Ministry for Primary Industries
Manatū Ahu Matua

Review of Dairy Industry Restructuring Act 2001 in response to Fonterra's capital restructure – Regulatory Impact Assessment

April 2022

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Coversheet: Review of Dairy Industry Restructuring Act 2001 in response to Fonterra's capital restructure

Advising agency:	Ministry for Primary Industries
Decision sought:	Amend the Dairy Industry Restructuring Act 2001 to support Fonterra's capital restructure, while adjusting existing regulatory settings to reduce risks to contestability of farmers' milk supply.
Proposing Minister:	Hon Damien O'Connor, Minister of Agriculture
Date:	April 2022

Section A: Summary: Problem and Proposed Approach

Problem Definition

The New Zealand dairy industry plays a key role in New Zealand's economic, environmental and social wellbeing. A high-performing Fonterra underpins a well-functioning dairy industry. Competition for farmers' milk is expected to intensify over the coming years and Fonterra considers its current capital structure impedes its ability to attract and retain milk supply.

Fonterra is seeking a legislative amendment to the Dairy Industry Restructuring Act 2001 (DIRA) to specifically enable a key aspect of a new capital structure that has recently been agreed by its farmer-shareholders. The DIRA does not explicitly prohibit Fonterra from proceeding with its capital restructure but doing so exposes Fonterra to a risk of legal challenge. Fonterra is seeking a DIRA amendment to mitigate that risk.

In considering Fonterra's request for a DIRA amendment, the Government needs to strike a balance between:

- **enabling Fonterra to pursue its commercial objectives**, which would maintain or improve Fonterra's significant financial contribution to the dairy industry, rural communities, and the wider New Zealand economy, in the short to medium term; and
- **mitigating risks and potential flow-on impacts** of Fonterra's intended capital restructure for the long-term performance of the wider dairy industry (including Fonterra itself) and the incentives to invest in innovation, sustainability, and value creation, over time.

Summary of proposed approach

The Cabinet paper proposes to amend the DIRA to support Fonterra's capital restructure, while adjusting the existing DIRA regulatory settings to reduce long-term performance risks that Fonterra's capital restructure could create.

MPI considers that the proposed regulatory adjustments are necessary but not sufficient. In our view, stronger and more direct regulation of Fonterra's farm gate milk price would be required to mitigate the risks more comprehensively, if the DIRA was amended to support Fonterra's capital restructure. However, given that such form of alternative regulation would impose substantial regulatory costs, create significant risk of regulatory error, and potentially distort Fonterra' business and investment decisions, this is not MPI's preferred approach.

Instead, MPI recommends amending the DIRA to clarify and reflect the original policy rationale underpinning the relevant capital structure provisions. Although this would mean Fonterra could not continue with one aspect of its intended capital restructure, it would result in Fonterra having the choice of either proceeding with the remaining aspects of its capital restructure; continuing to operate under its current capital structure; reverting to its original share issue and

redemption share trading system; or developing a different capital restructure proposal for its shareholders' and the Government's re-consideration. The Cabinet paper proposals and MPI's recommended approach both aim to strike the balance between supporting Fonterra's commercial objectives and mitigating the long-term risks. Overall, the Cabinet paper proposals place greater weight on supporting Fonterra's commercial objectives of operating a large-scale, productively efficient, New Zealand farmer-owned co-operative, whereas MPI's recommended approach equally weighs all of the assessment criteria (set out in section 3.2 below). The appropriate weighting for the criteria is a matter of judgement.

Section B: Summary Impacts: Benefits and costs

Who are the main expected beneficiaries and what is the nature of the expected benefit?
The main beneficiaries of these proposals in the short to medium term are Fonterra, the subset of Fonterra's current farmer-shareholders who do not plan to retire or exit Fonterra in the near future, as well as other dairy farmers considering joining Fonterra or supplying other processors. Fonterra's improved ability to retain and attract new milk supply would assist efficient capacity utilisation of Fonterra's existing processing plants and enable Fonterra to maintain or improve its ability to pay the maximum possible price for farmers' milk. Fonterra's milk prices are a key driver of on-farm profitability and dairy land prices, that underpin the economic and financial wellbeing of New Zealand rural communities. The proposals would support Fonterra's commercial objectives of operating a large-scale, productively efficient, New Zealand farmer-owned co-operative, able to allocate capital to investments in innovation and sustainability, in the short to medium term. They would place Fonterra, New Zealand's largest company, in a good stead to confront the challenges of a flat or potentially declining New Zealand milk production at a time when New Zealand is also facing wider economic and geo-political disruption and uncertainty.
Where do the costs/risks fall?
The immediate cost of Fonterra's capital restructure falls to its farmer-shareholders and unit holders' balance sheets. Collectively, Fonterra's farmer-shareholders have accepted a balance sheet hit of around $2.5 billion and imposed an additional $160 million value loss on unit holders. Over time, Fonterra's capital restructure could create risks of reduced contestability for farmers' milk supply, weakening incentives for Fonterra (and reducing the ability for other processors) to drive long-term performance, innovation, sustainability, and value creation for the wider dairy industry. It could also have negative flow-on impacts on Fonterra's future financial resilience, confidence in New Zealand capital markets, and the cost of dairy products for New Zealand consumers.
How will the costs/risks be mitigated?
The Cabinet paper proposals include a range of regulatory adjustments to the existing DIRA settings. These measures aim to reduce risks to contestability of farmers' milk supply arising from Fonterra's capital restructuring. Once these measures are implemented, MPI would monitor the extent of their effectiveness. This monitoring will provide information and evidence that will be considered as part of the wider DIRA review, which is statutorily required to commence between June 2025 and June 2027.

Section C: Evidence certainty and quality assurance

Agency rating of evidence certainty?
It is difficult to quantify the costs and benefits of changes to the DIRA regulatory regime and the scale of benefit and detriment to Fonterra, dairy farmers, other processors, or the wider economy. The benefits of maintaining an effective regulatory regime would come from dynamic efficiency across the economy not being foreclosed, but this is all but impossible to isolate and measure. Instead, the analysis of issues in this RIS has been informed by qualitative assessment and input provided during targeted stakeholder engagement process we undertook with Fonterra, other dairy processors (including Open Country Dairy, Synlait, Miraka, Westland Milk, Oceania Dairy, Tatua, Yashili, Happy Valley, and Matarua Valley), the Manager of the unit Fund and Federated Farmers New Zealand. Our analysis has also been informed by the following independent expert reports: • MPI-commissioned reports from Frontier Economics and TDB Advisory • Fonterra-commissioned reports from Sapere s 9(2)(b)(ii) [redacted] • Fonterra Co-operative Council-commissioned report from Northington Partners • Open Country Dairy-commissioned report from Castalia.

Responsible Manager:
Chris Kerr Director, Strategy & Insights, Policy & Trade Ministry for Primary Industries April 2022

Quality Assurance	
Reviewing Agency:	The MPI Regulatory Impact Analysis Panel has reviewed the Regulatory Impact Assessment "*Review of Dairy Industry Restructuring Act 2001 in response to Fonterra's capital restructure*" produced by MPI and dated April 2022.
Panel Assessment, Comments, and Recommendations:	The review team considers that it partially meets the Quality Assurance criteria. The Panel found the RIA met the *complete* QA criteria. However, while the Panel appreciates that efforts were made to make the RIA more clear and concise, there was too much detailed background information which obscures the problem definition, for this reason the Panel considered the RIA only partially met the *clear and concise* QA criteria. This also meant that the options analysis was not as convincing as could be, hence partially meeting the *convincing* QA criteria. The Panel notes there may be further consultation at a later stage but that there was no mention of Treaty partners or their involvement in the consultation process, further, there was a lack of clarity around who may be part of any wider consultation. The Panel therefore determined that the RIA partially met the *consulted* QA criteria. The Panel therefore concluded this RIA only partially meets.

Impact Statement: Review of Dairy Industry Restructuring Act 2001 in response to Fonterra's capital restructure

Section 1: General information

1.1 Purpose

The Ministry for Primary Industries (MPI) is solely responsible for the analysis and advice set out in this Regulatory Impact Statement (RIS), except as otherwise explicitly indicated. This advice has been produced for the purpose of informing key policy decisions to be taken by Cabinet.

1.2 Key Limitations or Constraints on Analysis

Consultation

The content of this RIS has not been informed by public consultation. To test the issues set out in this RIS, we held targeted engagement with Fonterra, other dairy processors (including Open Country Dairy, Synlait, Miraka, Westland Milk, Oceania Dairy, Tatua, Yashili, Happy Valley, and Matarua Valley), Federated Farmers of New Zealand, and the Manager of the Fonterra Shareholders Fund (the unit Fund). The analysis of issues and options in this RIS has been informed by the comments we received during that targeted engagement process, as well as MPI and other interested parties' commissioned expert reports, including:

- MPI-commissioned reports from Frontier Economics and TDB Advisory,
- Fonterra-commissioned reports from Sapere s 9(2)(b)(ii) [redacted],
- Fonterra Co-Operative Council-commissioned report from Northington Partners,
- Open Country Dairy-commissioned report from Castalia, as well as
- Correspondence from Miraka and Happy Valley Nutrition Ltd.

We also note that the issues raised were closely related to those identified in close to 800 submissions MPI received during the 2010-2012 policy development and legislative change process undertaken in the lead up to the 2012 amendments of the Dairy Industry Restructuring Act (DIRA) that enabled Fonterra's implementation of its current capital structure.

This RIS also does not include detailed regulatory design for each of the options outlined. This level of regulatory design detail will be developed in consultation with interested and affected parties once Cabinet has taken policy decisions.

Scope for decision-making

The primary policy question of whether Fonterra (at its current market share of 79 percent) still has significant market power in the New Zealand farmers' milk market has not been revisited in this RIS. This question was last considered as part of the 2018/19 comprehensive DIRA review and will be revisited again as part of the next DIRA review required to commence between June 2025 and June 2027. This RIS is therefore based on the premise that Fonterra does have significant market power, and therefore a company-specific regulatory regime is required to manage the risks of Fonterra potentially taking advantage of its market power in the New Zealand farmers' milk market.

Evidence base

It is difficult to quantify the costs and benefits of changes to the DIRA regulatory regime, or the scale of benefit or detriment to Fonterra, dairy farmers, other processors, or the wider economy. The benefits of maintaining an effective regulatory regime would come from dynamic efficiency across the economy not being foreclosed, but this is all but impossible to isolate and measure.

Section 2: Problem definition and objectives

2.0 What is the summary problem definition?

The New Zealand dairy industry plays a key role in New Zealand's economic, environmental and social wellbeing. A high-performing Fonterra underpins a well-functioning dairy industry. Competition for farmers' milk is expected to intensify over the coming years and Fonterra advises that it considers its current capital structure impedes its ability to attract and retain milk supply.

Fonterra is seeking a legislative amendment to the Dairy Industry Restructuring Act 2001 (DIRA) to specifically enable a key aspect of a new capital structure that has recently been agreed by its farmer-shareholders. The DIRA does not explicitly prohibit Fonterra from proceeding with its capital restructure, but doing so exposes Fonterra to a risk of legal challenge. Fonterra is seeking a DIRA amendment to mitigate that risk.

In considering Fonterra's request for a DIRA amendment, the Government needs to strike a balance between:

- enabling Fonterra to pursue its commercial objectives, which would maintain or improve Fonterra's significant financial contribution to the dairy industry, rural communities, and the wider New Zealand economy, in the short to medium term; and
- mitigating risks and potential flow-on impacts of Fonterra's intended capital restructure for the long-term performance of the wider dairy industry (including Fonterra itself) and the incentives to invest in innovation, sustainability, and value creation, over time.

2.1 What is the context within which action is proposed?

The New Zealand dairy industry plays a key role in the nation's economic, environmental, and social wellbeing

The functioning of the dairy industry is of significant national interest. Its future performance will be driven by the incentives and ability of dairy farmers and processors to maintain the industry's international competitiveness and export earning potential, while diversifying away from a mostly volume-driven to a more value-creating growth strategy. This would help reduce the industry's exposure to the highly volatile global commodity markets, mitigate the negative impacts on the environment, and build its social licence to operate.

The dairy industry is one of New Zealand's largest export sectors, earning approximately $19.1 billion a year, accounting for 35 percent of total merchandise exports, and around 3.1 percent of GDP. Dairy exports have grown at an average rate of around 7 percent per year between 2004 and 2020, with the value of dairy exports more than tripling over the period, from $6.1 billion to $20.1 billion per year.[1] The industry employs around 49,000 workers[2]. Employment in the industry has grown more than twice as fast as total employment, at an average of 3.7 percent

[1] Microsoft Word - TDB - Dairy Review Prod Comm Oct 2020.docx

[2] Primary industries workforce – fact sheets (mpi.govt.nz)

per year since 2000.[3] The industry brings considerable benefits to New Zealand's rural communities, with the largest increases in regional dairy-related employment occurring in Canterbury, Waikato, Southland and Otago.[4]

Global demand for dairy products is expected to continue to grow and New Zealand's share of processed dairy product trade is likely to remain strong. This is contingent on various external factors that could undermine global dairy prices and, therefore, the industry's near-term economic returns. Such factors include potential surplus of global milk production, the growth of milk alternatives, heavily concentrated export markets, the challenges of the COVID19 pandemic, and geo-political trade tensions.

New Zealand's dairy exports remain heavily focused on basic commodities, exposing the industry to significant international price volatility.[5] However, given that raw milk is a highly perishable product it is challenging to channel milk into anything other than commodity exports. With approximately 70 percent of farmers' milk being produced over a three-month spring period, New Zealand's dairy industry's processing assets have to be built and run to handle seasonal variations in raw milk supply. Efficient utilisation of Fonterra's processing assets is a key driver for Fonterra's intended capital restructure.

This had been driven by the increased on-farm profitability of dairying compared to other land-uses. More recently, the growth of dairy cow numbers has flattened. Increased regulatory environmental constraints are expected to reduce any further increases in land use intensification, including dairying. The New Zealand dairy cow population and the national dairy land use area is expected to decline. However, the impact on milk production is likely to be off-set to some degree by increases in on-farm productivity improvements, specifically in dairy cow genetics, advances in farm management practices and development of new technology.

The dairy industry has negative environmental impacts, including through contaminant discharges to freshwater and greenhouse gas emissions. Both of these environmental impacts are significant in the overall New Zealand context, and have been the focus of industry, regional government and central government initiatives to manage. With rising global demand and high global dairy prices, dairy cow numbers have, until recently, been rising, with dairying expanding into new areas and intensifying in existing areas. This dairy expansion has contributed to poor water quality in rivers that flow through pastoral land. From 2013 to 2017, compared with rivers in native forest land cover, pastoral land had nitrate-nitrogen levels that were 9.7 times higher, phosphorus levels 3.4 times higher and E.coli levels 14.6 times higher.[6] This expansion and intensification has been driven by the increased on-farm profitability of dairying compared to other land-uses. More recently, the growth of dairy cow numbers has flattened. Increased regulatory environmental constraints are expected to reduce any further increases in land use intensification, including dairying. The New Zealand dairy cow population and the national dairy land use area is expected to decline. However, the impact on milk production is likely to be off-set to some degree by the adoption of technologies and practices that mitigated environmental impacts, increases in on-farm productivity improvements, specifically in dairy cow genetics, advances in farm management practices and development of new technology. The industry's incentives and ability to reduce its environmental impacts (including on greenhouse gas emissions and water quality) play a key role in the environmental wellbeing of all New Zealanders.

3 dcanz_2018_final.pdf (nzier.org.nz)

4 MPI – Frontier Economics report one

5 Investor's Guide to the New Zealand Dairy Industry 2017 (mbie.govt.nz)

6 https://environment.govt.nz/publications/our-freshwater-2020/

The economic benefits from dairying have come at the cost of environmental harm and loss of environmental amenity value, impacting social wellbeing. There is also a perception of economic detriment to domestic consumers through higher prices for staple dairy foods. The dairy industry produces almost twenty times more dairy products than domestic consumers can consume. Around 95 percent of all milk produced in New Zealand is therefore exported. The retail dairy product market in New Zealand is relatively small, accounting for the remaining 5 percent of New Zealand dairy production, processed mostly into fresh consumer dairy products. Domestic consumer demand is relatively inelastic, with fresh liquid milk seen as a key staple.

Supermarkets account for the majority of dairy product retail sales.[7] They have been the subject of the Commerce Commission's recent market study into the grocery sector.[8] The Commission's study found that competition in the retail grocery sector is not working well for New Zealand consumers. It recommended a range of measures to promote competition, which the Government is currently considering.

A high-performing Fonterra underpins a well-functioning dairy industry

Fonterra is a vertically integrated farmer-owned dairy co-operative. It is New Zealand's largest company and New Zealand-based and fully New Zealand-owned multinational firm with the most significant global scale and reach. Owned and controlled by around 10,000 farmer-shareholders, Fonterra currently collects 79 percent of all milk produced in New Zealand, processes it into various dairy products across 28 processing sites in New Zealand, and exports these to more than 130 countries worldwide. In 2022, Fonterra expects to contribute over $14 billion to rural communities. About two thirds of Fonterra's revenue comes from its commodities and ingredients products, with the remaining one third from the consumer and foodservice business.

While Fonterra's relative share of New Zealand's farmers' milk market has reduced from 96 percent in 2001 to 79 percent in 2021, Fonterra still holds a dominant market position in terms of its scale and price-setting ability. It is the only processor in New Zealand with a nation-wide presence s 9(2)(b)(ii) [redacted]). Other processors competing with Fonterra are small in comparison (Appendix One refers).

Fonterra supplies raw milk to its domestic consumer business subsidiary, Fonterra Brands New Zealand, and to Goodman Fielder, a large multinational food company, that is the only other manufacturer of domestic consumer dairy products of national scale in New Zealand. We estimate that, collectively, Fonterra Brands and Goodman Fielder supply around s 9(2)(b)(ii) [redacted] of all domestic consumer dairy products in New Zealand. The remainder is supplied by smaller niche producers, imports, and more recently by Synlait Milk. Since 95 percent of New Zealand's milk production is exported, New Zealand domestic consumer dairy product prices are intrinsically linked to, and reflect trends in, international dairy commodity prices.

Fonterra also contributes to New Zealand's capital markets. While Fonterra's co-operative form precludes external investors from investing in Fonterra shares, its current capital structure gives external investors the opportunity to invest in units in the Fonterra Shareholders' Fund (the unit Fund). The unit Fund is a registered managed investment scheme, that acquires economic rights of shares in Fonterra and issues units in the Fund to external investors. Investors who own units in the unit Fund (the unit holders) have access to economic rights (such as distributions and capital movements) identical to those of a Fonterra share held by its farmer-shareholders, without the voting rights in Fonterra. This allows investors in the unit Fund an opportunity to earn returns based on Fonterra's financial performance. While Fonterra's primary purpose for launching the unit Fund was to support the effective functioning of its current co-

[7] MPI – Frontier Economics report one

[8] https://comcom.govt.nz/__data/assets/pdf_file/0023/278402/Market-study-into-the-retail-grocery-sector-Executive-summary-8-March-2022.pdf

operative capital structure, the unit Fund provides an ancillary benefit of deepening New Zealand's capital markets because it provides New Zealand investors with opportunities to invest (albeit indirectly) in the financial performance of New Zealand's largest company.

Given its size, Fonterra's successes and any opportunity costs of unrealised potential are not only borne by its farmer-shareholders, but also by rural communities and the wider New Zealand economy. A high-performing Fonterra is therefore central to a well-functioning dairy industry and the wider New Zealand economy.

Competition for farmers' milk is expected to intensify

The dairy industry is facing a flat or potentially declining milk production in the coming decades, driven by global and domestic factors such as climate change, environmental regulations, and alternative land uses. Fonterra expects total New Zealand milk supply to decline by 2.4 percent by 2030.[9]

As a result, competition for farmers' milk in New Zealand is likely to intensify. All dairy processors will need to develop different business strategies, organisational structures and innovate in order to attract, grow, or maintain their milk supply. This will require dairy processors to secure access to capital on competitive terms to invest in innovation and value creation.

In a flat or potentially declining milk production environment, farmers' ability to switch supply between processors and/or land uses would be critical to ensuring that milk production and land use can flow to their highest value use.

Fonterra and other dairy processors have invested heavily in their long-life processing capacity and therefore have strong incentives to retain their current supply volumes to avoid asset stranding and plant closures. The choice of competitive strategy will depend on individual processors' business and commercial decisions. These are, in turn, dependent on individual dairy processors' business models, competitive and comparative advantages, their cost and access to both debt and equity capital, and their shareholders' ability and willingness to make strategic trade-offs. Some processors, having adopted certain competitive strategies, will succeed, while others may not.

However, so long as the process of competition is based on fair and reasonable terms, and competitive strategies that individual dairy processors choose to adopt do not prevent, hinder, or deter other (actual or potential) processors from competing, the overall performance of the dairy industry should remain strong. It is worth noting that a competitive strategy undertaken by a dairy processor with substantial market power may have an anti-competitive effect, even though the same strategy could be neutral or even pro-competitive at times if undertaken by a processor with no market power.

Fonterra considers its current capital structure impedes its ability to compete for farmers' milk effectively

Fonterra has indicated that the level and cost of its current compulsory farmer-shareholding requirements is a barrier for new farmers to join the co-operative and an incentive for existing farmers to switch to other processors. Fonterra considers this presents a significant competitive disadvantage for the co-operative, particularly in the face of increasing competition for farmers' milk. Fonterra has also indicated that its current capital structure poses risks to farmer ownership and control of Fonterra, particularly if Fonterra's milk supply declines in the future.

Fonterra's current capital structure, known as Trading Among Farmers (TAF), comprises:

[9] Fonterra (2021) Capital Restructure Booklet, p. 23

a) the Fonterra Shareholders' Market, where only farmer-shareholders, the market maker[10], and Fonterra can trade compulsory (wet) and non-compulsory (dry)[11] shares in Fonterra;
b) the Fonterra Shareholders' Fund (unit Fund), where farmer-shareholders, the market maker, Fonterra and external investors can trade units in economic (non-voting) rights to Fonterra's shares (with the size of the unit Fund capped at 20 percent of Fonterra's total number of shares on issue); and
c) the linkage between the Fonterra Shareholders' Market and the unit Fund that allows Fonterra's farmer-shareholders, the market maker, and Fonterra to effectively convert dry shares to units and vice versa, thus providing an informed and liquid price-discovery mechanism for Fonterra shares.

Under this capital structure, declining milk supply could result in the number of non-compulsory (dry) shares increasing by the corresponding reduction in the compulsory (wet) shares. If farmer-shareholders were to choose to sell these dry shares into the unit Fund, the size of the unit Fund could grow beyond its current size.

