



Extension of the Pro-Competition Provisions of the Dairy Industry Restructuring Act 2001

Regulatory Impact Statement

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Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by the Ministry of Agriculture and Forestry. Its purpose is to support a Cabinet paper that recommends extending the Dairy Industry Restructuring Act 2001 (DIRA) pro-competition provisions beyond their current expiry thresholds.

The Regulatory Impact Statement summarises the findings of an independent competition analysis undertaken by NERA Economic Consultancy and the policy development process undertaken by the Ministry of Agriculture and Forestry. It is based on competition analysis of the New Zealand dairy industry and focuses on the extent of competitive pressure that is likely to be applied on Fonterra in the absence of the DIRA pro-competition provisions. The analysis was undertaken and conclusions drawn based on the following key assumptions:

- The open entry and exit requirements being substantially weakened in the absence of the DIRA pro-competition provisions. If Fonterra was to voluntarily continue with the current DIRA requirements, the need for the DIRA pro-competition provisions would be reduced, although not removed.
- The threshold for anti-competitive conduct imposed by section 36 of the Commerce Act remaining quite high, in terms of the time and cost of proceedings. If the threshold is reduced, an earlier transition to deregulation could be considered.
- Fonterra's future capital structure still requiring some form of regulatory regime. Fonterra's current capital restructuring process, if approved by its shareholders, would require the Government to consider amending the nature of the current DIRA pro-competition provisions. This may also impact on how long the regime is required to be in place.

The preferred policy option would see the DIRA regulatory provisions extended beyond the current expiry thresholds. Following the proposed new market share thresholds being reached, the Minister of Agriculture would be required to commission a report on the state of competition in the dairy industry (potentially from the Commerce Commission). The DIRA pro-competition provisions would lapse at the end of the dairy season following the season in which the Minister gazettes his/her response to the report, unless government introduced amending legislation for a further extension.

Unlike some other forms of economic regulations, the DIRA provisions are pro-competitive in nature and do not (materially) interfere directly with Fonterra's strategies, investment plans and pricing decisions. Instead, the DIRA pro-competition provisions are designed to minimise barriers to entry/expansion by independent processors, thus incentivising Fonterra to operate efficiently and in particular to price farmers' raw milk efficiently. The cost of extending the DIRA pro-competition provisions is therefore unlikely to be unreasonably burdensome on Fonterra and would be significantly less than the benefits of ensuring the long term growth and dynamic efficiency of the dairy industry.]

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3 June 2010

Status quo and problem definition

PURPOSE OF THE DIRA PRO-COMPETITION PROVISIONS

The enactment of the Dairy Industry Restructuring Act 2001 (DIRA) provided for an authorisation under the Commerce Act 1986 to allow the merger of New Zealand's two largest dairy co-operatives and the New Zealand Dairy Board to form a single co-operative company, Fonterra.

Upon its creation, Fonterra collected approximately 96 percent of New Zealand's milk production. Given this dominant market position it was necessary for the government to regulate the behaviour of Fonterra in relation to its suppliers and potential competitors to ensure the efficient operation of dairy markets in New Zealand.

The key competition concern with a co-operative company having such a dominant position in the market for farmers' raw milk was that such a company could have the incentives and the ability to operate to the detriment of the long term dynamic efficiency of the dairy industry. By declining applications for new supply, paying inefficiently high milk prices to existing suppliers and retaining the value of the exiting supplier's capital contributions for as long as possible after they ceased to supply milk, a co-operative in a dominant market position could "lock in" its suppliers. Such actions would create significant barriers to entry for those seeking to compete for farmers' raw milk, and allow Fonterra to operate inefficiently but nevertheless remain in business.

To address this concern the DIRA requires Fonterra to operate an open entry and exit regime. This means that Fonterra must accept all milk supply offers from dairy farmers in New Zealand and allow relatively costless exit from the co-operative upon the request of farmer-shareholders¹. These requirements ensure that Fonterra can not "lock in" its farmer-suppliers, and as a consequence, Fonterra faces strong commercial incentives to pay efficient prices for farmers' raw milk and capital invested in Fonterra.

