm gate milk price + 10 cents per Kgms.</p>	<p>The DIRA price was amended to 'Fonterra's farm gate milk price' plus reasonable costs of transport, winter milk and organic milk with the introduction of the monthly quantity limits (implementation of introducing monthly limits to reflect the seasonal supply curve and retaining the October rule).</p>	<p>The additional 10 cents is no longer required as the extra cost was to Fonterra providing IPs with the option of "flattening" the profile of the regulated milk.</p> <p>With the introduction of monthly limits, IPs who take up large quantities can no longer flatten its profile.</p>
<p>Final Farm gate milk price for the season (Default milk price).</p>	<p>Introduction of quarterly pricing as an option for DIRA milk pricing. Fonterra required to offer to sell regulated milk at Fonterra's most recent quarterly farm gate milk</p>	<p>To provide more price certainty to those IPs who need it the most.</p>

price forecast. This option is only available to those processors without their own significant milk supply.

What has happened since the restriction and monthly limit amendments

C4 DIRA milk sales have declined since 2011/12 (when the three consecutive season sunset clause amendment was implemented). Independent processors have anticipated that they will no longer have access to DIRA milk and so have sought to increase their own farmer supply.³²⁰

C5 []³²¹

C6 []³²²

C6.1 []

C6.2 [];

C6.3 [];

C6.4 []; and

C6.5 [].

C7 The amendments (particularly, the restriction on who can access DIRA milk and monthly limits) have resulted in IPs increasing their own farmer supply and decreasing Fonterra’s farm gate market share (which increases competition in the farm gate market).

C8 By retaining the October rule, Fonterra may not incur additional costs for providing raw milk to processors who take DIRA milk in the shoulder months and not during the peak.

C9 []³²³

³²⁰ As outlined in chapter 4

³²¹ []

³²² []

³²³ []

C10 Because the fixed quarterly pricing is only available to processors who have less than 30 million litres of their own-supply, larger IPs [] have purchased DIRA milk using the default price.

Attachment D: Market structure

Purpose

- D1 This appendix provides information about the current structure of the dairy markets and the structural changes which have occurred since Fonterra was established and MAF's 2010 review of the DIRA Regulation expiry thresholds.
- D2 We have identified three broad trends in respect of market structure that are relevant to competition in the farm gate and factory gate markets:
- D2.1 milk production has been growing and we expect this to grow further, although at a slower rate;
- D2.2 We understand that Fonterra is growing at a slower rate than rival IPs but has still claimed over two thirds of all new milk growth; and
- D2.3 although there has been significant entry and expansion of IPs, both since Fonterra was established, and since MAF's 2010 DIRA Regulation review,³²⁴ the markets are still highly concentrated and Fonterra remains a monopsony purchaser of raw milk at the farm gate, and a monopoly seller of raw milk at the factory gate in many regions.
- D3 The following sections look at the evidence behind each of these trends in the context of wider developments.

Milk production and growth

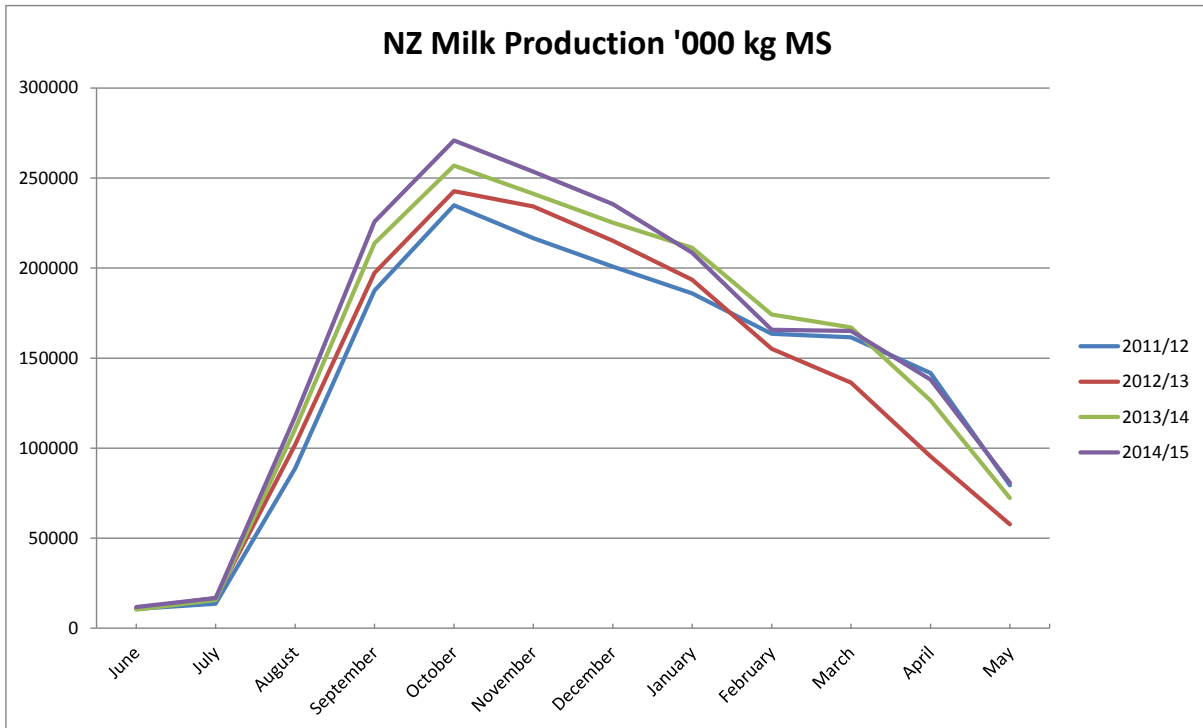
- D4 As of December 2014, New Zealand is the ninth largest milk producer globally, but is the world's largest exporter of dairy products.³²⁵
- D5 Milk production in New Zealand is reflective of the seasonal pattern of pasture growth.
- D6 Typically, the shoulder periods occur in September to October and December to March with peak production occurring in late October to late November.