The unit Fund currently accounts for around 6.7 percent of Fonterra's total number of shares on issue. Fonterra considers that the larger the unit Fund gets, the more influence the unit holders may be able to exert over Fonterra's strategic business decisions, despite the lack of voting rights attached to the units. However, keeping the unit Fund at its current potential size limit would, under the current capital structure settings, require share buy-backs by Fonterra. It estimates that any such buy-backs could cost the co-operative's balance sheet up to $1.2 billion over the next ten years.[12]

Fonterra is proposing to move to a new capital structure that would allow the co-operative to reduce both the level and cost of its compulsory farmer-shareholding requirements (to encourage farmers to join and stay with Fonterra), in a way that protects farmer ownership and control of Fonterra, while also minimising the cost of share buy-backs falling onto Fonterra's balance sheet.

In May 2021 Fonterra initiated a farmer-consultation process on the Board's preferred new capital structure. A key part of the initial proposal was for the unit Fund to be either removed (bought out by Fonterra) or partially delinked from the farmers-only share market. At the start of consultation Fonterra partially delinked the unit Fund by preventing shares from being able to be exchanged for units. The reason given for this restriction was to mitigate the risk of its farmer-shareholders opportunistically converting their shares into units in anticipation of a potential unit Fund buy-out (thus increasing the cost to Fonterra if it decided to buy out the unit Fund).

In December 2021 Fonterra's farmer-shareholders voted to move to a new capital structure, the two key elements of which are:

a) a reduction in the minimum shareholding requirement from one share for one kilograms of milk solids (kgMS) supplied (1:1) to one share for every ~ three kgMS supplied (1:3); and
b) a restricted farmer-only market for share trading, with the unit Fund being retained but capped so that shares could no longer be exchanged into new units on a day-to-day basis, and the overall size reduced, on a permanent basis. Under the proposed arrangements

[10] The market maker is a financial institution contracted by Fonterra to ensure liquidity in the Fonterra Shareholders' Market through continuous offering of both buy and sell orders for Fonterra shares. A key role of the market maker is to ensure that the spread between buy and sell prices is restricted to a narrow range, which is achieved by the market maker participating in the trading of units and exchanging them for shares, and vice versa.

[11] As a co-operative, Fonterra requires its farmer-suppliers to hold shares in proportion to the volumes of milk supplied in each season. These are informally referred to as wet shares and effectively have voting rights attached to them. Within some limits, Fonterra farmer-suppliers can also hold shares in excess to the volumes of their milk supply. These are informally referred to as dry shares and do not have voting rights attached to them. Both, however, attract the same dividend and capital gains or losses.

[12] Fonterra (2021) Consultation booklet.

neither farmer-shareholders nor the market-maker nor Fonterra would be able to exchange shares into units, although existing units could still be converted back into shares.

Fonterra acknowledges that a restricted farmers-only share market would cause downward pressure on the share price and expects its shares to trade at least at a 20 to 25 percent discount to their full fair value but accepts that at times the share price could be lower.[13] The restricted farmers-only share market would likely be one-sided and at times highly illiquid. The discount to the full fair value share price is expected to remain, even with the following liquidity-enhancing measures Fonterra plans to incorporate into its market design:

a) an increase in the maximum shareholding ability – from two shares for every one kgMS supplied (2:1) to four shares for every one kgMS supplied (4:1) – and an opportunity for sharemilkers and contract milkers to invest directly in Fonterra shares (rather than units as now), thus increasing the pool of potential demand for shares in the farmers-only market;
b) an increase in the period over which exiting farmer-shareholders have to sell their Fonterra shares – from three years to 15 years (reducing to 10 years) – to provide an opportunity for exiting farmers to hold Fonterra shares for longer thus potentially reducing the sell-side pressure in the farmers-only market;
c) a commitment from Fonterra to allocate around $300 million of its balance sheet capital to support the transition to the farmer-only market by buying back and cancelling shares, thus mitigating the immediate sell side pressure likely to arise during the transition period; and
d) s 9(2)(b)(ii) [redacted]

Fonterra could face a risk of legal challenge if it proceeds with a key aspect of its capital restructure without a DIRA amendment

Under the Co-operative Companies Act 1996, changes in capital structure are the choice of the co-operative's shareholders and normally require at least 75 percent shareholder support. Fonterra's proposed capital restructure received 85 percent shareholder support, with almost 83 percent of eligible votes cast.

However, a key aspect of Fonterra's capital restructure (the partial delinking of the unit Fund on a permanent basis) also requires government's consideration of a potential DIRA amendment. As set out in section 2.2 below, the DIRA contains specific Fonterra capital structure requirements. These are in place to ensure that, so long as Fonterra remains dominant in the farmers' milk market, its share trading arrangements do not create barriers to contestability of farmers' milk supply.

[13] To mitigate the risk of the current consultation process potentially increasing the cost to Fonterra of buying back the unit Fund, Fonterra has temporarily suspended its farmer-shareholders' ability to exchange dry shares for units in the unit Fund. Since then, Fonterra's shares have been temporarily traded in a farmers-only market. The share price has to date fallen by about 30 to 40 percent.
s 9(2)(b)(ii) [redacted]

2.2 What regulatory system(s) are already in place?

The Dairy Industry Restructuring Act 2001

In 2001, Parliament enacted the DIRA to enable the merger of New Zealand's two largest dairy co-operatives and the New Zealand Dairy Board, by overriding the merger constraints of the Commerce Act 1986. The merged dairy co-operative (Fonterra) would have significant economies of scale and scope to compete strongly in international dairy markets for the benefit of the dairy industry and the wider New Zealand economy.

The merger also created significant risks associated with the loss of competition in New Zealand dairy markets, most notably in the market for farmers' milk and the wholesale supply of domestic consumer dairy products. The DIRA therefore introduced regulatory safeguards designed to promote the efficient operation of New Zealand's dairy industry by:

- ensuring contestability in the market for farmers' milk; and
- promoting competition in the wholesale supply of domestic consumer dairy products.

The nature of the specific risks and the DIRA regulatory safeguards designed to mitigate them are outlined in detail in Appendix Two. The DIRA safeguards operate in conjunction with the general provisions of the Commerce Act 1986. The need for them is contingent on Fonterra retaining significant market power in the relevant domestic dairy markets. The Minister of Agriculture is required to initiate a review of whether the DIRA regulatory regime should be retained, repealed or amended not earlier than four years (and not later than six years) after the findings of a previous review have been implemented. The next review must commence between June 2025 and June 2027.

The DIRA regulates some aspects of Fonterra's capital structure

The DIRA does not regulate Fonterra's minimum shareholding requirements, the period within which farmers must purchase shares, or the farmer ownership and control thresholds. However, the share price at which farmers buy and sell shares in Fonterra is a core element of the DIRA regime.

Originally the DIRA required Fonterra to issue and redeem its shares directly to and from farmers by charging and paying the same share price to farmers seeking to enter and exit the co-operative. Fonterra's share price range was calculated by a valuer using an administrative share valuation methodology, which reflected Fonterra's projected future earnings after deducting the payment for farmers' milk supply.[15] The Fonterra Board used the calculated range to set the co-operative share price (usually as a mid-point of the range) for the season. Fonterra then used its balance sheet to issue and redeem shares at that administratively set share price.

In 2012 Parliament amended the DIRA, at Fonterra's request, to enable Fonterra to move to its current Trading Among Farmers (TAF) capital structure. TAF enabled Fonterra to protect its balance sheet from a potential 'run on the money' (redemption risk). If, in any given season, the number of redeemed shares were to exceed the number of newly issued shares, Fonterra's balance sheet would incur a net redemption cost. Management of this redemption risk required Fonterra to hold some capital in reserves. This incurred an opportunity cost as that capital could not be used for investment in Fonterra's business strategy or paid out to farmer-shareholders as dividends. TAF was designed to shift Fonterra's redemption risk off its (farmer-collective) balance sheet and on to (individual) farmers' balance sheets.

[15] This methodology is commonly referred to as 'fair value' and is generally accepted as being reflective of an efficient share price, albeit second-best to one discovered in a well-functioning share market. Given the importance of Fonterra's share price for contestability of farmers' milk market, the DIRA enshrined Fonterra's 'fair value' share pricing methodology, requiring it be in Fonterra's constitution.

Under TAF, farmers exiting Fonterra sell their Fonterra shares directly to farmers entering Fonterra, thus individually bearing the risk of an excess supply of shares driving the share price down at the time of their exit. Left to its own devices, such a farmers-only market for Fonterra shares would have one-sided trading, insufficient depth and liquidity, and price volatility. To overcome these limitations, TAF relies on a unit Fund that provides for non-farmer investors (who have different economic drivers and greater propensity to trade more actively and frequently than farmers) to trade units in economic (non-voting) rights to Fonterra's shares. The liquidity in the unit Fund transfers to the farmers-only share market through the ability of the market-maker, Fonterra, and farmer-shareholders to participate in both share and unit markets at the same time, by converting shares into units and vice versa. This fungibility of the share and unit markets enables TAF to deliver sufficient depth and liquidity, resulting in a relatively well-functioning capital markets scheme capable of discovering a relatively efficient price for Fonterra's shares.

To ensure that TAF operates in a way that provides an effective substitute to the issue/redemption at 'fair value' share price obligation, the DIRA requires:

- Fonterra's shares to be traded on a licensed market by shareholding farmers (other than in the case of a temporary halt) with one or more market-makers supporting liquidity in share trading,
- the units to be traded on a licensed market by the public, able to be exchanged by farmer-shareholders, the market maker, and Fonterra for co-operative shares and vice versa, and
- Fonterra to not engage in conduct that restricts prevents or deters trading in co-operative shares or units or the exchange of co-operative shares for units and vice versa, for the purpose of restricting, preventing or deterring new entrants from becoming shareholder farmers, or current shareholder farmers from increasing, reducing or ceasing supply.

The TAF enabling DIRA provisions rely on the intrinsic link between the share and unit markets in the TAF system to ensure efficient price-discovery and mobility of farmers' capital investment in Fonterra, as a means of maintaining contestability in the farmers' milk market. If the key TAF elements outlined above are removed, the DIRA provides for the TAF enabling provisions to be administratively revoked by Order in Council, reinstating the original statutory issue and redemption obligation without further legislative change. The Minister of Agriculture is required to recommend such revocation if either Fonterra shares or units are no longer traded on licensed markets, or the unit Fund has been wound up.

The DIRA promotes transparency of Fonterra's milk price but does not regulate it

When enacting the DIRA, Parliament made a deliberate policy choice to avoid directly regulating Fonterra's farm gate milk price. Direct price control imposes significant regulatory costs and risks of distorting business and investment decisions, regulatory error and unintended consequences associated with an independent regulatory body setting Fonterra's farm gate milk price.

Instead, the DIRA regime was designed to strengthen Fonterra's commercial incentives to calculate and pay an efficient (not "too high" and not "too low") farm gate milk price. With limited exceptions, the DIRA required Fonterra to accept milk supply offers and allow relatively costless exit from the co-operative at an efficient (full fair value) share price. These 'open entry and exit' requirements were designed to ensure that Fonterra could not 'lock in' or 'lock out' farmers' milk supply. Fonterra could therefore influence its milk supply volumes only through the milk price signals to farmers. If Fonterra's milk price was 'too low', farmers would be able to switch their supply to another processor, leaving Fonterra with underutilised assets and associated inefficiencies. The higher operating costs would result in lower profits, and the associated lowering of its dividend and share price. In contrast, if Fonterra's milk price was 'too high', it would receive an excess supply of uneconomic milk and would have to build additional processing capacity causing its dividend and the share value to decline.

In 2012 the DIRA was amended to add a new Subpart 5A to supplement (not supplant) the open entry and exit regime by promoting additional transparency of Fonterra's farm gate milk price-setting processes. Fonterra's methodology for calculating the base milk price (as set out in its Milk Price Manual) was deemed to be conceptually consistent with contestable market outcomes. However, the specific inputs, assumptions, and processes that informed the base milk price calculation were considered to have the potential to result in a less than efficient base milk price outcome, in any given season.

To promote transparency of, and confidence in, Fonterra's internal farm gate milk pricing decisions, and consistency of the base milk price calculation outcomes with those arising in contestable markets for farmers' milk, the new Subpart 5A of the DIRA:

- Embedded Fonterra's internal milk price-setting governance arrangements in law. Fonterra is required to maintain an internal committee (the Milk Price Panel) and ensure that the majority of the appointed Panel members and Chair are 'independent' (free of any personal supplier and/or investor relationship with Fonterra). One appointed Panel member is nominated by the Minister of Agriculture. The DIRA clearly delineates the roles and responsibilities between the Milk Price Panel (as an advisory body that oversees the base milk price calculation and recommends the base milk price to the Fonterra Board) and the Fonterra Board (as the ultimate decision-making body that determines, at its unfettered discretion, whether to pay a farm gate milk price that is the same or different to the calculated base milk price).
- Embedded Fonterra's methodology for calculating the base milk price in law and required Fonterra to apply it in accordance with some mandatory assumptions. This provided a degree of regulatory certainty, while still giving Fonterra sufficient flexibility to make the necessarily subjective judgements in response to changing market dynamics.
- Required the Commerce Commission to annually review and publicly comment on the consistency of the base milk price methodology and calculation with efficient and contestable market outcomes. The Commission's review findings are not binding on Fonterra's base milk price calculation. Instead, they provide a credible information platform for potential future regulation should Fonterra not address or be able to mount a reasonable explanation of significant and/or persistent issues raised by the Commission.
- Required Fonterra to publish certain base and farm gate milk price-related information including:
    - Fonterra's methodology for the base milk price calculation (the Milk Price Manual) and any changes to it;
    - Fonterra's terms of reference for its Milk Price Panel;
    - The Milk Price Panel's recommendation to the Fonterra Board as to what the calculated base milk price for the season should be; and
    - The Fonterra Board's reasons for choosing to pay the farm gate milk price that is the same or different to the calculated base milk price recommended by the Milk Price Panel.

2.3 What is the policy problem or opportunity?

Fonterra is seeking a legislative amendment so it can proceed with its capital restructure without a risk of legal challenge under DIRA

As outlined in section 2.2 above, the exchangeability of Fonterra shares for units is a key feature of the DIRA regime that underpins Fonterra's current capital structure. It was designed to provide liquidity and full fair value price discovery for Fonterra shares, thereby maintaining contestability of farmers' milk supply and applying performance pressure to Fonterra.

Fonterra's intention to retain a partially delinked unit Fund on a permanent basis (something that was not anticipated or provided for by the DIRA) means that the unit Fund could no longer fulfil its original purpose. If Fonterra proceeds without a DIRA amendment (that specifically enables the unit Fund to remain partially delinked on a permanent basis) it could be exposed to a risk of legal challenge.

Although there is no explicit statutory prohibition in the DIRA against Fonterra's intention regarding the unit Fund, the legal challenge could be initiated on grounds including that Fonterra's partial delinking of the unit Fund restricts, prevents, or deters the exchange of co-operative shares for units, and does so for the purpose of restricting, preventing or deterring a new entrant from becoming a shareholding supplier, or a shareholding supplier from increasing, decreasing or ceasing to supply milk, which is conduct prohibited under the DIRA. Fonterra's position is that its intention to partially delink the unit Fund on a permanent basis has no such purpose. We understand that Fonterra's concern is not that its actions could be in breach of the DIRA, but rather that other persons may challenge or threaten to challenge Fonterra's underlying purpose and rationale[16] for this intention in court. s 9(2)(h) [redacted]

Fonterra is seeking a DIRA amendment that would specifically enable the unit Fund to remain partially delinked on a permanent basis. This would mean that Fonterra's Board could proceed with confidence that its intentions regarding the unit Fund would not be restricted by the DIRA.

The policy challenge for the Government is to strike the right balance

In considering Fonterra's request for a DIRA amendment, the Government needs to strike a balance between:

- **enabling Fonterra to pursue its commercial objectives**, which would maintain or improve Fonterra's significant financial contribution to the dairy industry, rural communities, and the wider New Zealand economy, in the short to medium term; and
- **mitigating risks and potential flow-on impacts** of Fonterra's intended capital restructure for the overall performance of the wider dairy industry (including Fonterra itself) and the incentives to invest in innovation, sustainability, and value creation, in the long term.

Enabling Fonterra to pursue its commercial objectives would strengthen Fonterra's ability to retain and attract milk supply and support its operations as a productively efficient large-scale co-operative, in the short to medium term. The practical effect of Fonterra and its farmer-shareholders' commercial decision to move to a capital structure (that significantly reduces the level of compulsory shareholding and creates a downward pressure on the share price) would be to prioritise the retention and growth of Fonterra's absolute size and relative share of the farmers' milk market in the short term over the capital returns to farmer-shareholders and

[16] We understand Fonterra's position is that its underlying purpose is to provide for flexible shareholding by reducing the minimum shareholding requirements to maintain sustainable supply in a flat or declining mi k production environment, and to protect farmer ownership and control, as well as protecting Fonterra's balance sheet, by capping the unit Fund.

Fonterra's access to and cost of equity capital in the future. This commercial trade-off appears to be underpinned by Fonterra's current business strategy, which does not envisage Fonterra making significant capital-intensive investments in dairy processing assets in the foreseeable future meaning that reduced access to and increased cost of equity capital may have little/no practical impact on Fonterra.

The impact would instead fall on the Fonterra farmer-shareholders and unit holders' balance sheets. In exchange for taking an immediate balance sheet hit of around $2.5 billion (and imposing an additional $160 million balance sheet hit on unit holders) and the risk of increased share and unit price volatility in the future, the majority of Fonterra's farmer-shareholders are providing Fonterra with an improved ability to attract new, and retain existing, milk supply. This milk supply is expected to support more efficient capacity utilisation of Fonterra's existing processing assets, enabling the co-operative to maintain and potentially improve its ability to pay farmers the maximum possible price for their milk.

The maximum possible milk price, in turn, flows back to the existing farmer-shareholders' wealth in the form of maintained and potentially improved on-farm profitability and dairy land prices. Because other dairy processors must match or better Fonterra's milk price to retain or attract their milk supply, dairy farmers supplying those processors are likely to also benefit from this commercial decision by Fonterra's existing farmer-shareholders. Given the size of the dairy farming industry in New Zealand, these benefits are likely to flow through to rural communities and the wider New Zealand economy, in the short to medium term.

The reduced minimum shareholding requirement could (if the reduction in the share price is acceptable) enable farmers to free up some capital. Farmers could then use that capital to repay on-farm debt, invest in on-farm environmental improvements, including in freshwater and greenhouse gas emissions, or make other on-farm investments (some of which may enable farmers to maintain or increase their otherwise potentially declining milk production).

Fonterra advises that if its milk supply were to decline, its asset stranding costs could lead to a 6 - 13 cents per kgMS reduction in the milk price, and potentially necessitate the closure of 12 – 18 plants by 2030.

Fonterra has not published, or provided MPI, the data, analysis, and/or its modelling assumptions that underpin its scenarios. Fonterra has noted that this information relates to future matters that are subject to uncertainties and that actual outcomes may vary materially from those suggested or implied. It therefore cautions against relying on such forward-looking information as a representation by Fonterra that those forward-looking statements will be achieved or that the assumptions underlying any forward-looking statements will in fact be correct.[17]

We agree that this type of modelling is fraught with difficulties because of the very high levels of uncertainty associated with the many factors that affect milk production and processors' various potential responses, which in combination may compound or offset each other. Given the uncertainty, this type of scenario modelling may not necessarily provide any useful insight into how the dairy processing sector as a whole, and Fonterra and other dairy processors individually, may respond to declining milk supply and the related risk of stranded assets.

At a high level, some potential impacts and trade-offs that could arise as a result of a plant closure are set out below.

- The most immediate impact is the potential displacement of the work force. The extent to which re-employment is feasible would depend on the location of the plant and alternatives within travelling distance, alternative jobs in the region, the immigration rebalance and increasingly scarce migrant work force arising from the global pandemic. To take a small

[17] Fonterra (2021) Consultation booklet.

local example the closure of Fonterra's Te Roto cheese plant in Paraparaumu resulted in the loss of over 70 jobs. This was somewhat offset by the creation of 34 new jobs at Elsdon.

- In the event of significant job losses and limited alternative employment, there would be impacts on the rural community concerned. We note, however, that as these impacts would not involve the displacement of farmers, it would seem unlikely that the wider rural economy (contractors, feed suppliers, transport operators etc.) would be affected.
- The extent to which a plant closure may impact Fonterra and its shareholders would depend on the scale of operations, the nature of the plant (i.e. whether it is a large manufacturing or a small packaging plant), its age and whether some operations were transferred elsewhere or ceased. We note that Fonterra has a very large and diverse asset base and has included significant optionality in its network to vary product mix according to international demand and prices. This could mean that any financial impacts from a specific closure might be smoothed across the network as a whole.
- Depending on the location of alternative plants, Fonterra has some options (albeit at some cost) for mitigating asset stranding risk, which can help reduce its materiality. These include flexibility in where it processes farmers' milk (e.g., in the past, Fonterra has transported milk across regions to realise option value in its product mix); and ability to use regional pricing in order to fill surplus capacity.
- If rival dairy processors were to attract larger volumes of milk formerly processed by Fonterra, they may in turn seek additional capacity. As an alternative to closure, Fonterra might have the option of toll processing, or of selling the facility to another dairy processor. We understand that when the closure of Fonterra's Dennington (Australia) plant (employing 100 workers) was announced, other processors expressed interest in purchasing the facility.

Mitigating risks and potential flow-on impacts of Fonterra's intended capital restructure would support the long-term performance of the wider dairy industry (including Fonterra itself) and maintain incentives to invest in innovation, sustainability, and value creation, over time. As set out in section 2.2 above, the exchangeability of Fonterra shares for units is a key feature of Fonterra's current TAF capital structure, designed to support liquidity and full fair value price discovery for Fonterra shares. Fonterra's intention to partially delink the unit Fund on a permanent basis would result in Fonterra shares trading at:

- a structural restricted-market discount of up to 20-30 percent, arising from an undiversified pool of shareholders exposed to the same economic drivers with competing demands for their capital; and
- a liquidity discount of up to an additional 30 percent, arising from a limited ability to sell sufficient volumes of Fonterra shares without adversely affecting the share price.

