Westland Milk Products
Hokitika · New Zealand

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Westland Milk Products - Submission on the Dairy Competition Review Draft Report, 4 December 2015

Introduction

1. This Submission on the Dairy Competition Review Draft Report, 4 December 2015 (*the Draft Report*) by the New Zealand Commerce Commission (*Commission*) is made by Westland Co-operative Dairy Company Limited (*Westland*).

2. Westland can be contacted by reference to the following:

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Overview:

1. On 10 July 2015 Westland submitted on the Commission's Dairy Competition Review Consultation Paper 12 June 2015.

2. In this submission, Westland responds on the Draft Report in which the Commission:

   2.1. reports its finding that competition in the factory gate is very limited and without the DIRA Regulation Fonterra would be able to increase the price of raw milk it sells to other domestic processors, resulting in higher prices for dairy products in downstream domestic markets and this would probably impact upon the price consumer pays for milk, and

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2.2. recommends resetting:

2.2.1. the market share thresholds from 20% to 30%, and

2.2.2. the time limit to 2021/22

with whichever of these events happens first triggering another report on the state of competition, and

2.3. recommends that Ministers consider options for changes to the regulations with the objective of facilitating the development of the factory gate market.

3. Westland supports the view held by the Commission that the efficiency purpose is the overriding goal of the DIRA Regulation and competition will only be sufficient when the relevant dairy markets would be more efficient without the Regulation and also that the relevant dairy markets are the farm gate and factory gate markets.

4. Westland agrees with the Commission's 'on balance' approach to its assessment of the state of competition in these markets because of the danger that full deregulation today could irreparably harm the emerging competition evidenced in some regional markets.

5. Westland favours the re-setting of the threshold to 30% for both islands and the inclusion of an expiry trigger; however 4 years is preferred instead of 5 years as suggested by the Commission.

6. No further expiry triggers are recommended by Westland.

7. Further improvements or enhancements to the DIRA Regulations that have the potential to incentivise additional demand and supply in the factory gate market should be considered. However, care is also required in setting a pathway to transition: if the implementation of the pathway occurs too late, or conversely too soon, competition for the industry may be put at risk.

8. Westland views a functioning factory gate market as a pre-condition to full deregulation.

9. Whilst the Commission considers the factory gate and farm gate markets to be separate markets that have not merged, Westland believes that the interrelationship between the two should not be overlooked because:

9.1. improvements or enhancements to the freedom of entry and exit provisions also have a key role to play in the development of a functioning factory gate market. It may be no coincidence that in its consideration of the order of priority for removing the DIRA Regulations, the milk price setting and monitoring regime, and the freedom of entry and exit rules, the Commission has recommended the freedom of entry and exit rules should be the last to be removed in a transitional pathway to full deregulation.

9.2. it is logical that competition for farm gate milk must exist before, or concurrently with, competition for factory gate milk because a factory gate milk market requires access to milk in the first instance and this is achieved either by the IP purchasing raw milk directly from another IP that already collects off farm under contract or own shareholder supply i.e. at the factory gate market, or securing the collection rights (under contract or own shareholder supply to the IP). Hence Westland strongly agrees with the Commission at paragraph X27 where it states that "the factory gate market also benefits from the regulations at the farm gate, particularly the open entry and exit regulations"

10. Westland views the adoption of a transition pathway that supports the development of the factory gate market to be essential to de-risk full deregulation.

11. Set out below is Westland's detailed response to the Commission's Draft Report.

Resetting of threshold

12. Westland accepts the Commission's proposal to recommend the re-setting of the thresholds to 30% in each island given that:

    12.1. competition at a regional farm gate and factory gate market level across both of the Islands differs greatly,

    12.2. the 20% threshold has already been met in the South Island but on analysis there is insufficient competition to meet the efficient and contestable standard for the farm gate and factory gate markets, and

    12.3. the threshold does not trigger de-regulation, but simply a review of competition.

Other expiry triggers that should be provided for

13. Westland also agrees with the Commission that including a time bound review, as well as the 30% threshold provides the industry with comfort that regardless of whether or not the threshold is met there will be an automatic review of competition in the industry at a given point in time. Having a transparent and certain time horizon for the next review is paramount given the potential dominance by Fonterra in the dairy market.

14. However, Westland prefers a 4 year expiry trigger, which is arguably a more conservative approach than is being proposed by the Commission, given that it is possible there will be sufficient new information on activity in the farm gate and factory gate markets to warrant this, for instance, continued activity in the South Island due to irrigation schemes being implemented and given the significant variation in levels of competition across regional farm gate and factory gate markets identified in the Draft Report.

    14.1. Westland sees no hardship for the industry if a 4 year expiry trigger is adopted. This is unlikely to reduce the level of engagement by IPs and Fonterra in the review process and the upside is considered greater than the cost in bringing this process forward (in the event that the threshold is not triggered in either Island before the automatic review).