Another policy concern was the ability and incentives for Fonterra to charge inefficiently high price for raw milk it supplies to independent processors in the wholesale raw milk market or to withdraw wholesale supply all together. Vertically integrated independent processors tend to rely on wholesale milk supply at the initial stages of their operations as farmers are often wary of committing to supply milk to newly establishing processors until a certain degree of credibility is established. Lack of availability of a wholesale raw milk supply for processing, at efficient prices, is a potential barrier to entry for new dairy processors.

Another group of raw milk purchasers in the wholesale milk market is food companies, i.e. chocolate and ice-cream manufacturers, that choose to outsource their raw milk supply to vertically integrated dairy processors rather than sourcing it directly from farmers. The ability to outsource milk supply at efficient prices is important for allowing the development of a range of business models in the New Zealand dairy industry.

To address this concern the DIRA, through the Dairy Industry Restructuring (Raw Milk) Regulations 2001 (Raw Milk Regulations), compels Fonterra to make available up to five

¹ The DIRA also requires that Fonterra a) pays farmers a fair value for their milk vats, b) allows farmers to divert up to 20 percent of their weekly milk supply to independent processors and c) ensures 1/3 of all milksolids in a 160km range must either be on contract with an independent processors or on a contract with Fonterra that expires at the end of the season.

percent of the raw milk it collects from farmers to independent processors at either an agreed price or at the default price specified in the Regulations.

The DIRA pro-competition provisions work as a package to reduce farmers' switching costs, thus lowering barriers to entry for independent processors and ensuring that milk flows to the highest value user (whether the user be a producer of dairy commodities, ingredients or fresh consumer products).

The DIRA pro-competition provisions work in parallel with, and are supplementary to, the general competition provisions of the Commerce Act 1986.

CURRENT EXPIRY THRESHOLDS

The DIRA pro-competition provisions were always intended to be temporary. The provisions are only necessary until sufficient competitive pressure on Fonterra can be applied by existing and potential future competitors in the market, supported only by the general provisions of the Commerce Act 1986. At that time, competitive pressure rather than regulatory provisions would drive the long term growth and dynamic efficiency of the dairy industry.

The current DIRA expiry thresholds, which were negotiated with Fonterra as part of the deal with government at the time of Fonterra's formation in 2001, are based on Fonterra's market share. The thresholds are set at levels where independent processors collect in a season:

- at least 65 Million (M) kilograms of milksolids from dairy farmers in the South Island with one independent processor collecting at least 25M kilograms of milksolids outside the boundaries of the Westland Regional Council, and
- at least 12.5 percent of milksolids produced in the North Island.

These thresholds are expected to be triggered by 31 May 2011 in the South Island, and possibly by 31 May 2012 in the North Island. Once the thresholds are reached, the Minister of Agriculture is required to make a recommendation to the Governor-General to revoke the DIRA pro-competition provisions.

The key policy concern at present is that at the time DIRA pro-competition provisions are currently set to expire, existing and potential competitors in the market for farmers' raw milk, backed only by the Commerce Act 1986, may not be in a position to apply sufficient competitive pressure on Fonterra to ensure that it operates efficiently. If this was the case, the efficient operation of dairy markets in New Zealand would be impaired.

Objectives

The government objective is to ensure the long term growth and dynamic efficiency of the New Zealand dairy industry. Given the significance of Fonterra to the New Zealand dairy industry and economy as a whole, it is critical to ensure that there is sufficient competitive pressure on Fonterra to operate efficiently in order to drive the long term growth and dynamic efficiency of the New Zealand dairy industry.

Before allowing the DIRA pro-competition provisions to expire it is crucial to examine the extent of competitive pressure that would be applied on Fonterra in the absence of the DIRA pro-competition provisions.