While the restricted market discount would be a permanent feature of the farmers-only market, the liquidity discount could fluctuate depending on:

- how many farmers may decide to divest some or all of their non-compulsory shares and over what period of time;
- how many farmers may decide to purchase additional non-compulsory shares for investment purposes or to maintain their voting rights; and
- s 9(2)(b)(ii) [redacted]

Fonterra's shares could therefore trade at anywhere between 20 and 60 percent discount to their full fair value, at any given point in time. These limitations of a farmers-only share market design risk impacting contestability for farmers' milk supply, reducing performance pressure on Fonterra, and ultimately leading to fewer incentives and reduced scope for investment in innovation in the dairy processing sector. Over time, this could risk eroding performance and value to Fonterra, the broader dairy industry, and the wider New Zealand economy. The nature and origins of the risks and potential flow-on impacts are set out below.

Risk 1: deterring Fonterra farmers from switching to other processors and/or alternative land-uses, when it may be efficient for them to do so

If Fonterra's shares are priced substantially below their full fair value and/or cannot be sold in a timely manner without affecting the share price, mobility of farmers' capital investment in Fonterra could be impeded. The inability to realise the full value of farmers' capital investment in Fonterra on exit could act as a price barrier to farmers considering switching to other (potentially more efficient and innovative) dairy processors or pursuing other (potentially more environmentally and climate change-friendly) land uses.

Fonterra shares make up 10 to 15 percent of a dairy farms' assets. A material reduction in the share price could have a significant negative impact on farmers' balance sheets and wealth. An average farmer, looking to exit Fonterra with 150,000 kgMS and sell their 150,000 shares, could forgo between $135,000 and $400,000 depending on whether the price discount is as little as 20 percent, as Fonterra expects, or as large as 60 percent, as some analysts are predicting. A larger farmer, looking to exit Fonterra with 450,000 kgMS and sell their 450,000 shares, could forgo between $500,000 and $1 million worth of value. This impact would be most significant for farms that are heavily indebted. This disincentive to exit would increase if farmers believed that Fonterra's share price could return to its full fair value in the future (e.g. due to another capital restructure).

Such a price barrier to farmer switching would reduce other dairy processors' ability to compete for farmers' milk, potentially impeding what may otherwise be efficient growth of smaller dairy processors. Given that Fonterra's actual or potential competitors would only need a very small number of Fonterra's 10,000 farmer-shareholders to switch to make or keep their operations viable, Fonterra's undervalued share price would only need to deter as few as 50 average farmers or 20 larger farmers from exiting to be sufficient for Fonterra to reduce the competitive pressure it might otherwise face from other processors or alternative land uses.

Risk 2: encouraging farmers to produce and supply more milk to Fonterra, when it may be inefficient for them to do so

A Fonterra share price substantially below its full fair value could also encourage dairy farmers to produce and supply more milk to Fonterra, potentially at the expense of the Government's environmental and climate change goals and/or by switching away from competing dairy processors. The investment in Fonterra shares represents a direct cost of supplying milk to the co-operative. Lowering this cost could encourage farmers to produce and supply more milk to Fonterra. Farmers would be incentivised to join and supply Fonterra over its rivals, or increase their milk production, as they would be able to buy into Fonterra without contributing the full fair value of their share in Fonterra's underlying business.

In addition, dividends on an undervalued share price would represent an artificially inflated rate of return (dividend yield), potentially disincentivising investment into other economic activities (e.g. purchasing low emitting dairy cattle or fencing of the waterways) particularly where such economic returns are not able to match the distorted yields on a shareholding in Fonterra.

This would enhance Fonterra's competitiveness in the farmers' milk market and grow its milk supply not because of its improved performance, but because of its structural market design for shares. As a result, Fonterra could be collecting and processing higher than economically efficient volumes of milk, while avoiding, delaying, or deferring decommissioning or reconfiguring some of its existing commodity processing capacity. This may take pressure off management to continuously seek to optimise the co-operative's size and product mix, drive cost efficiencies and invest in innovation and value creation. Over time this could work to the detriment of Fonterra's farmer-shareholders, as potential for added value in their co-operative may not be fully realised, with the overall value of the co-operative potentially declining over time.

Risk 3: reduced transparency of Fonterra's financial performance, potentially taking pressure off Fonterra management to invest in innovation

Although subject to short-term fluctuations, a share price is a simple and effective proxy of a business's long-term strategic and financial performance. A steadily rising share price generally signals that executive management is steering the business toward long-term success. Alternative measures, which focus on the business's short-term profitability, absolute size, or relative market share, are likely to be less effective proxies, and may reduce management incentives to create additional value for shareholders.

In a well-functioning market, the price of Fonterra's shares would reflect the extra return Fonterra management is able to create on top of what a business selling only basic commodity products would earn. While Fonterra's payment for milk is also a performance indicator, it has limited value in that it is only a snapshot of Fonterra's performance for one season. In contrast, the fair value share price takes into account the future prospects of the co-operative and reflects on the quality of financial and strategic management of the business over the long term.

In a restricted farmer-only share market, the value of Fonterra's shares would be materially divorced from the underlying value of Fonterra's future returns from its value-added activities. This would reduce transparency of Fonterra's strategic performance and could take pressure off management to invest in innovation and instead focus on shorter term tactical decisions.

Risk 4: increased ability for Fonterra to pay a higher milk price, potentially at the expense of other dairy processors and Fonterra's own investment in innovation and value creation

An artificially inflated dividend yield (arising from a substantially below fair value price for Fonterra shares) could provide sufficient room for Fonterra to shift some of its capital returns from the dividend to the milk price. The current DIRA base milk provisions, including the Commerce Commission's monitoring regime, have not been designed, and are not equipped to compensate, for Fonterra's increased ability to pay a higher than efficient milk price to farmers. A moderately higher than efficient milk price would be highly unlikely to be picked up by the current Commerce Commission's monitoring regime, but even if it was, the Commerce Commission's findings are not binding on Fonterra. However, it might be more than sufficient for Fonterra to reduce the competitive pressure it may otherwise be facing for milk supply.

Rival dairy processors need to match or better Fonterra's higher milk price to retain and attract suppliers. This is likely to come at the expense of retaining earnings to pursue their own value-add investment strategies. Distorted pricing may also deter entry by new, potentially more innovative processors ultimately leading to less scope for investment in innovation for the sector. Under such a scenario Fonterra could effectively maintain or gain market share, and the economy forego the added opportunity for value creation and innovation.

Potential flow-on impact 1: reduced ability for Fonterra to raise or retain equity capital, potentially impacting the co-operative's financial resilience and/or potentially creating a risk transfer to the Crown

The primary purpose of Fonterra's current TAF capital structure has never been to enable Fonterra to raise external capital for investment purposes. If anything, the unit Fund provided additional sources of capital raising for farmers, as they could finance the purchase of some of their shares in Fonterra by selling the economic rights of those shares to the unit Fund rather than borrowing from banks.

Nevertheless, the existence of a fully linked unit Fund provided Fonterra with an additional avenue – should its farmer-shareholders permit it in the future – to raise equity capital from non-farmer investors. With the unit Fund capped, Fonterra's future options to raise equity capital would be more limited. Although Fonterra could develop new/different equity capital-raising sources, the ease and speed with which it could have access to an external source of equity capital may be reduced.

At the same time, Fonterra's ability to retain sufficient levels of internal capital may also be reduced. This is due to a higher risk of diverging shareholder interests within the co-operative arising from Fonterra's reduced minimum shareholding requirement (1:3 rather than 1:1) and increased maximum possible shareholding (4:1 rather than 2:1). There would likely be an increased divergence between those shareholders who hold the minimum number of shares to supply milk (who would wish to see the milk price maximised), and those who hold larger numbers of shares for investment purposes (who would also want to see higher returns on investment through dividends). If there is shareholder pressure to pay both a high milk price and a high dividend, this could result in Fonterra generating insufficient internal capital. To meet its capital requirements, Fonterra might need to source additional capital through debt or forego making critical investments (e.g., in R&D, market development, value-add products etc.). Taking on excessive amounts of debt has been a major reason for the failure of agricultural co-operatives globally.

Fonterra is aware of the need to manage internal shareholder tensions and its proposals include a number of mitigating factors. Namely, Fonterra farmer-shareholders' voting rights remain tied to milk supply, constraining the ability of the more dividend-minded shareholders to apply undue pressure through formal processes. Fonterra is also putting in place limits to manage individual shareholder concentration risk by constraining any individual farmer's shareholding to no more than 5 percent of the total shares on issue.

If Fonterra could not manage this risk effectively, there could be a financial risk transfer to the Crown. In the event of a commercial strategy failure or a significant global financial markets shock, Fonterra's size and importance to the New Zealand economy might mean that the Crown could be called upon to support the solvency of New Zealand's largest company and the wider dairy farming sector' financial viability (should Fonterra be unable to raise capital from sources other than debt or retentions at that point in time). The likelihood and magnitude of any such potential flow-on impact is extremely difficult to ascertain ahead of time.

Potential flow-on impact 2: eroding value for unit holders may reduce confidence in New Zealand capital markets

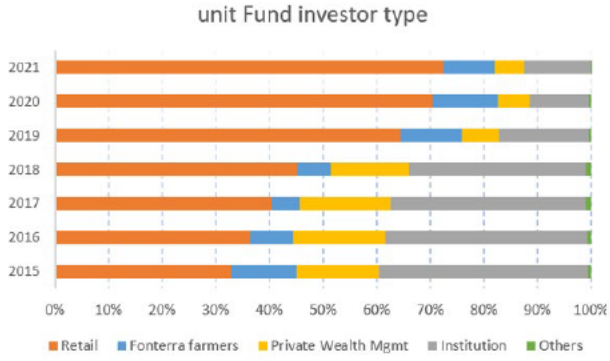
Fonterra and its farmer-shareholders' decision to delink and retain but cap the size of the unit Fund at 10 percent (down from 20 percent) of Fonterra's total shares on issue, means that the unit Fund may reduce in size but cannot grow.[18]

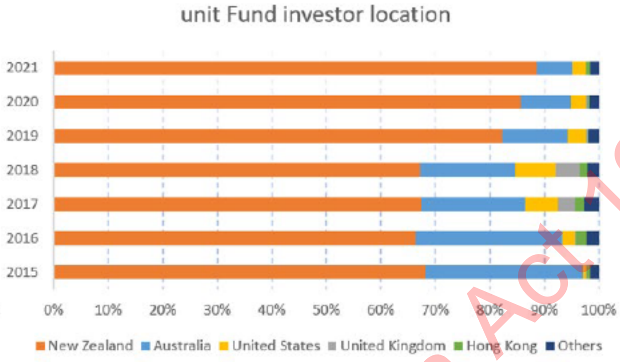
At the time of Fonterra's decision to temporarily delink the unit Fund, there were approximately 106 million units on issue, which corresponds to about 6.7 percent of Fonterra's total number of shares on issue. Units at that time were trading at around $4.50. The units are currently trading at around $3.0 This equates to around $160 million of immediate value loss to unit holders.

It is unclear whether the price of units would increase or reduce further if the unit Fund remains delinked on a permanent basis. On one hand, removing the unit Fund's ability to grow could reduce its relevance in investment markets, which may put further downward pressure on the unit price. The unit Fund currently sits at number 46, having dropped from 25 in the NZX50 index when it was originally launched. If it were to drop out of NZX50 index, this could cause a flow of liquidity away from retail investors as financial analyst research coverage of Fonterra would be expected to reduce. On the other hand, if Fonterra's financial performance improves and it is able to maintain a consistent dividend policy, investment returns on units may improve.

[18] Fonterra indicated that if, at some point in the future, it were to issue bonus shares in lieu of a dividend, this would increase the number of units in the unit Fund. This is because existing units will continue to be entitled to the dividend, which in this case will be in the form of additional units.

As the graphs below show, more than 70 percent of unit holders are currently retail (not institutional) investors, of which around 46 percent are ex-farmers or ex-Fonterra suppliers. In addition, a further 10 percent of unit holders are current Fonterra farmers. There is very little foreign ownership in units, with 89 percent unit holders domiciled in New Zealand and an additional seven percent domiciled in Australia.





The unit holders are not shareholders in Fonterra. The units are issued by the Manager of the unit Fund, not by Fonterra, and do not confer any shareholding rights and obligations, especially no voting rights. The nature of unit holders' investment, and the risks associated with it, appear to have been clearly articulated to unit holders in the unit Fund IPO documents[19]. No promises appear to have been made as to the future of the unit Fund and its existence in the original or somewhat evolved form in perpetuity.

Nevertheless, unit holders may feel that their financial interests have been unfairly prejudiced by Fonterra and its farmer-shareholders' decision to retain but cap the unit Fund. The Manager of the unit Fund has expressed a strong preference for Fonterra to give the unit holders an opportunity to consider an offer to buy out the Fund at fair value. Fonterra's decision to allocate its capital to other priorities may undermine investor confidence in Fonterra and, given that Fonterra is New Zealand's largest company, potentially reduce confidence in New Zealand capital markets.

s 9(2)(h) [redacted]

Potential flow-on impact 3: higher farm gate milk prices could potentially flow through to New Zealand consumers

While Fonterra's capital restructure could create an upward pressure on the domestic consumer dairy product prices, there are multiple points along the supply chain where that pressure could be either alleviated or amplified. This makes it extremely difficult to ascertain both the likelihood and magnitude of this potential flow-on impact.

Fonterra supplies raw milk to its domestic consumer business subsidiary, Fonterra Brands New Zealand, and to Goodman Fielder, a large multinational food company. Goodman Fielder is the only other manufacturer of domestic consumer dairy products of national scale in New Zealand. We estimate that, collectively, Fonterra Brands and Goodman Fielder manufacture and provide wholesale supply of s 9(2)(b)(ii) [redacted] of all domestic dairy products sold in New Zealand. The remainder is supplied by smaller niche producers, imports, and more recently, by Synlait Milk.

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Because 95 percent of New Zealand's milk production is exported, New Zealand domestic consumer dairy product prices are influenced by international dairy commodity prices. Since the vast majority s 9(2)(b)(ii) [redacted] of domestic consumer dairy products are manufactured using Fonterra's milk, any increase in Fonterra's farm gate milk price would (unless absorbed by Fonterra) represent a cost increase to the manufacturers of domestic dairy products. These include Fonterra Brands, Goodman Fielder, small niche dairy food companies, and depending on Synlait's own supply arrangements potentially Synlait's domestic product manufacturing arm.

The extent to which any increases in farm gate milk prices could be absorbed at the manufacturing/wholesale part of the supply chain (e.g. through improved manufacturing cost efficiencies) would depend on the intensity of competition for retail customers (i.e. supermarkets, corner dairies, petrol stations, food services, etc.) among the manufacturers/wholesale suppliers of domestic dairy products. Retailers' bargaining power (particularly large supermarkets) would also play a role in whether any cost increases may flow through to the wholesale price of dairy products.

Similarly, the extent to which retailers might absorb any cost increases arising from potentially higher farm gate milk price flowing thought to the wholesale prices would depend on the extent of competition for domestic consumers. Consumers' shopping habits and brand loyalties would play a role in whether any retail price increases may flow through and increase the grocery bills for New Zealand households.

While information about the profit margins and cost structures of various market participants at various points of the domestic dairy products' supply chain is not publicly available, in 2011 (in response to a Parliamentary Inquiry into the price of milk) Fonterra had estimated that a 15-20 cents change in its farm gate milk price, could (if not absorbed by or competed away at any of the above-mentioned parts of the supply chain) represent 1-2 cents a litre in the final retail price for fresh milk products in New Zealand.

The magnitude and speed with which these risks and potential flow-on impacts could eventuate cannot be quantified with any certainty

While the nature of the potential risks and impacts is clearly significant, it is difficult to assess the magnitude and speed with which they could eventuate with any certainty in advance of Fonterra's new capital structure being implemented. Any scenario modelling is fraught with difficulties as there is a range of factors, interactions, and variables that in combination may compound or offset each other. The key factors relate to (among other things):

- how farmers in different stages of their farming lifecycles actually respond to holding and trading their Fonterra shares in the farmers-only market,
- how Fonterra may choose to use its balance sheet to participate in the market and what impact this may have on the share price, and therefore farmers' decisions to enter and exit the co-operative, at any given point in time,
- how Fonterra might choose to exercise its discretion in setting the milk price and dividend payment in the context of its new farmer-only share trading environment, and therefore farmers entry and exit decisions, and
- how other processors and alternative land uses might respond to supply and pricing issues.

2.4 What do stakeholders think about the problem?

Industry consultation

We did not consult publicly on the issues and options considered in this RIS. However, we undertook targeted engagement with Fonterra, other dairy processors (including Open Country Dairy, Synlait, Miraka, Westland Milk, Oceania Dairy, Tatua, Yashili, Happy Valley, and Matarua Valley), as well as the Manager of the unit Fund and Federated Farmers New Zealand. Our analysis of issues and options in this RIS has also been informed by the following expert reports, including:

- MPI-commissioned reports from Frontier Economics and TDB Advisory,
- Fonterra-commissioned reports from Sapere s 9(2)(b)(ii) [redacted]
- Fonterra Co-Operative Council-commissioned report from Northington Partners,
- Open Country Dairy-commissioned report from Castalia, as well as
- Correspondence from Miraka and Happy Valley Nutrition Ltd.

Fonterra asserts that its proposed new capital structure does not present any risk to contestability of farmers' milk supply, as farmers would continue to be able to buy and sell Fonterra shares at their new 'fair' prices. Fonterra considers that the discounted share price that would be discovered in a restricted farmer-only market represents the true fair value that farmers place on being shareholders in Fonterra. Fonterra believes that under its current capital structure, its shares are over-valued because they are influenced by unit holders. Since unit holders typically have a different (and more diversified) investor profile to farmers, unit holders' cost of capital is likely to be lower than that of farmers. Therefore, the value unit holders put on Fonterra shares is higher than the value farmers trading only between themselves would put on Fonterra shares. Since the farmers-only market would reflect only farmers' cost of capital, the share price will, in Fonterra's opinion, be justifiably lower.

MPI was unable to identify or review evidence to suggest that for all, most, or some of Fonterra farmer-shareholders' their cost of capital is higher than that of retail unit holders. Fonterra's data shows that farmers' cost of capital varies significantly from farmer to farmer. Fonterra's survey of farmers shows that s9(2)(b)(ii) [redacted] percent of farmers currently voluntarily choose to hold dry shares. Of those s9(2)(b)(ii) [redacted] percent do so because they consider it to be a good investment, and the remaining s9(2)(b)(ii) [redacted] percent do so for other reasons, most likely associated with the expected increases in their future milk production. That means that the cost of capital of at least s9(2)(b)(ii) [redacted] percent s9(2)(b)(ii) s9(2)(b)(ii) [redacted] of farmers is no different from that of unit holders, and at least a further s9(2)(b)(ii) [redacted] percent s9(2)(b)(ii) [redacted] of farmers are satisfied with the current returns they receive on their voluntary investment in Fonterra.

It is possible that the remaining s9(2)(b)(ii) [redacted] percent of farmers, who do not hold any dry shares, have a higher cost of capital than that of unit holders. However, it is also possible that they have achieved their desired level of investment portfolio diversification, which includes having just the minimum required shareholding in Fonterra, and that any further investment in Fonterra, at any return, would provide them with a less optimally balanced financial portfolio. Furthermore, even if the remaining s9(2)(b)(ii) [redacted] percent of farmers did have a higher cost of capital, Fonterra's proposed reduction of the share standard would significantly lower the level of compulsory shareholding in Fonterra, thus reducing the level of farmers' compulsory exposure to dairy, and with it, their cost of capital.

We agree that a restricted farmer-only market for Fonterra shares would discover a price that a farmer with the highest cost of capital would be willing to pay. While this would ensure that that type of farmer looking to buy Fonterra shares does not overpay for Fonterra shares, it would mean that all other farmers, with a lower cost of capital, would underpay for shares when buying and be unable to realise their full value when selling. As a result, many farmers' decisions to purchase and sell Fonterra shares, and therefore decisions on which processor to supply their milk to and what land use to pursue, would be distorted by the proposed market design for Fonterra shares.

Fonterra also considers that the investment by farmers in Fonterra shares represents a relatively small part of each farmer's overall balance sheet and wealth. Therefore, depending on the shareholder's circumstances, the dividend return from shares held in Fonterra may be of marginal relevance to the shareholder when compared with the returns generated by their core farming activities. For this reason, Fonterra considers that share prices and dividend returns do not materially influence the majority of farmers' milk supply and switching decisions.

The DIRA regulatory regime was specifically designed to mitigate the impacts of Fonterra's share price, dividend returns and the interrelated milk price returns, on farmers' switching decisions. While there will be many other factors influencing farmers' switching decisions, we consider that Fonterra's share price and dividend returns do play a key role in farmers' switching decisions. Fonterra's stated purpose for the proposed capital restructure states that: "The investment that is required to supply the Co-op is making it challenging for new farmers to join and can be a key factor for existing farmers in deciding to leave so they can pay down debt or invest their capital in other things. At a share price of $5.00, a farmer supplying 150,000 kgMS would have $750,000 invested in our Co-op. Strong performance only increases this investment requirement. As our earnings increase, so too should the share price, which increases the capital investment to join, and the capital for those who leave… In short, we believe our capital structure is tilting the playing field against us when compared to other processors – the vast majority of which are corporates and don't require any capital investment from farmers who supply them."[20]

Several other dairy processors expressed strong concerns about the possibility of Fonterra shares being traded in a restricted farmer-only market. They see the role of the unit Fund as critical for overcoming the limitations of farmer-only share trading. The limitations are around liquidity and efficient share price discovery. Other dairy processors see an efficient share price as the key component of the current regulatory regime that prevents Fonterra from strategically locking farmers in to supply the co-operative at the expense of supply to other dairy processors, particularly in a flattening or declining milk production environment. The nature of the impact, identified by other processors supports our analysis, as set out in section 2.3 above.

The Manager of the **unit Fund** reiterated the views that it has expressed publicly, indicating a strong preference for Fonterra to give the unit holders an opportunity to consider an offer to buy out the Fund at fair value. Acknowledging that Fonterra has competing demands on its capital, the Manager of the unit Fund suggested that, if the unit Fund is retained, Fonterra clearly articulates the new purpose for the Fund and ensures that it remains relevant (i.e., large enough to remain in the NZX50 Index) and attractive to external investors (e.g., through improved reliability of dividends). In response to this issue, Fonterra has raised the cap on the potential size of the unit Fund (from 6.7 percent as originally intended to 10 percent), which was welcomed by the Manager of the unit Fund. The Manager of the unit Fund also stressed that, if the DIRA were to be amended to facilitate Fonterra's implementation of its proposed new capital structure, Parliament would need to consider the interests of, and impacts on, the unit holders.

Federated Farmers chose not to express a view on the implications of Fonterra's capital restructuring proposals at the time of our discussion.