³²⁴ MAF "Extension of the Pro-Competition Provisions of the Dairy Industry Restructuring Act 2001: Regulatory Impact Statement" July 2010.

³²⁵ DairyNZ "QuickStats about dairying – New Zealand" December 2014
www.dairynz.co.nz/media/1357994/quickstats-new-zealand.pdf (Viewed 4 November 2015)

D7 Figure D1 shows milk production for the last four seasons.³²⁶

Figure D1: Milk production from 2011/12 to 2014/15 (million kgs)



Source: New Zealand Dairy Statistics 2013-2014 LIC and Dairy NZ

Milk growth has occurred through increased production and conversions

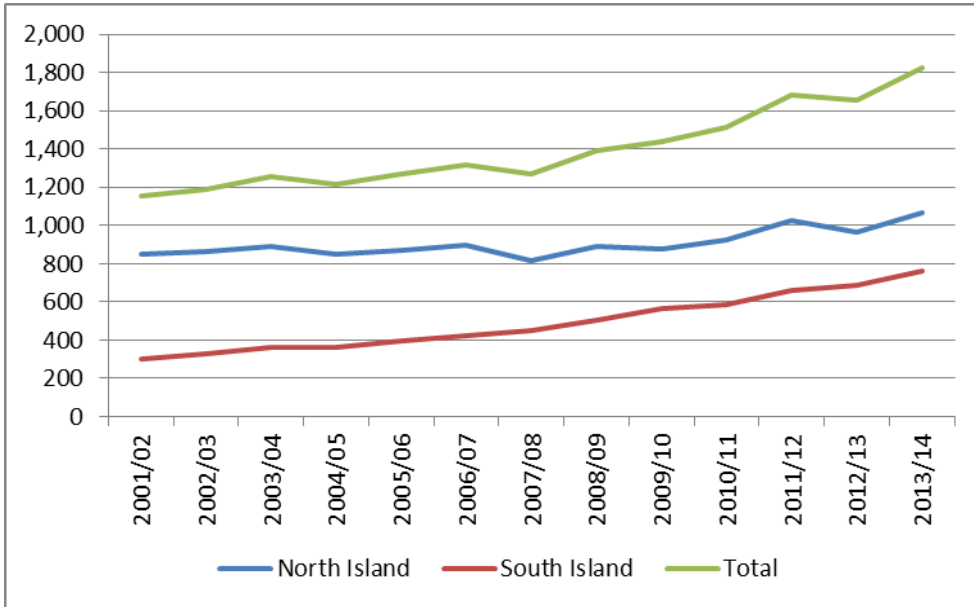
D8 Milk volumes have been trending upwards. This upwards trend is due to increased farm productivity due to more efficient land use and feed being used to supplement pasture growth.³²⁷ It is also due to an upward trend in farm conversions. Figure D2 shows the increase in production since Fonterra was created in 2001.

D9 Total milk production has increased by around 12% since the 2011/12 season.

³²⁶ The New Zealand dairy season runs from 1 June to 31 May.

³²⁷ DairyNZ “New Zealand Dairy Statistics 2013-2014” < <http://www.dairynz.co.nz/publications/dairy-industry/new-zealand-dairy-statistics-2013-14/>> (Viewed 4 November 2015).