Regulatory impact analysis

The Ministry of Agriculture and Forestry, in consultation with the Ministry of Economic Development, commissioned independent competition analysis from NERA Economic Consultancy to address the following questions:

- At the time that the DIRA is currently legislated to expire, will Fonterra still have (significant) market power in each of the relevant dairy markets or will the relevant markets be workably competitive?
- If the dairy markets are unlikely to be workably competitive at the time the DIRA is currently legislated to expire, what are the likely detriments and how material will they be?
- If there are material detriments, would maintaining the current DIRA pro-competition regime *ceteris paribus*, in its entirety or partially, ensure the efficient operation of dairy markets?
- If so, at what point would the dairy markets be likely to become workably competitive, thereby making the DIRA pro-competition regulatory regime unnecessary.
- What should the new expiry thresholds be and how should they be defined? In particular, should the new thresholds be based on measures in addition to or in place of market share?
- Would Fonterra's current capital structure proposal be likely to have a significant impact on the timeframe for achieving workable competition in the relevant dairy markets if the DIRA thresholds were to be extended?

In addition to the NERA study, the Ministry of Agriculture and Forestry have also consulted dairy industry stakeholders on the following three options:

- status quo, whereby the DIRA pro-competition provisions expire as currently legislated for, and the dairy industry is being regulated only by the general provisions of the Commerce Act;
- extension of the DIRA pro-competition provisions in their entirety; and
- extension of the Raw Milk Regulations only, which are one part of the suite of the DIRA pro-competition provisions.

An option, whereby the DIRA pro-competition provisions would expire but the Commerce Commission would undertake an inquiry under Part 4 of the Commerce Act 1986, was identified but discounted as being not feasible. This is because the recent amendments to Part 4 of the Commerce Act removed the provisions allowing price control being introduced to benefit suppliers, as opposed to consumers, of goods and services.

The NERA report is attached and the analysis is summarised below.

OPTION ONE: MAINTAIN STATUS QUO

If no action was to be taken prior to the current market share thresholds being reached, the Minister of Agriculture would have no choice but to recommend to the Governor-General that the DIRA pro-competition provisions be revoked upon the reaching of the thresholds.

At that point, Fonterra would be collecting 87.5 percent of farmers' raw milk in the North Island; and 80–82 percent in the total South Island (but approximately 90 percent in the South Island excluding milk produced within the boundaries of Westland Regional Council²).

² The Southern Alps constrain the pressures Westland can place on Fonterra, due to significant transport costs.

Both regulatory precedent and economic literature suggest that at this level of market share, Fonterra would be likely to have the ability to exercise market power, especially if existing competition was relatively weak and the barriers to entry were material.

In the market for farmers' raw milk, Fonterra's existing competition comprises five independent processors, which together collect and process around 10 percent of farmers' milk. These processors include:

- **Tatua** is a closed co-operative and rarely competes for new suppliers; [withheld under s9(2)(b)(ii) of the Official Information Act 1982];
- Westland is isolated by the Southern Alps, and therefore unlikely to compete for suppliers located too far from the West Coast; [withheld under s9(2)(b)(ii) of the Official Information Act 1982];
- **Synlait** currently has one site in the South Island and has been in operation since August 2007 [withheld under s9(2)(b)(ii) of the Official Information Act 1982];
- **New Zealand Dairies** also operates one processing site and has been in operation since 2007; [withheld under s9(2)(b)(ii) of the Official Information Act 1982]; and
- **Open Country Dairy (OCD)** is the result of New Zealand Dairy Trust purchasing Open Country Cheese (which began operating in 2004) during 2008. OCD currently operates three sites: two in the North Island and one in the South Island [withheld under s9(2)(b)(ii) of the Official Information Act 1982];

While there are a number of competitors to Fonterra, OCD is likely to be the only existing player in the market for farmers' raw milk that could apply some competitive pressure on Fonterra. However, OCD's limited operational history raises some doubt as to whether this pressure would provide sufficient incentives on Fonterra to operate efficiently.