We note that issues raised by independent processors, in this targeted engagement process, are closely related to the issues raised in close to 800 submissions MPI received during the 2010-2012 policy development and legislative change process undertaken in the lead up to Fonterra's current capital structure being enabled by the DIRA. The key issues raised at the time are

[20] Fonterra, 2021. Consultation booklet

directly relevant to Fonterra's current proposals, as both aim to enable Fonterra to manage its redemption risk effectively, while mitigating the risks to the dynamic industry environment.

Departmental consultation

The government departments that were consulted on the issues and options set out in this RIS included the Ministry of Business, Innovation, and Employment, the Treasury, Ministry of Foreign Affairs and Trade, and the Ministry for the Environment. The Department of the Prime Minister and Cabinet and the Commerce Commission have also been informed.

Further consultation

The options considered in this RIS are focused on high-level regulatory options. Once Cabinet takes policy decisions on its approach, detailed design and implementation would be developed in consultation with industry stakeholders, including Māori agri-business, later in 2022.

Section 3: Options identification

3.1 What options are available to address the problem?

For each specific issue we have identified and analysed a range of options. We describe these options in detail in section 4 below. Some options are designed to work together as a package in order to balance the risks and benefits associated with Fonterra's capital restructure. The interdependencies in relation to the specific options are identified in section 4 below.

We also considered non-regulatory options. We have recommended some, such as close monitoring of Fonterra's share trading outcomes. In general, though, regulatory options are the main focus of this RIS. This is because the underlying policy problems stem from the current legislative settings.

We have not drawn on experience from comparable regulatory regimes or jurisdictions in developing the options in this RIS. We are not aware of other companies in New Zealand or overseas, whose significant market power is regulated by ensuring contestability, rather than promoting actual competition, as a form of regulation. The DIRA regime is a unique regulatory response to managing substantial market power.[21]

Both the Cabinet paper proposals and MPI's recommended approach both aim to strike the balance between supporting Fonterra's commercial objectives and mitigating the long-term risks. Overall, the Cabinet paper proposals place greater weight on supporting Fonterra's commercial objectives of operating a large-scale, productively efficient, New Zealand farmer-owned co-operative, whereas MPI's recommended approach equally weighs all of the assessment criteria (set out in section 3.2 below). The appropriate weighting for the criteria is a matter of judgement.

3.2 What criteria, in addition to monetary costs and benefits, have been used to assess the likely impacts on the options under consideration?

We assessed options in this RIS against against the following key criteria:

- ***Effectiveness*:** does the option achieve its objectives effectively, that is (where relevant):
  - Does the option enable Fonterra to pursue its commercial objectives of operating a productively efficient dairy processing co-operative of scale in the short to medium term?
  - Does the option mitigate the risks to contestability of farmers' milk supply in the long term?

[21] https://www.mpi.govt.nz/dmsdocument/31212-mpi-archives-2001-cabinet-paper-on-dairy-industry-merger

- Does the option provide sufficient confidence in Fonterra's future milk price-setting processes and the consistency of the outcomes with those arising in a contestable market for farmers' milk?
- Does the option manage potential flow-on impacts effectively?

- ***Proportionality***: does the option achieve its objectives in a cost-effective and proportionate way, without imposing undue regulatory costs and risks on Fonterra's commercial operations, while ensuring that Fonterra retains sufficient flexibility to make timely commercial decisions in response to changing market dynamics?
- ***Regulatory certainty***: does the option achieve its objectives in a way that makes the DIRA regulatory regime more certain, predictable and transparent, and enable timely decision-making?
- ***Predictability of outcomes:*** does the option improve predictability of regulatory outcomes?
- ***Practicality:*** is the option administratively straightforward to implement, creating minimal risks of regulatory error and/or unintended consequences?

We have weighted the criteria evenly – the impact of enabling Fonterra to maintain or improve its productive efficiency in the short-medium term needs to be balanced against the long-term dynamic efficiency risks that Fonterra's capital structure could create. Applying a different weighting to potential short-medium and long-term risks will lead to different preferences. We have identified where this has happened (e.g., the Cabinet paper proposals differ from MPI's recommended approach, and applies weightings differently).

There is tension in balancing these criteria. For example, increasing confidence in Fonterra's milk price outcomes will introduce a degree of inflexibility as it would reduce Fonterra's discretion to manage risks and respond to changing market dynamics in a timely manner. Conversely, refraining from providing stronger direction on how Fonterra calculates its base milk price would maintain the high degree of flexibility for Fonterra's business decisions, but will not increase confidence in Fonterra's base milk price outcomes.

3.3 What other options have been ruled out of scope, or not considered, and why?

Options not otherwise considered or progressed are identified in relation to each area of specific issues and options in section 4 below.

Each set of options outlined in section 4 below was designed to directly mitigate the four key risks associated with Fonterra's capital restructure identified in section 2.3 above. These options do not attempt to directly address the potential flow-on impacts set out in section 2.3 above. Instead, we have included in the assessment criteria a consideration of whether each of the options also mitigates these flow-on impacts. This is because:

- Addressing the risk of Fonterra having reduced access to either external or internal equity capital through regulatory means would not be practical. While a robust and credible dividends/retentions policy would help mitigate this risk, a prescriptive regulatory approach to specific levels of retentions and dividends would be unduly intrusive in the business decisions that are for the Fonterra Board to take. It could severely limit Fonterra's Board ability to respond to changing commercial circumstances. Fonterra already maintains a set of dividend policy guidelines[22]. Under these guidelines, the Fonterra Board expects over time to distribute 50 percent of the co-operative's net earnings, excluding abnormal gains, as dividends. However, the Board applies these guidelines at its discretion, alongside any other factors it considers relevant. This provides the co-operative with the commercial flexibility it needs to run a business. The DIRA could include a simple requirement for Fonterra to maintain and publish

22 Dividends (fonterra.com)

a dividend and retentions policy. This would not include any statutory requirement or direction on the scope of that policy but would embed in legislation what Fonterra already does.

- Addressing the risk of Fonterra being perceived as unfairly prejudicing the interests of unit holders (by Fonterra buying out the unit Fund now) would come at significant opportunity cost to Fonterra and potentially not be in unit holders' long-term interests. The potential perception of the Government's role in facilitating Fonterra's "unfair" treatment of unit holders, and introducing uncertainty into New Zealand's investment climate, if it amends the DIRA as sought by Fonterra, will be addressed by following sound and robust legislative change processes, including opportunities for consultation. s 9(2)(h) [redacted]

- We also do not consider there is a practical way to mitigate the impact of potentially higher farm gate milk prices flowing through to New Zealand consumers. Separating domestic and international dairy prices would be both complex and costly, and would either require a direct government subsidy to compensate farmers for lost income or would mean that dairy farmers would be subsidising domestic consumers. Even if either of these subsidies were put in place, they would only limit farm gate milk price increases flowing through to the manufacturers/wholesale suppliers of dairy products. Additional interventions at every other part of the supply chain would be needed to ensure that cost savings for manufacturers flowed through to retailers. Intervening at all parts of the supply chain, would not, in our view, be feasible. At the same time, any such subsidy would reduce incentives for manufacturers to drive manufacturing cost efficiencies and innovation. It may also negatively affect Synlait's recent competitive entry into the domestic wholesale dairy products market, as the costs of its major competitors (Fonterra Brands and Goodman Fielder) would be subsidised. This may not be in the long-term interests of New Zealand consumers. s 9(2)(h) [redacted]

Section 4: Specific issue, option identification and impact analysis

This section describes two sets of options for government response to Fonterra's capital restructure in detail. Each set of options is focused on mitigating risks to contestability of farmers' milk supply arising from:

A. Fonterra's shares being priced substantially below their full fair value.
B. Fonterra's increased ability to pay a higher than efficient milk price.

However, the option set B is only relevant if a certain option A is preferred.

Ratings

In the impact analysis section of each chapter (section 4.3) the options for dealing with the issues set out in the problem definition are all assessed against the status quo, which is reflected in the rating for each option against each criterion. The impact tables include the status quo, which is rated **0** reflecting no change.

Key *compared with doing nothing (the status quo)*:

+++ much better

++ better

+ somewhat better

0 about the same

- somewhat worse

- - worse

- - - much worse

The overall assessment for each option is essentially an average of the rating against each criterion. Judgement is applied in determining the overall rating for each option.

Section 4: Striking the right balance

A. Options to mitigate risks to contestability of farmers' milk supply arising from Fonterra shares being priced substantially below their full fair value

A4.1 What is the specific problem?

Fonterra's intention to partially delink the unit Fund on a permanent basis, and move to a farmers-only market for its shares, would result in the shares trading at anywhere between 20 and 60 percent discount to their full fair value. As set out in section 2.3 above, this could:

- Risk deterring Fonterra farmers from switching to other (possibly more efficient and innovative) dairy processors and/or alternative (possibly more environmentally sustainable and climate change friendly) land-uses, because of their inability to realise the full value of their past capital investment in Fonterra on exit. If this risk were to eventuate and affect as few as 20-50 Fonterra farmers, this could be sufficient to hinder entry of potential future (or operation of many existing) dairy processors. Fonterra could then maintain its milk supply even if it would have been more efficient for other processors or alternative land-uses to grow instead.

- Encourage farmers to join and supply Fonterra over its rivals, or increase their existing milk supply to Fonterra, as they would be able to buy into Fonterra at a significantly lower entry cost and without contributing the full fair value of their share in Fonterra's underlying business. This may lead to Fonterra processing higher than economically efficient volumes of milk, while avoiding, delaying, or deferring decommissioning or reconfiguration of some of its existing commodity processing capacity, which might otherwise be in the co-operative's long-term benefit. As a result, the overall value of the co-operative may potentially decline over time.

- Risk of reducing transparency of Fonterra's financial performance, as the price of Fonterra's shares would be divorced from the underlying value of Fonterra's future returns from its value-added activities. This may, in turn, reduce transparency of Fonterra's strategic performance and could take pressure off management to invest in innovation, instead focusing on shorter term tactical strategies.

The DIRA does not explicitly prohibit Fonterra from partially delinking the unit Fund on a permanent basis. So long as Fonterra's purpose for delinking the unit Fund is not a prohibited purpose such as to restrict, prevent, or deter the exchange of co-operative shares for units, the DIRA is currently silent on how long a temporary suspension of the exchangeability of shares for units could go on for.

From a policy perspective, this is a legislative gap in the drafting of the 2012 DIRA provisions that enabled Fonterra to move to its current TAF capital structure. The policy makers at the time had anticipated the possibility of the unit Fund being wound up (and provided for an automatic trigger for Fonterra to revert to its original issue and redemption obligation if the unit Fund were wound up).[23] However, the 2012 DIRA amendments had not anticipated a scenario whereby Fonterra would retain the unit Fund in a delinked state for a prolonged period of time. The practical policy effect of a delinked unit Fund on Fonterra's share price-discovery (and therefore contestability of farmers' milk supply) is however the same as the scenario under which the unit Fund is wound up (a scenario that had been anticipated and provided for in the DIRA).

23 Microsoft Word - MAF departmental report on DIRA Bill for Primary Production Select Committee 6.doc (www.parliament.nz)

Fonterra is seeking a DIRA amendment that would specifically enable the unit Fund to remain partially delinked on a permanent basis. This would mean that Fonterra could proceed with confidence that its intentions regarding the unit Fund would not be restricted by the DIRA.

A4.2 What options are available to address the problem?

We considered four options, including the status quo, for mitigating risks to contestability of farmers' milk supply. We designed these options to strike the balance between enabling Fonterra to maintain and improve its productive efficiency in the short-medium and maintaining sufficient incentives for Fonterra to drive performance in the long term. These are described below.

Option A1: Maintain status quo – take no action to amend the DIRA to either support or prevent Fonterra's capital restructure

Option description

Under this option, the Government would take no action to either:

- support Fonterra's capital restructuring, by amending the DIRA to specifically enable Fonterra to retain a partially delinked unit Fund on a permanent basis; or
- prevent Fonterra from proceeding with its capital restructuring, by amending the DIRA to clarify and reflect the original policy rationale underpinning the relevant capital structure provisions.

Fonterra would then have a choice of either:

- proceeding with its current capital restructuring while taking the legal risk of its actions regarding the unit Fund being challenged in Court; or
- abandoning its current plans regarding the unit Fund and either:
  - relinking the unit Fund and proceeding with the remaining aspects of its capital restructuring; or
  - relinking the unit Fund and continuing to operate under its current TAF capital structure; or
  - buying out the unit Fund and reverting to its original issue and redemption capital structure; or
  - developing a different capital restructure proposal for its shareholders' and the Government's consideration.

At this stage, it is unclear which of the above choices Fonterra would most likely proceed with. There is, however, a reasonable chance that Fonterra would proceed with its current capital restructuring plans even without the DIRA amendment sought. Under this scenario, MPI would closely monitor Fonterra's farmer-only market trading patterns and their impacts on contestability of farmers' milk supply. This would form the basis of evidence on which any remedial action may be recommended in due course. The next DIRA review, required to commence between June 2025 and June 2027, could provide a timely opportunity for the Government to take stock and make informed regulatory decisions. If there were rapid market developments, the Government would have the option of commissioning a separate and different review earlier than June 2025.

Assessment against criteria

It is unclear whether this option would enable Fonterra to pursue its current capital restructuring. This would depend on Fonterra's assessment of, and appetite for, the risk of legal challenge.
s 9(2)(h)
[redacted] Fonterra could proceed with its intended capital restructuring, without the DIRA amendment. If Fonterra chose that path, the risks to a dynamic and contestable business environment for farmers' milk supply and all of its flow-on impacts would remain unmitigated. We

would then rely on MPI's monitoring of market developments and evidence of any risks eventuating, with recourse to remedial action that could be taken on short notice if necessary.

Alternatively, Fonterra might decide not to proceed with some or all aspects of its current capital restructuring. Fonterra might, for example, proceed with the reduced minimum shareholding requirement (from 1:1 to 1:3) and increased maximum possible shareholding (from 2:1 to 4:1) while relinking the unit Fund. Under this scenario, Fonterra would be able to secure most of the benefits of its proposed capital restructure but would need to rely on its balance sheet to manage potential divestment of shares arising from the reduced minimum shareholding requirement.

Under this scenario, the risks to contestability of farmers' milk supply would be sufficiently mitigated, as Fonterra's share price-discovery would continue to be supported by the linked unit Fund and Fonterra would, in effect, stand in the market to buy them back, if needed. This would also mitigate the risk of Fonterra's farm gate milk price being cross-subsidised with dividend returns (as the dividend yield would not be artificially inflated), maintain Fonterra's future financial resilience, confidence in New Zealand capital markets, and would not have any impacts on New Zealand consumers.

Fonterra might also decide to buy out the unit Fund and revert to the DIRA original issue and redemption obligation. Under this scenario, the risks to contestability of farmers' milk supply would be effectively safeguarded by the original DIRA provisions.

The option is cost-effective, as it does not require legislative change. This option would also not impose additional regulatory burden on Fonterra, beyond any information disclosure that may be necessary to inform MPI's market monitoring activities. Fonterra would retain sufficient flexibility to determine the course of action as it sees fit, within the parameters of the current DIRA provisions. However, if Fonterra chose to proceed with its capital restructuring and its actions were challenged in court, Fonterra would incur some litigation costs.

The option is administratively simple to implement, with minimal risks of regulatory error occurring.

However, given the uncertainty around Fonterra's potential actions under this option, the outcomes are difficult to predict.

Option A2: Amend the DIRA to support Fonterra's capital restructuring, by specifically enabling Fonterra to retain a delinked unit Fund on a permanent basis

Option description

Under this option, the DIRA would be amended to remove the ability for affected parties (e.g. a shareholder or unit holder) to take legal action against Fonterra partially delinking the unit Fund on a permanent basis, under the DIRA provisions. This would enable Fonterra to proceed with confidence that its intentions regarding the unit Fund would not be restricted by the DIRA.

Assessment against criteria

This option would enable Fonterra to fully implement its current capital restructuring proposal and pursue its commercial objectives without the risk of legal challenge. However, the risks to a dynamic and contestable business environment for farmers' milk supply and its flow-on impacts would remain unmitigated. As outlined elsewhere in this RIS, reduced contestability for farmers' milk could lead to reduced pressure on Fonterra to improve its long-term performance and grow farmers' returns over time. The potential flow-on impacts for the wider economy may also be significant.

This option would not impose any additional regulatory costs and risks on Fonterra and would provide the co-operative with greater flexibility to make timely commercial decisions.

It would provide regulatory certainty, as it would mitigate the risk of legal challenge for Fonterra over a decision to partially delink the unit Fund on a permanent basis. The option would also be administratively simple to implement, as it would involve a straightforward drafting amendment.

The option would however weaken the regulatory integrity of the DIRA regime, as it would effectively remove the remaining discipline of the original 'open entry and exit' provisions.

Option A3: Amend the DIRA to support Fonterra's capital restructuring (as per option A2) while also requiring Fonterra to provide sufficient liquidity support in the farmers-only market

Option description

This option would supplement option A2 above, by introducing new DIRA requirements that would aim to minimise the liquidity discount that could arise in a farmers-only market for Fonterra shares.

We note that even at sufficient levels of liquidity the farmers-only market would still produce a structural restricted-market discount (which would arise from having an undiversified pool of shareholders exposed to the same economic drivers). Any liquidity-support measures in the DIRA would therefore aim to limit the extent to which Fonterra's share price reflects only the restricted market discount, rather than attempt to eliminate it.

Fonterra's farmers-only market design envisages liquidity in the farmers-only market to continue to be supported by the function of a market-maker and Fonterra's own balance sheet. Left unregulated, the nature and extent of the market-maker's liquidity support would continue to be provided for in its contractual arrangements with Fonterra and be determined as a matter of company policy by the Fonterra Board, changing from time to time in response to changing share market dynamics.

However, we expect these contractual arrangements to be materially different from those currently in place. This is because the market-maker's ability to protect its balance sheet exposure to share price volatility by converting shares into units and vice versa would no longer exist under Fonterra's new capital structure. We would therefore expect the market-maker to be incentivised to rely on Fonterra's balance sheet for the additional risk management. Fonterra, on the other hand, would be incentivised to minimise its balance sheet exposure. As a result of these conflicting incentives, the liquidity support in the farmers-only market may not always be adequate.

To minimise the liquidity discount the DIRA could:

- require a market-maker to maintain a range of minimum bid/ask spreads in the market, with a scaled obligation to participate as liquidity changes, and an obligation to hold a minimum amount of inventory with the ability to hold additional inventory for long periods of time to facilitate liquidity in the market, and
- require Fonterra to ensure independent financial markets (e.g., broker or other) research and analysis of Fonterra's performance are easily accessible to farmers.

Both of these measures aim to increase confidence in the ongoing liquidity of the restricted farmer-only market for Fonterra shares. They would set out broad expectations, rather than prescriptive requirements.

Assessment against criteria

This option would enable Fonterra to pursue its commercial objectives, while mitigating the extent to which the discount to Fonterra's full fair value share price could affect contestability of farmers milk supply, and lead to other flow-on impacts as identified in section 2.3 above. However, it would not be sufficient, in and of itself, to fully mitigate the risks and impacts arising from proceeding with option A2 above. Additional mitigations (such as those outlined in options B1-B4 below) could be adopted to improve the effectiveness of this option.

This option would not impose significant regulatory costs and risks on Fonterra and would maintain the co-operative's flexibility to make timely commercial decisions. It may also provide some assurance for farmers that their Fonterra shares could be sold in a timely manner (albeit at lower prices) and maintain some transparency of Fonterra's financial performance due to maintained financial markets analysis and reports that will be available to farmers. The option would support regulatory certainty and be relatively administratively simple to implement, as it would involve relatively straightforward drafting amendments.

Option A4: Amend the DIRA to prevent Fonterra from retaining a delinked unit Fund on a permanent basis, by clarifying and reflecting the original policy rationale underpinning the relevant capital structure provisions (MPI's preferred option)

Option description

Under this option, the DIRA would be amended to prevent Fonterra from retaining a delinked unit Fund beyond a relatively short period of time (e.g. 2-3 days). This option would involve a technical amendment to the DIRA that would identify delinking of the unit Fund as a circumstance that would trigger the automatic snapback of the original issue and redemption obligation on Fonterra. This would reflect the original policy rationale underpinning the relevant TAF-related provisions and maintain an effective status quo in relation to contestability of milk supply.

This option would prevent Fonterra from proceeding with its current capital restructuring plans regarding the unit Fund. Fonterra would then have a choice of either:

- relinking the unit Fund and proceeding with other aspects of its capital restructuring; or
- relinking the unit Fund and continuing to operate under its current TAF capital structure; or
- buying out the unit Fund and reverting to its original issue and redemption obligation; or
- developing a different capital restructure proposal for its shareholders' and the Government's consideration.

Assessment against criteria

This option would prevent Fonterra from retaining a partially delinked unit Fund on a permanent basis. However, Fonterra could proceed with other aspects of its capital restructure. As outlined in option A1 above, Fonterra might decide to go ahead with its proposal to reduce the minimum shareholding requirement (from 1:1 to 1:3) and increase maximum possible shareholding (from 2:1 to 4:1) while relinking the unit Fund. This would enable Fonterra to secure most of the benefits of its proposed capital restructure. However, it would need to rely on its balance sheet to manage potential divestment of shares arising from the reduced minimum shareholding requirement.

Under this scenario, the risks to contestability of farmers' milk supply would be mitigated, as Fonterra's share price-discovery would continue to be supported by the linked unit Fund and Fonterra would, in effect, stand in the market and buy back the shares, if needed. This would also mitigate the risk of Fonterra's farm gate milk price being cross-subsidised with dividend returns (as the dividend yield would not be artificially inflated), and maintain Fonterra's future financial resilience, as well as confidence in New Zealand capital markets.

Alternatively, Fonterra might decide to buy out the unit Fund and revert to the DIRA original issue and redemption obligation. Under this scenario, the risks to contestability of farmers' milk supply would be effectively safeguarded by the original DIRA provisions.

This option might also motivate Fonterra to develop a different capital structure proposal for its shareholders' and the Government's re-consideration. The relative merits of any such proposal would be subject to future evaluation of its benefits, costs and risks.

The option is relatively cost-effective, as it requires only a technical DIRA amendment. Fonterra would retain sufficient flexibility to determine the course of action as it sees fit, within the parameters of the current DIRA provisions. Depending on Fonterra's preferred approach, this option may impose additional regulatory burden and costs on Fonterra. Fonterra would need to weigh up the relative costs and benefits of its preferred approach under this option.

This option would also improve regulatory certainty by clarifying the original policy intent of the 2012 DIRA amendments. The option is also administratively simple to implement, with minimal risks of regulatory error occurring.