15. Given that the 30% trigger is by Island (and not by region) Westland believes it is possible that the volume of milk collected by IPs in a number of regional markets could exceed the 30% trigger without activating a review albeit the competitive landscape will have changed significantly in one or more regions. If that were to occur, then without a review and amendment to the DIRA Regulations or deregulation resulting from a review, efficiencies initially produced by the legislation could create inefficiencies and certain IPs could be discriminated by the failure of the regime to be monitored and adjusted or removed on a timely basis. This would be contrary to the purpose of the DIRA Regulation.

16. Westland does not recommend any additional expiry triggers such as measures of the factory gate market industry concentration, industry dynamics, and geographic area based triggers – sub-island regional or national/whole NZ triggers.

Transition pathway

17. Westland agrees with the Commission that full deregulation nationwide immediately and without a transition pathway is too risky.

18. Westland also considers that it could be detrimental to the emerging competition identified in the Draft Report if the thresholds are reset without the introduction of a transition pathway. It believes that to re-set the thresholds right now without also introducing a transition pathway creates a degree of dependence upon the Regulations by some IPs and with it the potential for inefficient farm gate and factory gate markets.

19. The Draft Report proposes a staged approach that weans IPs off the protections in provided by the DIRA Regulations over time in the following order:

    19.1. first: amend DIRA Regulations reducing processor dependence on access to DIRA milk

    19.2. second: remove base milk price disclosure and monitoring

    19.3. third and last: remove open entry and exit obligations on Fonterra.

20. Westland believes the staged approach supports the drive for efficiency, the growth of competition and mitigates the risk of full deregulation.

21. Long term dependence on DIRA milk, especially by the largest processors, is an impediment to the development of both the farm gate and the factory gate milk markets. Reducing dependence on access to DIRA milk should be pursued before relaxation or removal of the regulations concerning the base milk price disclosure and monitoring open entry and exit.

22. In its previous submission Westland noted its support for the continuation of the regulations pertaining to farm gate milk market intended to promote the concept of freedom of entry and exit (to/from Fonterra). That view remains unchanged and Westland agrees with the Commission that in particular provisions protecting freedom of entry and exit should be removed last. Entry into the farm gate market by new IPs is eased by the regulations. Entry to the farm gate market by IPs is likely to be supressed if open entry and exit are not retained. Westland agrees with the commission that open entry and exit and non-discrimination regulations are likely to be a factor that a farmer, considering switching to a start-up IP, that has no track record, will take comfort from knowing they can likely return to Fonterra reduces that farmer's risk of making the switch.

23. Westland also agrees with the Commission's analysis that with the DIRA Regulations in place the industry has witnessed significant new entry – the fact that 20% of its milk collection now comes from its Canterbury supplier base supports this.

Consider amendments but do not repeal subparts in entirety

24. Per its earlier submission Westland is of the view that the 20% rule has been ineffectual. Certainly when it has looked at utilising this the required co-ordination in the case of multiple processors collecting milk from the same farm gate and the apparent need to duplicate on farm assets, such as the farm holding tanks, appeared difficult to accommodate. However, it appears that the Commission has, through the submission and consultation process, identified occasions on which the 20% rule is being used. Westland favours maintaining this optionality but recommends that further assessment be given to ensure this is practically workable for the farmer, Fonterra and the IP and amending this rule accordingly. Unlike DIRA milk, Westland believes milk should be available to any IP under the 20% rule. Access to farm gate milk under this rule has the benefit of allowing the farmer to choose to supply a portion of their milk to another IP and should support the development of a competitive farm gate milk price.

Options for changing the regulations to facilitate the development of the factory gate market

25. Westland has observed that the Draft Report says the Commission "will highlight for consideration by the Minister ...options for different regulation proposed by interested parties." Westland respectfully submits that the following be raised with the Minister for consideration:

25.1. Changes to stimulate the factory gate market:

25.1.1. Dependency on DIRA milk: Westland is concerned that the regulations have contributed to an inefficient factory gate market due to dependency on DIRA milk and that a weaning off from the Regulations is key. It agrees that in order to de-risk full deregulation a deliberate and well signalled reduction in access to DIRA milk by IPs is desirable. This should also give the market time to respond i.e. for those IPs to either secure other sources of milk from other IPs or to obtain their own supply direct from the farm gate. Westland observes that the Draft Report expressed the following view of the Commission at paragraph 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."

25.1.2. Price for DIRA milk: Westland also believes that the price for DIRA milk does not achieve a competitive price for factory gate milk and the only way to reveal the true price for factory gate milk is by growing competition at the factory gate, hence the view in 25.1.1. above.

25.2. The 33% rule: Consistent with our view expressed above, given the interrelationship between the farm gate market and factory gate market Westland recommends re-defining of the provisions around exit rights for all Fonterra suppliers so that it is simple for farmers and IPs alike to understand and apply. The 33% rule lacks transparency and it is difficult for IPs to have confidence that this rule is being observed.

Catherine Walker
General Counsel