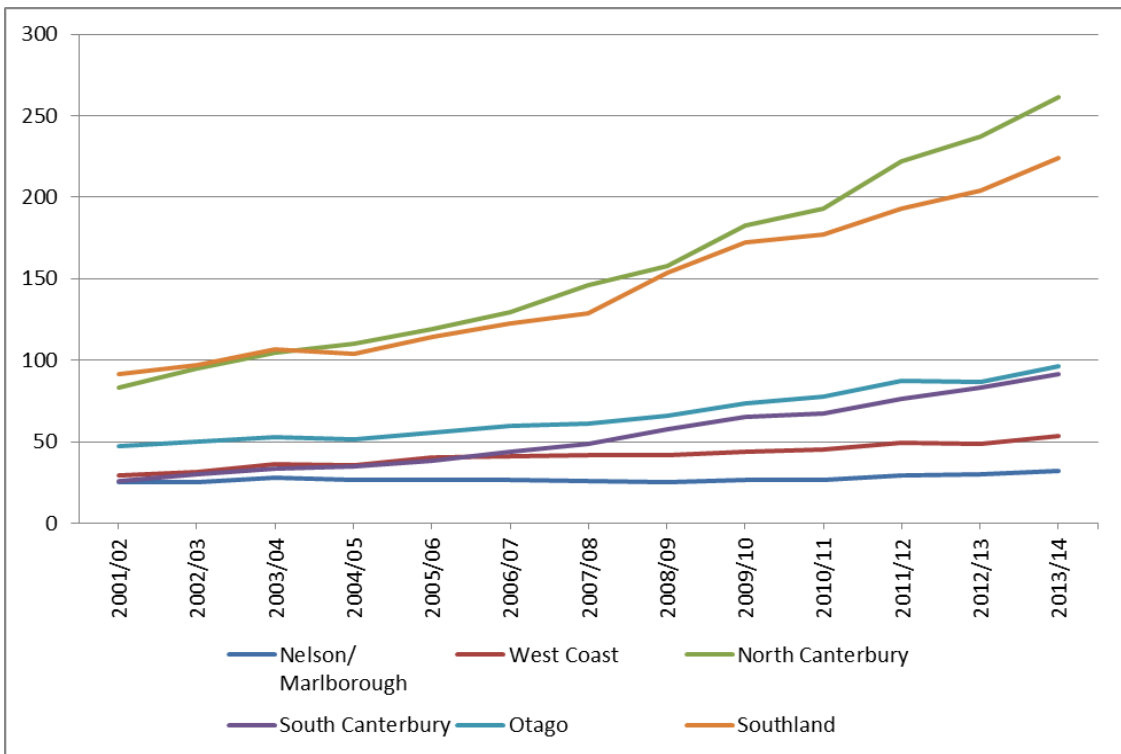
Figure D2: Milk processed nationally and by island (million kgs)



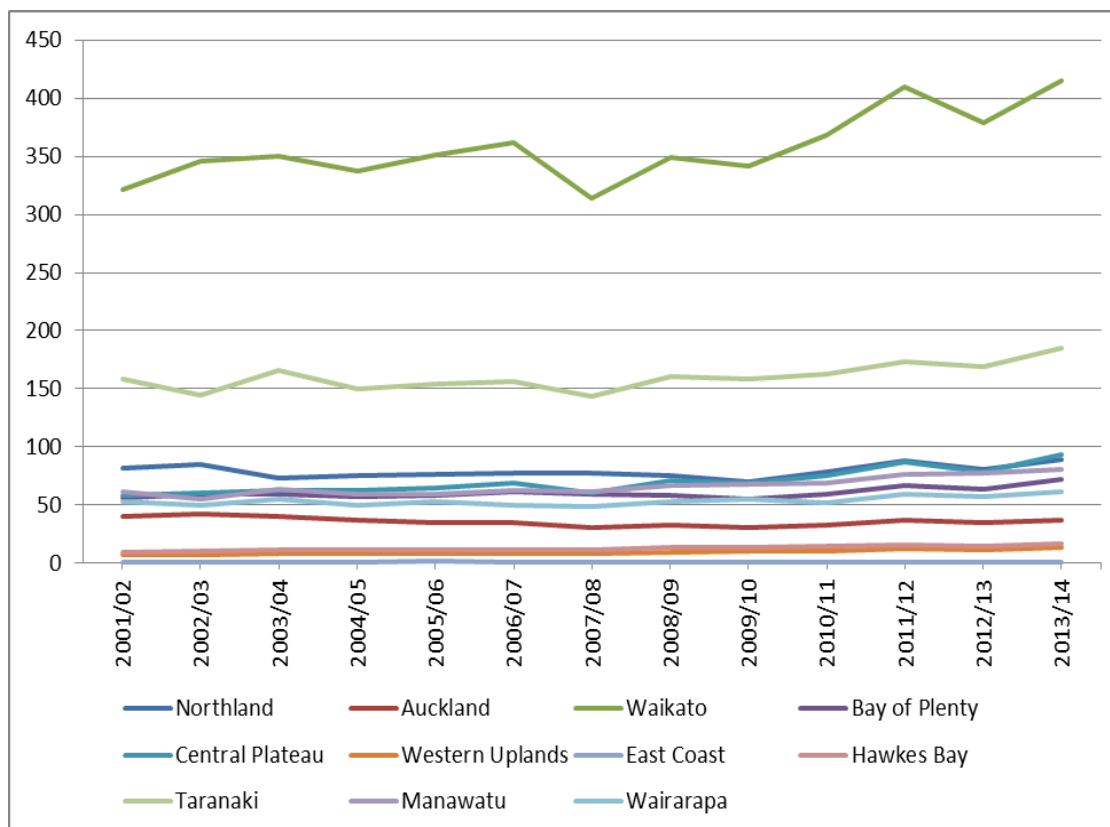
Source: New Zealand Dairy Statistics 2013-2014 LIC and Dairy NZ