However, given the uncertainty around Fonterra's potential actions in response to this option, the outcomes are difficult to predict.

A4.3 What other options have been ruled out of scope, or not considered, and why?

We have briefly considered options that could require Fonterra to stand in the market to purchase shares of exiting farmers at an independently established full fair value share price. However, we have concluded that such options would be impractical as they would create significant gaming risks and further undermine the workings of the farmers-only market.

A4.4 Impact analysis

Options / Assessment Criteria	A1: SQ – Do not amend DIRA to either support or prevent Fonterra's capital restructuring	A2: Amend DIRA to support Fonterra's capital restructuring, leaving risks unmitigated	A3: Amend DIRA to support Fonterra's capital restructuring (A2) while supporting liquidity in the farmers-only market	A4: Amend DIRA to prevent Fonterra from delinking unit Fund, by clarifying original policy rationale (MPI's preferred option)
***Effectiveness*:** Does the option enable Fonterra to pursue its commercial objectives in the short/medium term?	0 Impact is unclear, depends on Fonterra's choice of action	+++ Enables Fonterra to fully implement its capital restructure, while removing Fonterra's risk of legal challenge from de-linking	+ Enables Fonterra to fully implement its capital restructure while removing Fonterra's risk of legal challenge from de-linking	- / 0 Prevents Fonterra from proceeding with one but not all aspects of its capital restructure
Does the option maintain contestability for farmers' milk in the long term?	0 Impact is unclear, depends on Fonterra's choice of action	- - - Leaves significant risks unmitigated	+ Reduces the extent of liquidity discount, maintaining a degree of contestability	+++ Fully mitigates risks to contestability of farmers' milk supply
Does the option provide confidence that Fonterra's farm gate milk price is consistent with contestable market outcomes?	0 Impact is unclear, depends on Fonterra's choice of action	- - Reduces confidence in Fonterra's milk price being consistent with contestable market outcomes	- Reduces confidence in Fonterra's milk price being consistent with contestable market outcomes as restricted market discount would remain	0 Does not affect current levels of confidence in Fonterra's milk price being consistent with contestable market outcomes
Does the option manage the flow-on impacts effectively?	0 Impact is unclear, depends on Fonterra's choice of action	- - - Leaves potential flow-on impacts unmanaged	- - - Leaves potential flow-on impacts unmanaged	+++ Manages potential flow-on impacts effectively
Proportionality: does the option achieve its objectives in a cost-effective and proportionate way?	0 Impact is unclear, depends on Fonterra's choice of action	+ Does not increase regulatory cost or reduce flexibility for Fonterra	+ Does not increase regulatory cost or reduce flexibility for Fonterra	- - Relies on Fonterra to manage costs of its partial capital restructure, redemption risk, or the cost of developing new proposal
Regulatory certainty: does the option make the DIRA regime more certain, and enable timely decision-making?	0 Maintains current regulatory provisions and uncertainty	+/ - - Improves regulatory certainty as it mitigates risk of legal challenge for Fonterra from de-linking, but weakens regulatory integrity of the DIRA regime	+ Provides some assurance to farmers that shares could be sold in a timely manner (albeit at lower prices)	+++ Improves regulatory certainty and maintains regulatory integrity of the DIRA regime
Predictability of outcomes: *does the option improve predictability of outcomes?*	0 Does not provide for predictable outcomes	+ Fonterra would likely proceed with its capital restructure plans	+ Fonterra would likely proceed with its capital restructure plans	- - Does not provide for predictable outcomes
Practicality: is the option administratively simple to implement, with minimal risks of regulatory error and/or unintended consequences?	0 No legislative change required	+ Administratively simple, with minimal risk of unforeseen consequences	+ Relatively administratively simple, with minimal risk of unintended consequences	+ Relatively administratively simple, with minimal risk of unintended consequences
Overall assessment	**0 no change**	**- - worse than SQ**	**+ somewhat better than SQ**	**++ better than SQ**

B. Options to mitigate risks to contestability of farmers' milk supply arising from Fonterra's increased ability to pay a higher than efficient milk price

B4.1 What is the specific problem?

Fonterra's capital restructure could increase Fonterra's ability to pay a higher than efficient milk price. Fonterra could leverage its inflated dividend yield to shift some of its capital returns from the dividend to the milk price. A moderately higher than efficient milk price could be sufficient for Fonterra to reduce the competitive pressure it may otherwise face for its milk supply. A higher milk price would increase costs to dairy processors (including Fonterra) and may impede their ability to pursue value-add investment strategies. Distorted pricing may also deter entry by new, potentially more innovative processors, ultimately leading to less scope for investment in innovation. Under such a scenario Fonterra could effectively maintain or gain market share, and the economy forego added opportunity for value creation and innovation.

Because Fonterra collects and processes 79 percent of New Zealand's total milk production, there is no market price for farmers' milk that is independent of the price paid by Fonterra. Fonterra relies on an administrative methodology to calculate the aggregate price a notionally efficient processor[24] would pay farmers for milk in a season (the base milk price). This calculation provides the key input and the reference point for the Fonterra Board's business decisions on the allocation of the co-operative's total returns between payments for milk to farmer-suppliers (the farm gate milk price), retentions for reinvestment, and dividend payments on the capital invested by farmer-shareholders (and unit holders) in any given season.

There is currently no direct regulation of Fonterra's milk price. Until amended in 2020, the DIRA relied primarily on the 'open entry' requirement – for Fonterra to accept all milk supply offers – to incentivise Fonterra not to overpay for milk. This requirement aimed to ensure that if Fonterra paid a higher than efficient milk price it would receive uneconomic volumes of milk. Fonterra's inability to quantity ration milk supply offers was the key regulatory mechanism that strengthened Fonterra's incentives to price milk efficiently.

To supplement (rather than supplant) this key requirement, the DIRA also contains a number of base milk price specific provisions. These were designed to promote transparency of Fonterra's farm gate milk price-setting processes and increase confidence in the outcomes. To do that, the DIRA provides for Fonterra's base milk price governance, information disclosure, the basis for Fonterra's base milk price calculation, and the Commerce Commission's monitoring of it. Together, these DIRA provisions aim to ensure that there is transparent framework for Fonterra to calculate a reference point against which its Board subsequently sets the farm gate milk price.

The current base milk price transparency framework is not however equipped to compensate for the combined effect of a changing regulatory environment, where Fonterra's incentives to price milk efficiently are reduced (by the removal of the 'open entry' obligation from 1 June 2023) and its ability to shift some of its capital returns from the dividend to the milk price are increased (by the proposed capital restructuring).

Over the last decade, the Commerce Commission has conducted bi-annual reviews and worked through and assessed a large volume of submissions and expert opinions on many of the assumptions, inputs and processes that underpin Fonterra's base milk price calculation. In 2020, after the Commerce Commission had repeatedly raised significant and persistent concerns with Fonterra's chosen approach to setting a key component of the base milk price calculation (the

[24] The notionally efficient processor is assumed to be of Fonterra's size and scale, processing all its mi k into a bundle of profitable commodity products, selling them in global dairy markets, making no economic profit, in any given season.

asset beta), Parliament amended the DIRA to reduce Fonterra's discretion in setting that specific input. We understand that Fonterra's current interpretation of the asset beta assumption as now prescribed in legislation, is that Fonterra retains discretion over a number of key steps underpinning the asset beta calculation. In effect its discretion in setting the asset beta was not significantly impacted by the 2020 DIRA amendment.

Other dairy processors continuously raise concerns about a lack of transparency and Fonterra's perceived ability to manipulate the base milk price calculation. Some have additional concerns about their inability to access the more detailed assumptions and inputs that inform Fonterra's base milk price calculation. This makes it difficult for other processors to accurately forecast where the market price for farmers' milk will land. These concerns arise from the relatively high-level nature of Fonterra's information disclosures, which are designed to protect commercially sensitive information. The Commerce Commission often comments on what additional information Fonterra could helpfully disclose to alleviate some of the other processors' concerns. As the Commission's commentary is not binding on Fonterra, Fonterra's voluntary disclosures have not been always forthcoming.

B4.2 What options are available to address the problem?

We considered four options, excluding the status quo, for strengthening the current DIRA base milk price provisions. These options outline various means of reducing risk to contestability of farmers' milk supply that would arise if option A2 (Amending the DIRA to support Fonterra's capital restructuring) is proceeded with. Just like option A3 above, all four options B (B1 to B4) below are additional to option A2. They aim to mitigate the specific risk of Fonterra's increased ability to shift capital returns from dividends to milk price, inherent in its proposed capital restructuring. We note that all four options (B1 to B4) below would be redundant if options A1 or A4 were proceed with instead of option A2.

Option B1: Amend the DIRA to increase independence of Fonterra's base milk price governance arrangements

Option description

Under this option, the DIRA would be amended to increase the independence of Fonterra's internal base milk price-setting processes. This would involve amending the DIRA to:

- Increase the number of Ministerial nominees to Fonterra's Milk Price Panel (Panel) from one to two and ensure that their proportional contribution to Panel's recommendations to the Fonterra Board cannot be diluted by prescribing both the maximum (seven) and minimum (five) number of Panel members, including at least one Ministerial nominee. The terms and conditions for the appointment and conduct of the additional Panel member would be the same as for the existing Ministerial nominee. Fonterra's Board is responsible for appointing the Ministerial nominee and that person is subject to the Terms of Reference set by the Board and applicable to all Panel members.
- Require that the Chair of the Panel was approved by the Minister of Agriculture, before being appointed by Fonterra's Board; that the person be suitably independent of Fonterra (for example, not connected to a shareholding farmer, or an employee, director, an agent or an associate of Fonterra or its Co-operative Council); and is additional to the two Ministerial nominees on the Panel.
- Require Fonterra to contract out the day-to-day administration of the base milk price calculation (currently performed by the Milk Price Group) to an external party to be rotated every 4-6 years. This would embed and improve Fonterra's current practice in law (as Fonterra currently outsources the function of the Milk Price Group to Ernst & Young but there is no time limit on this). It would require the external party to operate at arms-length from

Fonterra management and Board. The criteria for selecting and appointing the external party would be specified in DIRA and be similar to the criteria for selecting and appointing external auditors.

Assessment against criteria

This option would provide an increased degree of confidence in Fonterra's internal base milk price calculation processes. It builds on the existing DIRA provisions and increases the Panel's ability to operate more independently of the Fonterra Board in providing its recommendations, which are intended to serve as a transparent reference point for the Board's farm gate milk pricing decisions. It also ensures that the Milk Price Group function continues to be performed at an arms-length from Fonterra management, while the requirement to rotate external providers contributes to reduced risk of potential management capture.

However, this option stops short of increasing confidence in the consistency of the base milk price calculation with the contestable market outcomes. This is because the role of the Panel is to provide assurances to the Fonterra Board that the base milk price calculation adheres to the milk price principles as set out in Fonterra's constitution. This option would not change that. Fonterra's constitutional milk price principles focus on ensuring that Fonterra's milk price is the maximum amount that Fonterra, as a properly managed and efficiently run sustainable co-operative, could pay farmers for milk in any given season.[25] Fonterra's Constitution does not concern itself with contestable market outcomes. This is instead the purpose of the relevant DIRA provisions and the focus of the Commerce Commission's monitoring function. This option is therefore unlikely to be an effective mitigation measure against the risks created by Fonterra's capital restructure. It is also likely to have little practical impact on the risk of higher than efficient farm gate milk prices flowing through to the wholesale prices of domestic dairy products.

The option is relatively cost-effective and we do not consider would impose undue regulatory costs and risks on Fonterra's commercial operations, given the limited advisory function both the Panel and the Milk Price Group perform. Fonterra would incur additional costs of securing more independent expertise for the Panel and building the necessary technical capability. But it would maintain some flexibility to select, appoint, and rotate Panel members with various skillsets and areas of expertise necessary to ensure well-functioning internal governance arrangements.

This option would also improve regulatory certainty by ensuring that the proportional contribution of more independent Panel members cannot be diluted. Furthermore, the components of this option would involve relatively straightforward amendments to the DIRA with minimal risk of unintended consequences.

Option B2: Amend the DIRA to provide stronger direction on how Fonterra calculates its base milk price by giving the Commerce Commission powers to make its base milk price reviews' findings binding

Option description

Under this option, the DIRA would be amended to give the Commerce Commission limited powers of direction on all or some inputs, assumptions and processes used by Fonterra in its base milk price Manual and calculation. Currently, the Commerce Commission is able only to monitor and question but cannot require Fonterra to act on, or comply with, any of its findings. Under this option, the Commission would have the powers to require Fonterra to comply with all or some of its findings in relation to all or some of Fonterra's inputs, assumptions and processes in the base milk price Manual and calculation. The Commission would exercise its judgment and could still

25 Annexure 1 of Fonterra's constitution.

make some non-binding findings and observations, in addition to having the power to direct where the Commission considers it necessary.

The proposed powers would not extend to direction of either the quantum of the calculated base milk price or the quantum of the actual farm gate milk price paid by Fonterra to farmers. Fonterra's Board would retain its current ability to pay a farm gate milk price that is the same or different from the calculated base milk price.

The table below sets out key parameters for the proposed powers. These have been modelled on a similar regime and powers proposed to be given to the Commerce Commission under the Retail Payment System Bill[26] currently in the House.

Nature of proposed powers	The Commission would be able to direct Fonterra to: • adopt, amend, or comply with the Commission's views to setting all or some[27] inputs, assumptions, and processes in the Milk Price Manual and base milk price calculation for the season, • notify the Commission of any amendments Fonterra has made or plans to make to the inputs, assumptions, and processes in the Milk Price Manual and base milk price calculation for the season, • obtain the Commission's approval before making any material[28] amendments to the inputs, assumptions, and processes in the Milk Price Manual and base milk price calculation for the season, and • publish certain (not commercially sensitive) Milk Price Manual- and base milk price calculation-related information.
Criteria for exercising proposing powers	The Commission could use its powers to direct Fonterra on the specific assumptions, inputs, and processes that the Commission considers would be consistent with the s 150A purpose of Subpart 5A of the DIRA.
Process and timing for exercising proposed powers	Before giving a direction, the Commission would be required to consult Fonterra on the proposed direction, and the Commission's reasons for considering issuing the proposed direction. The Commission would then be required to consider Fonterra's submission before finalising the direction. The Commission's direction could be amended or revoked at the Commission's volition, the process for which would be similar to the process for making the direction. Consideration would need to be given to the timing of any direction made and the relevant season they would apply to. The current statutory deadlines for the Manual and calculation reviews do not allow for the direction to be proposed, consulted on as part of the draft report, and made in time for the final report. The statutory deadlines would therefore need to be substantially[29] altered if the directions were to take effect in the dairy season that they are made. Alternatively, if the statutory timelines were kept substantially the same, the directions could be made following the

[26] Sections 24-28 of the Bill (Retail Payment System Bill 80-1 (2021), Government Bill – New Zealand Legislation).

[27] Depending on what other options form part of the regulatory response, there may be a need to limit the powers to some key aspects of the base milk price calculation, eg. the cost of capital and information disclosure..

[28] The definition of 'materiality' would need to be considered carefully and may be wider than what is outlined in paragraph 19(c) below..

[29] A further consideration would need to be given to the current statutory timelines and whether they should be adjusted to improve the operation of the current monitoring regime, irrespective of the proposed powers.

	Commission's final Manual or calculation reports and take effect the following year.[30]
Form of proposed powers	The Commission would give the direction, by issuing a direction notice, as part of, or following, its annual final reports on the Milk Price Manual and base milk price calculation. The notice would include the Commission's reasoning for its direction.
Checks and balances on exercise of proposed powers	Fonterra would be able to request that Commission amends or revokes a previous direction. Provided Fonterra supplied sufficient evidence and/or mounted a reasonable case for any such amendment or revocation, the Commission would be required to consider the request. The Commission's exercise of its powers to direct would be subject to judicial review only. This would be on the basis that the powers to direct would only apply to the inputs, processes, and assumptions informing the Milk Price Manual and base milk price calculation, not the quantum of the calculated base milk price and not the quantum of the farm gate milk price that the Fonterra Board subsequently sets.
Penalty for contravening directions	The DIRA's standard penalty provision for contraventions is a fine not exceeding $200,000 and a fine of $10,000 for each day that the offence continues. Consideration would need to be given as to whether this level of penalties should be retained or increased to more closely align with other similar regulatory regimes' penalties, including: • the Retail Payment System Bill, which provides for penalties for contravention of a direction of up to $2 million; • Part 4 of the Commerce Act, which provides for penalties for breaches of price-quality requirements of up to $5 million; and • the Fuel Industry Act, which provides for penalties of up to $5 million.

Assessment against criteria

This option would increase confidence in Fonterra's internal Milk Price Manual and base milk price calculation processes, as it would ensure that the recommendation to the Board (on the key reference point for its farm gate milk pricing decisions) is consistent with the DIRA legislative purpose. It would also significantly increase confidence in the consistency of the base milk price with the contestable market outcomes. The additional confidence would arise from changing the nature of the Commission's role from one that aims to create transparency and encourage behaviour change to requiring Fonterra to comply with the Commission's directions, should Fonterra's practices be at odds with the Commission's expert view. This option would also reduce the risk of higher than efficient farm gate milk prices flowing through to the wholesale prices of domestic dairy products (although impact on retail prices would remain uncertain).

However, this option would not provide confidence that Fonterra's farm gate milk price is consistent with contestable market outcomes, because Fonterra would retain the flexibility to pay a farm gate milk price that is different from the calculated base milk price. Under this option, there would be continued reliance on an improved but still mainly transparency-enhancing framework in the DIRA to disincentivise the Board from paying a higher farm gate milk price. This option would therefore be insufficient to mitigate the risks created by Fonterra's capital restructure.

[30] Additional consideration may also need to be given to the timing of Fonterra's internal mi k price-setting processes, how they correspond to the Commission's calculation review statutory timeframes, and whether additional statutory timeframes should be introduced, e.g. for the Milk Price Panel's recommendation to the Fonterra Board.

There would be additional costs to Fonterra and other stakeholders to participating in the Commerce Commission's consultation processes on directions. There would also be additional costs for the Commission, which would be appropriated by the Crown but recovered from Fonterra under the existing Fonterra levy funding arrangements. To consider the need for and/or issue binding directions, the Commission would need to apply additional rigour, scrutiny, and specialist expertise. It would also need to be able to undertake appropriate compliance and enforcement activities. Depending on the final regulatory design detail of the proposed powers, the Commission estimates that its appropriation may need to be increased by around $1.5 million per annum. This is a high-level estimate only at this stage and subject to further refinement and testing during the next phase of regulatory design.

This option would improve regulatory certainty. Currently, if Fonterra does not voluntarily change its approach, legislative change is required to give effect to the Commerce Commission's findings. This option would reduce the need to rely on legislative change to affect change.

The option would also involve relatively straightforward amendments to the DIRA, leaving sufficient flexibility for changes to be made at an operational level with relatively low risk of unintended consequences. This option could be implemented on its own, or in combination with some aspects of option B3 below.

Option B3: Amend the DIRA to more tightly prescribe key parameters of the base milk price calculation in legislation

Option description

This option would define key technical terms and require Fonterra to publish more detailed base milk price related information, in order to more tightly prescribe the key parameters of the base milk price calculation in law. This would reduce Fonterra's discretion regarding specified inputs, assumptions, and processes.

Under this option, the DIRA would be amended to prescribe the definitions for key technical terms, stipulate additional mandatory assumptions, and clarify the use of safe harbours in legislation, as well as require Fonterra to publish more detailed base milk price-related information. The non-exhaustive list of examples of the proposed prescription and clarification (which may be refined at the next stage of regulatory design detail work) is set out in the table below.

Defining key technical terms in DIRA	The DIRA would be amended to provide for the definitions of the key technical terms, including: • *Commodity* – some commodity products sold off-GDT may have the same specification in terms of fat and protein content as the commodity products sold on GDT but are nonetheless quite different in terms of manufacturing processes and cost of plant required to process them. The DIRA could therefore define commodity products in terms of their uniform technical specifications and the ability to manufacture these products on standard plants using the same processes used to manufacture standard specification products sold on GDT. • *Standard plant* – to help determine whether some borderline commodity products should be informing the base milk price calculation, the DIRA would define standard plant as plant required to manufacture standard specification products to be sold on GDT without modification. • *Materiality* – to clarify what constitutes 'material change' to the base milk price methodology that requires an amendment to the Manual, the DIRA

	could define materiality as a 'floor' value – i.e., any change that results in an impact on the base milk price of at least X cents per kgMS (all else equal) would be considered material.
Specifying additional mandatory assumptions	The DIRA would be amended to specify additional mandatory assumptions to: • Include a geographic location requirement for standard plants – to ensure that standard plants are allocated to each dairy region in a way that aligns to Fonterra's actual processing capacity in the region (rather than allocation only on a North Island/South Island basis) the DIRA would specifically require that standard plants be allocated on a regional basis. • Further clarify the asset beta assumption – clarify that the current s 150C(4) provision that requires that the asset beta "must be consistent with the estimated asset betas of other processors of dairy and other food products" does not allow Fonterra to adjust the average obtained by estimating the asset betas of the 'other processors' that meet the criteria. Consideration would need to be given, as to whether Fonterra's own asset beta estimate should be permitted to be included as one of the data points in the calculation of the notional processor's asset beta, and if the DIRA would need to explicitly state that.
Clarifying the use of safe harbours	The DIRA would be amended to clarify the use of the current safe harbour provisions by: • Explicitly stating that the use of actual manufacturing footprint (i.e., plant capacity, costs, and regional location) is allowed as long as it is applied consistently across all aspects of the base milk price calculation. • Referring to specific assumptions Fonterra may apply in translating its actual foreign currency gains/losses (and whether those are on a monthly average or annual average basis) to monthly benchmark rates in the base milk price calculation.
Requiring Fonterra to publish detailed base milk price-related information	The DIRA would be amended to require Fonterra to annually publish base milk price related information, such as: • the notional processor's plant capacity (short-term vs. long-term); • forecast foreign exchange conversion rates; • the methodology used to translate Fonterra's actual conversion rate into the notional processor's conversion rate for foreign currency fluctuations; • cents per kgMS impact on the base milk price from the inclusion of off-GDT sales; • average off-GDT prices of the reference commodity products (possibly with a delayed publication date to protect current-year business sensitive information); • information on the incremental cost adjustments made to allow for product differences when products do not strictly fit the definition of a reference commodity product (incl. for example, adjustments for additional plant that does not constitute 'specialised plant'; allowances for changes in yields implied by stop/start manufacturing of different products rather than long run processing of standard products; and

	adjustments for additional processing and overhead costs associated with different products).