Moreover, NERA's findings suggest that workable competition would require at least two efficient independent processors competing against Fonterra in each relevant geographic and product markets. NERA notes that one efficient independent processor might be sufficient if entry and expansion barriers were not material, but in the absence of this threat, the allocative, productive and dynamic efficiency pressures are likely to be greater with three players (i.e. Fonterra plus two others).

In the absence of the DIRA requirement for Fonterra to operate an open entry and exit regime, the barriers to entry/expansion by independent processors in the market for farmers' raw milk are likely to become significant. Without the legislative requirements, Fonterra would have the ability and incentives to remove or substantially weaken the current open entry and exit conditions for its suppliers.

Fonterra's co-operative status may mean that as suppliers of milk, Fonterra shareholders would favour freedom of entry and exit. However, as investors in Fonterra, Fonterra suppliers may prefer security of supply of both milk and capital for the co-operative, thus potentially accepting some form of "sticky exit". [withheld under s9(2)(g)(i) of the Official Information Act 1982]

The barriers to entry into the market for farmers' raw milk may also increase in the absence the Raw Milk Regulations. If Fonterra chose to set the price for the wholesale raw milk inefficiently high or withdraw wholesale supply all together, potential new entrants to the farmers' raw milk market could find it increasing difficult to get established.

Food companies that purchase wholesale raw milk would also be likely to be affected by Fonterra's dominant position in the wholesale milk market. For many food companies, there

are unlikely to be close substitutes for the raw milk supplied by vertically integrated dairy processors. Purchasing milk directly from farmers is often not an option due to the food companies' demand characteristics and their lack of in-house capability to handle the logistics of collecting and transporting milk.

Other vertically integrated dairy processors who could, in the future, supply the wholesale raw milk market would be likely to lack scale to do so at the time the Raw Milk Regulations are currently set to expire.

In the absence of the DIRA pro-competition provisions, potential actions by Fonterra that could be perceived to be anti-competitive would be tested against the general provisions of the Commerce Act. However, the key differences between the DIRA pro-competition provisions and the Commerce Act, are that the DIRA provides for ex-ante constraints on Fonterra, is relatively clear-cut and easy to enforce. On the other hand, the Commerce Act provides for ex-post consideration of Fonterra's actions, is less specific in its requirements and can be more difficult to enforce in a timely and cost-effective way.

At some point, however, the transition to the Commerce Act should be made. It is recognised, however, that the threshold for anti-competitive conduct imposed by section 36 of the Commerce Act is quite high. It is, therefore, necessary to ensure that there is sufficient competition in the dairy industry before this transition is made.

Retaining the status quo is not recommended because, at the time of the current prospective expiry of the DIRA pro-competition provisions, there is reasonable likelihood that existing and potential competitors, backed only by the Commerce Act, would not be in a position to place sufficient competitive pressure on Fonterra, thus increasing the likelihood of Fonterra creating significant barriers to entry for those seeking to compete for farmers' raw milk, and allow Fonterra to operate inefficiently but nevertheless remain in business.

OPTION TWO: EXTEND THE DIRA PRO-COMPETITION PROVISIONS IN THEIR ENTIRETY

As noted by NERA, the most important (potential) costs of economic regulation are the impacts on the incentives of the regulated firm to invest, innovate and improve its productive efficiency over time. These dynamic efficiency costs can be quite large, and can occur because expected profits are constrained to such a degree that it is difficult to justify investments.

However, the DIRA is quite a different form of regulation as it does not (materially) interfere directly with Fonterra's strategies, investment plans and pricing decisions. Instead, the DIRA pro-competition provisions are designed to minimise barriers to entry/expansion by independent processors, thus creating incentives for Fonterra to operate efficiently. The DIRA does not seek to reduce Fonterra's market share, it simply eliminates entry/expansion barriers that might otherwise exist as a result of Fonterra's dominance.