D10 Milk growth has been much higher in the South Island than in the North Island. This is shown in Figures D3 and D4 below.

Figure D3: Milk processed in the South Island (million kgs)



Source: New Zealand Dairy Statistics 2013-2014 LIC and Dairy NZ

Figure D4: Milk processed in the North Island (million kgs)

Source: New Zealand Dairy Statistics 2013-2014 LIC and Dairy NZ

- D11 Most of the growth in the South Island has occurred in Canterbury and Southland and has been driven by both dairy conversions and farm productivity growth.
- D12 Most of the growth in the North Island has taken place in the in the Waikato. This growth has largely been driven by higher milk output per cow rather than by dairy conversions.

Expectations for milk growth in the future

- D13 There is an expectation that milk volumes will grow overall over the next ten years, but that the rate of growth is likely to slow.
- D14 In the short term, milk production may slow owing to low milk prices as farmers cut back on supplementary feed and decrease the size of their herds.³²⁸ MPI expects milksolids production to fall in the 2015/2016 season as lower prices lead to cutbacks in supplementary feeding.³²⁹ Over the longer term Fonterra expects milk

³²⁸ More than one million cows were expected to be culled in the 2014/2015 season owing to the low milk solids pay-out. (See http://www.nzherald.co.nz/business/news/article.cfm?c_id=3&objectid=11461065)

³²⁹ Ministry for Primary Industries "Situation and Outlook for Primary Industries" June 2015, p.20.

growth to continue. MAF expects the national herd size to continue growing to 2019.³³⁰

- D15 There is also potential for further conversions in the South Canterbury/North Otago region because irrigation schemes are being developed. The Central Plains Water Enhancement Scheme is a large-scale proposal to supply water for irrigation to an area of 60,000 hectares on the Canterbury Plains due for completion in 2019. Construction started on the scheme in 2014; phase one will distribute water to 120 farms or about 20,000 hectares.³³¹ These irrigation schemes are expected to drive conversions.

Fonterra's growth over time

- D16 Fonterra, collects and processes a high percentage of the raw milk produced in New Zealand
- D17 Fonterra is the world's 2nd largest milk processor and remains the largest processor and milk collector in New Zealand. Fonterra collected 86% of the raw milk in New Zealand in the 2014/2015 season. This amounted to approximately []³³²
- D18 Fonterra processes the milk it collects at [] sites across New Zealand.³³³ Figure D5 below shows Fonterra's processing sites and the different products they produce.

³³⁰ Ministry for Primary Industries "Situation and Outlook for Primary Industries" June 2015, p.20.

³³¹ For example: <http://www.3news.co.nz/nznews/canterbury-irrigation-project-making-progress-2014110418#ixzz3mQOLy7rg>

³³² []

³³³ []

Figure D5: Fonterra's New Zealand processing sites

[]

[]

D19 Fonterra's peak volume processing capacity has increased over the last three seasons. Fonterra processed just over [] at its peak in the 2014/2015 season.³³⁴ Figure D6 shows Fonterra's peak volume processing capacity over the last three seasons.

Figure D6: Fonterra's peak volume supply

[]

D20 Fonterra expects to add [] of processing capacity between []:³³⁵

D20.1 2015 saw the completion of a [] at Pahiatua, just east of Palmerston North, and the addition of [].

D20.2 [].

D20.3 Fonterra has plans [].

Sources of Fonterra's milk

D21 Fonterra is a co-operative, owned by its shareholder suppliers. Almost all of Fonterra's farmer suppliers are shareholders.

D22 Fonterra requires its shareholder suppliers to invest in Fonterra by purchasing shares that reflect the volumes of milk that they supplied (equal to the KgMS supplied to Fonterra). These shares are known as 'wet shares'. We understand these requirements have softened so that farmers now have three years to adjust their shares if they increase output.