Assessment against criteria

This option would increase confidence in Fonterra's base milk price calculation process and the consistency of the base milk price with contestable market outcomes. The additional confidence would arise from removing Fonterra's discretion relating to specific inputs, assumptions and processes. This would not, however, reduce the risk of Fonterra setting higher than efficient farm gate milk prices. This option would not therefore provide an effective mitigation measure against the risks created by Fonterra's capital restructure.

This option would significantly reduce the flexibility for both Fonterra and the Commerce Commission to adjust to changes in industry dynamics in a timely manner. Any corrections in response to a changing dynamic would then rely on the Fonterra Board to pay a farm gate milk price that is different from the calculated base milk price. This could over time undermine confidence in the base milk price calculation.

In the short term, this option may improve regulatory certainty, but the difficulties in making timely adjustments to the tightly prescribed inputs and information disclosure would make this option highly inflexible. This option would need to rely on legislative change to affect change over time.

The option involves considerable drafting complexity and the approach was attempted (to limit Fonterra's discretion regarding the asset beta assumption) in the 2020 DIRA amendment with limited success. Fonterra's current interpretation of the asset beta assumption prescribed in the DIRA is that Fonterra retains discretion over a number of key steps underpinning the asset beta calculation. In effect, its discretion in setting the asset beta was not significantly impacted by the 2020 DIRA amendment. This option could be implemented on its own, or in combination with some or all aspects of option B2 above.

Option B4: Amend the DIRA to give the Commerce Commission power to directly set the maximum total amount that Fonterra could pay for milk supply in a season

Option description

Under this option, the DIRA would be amended to give the Commerce Commission power to directly set the maximum total amount that Fonterra could pay for milk supply in a season. This power would include the Commerce Commission setting input methodologies and making decisions on such matters as the choice of the product mix, conversion of global prices into revenue, selection of the appropriate asset base, product yields, determination of the cost of capital and depreciation schedules.

The Commerce Commission would not set the farm gate milk price that Fonterra could pay to individual farmers per kgMS supplied. Fonterra would retain its discretion to pay any premiums for quality, sustainability and the like, as set out in its terms of supply and in supply contracts with farmers. The only proviso would be that the total payment to all farmers in a season could not exceed the amount set by the Commerce Commission. The Commerce Commission would require sufficient enforcement powers to ensure that Fonterra did not deviate from its determination of the total payment for milk supply. As with other regimes of this type, the Commission could be subject to judicial and potentially merits review.

Assessment against criteria

This option would provide confidence that Fonterra's farm gate milk price was consistent with contestable market outcomes, as the task would be undertaken by an independent regulatory body rather than Fonterra itself.

Designing and implementing this regulatory option could take between two and three years and could incur an administrative cost of around $8 - $12 million to set up and around $2 - $3 million per annum to operate. These costs would be met by the Crown but recovered from Fonterra under the existing Fonterra levy arrangements. This would impose significant costs on Fonterra.

This option would also create significant risks of regulatory error and unintended consequences distorting Fonterra's business and investment decisions. It would remove Fonterra's flexibility to make timely commercial decisions in response to changing market dynamics at the total/average quantum level. However, Fonterra would continue to have the flexibility (within the total regulatory cap) to adjust its individual farmer's farm gate milk price and pay either above or below the average farm gate milk price for milk quality, sustainability and the like, as set out in its terms of supply and in supply contracts with farmers.

This approach would however make the DIRA regime more certain and predictable in promoting contestable market outcomes. This is because Fonterra would no longer have the ability to shift some of its capital returns from the dividends to the milk price.

Although the drafting of this option could mirror some of the existing price control regulatory regimes (e.g., electricity lines business regulation), it would be highly complex and resource-intensive for the Commerce Commission to implement.

s 9(2)(h)

[redacted]

B4.3 What other options have been ruled out of scope, or not considered, and why?

There are multiple options along the spectrum of options B1 to B4. We have focused our analysis on some key points on that spectrum.

B4.4 Impact analysis of options to accompany option A2: Amend DIRA to support Fonterra's capital restructuring (not preferred by MPI)

Options / Assessment criteria	B0: SQ – maintain current DIRA base milk price provisions	B1: Amend DIRA to increase independence of Fonterra's base milk price governance	B2: Amend DIRA to give the ComCom powers to make its review findings binding on the base milk price inputs, assumptions, & processes	B3: Amend DIRA to prescribe key terms & assumptions, and clarify safe harbours for the base milk price calculation	B4: Amend DIRA to give ComCom power to set the maximum quantum Fonterra could pay for milk in a season
Effectiveness: Does the option provide sufficient confidence in Fonterra's farm gate milk price processes and consistency with contestable market outcomes?	0 Does not provide sufficient confidence	+ / 0 Improves confidence in Fonterra's internal processes, but not in the base milk price or the farm gate milk pricing outcomes	++ Improves confidence in Fonterra's internal processes and base milk price outcomes, but not in the farm gate milk price itself	++ Improves confidence in Fonterra's internal processes and base milk price outcomes, but not in the farm gate milk price itself	+++ Improves confidence in the independence of Fonterra's farm gate milk price
Does the option minimise the potential flow-on impact on NZ consumers?'	0 Risk of inflated farm gate milk price flowing to wholesale prices; impact on retail prices is uncertain	0 Little practical impact on the wholesale prices, with impact on retail prices remaining uncertain	+ Reduces risk of inflated farm gate milk price flowing to wholesale prices, impact on retail prices is uncertain	+ Reduces risk of inflated farm gate milk price flowing to wholesale prices, impact on retail prices is uncertain	++ Reduces perception risk of potentially inflated farm gate milk price flowing to wholesale prices, impact on retail prices is uncertain
Proportionality: does the option achieve its objectives in a cost-effective and proportionate way?	0 Relatively cost-effective	- / 0 Increases compliance costs to Fonterra, but not significantly or disproportionately	- Increases compliance costs to Fonterra, but not disproportionately	- Increases compliance costs to Fonterra, but not disproportionately	- - - Imposes significant cost and regulatory burden on Fonterra
Regulatory certainty: does the option make the DIRA regime more certain and enable timely decision-making?	0 Provides limited regulatory certainty Does not provide for timeliness of regulatory adjustments	+ / 0 Improves certainty of proportionate independence and arms-length administration	++ Improves certainty of base milk pricing outcomes, and timeliness of regulatory adjustments	+ / - May improve certainty of base milk pricing outcomes, but may also impede timeliness of regulatory adjustments	++ Improves regulatory certainty of farm gate milk pricing, and timelines of any regulatory adjustments
Predictability of outcomes: *does the option improve predictability of outcomes?*	0 Provides limited predictability of outcomes	+ / 0 May improve predictability of base milk pricing outcomes.	++ Improves predictability of base milk pricing outcomes	+ / 0 May improve predictability of base milk pricing outcomes.	++ Improves predictability of farm gate milk pricing
Practicality: is the option administratively simple to implement, with minimal risks of regulatory error and/or unintended consequences?	0 Administratively simple, with minimal risk of unintended consequences	+ Administratively simple, with minimal risk of unintended consequences	+ / - Relatively simple to draft, but requires specialist expertise to implement with some risk of regulatory error	- Complex to draft and implement, with higher risk of regulatory error	- - - Highly complex, creating significant risk of regulatory error and unintended consequences
Overall assessment	**0 no change**	**+ somewhat better than SQ**	**++ better than SQ**	**+ somewhat better than SQ**	**- - worse than SQ**

Section 5: Conclusions

5.1 What option, or combination of options is likely to best address the problem, meet the policy objectives and deliver the highest net benefits?

Cabinet paper proposals

The Cabinet paper proposes a combination of options that would amend the DIRA to:

- specifically enable Fonterra to retain a partially delinked unit Fund on a permanent basis (option A2); and
- require Fonterra to provide liquidity support in the farmers-only market (option A3); and
- strengthen the existing DIRA base milk price provisions (options B1 and B2); and
- require Fonterra to maintain and publish a dividend and retentions policy.

MPI considers that the regulatory adjustments (options A3, B1, and B2) are necessary but not sufficient to mitigate the risks that supporting Fonterra's capital restructure (option A2) could create. In our view, stronger and more direct regulation of Fonterra's farm gate milk price (option B4) would be required to mitigate the risks more comprehensively, if the DIRA was amended to support Fonterra's capital restructure (as per option A2). However, MPI recognises that such form of alternative regulation would impose substantial regulatory costs, create significant risk of regulatory error, and potentially distort Fonterra' business and investment decisions. The regulatory costs and risks of such direct price regulation would, in our view, outweigh the regulatory benefits.

MPI's recommended approach

MPI therefore recommends amending the DIRA to clarify and reflect the original policy rationale underpinning the relevant capital structure provision (option A4). Although this would mean Fonterra could not continue to retain a partially delinked unit Fund on a permanent basis, it would still have the choice of either:

- proceeding with the remaining aspects of its capital restructure; or
- maintaining its current capital structure; or
- reverting to its original share issue and redemption arrangements; or
- developing a different capital restructure proposal for its shareholders' and the Government's re-consideration.

Depending on Fonterra's chosen course of action, MPI's recommended approach may result in fewer benefits to Fonterra. However, when considered alongside other alternative approaches, MPI considers this approach best responds to the opportunities and risks arising from Fonterra's intended capital restructure.

The Cabinet paper proposals and MPI's recommended approach both aim to strike the balance between supporting Fonterra's commercial objectives and mitigating the long-term risks. Overall, the Cabinet paper proposals place greater weight on supporting Fonterra's commercial objectives of operating a large-scale, productively efficient, New Zealand farmer-owned co-operative, whereas MPI's recommended approach equally weights all of the assessment criteria (set out in section 3.2 below). The appropriate weighting for the criteria is a matter of judgement.

5.2 Summary table of costs and benefits of the Cabinet paper proposals

Additional costs of Cabinet paper proposals, compared with taking no action

Affected parties	Comment	Impact	Evidence certainty
Fonterra	Increased levy costs associated with the Commerce Commission's proposed powers of direction. Increased cost of participating in consultation processes on directions that might be issued by the Commerce Commission. Potentially processing higher than economically efficient volumes of milk. Reduced access to, and increased cost of, equity capital raising in future. Reduced incentive to shift away from volume to value strategy, with overall value potentially declining over time.	**Medium:** around $1.5 million for the additional levy costs	**Low**
Fonterra's farmer-shareholders **not** planning to switch to other processors or pursue alternative land-use choices	Immediate balance sheet hit with unknown future wealth impacts	**High**: around $2.5 billion collectively	**High**
Fonterra's farmer-shareholders considering switching to other processors or alternative land-uses	These farmers face the choice of either selling their Fonterra shares at significantly lower prices or continuing to supply Fonterra, at the expense of supplying other (potentially more efficient and innovative) dairy processors, or converting their dairy land to other land uses, e.g., horticulture. Continuing dairying may inhibit environmental quality and climate change improvements from being realised.	**High**	**High**
Current dairy processors competing for farmers' milk supply with Fonterra	Increased barriers to expansion and reduced ability to compete for famers' milk and/or pursue value add investment strategies. This may lead to reduced diversity and innovation in the dairy processing sector. Increased cost of participating in consultation processes on directions that might be issued by the Commerce Commission.	**High**	**Medium**
Potential future dairy processors considering	Increased barriers to entry and reduced ability to compete for farmers' milk and/or pursue value add investment strategies.	**High**	**High**

entering the processing sector and competing for farmers' milk supply with Fonterra	This may lead to reduced diversity and innovation in the dairy processing sector.		
New Zealand consumers of dairy products	Any increases in Fonterra's milk price to farmers may flow though to retail prices of domestic consumer dairy products (unless absorbed elsewhere along the supply chain)	**Low**	**Low**
Investors in the unit Fund and confidence in New Zealand capital markets	Immediate balance sheet hit, with unknown future wealth impacts. Given Fonterra is NZ's largest company, this may undermine NZ's investment climate.	**High**: around $160 million collectively	**High**
Crown	Fonterra's reduced access to external and internal equity capital raising may (in the event of a commercial strategy failure or a significant global financial markets shock) result in a financial risk transfer to the Crown.	**Medium/High**	**Low**
Commerce Commission	Additional administrative costs	**Medium**: around $1.5 million per annum cost-recovered from Fonterra	**Medium**

Expected benefits of Cabinet paper proposals, compared with taking no action

Affected parties	**Comment**	**Impact**	**Evidence certainty**
Fonterra	Fonterra's ability to retain and attract milk supply is primarily driven by its underlying performance, not capital structure. Aspects of Fonterra's capital restructure that do not require legislative change would deliver the majority of benefit to Fonterra.	**Low**	**Medium**
Fonterra's farmer-shareholders not planning to switch to other processors or pursue alternative land-use choices	Fonterra would be able to continue paying existing supplier-shareholders the maximum possible milk price. This would maintain or increase on-farm profitability and dairy land prices. Any capital freed up from shareholding in Fonterra could be used by farmers to repay on-farm debt, invest in on-farm environmental and/or climate change mitigations, or make other on-farm investments (some of which may enable	**High**	**High**

	farmers to maintain or increase their otherwise potentially declining milk production).		
Dairy farmers supplying other processors considering switching to Fonterra	New or returning dairy farmers would be able to join Fonterra at much lower level and cost of shareholding. This would leave more capital in farmers' hands to repay on-farm debt, invest in on-farm environmental and/or climate change mitigations, or make other on-farm investments (some of which may enable farmers to maintain or increase their otherwise potentially declining milk production).	**High**	**High**
Dairy farmers intending to continue to supply other processors	Since other dairy processors match or better Fonterra's milk price, dairy farmers supplying those processors would also benefit from maintained or increased on-farm profitability and dairy land prices.	**High**	**High**
Rural communities and wider economy	Maintained or increased on-farm profitability would flow through to rural communities and the wider New Zealand economy	**High**	**High**

Costs and benefits of MPI's recommended approach relative to Cabinet paper proposals

MPI's recommended approach would mitigate the long-term risks more comprehensively than the Cabinet paper proposals. However, depending on Fonterra's chosen course of action, it may reduce the benefits of Fonterra remaining a large-scale productively efficient New Zealand farmer-owned dairy processing co-operative.

5.3 Are the Cabinet paper proposals compatible with the Government's 'Expectations for the design of regulatory systems'?

The Cabinet paper proposals are compatible with the Government's 'Expectations for the design of regulatory systems'. They achieve clear objectives and would improve regulatory certainty for Fonterra and its farmer-shareholders, while adjusting existing regulatory settings to reduce risks to contestability of farmers' milk supply arising from Fonterra's capital restructure.

5.4 Summary impact and cost benefit analysis of MPI's recommended approach relative to Cabinet paper proposals and other options

Alternative approaches for a government response: **Key considerations:**	**1: Do not amend DIRA to either support or prevent Fonterra's capital restructure**	**2: Amend DIRA to support Fonterra's capital restructure & adjust existing DIRA settings to reduce risks (Cabinet paper proposals) by:** i. specifically enabling Fonterra to retain a partially delinked unit Fund on a permanent basis (option A2); & ii. requiring Fonterra to provide liquidity support in the farmers-only market (option A3); & iii. strengthening existing base milk price-setting regime (options B1 and B2); & iv. requiring Fonterra to maintain and publish a dividend and retentions policy.	**3: Amend DIRA to support Fonterra's capital restructure & introduce alternative regulation to mitigate risks by:** i. specifically enabling Fonterra to retain a partially delinked unit Fund on a permanent basis (option A2); & ii. giving ComCom power to set the maximum quantum Fonterra could pay for milk in a season (option B4).	**4: Amend DIRA to clarify and reflect original policy rationale for the capital structure provisions (MPI's recommended approach)**
Does the approach support Fonterra's commercial objectives of operating a large-scale, productively efficient, NZ farmer-owned cooperative?	**Unclear, depends on Fonterra's response:** +++ if Fonterra proceeds while facing the legal risk + if Fonterra relinks unit Fund but proceeds with other aspects of its capital restructure - If Fonterra relinks unit Fund and reverts to TAF - If Fonterra buys out the unit Fund and reverts to issue/redemption system **0** If Fonterra designs a different capital restructure for its shareholders and Govt's re-consideration	+++ Enables Fonterra to fully implement its current capital restructure, while removing Fonterra's risk of legal challenge from de-linking	+++ Enables Fonterra to fully implement its current capital restructure, while removing Fonterra's risk of legal challenge from de-linking	**Fonterra would not be able to proceed with one aspect of its capital restructure**, but: + if Fonterra relinks unit Fund and proceeds with other aspects of its capital restructure - if Fonterra relinks unit Fund and reverts to TAF - if Fonterra buys out unit Fund and reverts to issue/redemption system **0** If Fonterra designs a different capital restructure for its shareholders and Govt's reconsideration
Does the approach mitigate risks to contestability for farmers' milk & long-term performance, innovation, sustainability, and value creation in the dairy processing sector (incl. Fonterra)?	**Unclear, depends on Fonterra's response:** - - - if Fonterra proceeds while facing the legal risk + if Fonterra relinks unit Fund but proceeds with other aspects of its capital restructure + If Fonterra relinks unit Fund and reverts to TAF + If Fonterra buys out unit Fund and reverts to issue/redemption system **0** If Fonterra designs a different capital restructure for its shareholders and Govt's re-consideration	+ Improves transparency and strengthens some regulatory settings - - - But, does not sufficiently mitigate risks to contestability for farmers' mi k or Fonterra's farm gate milk pricing	+++ Significantly improves confidence in the independence and robustness of Fonterra's farm gate milk pricing, thus significantly reducing risk to contestability of farmers milk supply - Farmer switching may still be negatively affected as they may not be able to realise full capital value on exit, and the ability to join without paying full fair value on entry	+++ Sufficiently mitigates risks to contestability of farmers' mi k supply and the long-term performance, innovation, & value creation in the processing sector (incl. Fonterra).
Does the approach manage potential flow-on impacts for Fonterra's future financial resilience, confidence in NZ capital markets, and cost of NZ consumer dairy products?	**Unclear, depends on Fonterra's response:** - - - if Fonterra proceeds while facing the legal risk + if Fonterra relinks unit Fund but proceeds with other aspects of its capital restructure + If Fonterra relinks unit Fund and reverts to TAF + If Fonterra buys out unit Fund and reverts to issue/redemption system **0** If Fonterra designs a different capital restructure for its shareholders and Govt's re-consideration	+/ **0** Signals importance of retaining internal capital for future financial resilience, but does not require Fonterra to do so - - - Does not manage the potential flow-on impact on confidence in NZ capital markets +/ **0** Strengthens base milk price settings, but does not manage the potential flow-on impact on NZ consumer dairy prices	**0** Does not require Fonterra to retain sufficient internal capital - - - Does not manage the potential flow-on impact on confidence in NZ capital markets +++ Significantly improves confidence in Fonterra's milk price being consistent with contestable market outcomes, and fully manage the potential flow-on impact on NZ consumer dairy prices	+++ Sufficiently manages all potential flow-on impacts associated with Fonterra's future financial resilience, confidence in NZ capital markets, and cost of NZ consumer dairy products
Does the approach provide for a cost-effective and proportionate regulatory response to risks?	+ Cost-effective as no legislative change required, providing Fonterra with high degree of discretion - - Fonterra may spend time and resources defending a legal challenge	+ Cost-effective regulatory adjustments, providing Fonterra with somewhat reduced levels of discretion	- - - Highly administratively costly and burdensome on Fonterra, with highly reduced levels of discretion	+++ Technical amendment that mitigates all key risks and manages all potential flow-on impacts
Does the approach make law clear and outcomes more predictable?	- Regulatory provisions remain unclear and outcomes are not predictable	+ Improves clarity of regulatory provisions and predictability of outcomes	+ Improves clarity of regulatory provisions and predictability of outcomes	+ Improves clarity of regulatory provisions and predictability of outcomes
Is the approach simple to implement, with minimal risks of unintended consequences?	+ Simple to implement as no legislative change required	- Drafting complexity creates some risk of unintended consequences	- - - Highly complex, creating significant risk of regulatory error and unintended consequences	+++ Technical amendment with minimal risk of unintended consequences

Alternative approaches for a government response: Key considerations:	1: Do not amend DIRA to either support or prevent Fonterra's capital restructure	2: Amend DIRA to support Fonterra's capital restructure & adjust current DIRA settings to reduce risks (Cabinet paper proposals) by: i. specifically enabling Fonterra to retain a partially delinked unit Fund on a permanent basis (option A2); & ii. requiring Fonterra to provide liquidity support in the farmers-only market (option A3); & iii. strengthening existing base milk price-setting regime (options B1 and B2); & iv. requiring Fonterra to maintain and publish a dividend and retentions policy.	3: Amend DIRA to support Fonterra's capital restructure & introduce alternative regulation to mitigate risks by: i. specifically enabling Fonterra to retain a partially delinked unit Fund on a permanent basis (option A2); & ii. giving ComCom power to set the maximum quantum Fonterra could pay for milk in a season (option B4).	4: Amend DIRA to clarify and reflect original policy rationale for current capital structure provisions (MPI's recommended approach)
Who are the main beneficiaries?	**If Fonterra proceeds with its capital restructure:** +++ Fonterra, in the short to medium term, as it would retain milk supply and be able to efficiently utilise its existing processing capacity +++ Subset of dairy farmers not planning to retire or exit Fonterra, in the short to medium term +++ Subset of dairy farmers planning to join Fonterra, in the short to medium term +++Dairy farmers supplying other processors, in the short term +++Rural communities, in the short to medium term	+++ Fonterra, in the short to medium term, as it would retain milk supply and be able to efficiently utilise its existing processing capacity +++ Subset of dairy farmers not planning to retire or exit Fonterra, in the short to medium term +++ Subset of dairy farmers planning to join Fonterra, in the short to medium term +++Dairy farmers supplying other processors, in the short term +++Rural communities, in the short to medium term	+++ Fonterra, in the long term, as incentives to innovate and attract farmers on merit of performance would not reduce +++ all dairy farmers in the long term, as value of Fonterra would not risk being eroded +++rural communities, over time +++ other dairy processors, as their entry and expansion would not be hindered + potentially better environmental quality and climate change outcomes + potentially NZ consumers	+++ Fonterra, in the long term, as incentives to innovate and attract farmers on merit of performance would not reduce +++ all dairy farmers in the long term, as value of Fonterra would not risk being eroded +++rural communities, over time +++ other dairy processors, as their entry and expansion would not be hindered + potentially better environmental quality and climate change outcomes + unit holders, as unit Fund would be relinked or wound up + potentially NZ consumers
Where do the costs/risks fall?	**If Fonterra proceeds with its capital restructure:** - - - other dairy processors, in the short term, as entry and expansion likely to be hindered - - - Fonterra, in the long-term, as incentives to innovate and invest in value-creation would be reduced - - - all dairy farmers, in the long-term - - - rural communities and wider NZ economy, over time - - unit holders, as unit Fund would be retained in a delinked form - potentially reduced pressure to improve environmental quality and climate change outcomes - potentially NZ consumers	- - - other dairy processors, in the short term, as entry and expansion likely to be hindered - - - Fonterra, in the long-term, as incentives to innovate and invest in value-creation would be reduced - - - all dairy farmers, in the long-term - - rural communities and wider NZ economy, over time - - unit holders, as unit Fund would be retained in a delinked form - potentially reduced pressure to improve environmental quality and climate change outcomes - potentially NZ consumer	- - Fonterra, as it may lose some mi k supply to other potentially more efficient and innovative dairy processors, and incur a significantly higher financial cost of alternative regulation - - dairy farmers, in the short-term, as Fonterra's milk price may reduce on-farm profitability - -rural communities in the short to medium term, as on-farm profitability may reduce community spending - - unit holders, as unit Fund would be retained in a delinked form s 9(2)(h) [redacted]	- Fonterra, in the short-term, as it may lose milk supply to other potentially more efficient and innovative dairy processors - dairy farmers, in the short-term, as Fonterra's milk price may reduce on-farm profitability - rural communities in the short to medium term, as on-farm profitability may reduce community spending
Can (and if so how, will) the costs/risks be mitigated?	+ monitoring by MPI ahead of next DIRA review	+ monitoring by MPI ahead of next DIRA review	++ key risk mitigated via alternative regulation	+++ risks mitigated by design
Overall ranking of MPI's recommendations	**++ 2nd best approach**	**+ 4th best approach**	**+ 3rd best approach**	**+++ 1st best approach**

Section 6: Implementation and operation

6.1 How will the new arrangements work in practice?

The Cabinet paper proposals would require amendments to the DIRA to be implemented. We expect that a Dairy Industry Restructuring Amendment Bill could be introduced and progressed through the Parliamentary processes during 2022.

As mentioned in section 1.2 above, this RIS does not include detailed regulatory design for each of the options outlined in this RIS. This level of regulatory design detail would be developed in consultation with interested and affected parties once Cabinet has taken policy decisions.

Transitional arrangements may be required to provide all affected parties with sufficient time to adjust their operations. Traditionally, changes to the DIRA tend to come into effect at the start of the dairy season following the season in which the legislative amendment is passed. That is, if the legislative amendment is passed in 2022, the new provisions would normally be brought into force from 1 June 2023. There may, however, be reasons to bring some changes into force sooner (e.g., from 15 December 2022) timing it to the start of Fonterra's application period for milk to be supplied from 1 June 2023. These decisions will be made by Cabinet when considering any draft Dairy Industry Restructuring Amendment Bill for introduction. We expect this would take place around August 2022.

MPI would continue to administer the DIRA, and the Commerce Commission would remain responsible for the ongoing monitoring and review of Fonterra's base milk price calculation. The Commerce Commission would also continue to operate in its current role of enforcement agency for any disputes that may arise in relation to the key DIRA provisions, including those introduced as the result of options set out in this RIS.

6.2 What are the implementation risks?

A key implementation risk with some of the Cabinet paper proposals is the legal drafting challenge to ensure that the scope of any legal provisions is tight enough to minimise the risk of misinterpretation of Parliament's intent. This risk could be mitigated by MPI working closely with the Parliamentary Counsel Office to achieve as precise and clear definitions as possible. We could test draft definitions with other government agencies and in particular the Commerce Commission as the enforcement agency. Other stakeholders and affected parties, including Fonterra, could provide further testing during the Select Committee process.

There is also a risk that it could take longer for the Amendment Bill to be progressed through House. If the proposed changes do not come into effect on 1 June 2023, there may not be sufficient time for them to be in operation before the earliest possible date (1 June 2025) for the commencement of the next DIRA review. The timing of that review is mandated by statute. If this was the case, the commencement of the next DIRA review may need to be shifted towards the latest possible date (1 June 2027). This could increase the risk of Fonterra being regulated for longer than necessary.

Section 7: Monitoring, evaluation and review

7.1 How will the impact of the new arrangements be monitored?

MPI routinely collects information (including under existing information disclosure requirements of the DIRA) about the changing dynamics in the dairy industry and its markets. This enables us to monitor developments in the dairy industry and ensures that any significant changes are not overlooked. Industry stakeholders, including Fonterra and other dairy processors, are also well incentivised to bring any significant shifts in the industry dynamics to the Government's attention. Through ongoing monitoring and stakeholder relations, we are well placed to identify the need for, and recommend, changes to the DIRA regulatory regime in a timely manner.

In addition, the Commerce Commission will continue to operate in its current role as the enforcement agency for disputes arising in relation to subpart 5 of the DIRA, including the implementation of a number of the options considered in this RIS. The number of, and the costs associated with, such complaints or disputes is reviewed on an annual basis through the Fonterra levy-setting process. This annual review process provides an opportunity to consider the effectiveness of new arrangements.

7.2 When and how will the new arrangements be reviewed?

The DIRA contains a statutory requirement for periodic reviews, which trigger comprehensive policy evaluation of the need for the relevant parts of the DIRA regulatory regime and ensures that this happens in a timely manner.

The next review is required to commence between June 2025 and June 2027. Depending on the Government's terms of reference, this could cover a comprehensive set of relevant issues, including the effectiveness, efficiency and fitness-for-purpose of the overall DIRA regulatory regime in this area, and all its individual components.

Appendix One: Additional background information

Fonterra was formed to be New Zealand's national champion…

Fonterra was formed in 2001, when the Government granted an exemption to the mergers and acquisition provisions of the Commerce Act 1986 that allowed the merger of the then two largest dairy co-operatives (together collecting and processing 96 percent of all milk produced in New Zealand) and the New Zealand Dairy Board (a statutorily-mandated single desk export marketing board).

The formation of Fonterra enabled the dairy industry to capture cost efficiencies in the collection and processing of farmers' milk in New Zealand and to compete effectively and at scale internationally for the long-term benefit of New Zealand.

Critically, it enabled the Government to deregulate the single desk export marketing model, which at the time was becoming increasingly inconsistent with New Zealand's international trade policy. It also allowed the then Government to pursue its objectives of advancing the evolution of the industry's structure and strategy in a way that focused on markets and consumers (instead of the traditional production and supply focus). It provided for stronger innovation, product differentiation, the emergence of new business models, continuous pressures for efficiency and productivity gains, and more accurate returns from various on and off-farm investments.[31]

However, the merger also created significant public policy risks. The merger created an entity with substantial market power in a number of important New Zealand dairy markets, most notably the market for farmers' milk. The key risk was that Fonterra, having both incentives and ability to do so, could create barriers to farmers switching supply to actual or potential competing processors, or leaving the industry. This could result in a lack of competitive pressure on Fonterra, which could then become less efficient or fail to innovate over time.[32]

To counteract these risks and strengthen Fonterra's commercial incentives to operate efficiently and invest in innovation, a Fonterra-specific regulatory regime was put in place. This was to supplement (not replace) the general competition provisions of the Commerce Act 1986 and was designed to create incentives for Fonterra to perform, regardless of whether there was actual competition in place or not. In establishing this regime, the Government sought to establish an industry environment where farmers could sanction any non-performance on Fonterra's part by 'voting with their feet and wallets' and new dairy companies could realistically establish and compete with Fonterra for farmers' milk on a fair and reasonable basis.[33] This regulatory regime, known as 'open entry and exit', was the core element of the DIRA regulatory regime. It is outlined in section 2.2 of this RIS.

Some competition for farmers' milk has emerged and is now well established …

In addition to Tatua and Westland Milk, who chose not to participate in the Fonterra merger, several new dairy processors (including Open Country Dairy, Synlait Milk, Miraka, Oceania Dairy, Yashili, Matarua Valley, Fresha Valley, and Green Valley Dairies) have since entered the industry and successfully secured milk supply from farmers. Fonterra is currently facing competition from 10 dairy processors operating 15 processing plants across the country, together collecting and

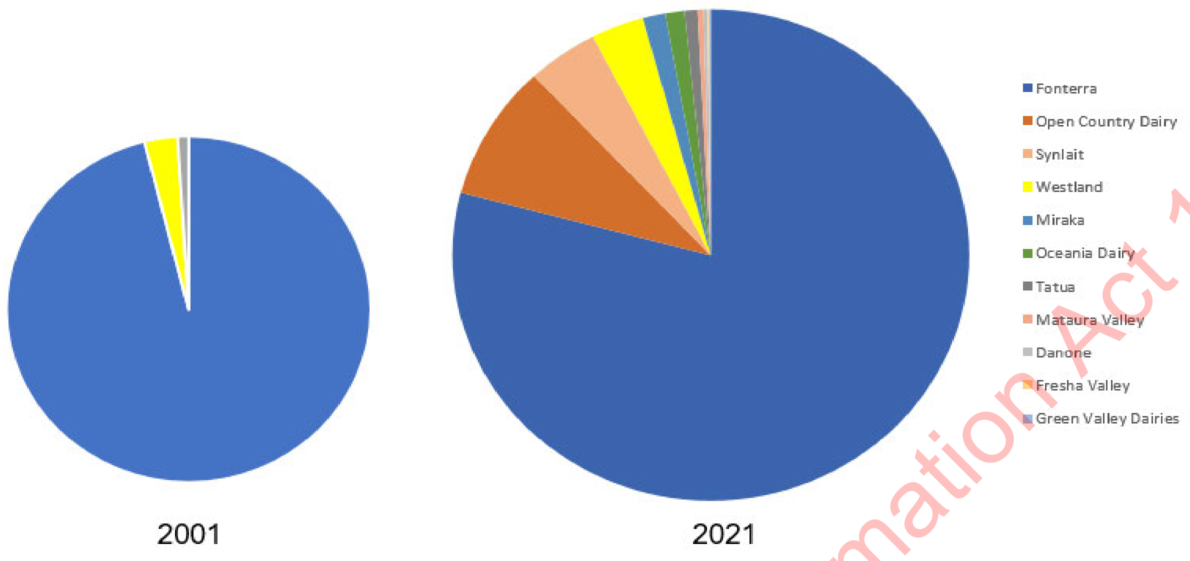
[31] 31212-MPI-archives-2001-Cabinet-paper-on-dairy-industry-merger

[32] The proponents of the merger argued that Fonterra would face strong incentives to operate efficiently because of both the competition in international markets and its farmer-ownership governance structure. However, these arguments were not accepted on the basis that: a) New Zealand farmers produced relatively low-cost mi k by global standards, giving Fonterra some natural competitive advantage and allowing its management considerable latitude for potential inefficiency; and b) farmer-shareholders may lack resources to obtain, analyse, and interpret sufficient information to assess management's performance in a timely manner.

[33] 31212-MPI-archives-2001-Cabinet-paper-on-dairy-industry-merger

processing approximately 21 percent of all milk produced in New Zealand. Two other dairy processors (Happy Valley Nutrition and Olam Food Ingredients) have plans to enter the industry.

Dairy processors' volume-based market share: 2001 v 2021



These dairy processors (with various business models and strategies, positioning themselves at different points on the value chain) have contributed to diversity in the industry. Open Country Dairy, for example, focuses on the cost-efficient production and distribution of basic dry commodities like whole-milk powder, milk proteins and block cheese. At the other end of the value chain, Tatua supplies consumer-branded or niche-market products. Synlait has tended to operate in the middle of the value chain. Originally focused on exports, it has more recently diversified into the New Zealand domestic consumer market, supplying consumer products such as cheese and butter, as well as some fresh milk.

The corporate forms of the competing dairy companies vary widely. Open Country Dairy is a publicly-owned but unlisted company, Synlait is NZX and ASX publicly listed company, Miraka is privately owned, and Oceania Dairy, Westland, Yashili, and Mataura Valley are privately-owned subsidiaries of major international food companies.

In many cases, new dairy processors have been backed by foreign investors (some in partnership with New Zealand, including Māori interests). This has provided linkages to established international distribution and marketing chains, which has facilitated access to emerging international dairy markets. The second largest dairy processor (Open Country Dairy) is fully New Zealand-owned.

Despite their range of business strategies, product lines, and corporate forms, no other dairy processing companies have achieved a similar extent of national sale and geographic coverage to Fonterra. The second largest dairy processor (Open Country Dairy) accounts for just under 9 percent of New Zealand's total milk production.

....while Fonterra's performance has been mixed

Fonterra's performance since its formation has fallen short of original expectations. At the time of its formation, the proponents of the merger projected that Fonterra's revenue could grow at 15 percent per annum, to $30 billion by 2010.[34] The co-operative planned to diversify into higher-value consumer products, by using its size advantage as a financial platform to pursue aggressive offshore investment strategies.

34 Public Draft Determination (comcom.govt.nz)

In reality, Fonterra's revenue has grown by less than 2.5 percent per annum and its global investment strategy has not worked out. As a result, it suffered a significant decline in earnings, rising debt levels, and a loss in farmer-shareholders' wealth of around $4 billion between 2014 and 2018.[35]

Since then, under new leadership, Fonterra has exited many of its global investments and sold off assets to stabilise the co-operative's debt position. Fonterra's current strategic direction is a back-to-basics focus based on maximising returns from its New Zealand-sourced milk and marketing the quality of that milk. The key themes of Fonterra's current business strategy include:

- Stepping back from consumer brands, focusing instead on its core ingredients and food service business, with further investment in specialty ingredients targeted at specialised nutritional products. The objective is to create a leaner, market-oriented operating model, focused around products which create greater value to the company, and away from the previous volume-driven growth strategy.
- Prioritising New Zealand milk supply over global milk pools and increasing the value from products derived from New Zealand sourced milk. The focus is on extracting premiums through a provenance story around its co-operative heritage, grass-fed New Zealand milk, as well as ethical and sustainable farming practices.
- Focusing on greater financial discipline and a leaner more operationally efficient business. The strategy reset has targeted reducing operating expenditures including reviewing and improving its underperforming businesses.
- Strengthening of the co-operative's balance sheet through increased retention of profits from improved earnings and the sale of assets that no longer fit with the group's revised strategy.
- Increasing total annual R&D investment from around $90 million to $160 million per annum in 2030, aimed at developing new products to support its value growth plans.

Under this business strategy, Fonterra's future innovation and value-add activities are more likely to be aimed at wholesale customers and further process improvement, rather than at complex, capital-intensive and riskier investments into differentiated premium consumer-end dairy products.

Furthermore, while Fonterra's intended R&D expenditure is close to doubling Fonterra's historic R&D investment levels, it is still low relative to Fonterra's international competitors' R&D expenditure. For example, the Irish Kerry Group's R&D expenditure has historically been around three times (NZ$448 million in 2017) of what Fonterra's aspiration for its R&D expenditure to be by 2030 (NZ$160 million).[36]

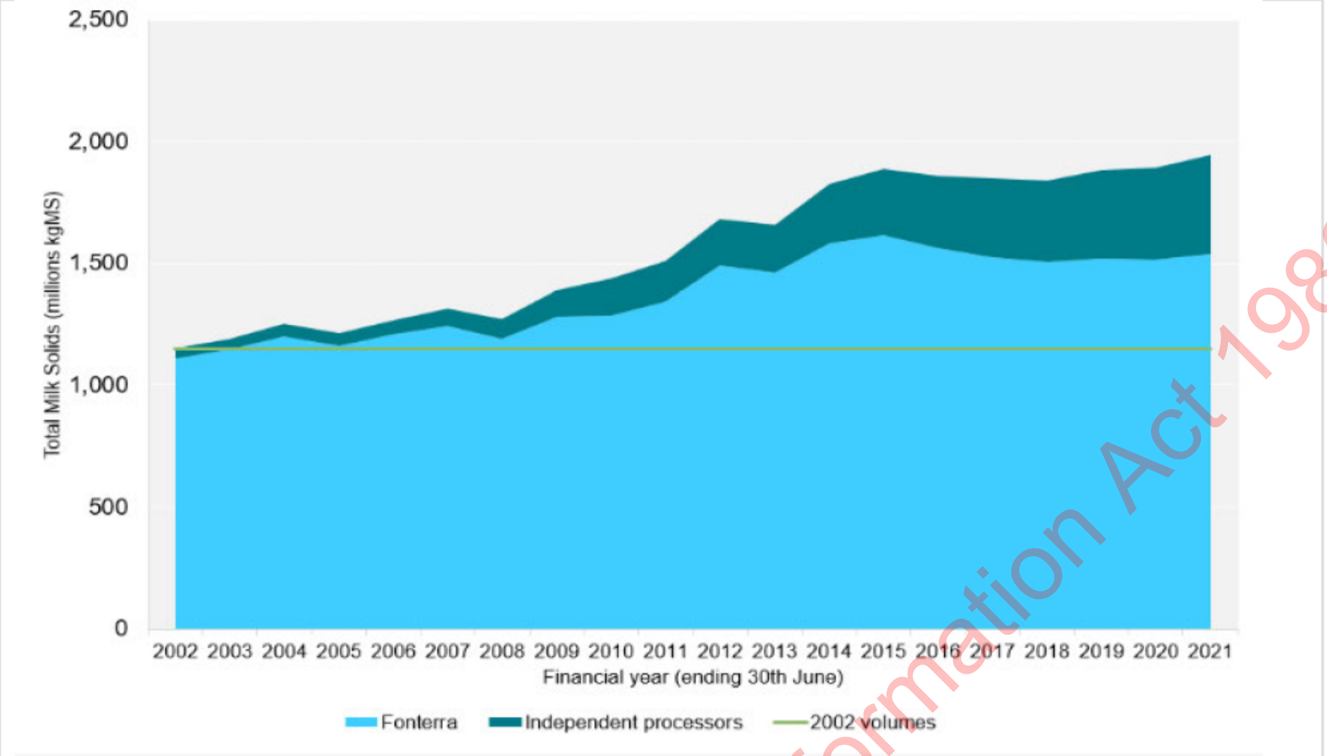
Fonterra's absolute milk supply has grown significantly, but its relative market share has reduced

Although Fonterra's absolute volumes of milk collection and the scale of its domestic processing capacity have increased significantly since 2001, its relative share of total milk production in New Zealand has fallen from 96 percent in 2001 to 79 percent in 2021.

However, as the graph below shows, competing dairy processors have to date been able to secure most of their milk supply from new dairy conversions, rather than attracting Fonterra farmers looking to swich their supply.

[35] Frontier firms: Industry case studies (productivity.govt.nz)

[36] MPI – Frontier Economics report one



…nevertheless, Fonterra still underpins and drives the dairy industry's performance

Despite the emergence of competing dairy processors, Fonterra remains the only dairy processor with truly national coverage. It currently collects 79 percent of all milk supply nationally, with s 9(2)(b)(i) [redacted]

None of the other processors competing with Fonterra have anything like Fonterra's scale and geographic coverage. The second largest (Open Country Dairy) has the broadest geographic coverage (four manufacturing sites in the Waikato, Bay of Plenty, Otago and Southland), collecting and processing s 9(2)(b)(ii) [redacted]

Fonterra's share of milk collections remains in excess of s 9(2)(b)(ii) [redacted] in most regions in New Zealand. The table below shows Fonterra's market share in key regions. s 9 [redacted] The regions with the greatest number of processors are Canterbury, Waikato, and Bay of Plenty.

Region	Fonterra's market share	Other Processors' collective market share
Northland	s9(2)(b)(ii) [redacted]	[redacted]
Bay of Plenty	[redacted]	[redacted]
Waikato	[redacted]	[redacted]
Taranaki	[redacted]	[redacted]
Lower North Island	[redacted]	[redacted]
Canterbury & North Otago	[redacted]	[redacted]
Otago-Southland	s 9(2)(b)(ii) [redacted]	[redacted]

s 9(2) [redacted]

Our analysis of regulatory precedent and economic literature in 2018/19, undertaken as part of the previous DIRA review, suggested that at a market share of over 70 percent, a firm could exercise market power, especially if competition was relatively weak and barriers to entry were material. Economic analysis also suggests that effective competition would require at least two processors competing with Fonterra in each regional market, whereas one rival could be sufficient if entry barriers were not material.[38] On this basis, we consider it is still highly unlikely that existing processors would be able to exert effective competitive pressure on Fonterra.

Critically, because Fonterra collects 79 per cent of all milk produced in New Zealand, there is no market price for farmers' milk that is independent of the price paid by Fonterra. Fonterra is therefore the 'price-setter/maker' and other processors the 'price-takers' in the farmers' milk market in New Zealand.

As a result, Fonterra calculates a base milk price, using an administrative methodology. This calculation provides the key input and the reference point for the Fonterra Board's business decisions on the allocation of the co-operative's total returns between payments for milk to farmer-suppliers (the farm gate milk price), retentions for reinvestment, and dividend payments on the capital invested by farmer-shareholders (and unit holders) in any given season.

The administrative methodology, which underpins the base milk price calculation, models the revenues and costs of a notionally efficient processor of Fonterra's size and scale, processing all its milk into a bundle of profitable commodity products, and selling them in global dairy markets in a particular season.[39]

This methodology is consistent with the long-run price outcomes that would be expected to arise in a workably competitive market over time. It is also consistent with Fonterra's co-operative form and Constitution, which require it to pay farmers the maximum sustainable milk price possible. Furthermore, it is entirely consistent with the underlying rationale for farmers to form and supply dairy co-operatives. Collective farmer ownership of dairy processing assets allows farmers to correct for what may otherwise be a market failure. Due to the highly perishable nature of milk, farmers would have limited bargaining power to negotiate a fair milk price with investor-owned dairy processors, who would be seeking to pay the minimum milk price possible to maximise profits and returns on investors' capital contributions. By becoming owners of the dairy processing assets, farmers seek to ensure a fair price for their produce, while also capturing any remaining profits and investor returns.

Fonterra's milk price settings work well for all farmers, including those supplying other processors. They provide incentives for Fonterra (and by extension other dairy processors who have to match or better Fonterra's milk price to attract and retain supply) to improve their processing efficiencies. Under these settings, it is the owner-shareholders, rather than farmer-suppliers, who face the consequences and bear the costs of any processing inefficiency via reduced profit and returns on capital contributions.