³³⁴ []

³³⁵ []

- D23 The Fonterra constitution allows 15% of total milks solids supplied by farmer shareholders to be on a contract supply basis.³³⁶ Only about [] of Fonterra's milk is presently sourced from contracted suppliers.³³⁷ Many of these contracted suppliers are in the process of sharing up to Fonterra. Only [] of the milk that Fonterra collects has no share backing.³³⁸
- D24 In 2014, Fonterra as an alternative to investing in the co-operative introduced MyMilk, which is open to farms in the Canterbury, Otago and Southland regions that are not currently Fonterra shareholders. MyMilk enables farmers who do not want to invest in Fonterra, to supply Fonterra for up to five seasons without immediately becoming a Fonterra shareholder.
- D25 In 2012, Fonterra acquired the dairy processing assets of New Zealand Dairies Limited after it was placed in receivership. As part of the merger, farmers who supplied New Zealand Dairies were required by Fonterra to take up a Growth Contract.³³⁹
- D26 The proportion of Fonterra's contract milk supply has increased over time as it has relaxed the requirements to share-up in order to make it easier for farmers to join the co-operative.
- D27 Fonterra suppliers are also able to invest in Fonterra by purchasing shares that are unrelated to production. These shares are known as 'dry shares'.
- D28 In 2012, Fonterra introduced trading among farmers (TAF). TAF provides farmers who supply milk to Fonterra more flexibility in their investment in Fonterra. It enables farmer shareholders to trade shares among themselves and also gives non-Fonterra suppliers an opportunity to invest in Fonterra through Fonterra's shareholder fund.

Market shares and processing capacities of Fonterra and IPs

- D29 Fonterra competes at the farm gate for the purchase of raw milk against 'own-source' IPs.

³³⁶ NERA Economic Consulting for Fonterra "Assessment of Competition in Raw Milk Markets and Costs and Benefits of the DIRA provisions" 17 August 2015, p.24.

³³⁷ []

³³⁸ Fonterra sourced [] kgMS from shareholding farmers (not all fully share backed yet) in the 2014/2015 season and only [] kgMS from suppliers that are not shareholders. []

³³⁹ []

]

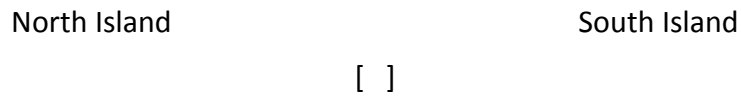
D30 While the volume of milk Fonterra collects has increased since 2001, Fonterra is growing at a slower rate than its competitors. Fonterra’s national market share of milk collected has declined since 2001 from around 96% to 85%.³⁴⁰ Figure D7 shows the steady decline in Fonterra’s market share and the corresponding increase in the market share of IPs nationally.

Figure D7: Fonterra and IP market shares of milk collected - 2001/02 to 2014/15

[] Source: Commission analysis based on information provided by Fonterra and market participants.

D31 Fonterra’s share of the milk collected has declined from around []% to []% in the South Island and from around []% to []% in the North Island since 2001. Figure 10 shows the decline in Fonterra’s market share of milk collected and the increase in the market share of IPs in the North and South islands.

Figure D8: Percentage of IP milk collection in each island - 2001/02 to 2014/15



Source: Commission analysis based on information provided by Fonterra and market participants.

D32 As Figure D8 shows IPs collect proportionately more milk in the South Island than in the North Island. This is because there are a number of large IPs with farmer suppliers in the South Island and because Fonterra does not collect milk from the West Coast.

D33 Fonterra’s market share varies within the North and South Island. Table D1 below sets out the market shares of Fonterra and the IPs across different regions in New Zealand based on the 2014/2015 dairy season.

Table D1: Farm gate market shares (processing capacity and milk collection) – by region for the 2014/2015 season[

	NORTHLAND		AUCKLAND/ WAIKATO/ BAY OF PLENTY		TARANAKI		CANTERBURY		OTAGO/ SOUTHLAND	
	Capacity	Milk collection	Capacity	Milk collection	Capacity	Milk collection	Capacity	Milk collection	Capacity	Milk collection
Fonterra	[]									
Fresha Valley										
Open Country										
Tatua										
Miraka										

³⁴⁰ Commission analysis based on information provided by Fonterra and market participants.

Green Valley									
Westland									
Synlait									
Oceania									
Danone Nutricia]

Source: Commission analysis based on information provided by Fonterra and market participants.

Independent processor growth and entry over time

D34 Independent processor growth and entry since the formation of Fonterra has had various forms: expansion by other cooperatives, and entry and expansion by IPs that, at least to some extent source their own milk directly from farmers, and IPs that rely on DIRA milk.

Other co-operatives

D35 The two dairy co-operatives to remain independent when Fonterra was established in October 2001 are Westland on the West Coast and Tatua in Waikato.³⁴¹

D36 Westland and Tatua have both grown their businesses by increasingly investing in value added product lines. Westland has also expanded its milk collection. It now has capacity of [] of Fonterra’s total processing capacity.³⁴² [³⁴³] Tatua has []% of Fonterra’s total processing capacity.³⁴⁴

Other Independent Processors

D37 A number of IPs have entered the New Zealand dairy market since the establishment of Fonterra. In 2006, the two co-operatives, Westland and Tatua, accounted for []% of milk supply outside of Fonterra, but by the 2015 season, this was []³⁴⁵.

D38 There are currently [] IPs that collect more than 30 million litres per season directly from their own farmers and so are subject to the DIRA sunset clause: [

³⁴¹ []

³⁴² Commission analysis based on information provided by Fonterra and market participants.

³⁴³ []

³⁴⁴ Commission analysis based on information provided by Fonterra and market participants.

³⁴⁵ Commission analysis based on information provided by Fonterra and market participants. See also Informetrics “Why is Fonterra losing grip of market share in the dairy industry?”

]. Under the sunset clause in the Raw Milk Regulations, an IP that collects more than 30 million litres from their own farmers for three consecutive seasons will no longer qualify for DIRA milk.³⁴⁶ This leaves [] large-scale IPs that do not collect 30 million litres directly from their own farmers and so are not subject to this clause.³⁴⁷

- D39 Some small IPs obtain all or part of their milk directly from farmers. The precise total volume of milk collected by small IPs from farmers is unknown but [] which is []% of total raw milk collected.

Own-source IPs subject to the sunset clause

- D40 Historically own-source IPs focused investment into processing commodity products such as WMP. As they have matured some IPs have invested in more value add products such as UHT milk and IMF.
- D41 Open Country was established in 2008 when Dairy Trust Limited acquired Open Country Cheese. It is majority owned by Affco New Zealand Limited, which is owned by Talley's Group Limited. It is currently the second largest milk processor and manufactures milk powders, milk proteins, milk fats and cheese. It has manufacturing plants in Waharoa, Whangai and Awarua. It has the capacity to process [].
- D42 Synlait was established in 2008 and is owned by Synlait Limited and Bright Dairy of China. It is located in Canterbury and manufactures milk powders and infant formula. Since entering it has become [³⁴⁸].
- D43 Miraka was established in 2011 and owned by a group of Maori trusts and corporations.³⁴⁹ Its plant in Mokai produces milk powders and UHT products for export. It has a []capacity WMP dryer plant and two UHT lines with combined capacity of [].
- D44 Oceania was established in 2014 and is a wholly-owned subsidiary of Inner Mongolia Yili Industrial Group. Oceania produces milk powder for export to produce infant formula in China. Its processing plant is located in Glenavy, Southern Canterbury. It

³⁴⁶ []

³⁴⁷ []

³⁴⁸ []

³⁴⁹ Wairarapa Moana Incorporation, Tuaropaki Trust, Waipapa 8 Trust, Hauhungaroa Partnership, Tauhara Moana Trust and Huiarau Farms.

commenced production initially with []operating a commodity powder dryer and [].³⁵⁰

D45 Danone Nutricia was established in 2014 and is owned by Danone, which is a global dairy food corporation based in Paris. [

].³⁵¹

D46 Green Valley, based in the Waikato, [

].³⁵²

D47 Fresha Valley is a smaller processor [

].³⁵³

D48 Yashili, based in Pokeno, south of Auckland [

].³⁵⁴

350 [

].

351 [

]

352 [

]

353 [

]

354 [

]

Attachment E: Market definition

- E1 The most common tool for assessing the scope of markets is the “hypothetical monopolist” or SSNIP test.³⁵⁵ Applying this test, it is necessary to determine whether a hypothetical monopolist could profitably impose a SSNIP. At the heart of this test is substitutability on both the demand-side (will customers switch?) and supply-side (will businesses switch production?). The principal focus is usually on the demand-side.
- E2 The test starts with the narrowest possible market. If imposing a SSNIP would be profitable, then this is the relevant market. If it is not profitable, then the market is widened and the test re-applied, until it is passed.
- E3 The following explains these questions with reference to the geographic dimension of market definition:
- E3.1 on the demand-side, can a business in a chosen geographic area increase prices without consumers switching to a nearby supplier of a substitute good or service in sufficient numbers so as to render the price increase unprofitable?
- E3.2 on the supply-side, can the business increase prices without attracting supply from other firms outside the chosen geographic area in sufficient quantities so as to render the price increase unprofitable?
- E4 If the answer to these two questions is ‘yes’, then it is likely that a hypothetical monopolist in the relevant area could profitably impose a SSNIP. The relevant geographic market therefore is likely to be the area tested. If the answer to one or both of these questions is ‘no’, then the area would be increased in size and the test re-applied.