At the same time, Fonterra's milk price settings impose a relatively high efficiency standard for Fonterra and other dairy processors at the outset, rather than allowing for all potentially efficient dairy processors to enter, compete, and arrive at such a relatively high efficiency standard over time. By bypassing the process of competition, Fonterra's milk price settings reduce the industry's opportunities to test some potentially efficient business models, product lines, commercial

[38] 34782-mo-redactions-for-public-release-regulatory-impact-assessements-watermarked-redacted (mpi.govt.nz)

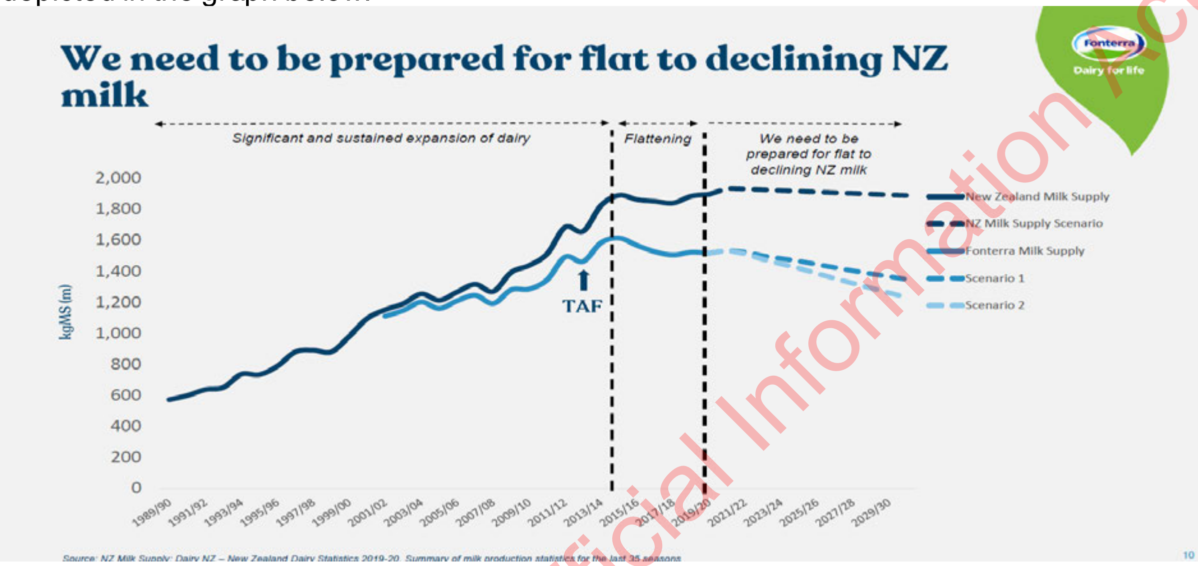
[39] While Fonterra can pay farmers a farm gate mi k price that is different from the calculated base mi k price (calculation of which is monitored by the Commerce Commission), for transparency purposes it is required by law to publicly explain its reasons for deviating from the calculated base mi k price.

strategies, and organizational forms - thereby dampening the incentives for investment and innovation.

Fonterra's current business strategy is based on retaining and attracting milk supply

Fonterra's current business strategy relies heavily on processing current large volumes of milk (necessarily into commodities) and maximising the use of Fonterra's existing processing assets. Flattening or potentially declining milk supply volumes represent a significant threat to a successful execution of this business strategy.

Fonterra has presented two potential scenarios (not the company's forecasts of what it considers likely to happen) for the magnitude and speed of its potentially declining milk supply volumes, depicted in the graph below.



We understand these scenarios are based on a simple extrapolation of what could happen if (everything else being equal) Fonterra's milk supply were to reduce by s 9(2)(b)(ii) [redacted]. We further understand that no provisions for variables such as changes in the global demand and therefore prices for New Zealand dairy goods, domestic weather conditions, or Fonterra's performance have been factored in.

Fonterra considers that if its milk supply were to decline in accordance with either of its scenarios, its asset stranding costs may lead to a structural decline of its milk price of between 6 - 13 cents per kgMS, a further structural decline of s 9(2)(b)(ii) [redacted] in Fonterra's profit, and may necessitate the potential closure of 12 – 18 plants by 2030, with some (unquantified) potential flow-on impacts on employment, rural communities, and the wider New Zealand economy. Because Fonterra's milk price acts as the benchmark for other competing dairy processors, a reduction in the industry's milk price of such magnitude would likely impact on-farm profitability across the entire dairy farming sector in New Zealand.

Appendix Two: Evolution of the DIRA regulatory regime

The Dairy Industry Restructuring Act 2001

In 2001, Parliament enacted the DIRA to enable the New Zealand dairy industry to implement significant structural change aimed at transforming the dairy industry's performance for the benefit of all New Zealanders. By enabling the merger of the two largest dairy co-operatives and the New Zealand Dairy Board (by overriding the merger constraints of the Commerce Act 1986), Parliament provided a pathway to deregulation of the then highly regulated dairy industry, and enabled the new merged dairy co-operative (Fonterra) to enjoy significant economies of scale and scope to compete strongly in international dairy markets for the benefit of the dairy industry and the wider New Zealand economy.

However, the merger also created significant risks associated with the loss of competition in New Zealand dairy markets, most notably in the market for farmers' milk and the wholesale supply of domestic consumer dairy products. To mitigate the risks (arising from Fonterra's significant market power in these domestic dairy markets), the DIRA introduced a set of regulatory safeguards designed to promote the efficient operation of New Zealand's dairy industry by:

- ensuring contestability in the market for farmers' milk; and
- promoting competition in the wholesale supply of domestic consumer dairy products.

The nature of the specific risks and the DIRA regulatory safeguards designed to mitigate them are outlined below. The DIRA safeguards operate in conjunction with the general provisions of the Commerce Act 1986, and the need for them is contingent on Fonterra retaining its significant market power in the relevant domestic dairy markets.

Ensuring contestability in the market for farmers' milk

Left unregulated, Fonterra could create strategic barriers to farmers switching milk supply to actual or potential competing processors, or otherwise leaving the industry. If Fonterra were to exercise its market power to create strategic barriers to farmer switching, it could retain and attract milk supply even if farmers were dissatisfied with its performance. This would, in turn, enable Fonterra to maintain its size and market share even if it became less efficient over time and lacked innovation, and generally did not perform to its full potential.

Given Fonterra's co-operative form, it could create the following specific non-price and price barriers to farmer-switching, thus reducing contestability of farmers' milk supply:

- **Non-price barriers**: Fonterra could lock existing milk supply into long term contracts, and/or decline to accept new or returning supply as a means of creating a chilling effect on existing farmers' willingness to switch to other processors or pursue alternative land uses. This would make it difficult for actual and potential competing dairy processors to attract milk supply away from Fonterra in a timely manner, even if competing processors were more efficient than Fonterra. This would also make it more difficult for farmers to pursue alternative land uses, even if those provided better long term returns to land owners.

- **Share/capital price barrier**: Fonterra could impede mobility of farmers' capital investment in Fonterra, by driving the price of Fonterra's shares substantially below their full fair value share of Fonterra's underlying business. This would discourage farmers from exiting Fonterra, as they would be unable to capitalise the full value of their past investment in Fonterra upon exit. At the same time, it would encourage new or expanding farmers to supply Fonterra over its rivals, as they would be able to buy into Fonterra without contributing the full value of their share in Fonterra's underlying business, and receive an artificially inflated dividend yield. While this would also reduce Fonterra's ability to raise new equity capital for future investments, and increase the cost of raising new capital for Fonterra, a relatively short period of a moderately lower than full fair value share price could be sufficient for Fonterra to reduce the competitive pressures it might otherwise be facing for milk supply. Critically, if Fonterra's near-term business strategy did not rely on raising new equity capital for future investment, constraints in raising equity capital would have no practical impact on Fonterra's operations, at least in the short to medium term.

- **Milk price barrier:** Fonterra could pay a higher than efficient price for farmers' milk, by cross-subsidising returns on milk (milk price) from returns on farmers' capital investment in the co-operative (dividends). This would reduce profitability of actual and potential future competing processors who need to match or better Fonterra's milk price to attract supply. It would also inflate the profitability of dairy farming and land prices, disincentivising more optimal land-use change over time. While this would also affect Fonterra's own profitability, a relatively short period of a moderately higher than efficient milk price could be sufficient for Fonterra to reduce competition that it might otherwise face for its milk supply. Critically, because of Fonterra's co-operative form, its farmer-shareholders would in the meantime be compensated for any reduced profitability through a higher milk price. Because farmer-shareholders are indifferent as to how their total pay-out is received (whether through the milk price or dividends), this form of strategic pricing could be sustainable for Fonterra, while distorting the wider sector price signals and investment outcomes.

The DIRA regulatory regime contains a set of regulatory safeguards designed to prevent Fonterra from relying on the above strategic non-price and price barriers to farmers switching. These regulatory safeguards are outlined below. Other potential non-price and price barriers that Fonterra may create to discourage farmer switching are not regulated by the DIRA. Instead, they fall within the remit of the general competition provisions under the Commerce Act 1986.

The DIRA aims to prevent Fonterra from locking in farmers' milk supply

The DIRA prohibits Fonterra from locking all existing milk supply into long-term contracts by requiring that one third of Fonterra's milk supply in a 160km range must either be contracted to other processors or be on a contract with Fonterra that expires at the end of the season. Otherwise, Fonterra is free to negotiate multi-season long term contracts with farmers.

Between 2001 and 2020, the DIRA also required Fonterra to accept all milk offered by new or returning farmer-suppliers willing to make capital contributions in proportion to their milk supply and able to meet Fonterra's terms of supply conditions. This gave farmers confidence that, should they switch to supply other processors, they could not be "locked out" of supplying Fonterra in the future as a punishment for leaving the co-operative in the first place. The concern was that Fonterra could threaten to refuse milk from returning farmers, or to apply discriminatory price or non-price terms to such farmers, a strategy to deter farmers from switching to other processors. This obligation on Fonterra will end from 1 June 2023. In 2020, Parliament determined that this obligation placed an undue regulatory burden on Fonterra. Parliament considered that the cost on Fonterra arising from having to carry surplus capacity to process new and returning milk, outweighed the benefit of preventing Fonterra from creating a chilling effect on farmers' willingness to switch supply.

The DIRA also:

- prevents Fonterra from discriminating between new and existing farmer-shareholders in certain circumstances,
- requires that Fonterra pays exiting farmers a fair value for their milk vats, and
- allows farmers to divert up to 20 percent of their weekly milk supply to other processors.

The DIRA aims to prevent Fonterra from impeding mobility of farmers' capital investment in Fonterra

The DIRA does not regulate Fonterra's minimum shareholding requirements, the period within which farmers must purchase shares, or the farmer ownership and control thresholds. However, the share price at which farmers buy and sell the co-operative shares is a core element of the DIRA regime.

Reflecting Fonterra's 2001 capital structure the DIRA originally required Fonterra to issue/redeem its shares directly to/from farmers charging/paying the same share price for entering/exiting. Fonterra's share price range was calculated by a valuer using an administrative share valuation methodology, which reflected Fonterra's projected future earnings after deducting the payment for farmers' milk supply.[40] The Fonterra Board used the calculated range to set the co-operative share price (usually as a mid-point of the range) for the season. Fonterra then used its balance sheet to issue/redeem shares at that administratively set share price to/from farmers seeking to enter/exit Fonterra as supplier-shareholders in each season.

In 2012 Parliament amended the DIRA to enable Fonterra to move to its current TAF capital structure. The TAF structure enabled Fonterra to protect its balance sheet from a potential 'run on the money' (redemption risk). If, in any given season, the number of redeemed shares were to exceed the number of newly issued shares, Fonterra's balance sheet would incur a net redemption cost. Management of this redemption risk required Fonterra to hold some capital in reserves. This incurred an opportunity cost as that capital could not be used for investment in Fonterra's business strategy or paid out to farmer-shareholders as dividends. TAF was therefore designed to shift Fonterra's redemption risk off its (farmer-collective) balance sheet and on to (individual) farmers' balance sheets.

Under TAF, farmers exiting Fonterra sell their Fonterra shares directly to farmers entering Fonterra. Farmers thus individually bear the risk of an excess supply of shares driving the share price down at the time of their exit. Left to its own devices, such a farmers-only market for Fonterra shares would suffer from one-sided trading, insufficient depth and liquidity, and price volatility. To overcome these limitations, TAF relies on a unit Fund that provides for non-farmer investors (who have different economic drivers and greater propensity to trade more actively and frequently than farmers) to trade units in economic (non-voting) rights to Fonterra's shares. The liquidity in the unit Fund transfers to the farmers-only share market through the ability of the market-maker, Fonterra, and farmer-shareholders to participate in both share and unit markets at the same time, by converting shares into units and vice versa. This fungibility of the share and unit markets enables TAF to deliver sufficient depth and liquidity, resulting in a relatively well-functioning capital markets scheme capable of discovering a relatively efficient price for Fonterra's shares.

To ensure that TAF operated in a way that provided an effective substitute to the issue/redemption at 'fair value' share price obligation, the DIRA places structural and behavioural obligations on Fonterra, including the requirements for:

- Fonterra's shares to be traded on a licensed market by shareholding farmers (other than in the case of a temporary halt) with one or more market-makers supporting liquidity in share trading,
- the units to be traded on a licensed market by the public, able to be exchanged by farmer-shareholders, the market maker, and Fonterra for co-operative shares and vice versa, and
- Fonterra to not engage in conduct that restricts, prevents or deters trading in co-operative shares or units or the exchange of co-operative shares for units and vice versa, among other things, for

[40] This methodology is commonly referred to as 'fair value' and is generally accepted as being reflective of an efficient share price, albeit second-best to one discovered in a well-functioning share market. Given the importance of Fonterra's share price for contestability of farmers' milk market, the DIRA enshrined Fonterra's 'fair value' share pricing methodology, requiring it be in Fonterra's constitution.

the purpose of restricting, preventing or deterring new entrants from becoming shareholder farmers, or current shareholder farmers from increasing, reducing or ceasing supply.

The TAF-enabling DIRA provisions rely on the intrinsic link between the share and unit markets in the TAF system to ensure efficient price-discovery and mobility of farmers' capital investment in Fonterra, as a means of maintaining contestability in the farmers' milk market. If these elements are removed, the DIRA provides for the TAF-enabling provisions to be administratively revoked by Order in Council, reinstating the original statutory issue and redemption obligation without further legislative change. The Minister of Agriculture is required to recommend such revocation in situations like if either Fonterra shares are no longer traded on a licensed market, or the unit Fund has been wound up.

Fonterra's decision to move to TAF also provided a number of ancillary benefits, including:

- improving transparency of Fonterra's milk price-setting processes and business performance, as the level of real time, market-driven information disclosure required under the financial markets conduct regulations increased public information and informed scrutiny of Fonterra's performance;
- increasing financial markets commentary, analysis, and scrutiny of Fonterra's financial performance due to the unit fund being publicly listed and therefore subject to various financial market rules, disclosure obligations, and regulations;
- providing additional sources of funding for farmers, as they could source capital from the unit Fund to finance the purchase of shares in Fonterra rather than borrowing from banks;
- deepening of New Zealand's capital markets by providing non-farmer investors with an opportunity to invest in the financial performance of the New Zealand's largest company; and
- providing Fonterra with an additional avenue to raise equity capital from non-farmer investors, which in the event of a strategy failure or a significant global financial markets shock could support the co-operative's financial viability, thereby reducing a risk to the Crown being called on to support the solvency of the New Zealand's largest company.

The DIRA promotes the efficient and contestable setting of Fonterra's milk price

When originally enacted, the DIRA deliberately treated Fonterra's farm gate milk price as a 'black box'. Avoiding direct milk price regulation was a deliberate policy choice. Direct price control imposes significant regulatory costs and risks of distorting business and investment decisions, regulatory error and unintended consequences associated with an independent regulatory body setting Fonterra's farm gate milk price.

Instead, the regime was designed to strengthen Fonterra's commercial incentives to calculate and pay an efficient (not "too high" and not "too low") farm gate milk price. It did so by requiring Fonterra to maintain an open entry and exit regime at efficient (full fair value) share price. The DIRA requirements to accept all milk supply offers and allow relatively costless exit from the co-operative (i.e. 'open entry and exit' requirements) were designed to ensure that Fonterra could not 'lock in' or 'lock out' farmers' milk supply, and therefore could influence its milk supply volumes only through the milk price signals it sent to farmers. If Fonterra's chosen milk price was 'too low', farmers would be able to switch their supply to another processor, leaving Fonterra with underutilised assets and associated inefficiencies. The higher operating costs would result in lower profits, and the associated lowering of its dividend and share price. In contrast, if Fonterra's chosen milk price was 'too high', it would receive an excess supply of uneconomic milk and would have to build additional processing capacity causing its dividend and the share value to decline.

In 2012 the DIRA was amended to add a new Subpart 5A that aimed to supplement (not supplant) the main discipline of the open entry and exit regime by promoting additional visibility and transparency of Fonterra's farm gate milk price-setting processes. Fonterra's methodology for calculating the base milk price (as set out in its Milk Price Manual) was deemed to be conceptually consistent with contestable market outcomes. However, the specific inputs, assumptions, and processes that informed the base milk price calculation were considered to have the potential to result in a less than efficient base milk price outcome, in any given season. Lack of visibility and any ongoing expert monitoring of the necessarily subjective judgements on inputs, assumptions, and processes used by Fonterra in the base milk price calculation undermined confidence in Fonterra's internal milk price-setting processes.

As a result, to promote transparency of, and confidence in, Fonterra's internal farm gate milk pricing decisions, and consistency of the base milk price calculation outcomes with those arising in contestable markets for farmers' milk, the new Subpart 5A of the DIRA:

- Embedded Fonterra's internal milk price-setting governance arrangements in law. These include a requirement for Fonterra to maintain an internal committee (known as the Milk Price Panel) and ensure that the majority of the appointed Panel members, including the Chair, are 'independent' (free of any personal supplier and/or investor relationship with Fonterra). One appointed Panel member is nominated by the Minister of Agriculture. The DIRA clearly delineates the roles and responsibilities between the Milk Price Panel (as an advisory body that oversees the base milk price calculation and recommends the base milk price to the Fonterra Board) and the Fonterra Board (as the ultimate decision-making body that determines, at its unfettered discretion, whether to pay a farm gate milk price that is the same or different to the calculated base milk price).
- Embedded Fonterra's methodology for calculating the base milk price in law and required Fonterra to apply it in accordance with some mandatory assumptions. Locking in the basis for the base milk price calculation provided a degree of regulatory certainty. Leaving the vast majority of the calculation's inputs, assumptions, and processes unspecified in law ensured that Fonterra had sufficient flexibility to make the necessarily subjective judgements in response to potentially fast changing market dynamics.
- Required the Commerce Commission to annually review and publicly comment on the consistency of the base milk price methodology and calculation with efficient and contestable market outcomes. The Commission's review findings are not binding on Fonterra's base milk price calculation. Instead, they provide a credible information platform for potential future regulation should Fonterra not address or be able to mount a reasonable explanation of significant and/or persistent issues raised by the Commission.
- Required Fonterra to publish certain base and farm gate milk price-related information including:
  - Fonterra's methodology for the base milk price calculation (the Milk Price Manual) and any changes to it;
  - Fonterra's terms of reference for its Milk Price Panel;
  - The Milk Price Panel's recommendation to the Fonterra Board as to what the calculated base milk price for the season should be; and
  - The Fonterra Board's reasons for choosing to pay the farm gate milk price that is the same or different to the calculated base milk price recommended by the Milk Price Panel.

Promoting competition in the wholesale supply of domestic consumer dairy products

Prior to Fonterra's formation, domestic consumer dairy products (such as town milk) were supplied mostly by two large export-focused dairy cooperatives in competition with each other. Competition in the wholesale supply of domestic consumer milk products somewhat reduces the risk of exposing New Zealand consumers to higher prices, less choice and lower quality of dairy products.

The creation of Fonterra eliminated that competition. At the time, the then Government recognised that without a viable national competitor at scale, Fonterra Brands New Zealand (the co-operative's

New Zealand consumer business subsidiary) would be a dominant wholesale supplier of dairy consumer products in New Zealand. It would be able to exercise market power and charge excessive wholesale prices, which (if not absorbed by the retail industry) could flow through to New Zealand consumers.

The DIRA supports competition in the wholesale supply of domestic consumer dairy products

To promote competition in the wholesale supply of domestic consumer dairy products in New Zealand, the Government required Fonterra to divest 50 percent of its domestic product manufacturing assets, thus providing for a national wholesale competitor at scale. To ensure that the newly-formed competitor (now Goodman Fielder) was able to start operating, the DIRA regime required Fonterra to supply it with up to 250 million litres of famers' milk per annum, at an agreed or regulated price, which mirrored Fonterra's farm gate milk price paid to farmers. In the long term, it was expected that the divested entity would develop its own sources of farmers' milk supply and become an independent competitor. This has not eventuated. Goodman Fielder continues to source the vast majority of its milk requirements from Fonterra. In 2020 the DIRA requirements were amended to increase Goodman Fielder's regulatory entitlement to purchase milk from Fonterra from 250 to 350 million per annum. However, Synlait Milk, which does have its own milk supply from farmers, has recently entered the domestic consumer product market by supplying some private label milk and cream products in the South Island, as well as cheese, butter, and ice-cream products through its recent purchases of Talbot Forest Cheese and Dairyworks. s 9(2)(b)(ii) [redacted]

The DIRA regime also requires Fonterra to supply other dairy product manufacturers (such as specialty cheese, chocolate and ice-cream producers), who do not have sufficient own milk supply from farmers[41], with up to 50 million litres of raw milk per annum, at an agreed or regulated price. This ensures that these typically small-scale operators are able to source milk according to their unique demand characteristics. This, in turn, promotes the development of an innovative and vibrant dairy food sector in New Zealand. There are currently around 20 small dairy food producers sourcing milk from Fonterra under the DIRA regulations.

The need for the DIRA regime is contingent on Fonterra's market power

When the DIRA was originally enacted, the assumption was that over time Fonterra's market position, and therefore its substantial market power, in the market for farmers' milk could be eroded. If and when Fonterra no longer had substantial market power, active competition for farmers' milk, rather than regulation, would become the means of ensuring that farmers' milk flowed to its highest value use. In the absence of the DIRA, the management of any risks of strategic conduct among competing dairy processors would rely solely on the provisions of the Commerce Act 1986.

To reduce the risk of Fonterra being regulated for longer than necessary, the original DIRA contained automatic expiry provisions based on set market share thresholds. These expiry provisions have been reviewed and amended over the years. Under amendments made in 2020, the Minister of Agriculture is required to initiate a review of whether the regulatory regime should be retained, repealed or amended not earlier than four years (and not later than six years) after the findings of a previous review have been implemented. The next review is legislatively required to commence between June 2025 and June 2027.

[41] The DIRA also enables newly entered dairy processors who are in the process of building own supply from farmers to purchase up to 50 million litres of milk from Fonterra, at an agreed or regulated price, for one season.