Farm gate markets for raw milk

Product dimension

- E5 Raw milk is traded at the farm gate between suppliers (farmers) and customers (processors). Consistent with previous decisions, the Commission considers that

³⁵⁵ A small but significant and non-transitory increase in price. For the purpose of determining relevant markets, the Commission will generally consider a SSNIP to involve a five percent increase in price for a period of one year, refer: Commerce Commission “Merger and Acquisition Guidelines” July 2013, p.15. For assessing market definition in non-merger cases (eg, allegations of anti-competitive behaviour), the relevant benchmark is the hypothetical competitive price rather than the prevailing price. Since it is usually unclear what the competitive price would be, the SSNIP test is primarily used in anti-competitive practice investigations as a conceptual framework for considering the various substitution possibilities, rather than as an empirical framework.

there is limited differentiation in raw milk supplied by farmers and that there are no close substitutes for raw milk.³⁵⁶

- E6 While we recognise that some differentiation exists within the raw milk market,³⁵⁷ this would not make any difference to our analysis and we therefore define the relevant product dimension of the market as the supply of farm gate raw milk by farmers to dairy processors.

Geographic dimension

- E7 Raw milk collection or 'catchment' areas tend to be localised. This is because raw milk is a perishable product and needs to be collected from farms daily and cannot be stored for any significant period in its raw form. There is a high cost of transporting milk relative to its value owing to the proportion of water that is extracted from raw milk during processing.³⁵⁸ Therefore much of the transport costs are spent on hauling water.
- E8 The geographic scope of the market is determined by what options farmers have to sell their raw milk and what options processors have to purchase raw milk. These options differ regionally. Some farmers may be able to earn a premium on their milk because processors are competing for supply from farmers in that region.
- E9 Fonterra faces impediments to fully competing in these regional markets. These impediments include its national pricing policy and potential disincentives to price above the milk price as set out in the Milk Price Manual. Under national pricing, the cost of competing for a farmer is not just the price increase to that one farmer, but an equivalent increase to all farmers. However, Fonterra has introduced innovations at the farm gate in the form of the MyMilk contracts in order to counter regional competition in the high milk growth areas of Canterbury, Southland and Otago.³⁵⁹ This suggests that Fonterra is responding to some extent to regional competition at the farm gate.
- E10 Consistent with our analysis in previous cases, we therefore consider that there are regional markets for farm gate milk.³⁶⁰

³⁵⁶ Fonterra Limited and New Zealand Dairies Limited (in receivership) [2012] NZCC 21.

³⁵⁷ For example, organic milk, which constitutes a very small proportion of the milk collected in New Zealand.

³⁵⁸ []

³⁵⁹ NERA maintains that Fonterra finds it difficult to attract new conversions because of its requirement to invest in shares. It has responded by allowing farmers to "share up" over time through the MyMilk scheme. Refer: NERA Economic Consulting for Fonterra "Assessment of Competition in Raw Milk Markets and Costs and Benefits of the DIRA provisions" 17 August 2015.

³⁶⁰ Fonterra Limited and New Zealand Dairies Limited (in receivership) [2012] NZCC 21.

Factory gate markets for raw milk

Product dimension

E11 This is a wholesale market where processors purchase raw milk from each other.

Geographic dimension

E12 As factory gate raw milk is supplied directly from farms, not from the suppliers' processing plants, a processor supplies raw milk to other processors when it already collects in that milk catchment zone.

E13 Therefore, factory gate raw milk supply is akin to a distribution service as this milk is not processed by the supplier.

E14 The geographic scope of the market is determined by what options selling processors have to sell their raw milk and purchasing processors have to buy raw milk. As with the farm gate market, the factory gate market for raw milk is localised because it is a highly perishable product with high relative transport costs.

E15 As these options differ regionally we consider that there are regional markets for factory gate milk.³⁶¹ We note that the adoption of narrower regional market definitions for purpose of our analysis differs from the North Island and South Island markets, we adopted in the our preliminary inquiry into domestic milk markets in our 2011 preliminary inquiry under Part 4 of the Commerce Act 1986.³⁶²

Milk supplied under the Raw Milk Regulations versus outside of the Raw Milk Regulations

E16 Under the Raw Milk Regulations, Fonterra is required to supply up to 50 million litres of raw milk to each IP capped at a total of 795 million litres in aggregate per season.³⁶³ Fonterra is also required to supply Goodman Fielder with up to 250 million litres of raw milk per season under the Raw Milk Regulations.³⁶⁴ We refer to this milk as 'DIRA milk'.

E17 [] of the factory gate milk that Fonterra supplied in the 2014/2015 season was DIRA milk.^{365 366}

E18 The price at which Fonterra supplies DIRA milk is regulated. The DIRA milk price equals Fonterra's forecast farm gate milk price plus average transport costs.³⁶⁷

³⁶¹ Fonterra Limited and New Zealand Dairies Limited (in receivership) [2012] NZCC 21.

³⁶² Commerce Commission "Milk Markets: consideration of whether to initiate a Commerce Act Part 4 inquiry into milk prices" August 2011.

³⁶³ Reg 4, reg 5(1), 6, 19 & 20.

³⁶⁴ Reg 7

³⁶⁵ [].

³⁶⁶ []

E19 Independent processors have a choice of:

19.1 a default price which is the forecast milk price every quarter with a wash-up at the end of each quarter; and

19.2 a fixed quarterly price at the forecast price without a wash-up mechanism.

E20 [368]

E21 However, some IPs do not qualify for DIRA milk for all or part of their factory gate requirements.³⁶⁹ Such IPs are charged Fonterra’s ‘market’ prices [370]³⁷¹

E22 Fonterra’s average market prices are []DIRA price. These price differences over the last three seasons are summarised in Table E1.

³⁶⁷ Regulation 20(4)(a) provides that IPs pay “reasonable” cost of transport to the processor.

³⁶⁸ []

³⁶⁹ For example, they may only require supply on some days; they may not obtain supply in October; they may have failed to comply with the required notice provisions; or they may have exceeded their DIRA milk quota.

³⁷⁰ []

³⁷¹ []

Table E1: The difference between Fonterra’s average market prices and the DIRA prices – 2012/2013 to 2014/2015

Season	Quarter	Fixed DIRA milk price	Final DIRA milk price	Non-DIRA price charged by Fonterra	Difference between the average market price and the fixed DIRA price	Difference between the average market price and the final DIRA price
[2012/2013	1	[
	2					
	3					
	4					
2013/2014	1					
	2					
	3					
	4					
2014/2015	1					
	2					
	3					
	4]	

[

]

E23 Although IPs do not sell much factory gate milk and, for the most part, do not do so on terms similar to DIRA milk sales, we have been told that []³⁷².

E24 Because of the price differential between the prices of DIRA milk and market milk, DIRA milk customers are unlikely to switch to market milk if the price of DIRA milk were to increase by a small but substantial amount.

E25 The supply of DIRA milk is therefore considered a separate market to the milk supplied by dairy processors to each other outside the Raw Milk Regulations.

Milk supplied at the factory gate vs milk supplied at the farm gate

E26 We have previously considered whether the regulatory arrangements had caused the farm gate and factory gate milk markets to merge, in that acquiring milk directly from farmers might be a close substitute for acquiring milk from a dairy processor.³⁷³

³⁷² [

]

³⁷³ Fonterra Co-operative Group Limited and Kapiti Fine Foods Limited and United Milk Limited (Commerce Commission Decision 574, 23 February 2006, paragraph 129).

- E27 In our August 2011 preliminary inquiry we maintained the separate market definitions.³⁷⁴
- E28 Consistent with our approach in the above matters, we consider that maintaining the separate market definitions for farm gate milk and factory gate milk is also appropriate for purposes of the current analysis.
- E29 Independent processors that do not have their own sources of milk are unlikely to switch to purchasing milk directly from farmers based on a SSNIP on the DIRA price because of the cost and difficulties involved.
- E30 Switching from factory gate to farm gate milk likely involves significant costs. These costs include:
- E30.1 managing the seasonality of milk supply;
 - E30.2 collection and transport of milk to the factory;
 - E30.3 managing multiple suppliers; and
 - E30.4 the risks associated with both obligations to accept supply and supply disruptions.
- E31 New entrant and small processors may also find it hard to attract farmers if they do not already have established reputations and/or some production and sales arrangements via supply from the factory gate markets.
- E32 Independent processors that source their own milk and are subject to the sunset clause will be seeking to fill their full milk requirements from farmers in the future. As such, they collect a portion of their milk under the DIRA as an interim measure. A small increase in the DIRA milk price is not likely to have much impact on the speed at which switching to own-source supply takes place.
- E33 For IPs that source some of their own milk in addition to buying DIRA milk, a small increase in the DIRA price might prompt a search for increased farmer supply, but many of these IPs are also likely to face the same barriers faced by IPs that do not currently collect from farmers.

³⁷⁴ Refer: Commerce Commission “Milk Markets: consideration of whether to initiate a Commerce Act Part 4 inquiry into milk prices” August 2011, Appendix 3, paragraphs 18-19.