Nevertheless, the DIRA pro-competition provisions do impose some costs on Fonterra. The key costs include:

- **The non permanent capital and redemption risk associated with the Fonterra shareholders ability to freely entry and exit the co-operative.** Fonterra's redemption risk is a function of its cooperative form. However, the DIRA heightens this risk by

requiring Fonterra to carry out the redemption process in a timely manner³. This DIRA requirement is a key pro-competition provision that incentivises Fonterra to set efficient prices for farmers' milk and Fonterra shares, as otherwise farmers would leave Fonterra, thereby exposing Fonterra to redemption risk. [withheld under s9(2)(g)(i) of the Official Information Act 1982]. Fonterra's proposed new capital structure seeks to substitute farmer share trading for the current share issuing/redemption obligations on Fonterra. This new approach would need to provide for an adequate level of assurance that the proposed market structures would meet the Government's competition policy objectives.

- **Reputational costs on Fonterra arising from having to collect and process milk from suppliers regardless of the suppliers' environmental and animal welfare record.** This issue is currently under review and could be addressed by an exclusion under the DIRA, if considered necessary and desirable.
- **The historical mis-pricing of regulated raw milk, arising from the regulated price formula not reflecting Fonterra's pricing mechanisms.** The recent amendments to the pricing formula for regulated raw milk seek to ensure that independent processors pay the same price as Fonterra pays its farmers for this milk.
- **The requirement to maintain processing capacity to provide for volatility in usage of raw milk by independent processors under the Raw Milk Regulations.** This potential issue could be considered in the future by further review of the Raw Milk Regulations.

A number of these issues are currently under review and could be addressed by modifying the current provisions, if considered necessary and desirable. None of these issues present fundamental flaws with the objectives or the intervention logic of the DIRA pro-competition provisions, which seek to promote the efficient operations of New Zealand dairy markets.

There may, however, be negative impacts on Fonterra's shareholder value arising from the proposal to extend the DIRA pro-competition provisions. As investors in Fonterra, farmers could, especially in the near term, prefer security of supply of both milk and capital for the co-operative over competitive tension ensured by the DIRA pro-competition requirements. However, the benefit to farmer-investors from removing the DIRA pro-competition provisions would be outweighed by the detriment to farmer-suppliers and the long term growth and dynamic efficiency of the dairy industry.

Overall, the cost of extending the DIRA pro-competition provisions is unlikely to be unreasonably burdensome on Fonterra and its shareholders. This option is preferred because of the reasonable likelihood of there being a net economic benefit in extending the DIRA pro-competition provisions.

OPTION THREE: EXTEND THE RAW MILK REGULATIONS ONLY

The Raw Milk Regulations are only one, relatively small, part of a package of the DIRA pro-competitive provisions. In light of the above conclusion – that at the time the DIRA pro-competition provisions are currently set to expire Fonterra's existing and potential competitors were unlikely to put sufficient competitive pressure on Fonterra – an extension of the Raw Milk Regulations only was not considered to be sufficient at this time.

³ The DIRA requires that Fonterra pays a farmer in cash within 30 working days following the end of the season in which Fonterra receives an exit notice from the farmer. Without this requirement Fonterra would have the option of retaining farmer capital up to five years, as provided for by the Cooperatives Companies Act.

Consultation

A public consultation document, entitled “The Future of the Pro-Competition Regulatory Regime in the New Zealand Dairy Industry”, was released by the Ministry of Agriculture and Forestry in December 2009 with a two month consultation period.

The consultation document identified MAF’s preferred option of extending the entire DIRA pro-competition regulatory regime, i.e. open entry and exit provisions as well as the Raw Milk Regulations, until Fonterra’s market share falls to between 75 and 85 percent. Other options outlined in the consultation document included: status quo, and an extension of the Raw Milk Regulations only.

During the consultation period 23 submissions were received, of those:

- 12 (independent processors, the Commerce Commission and other stakeholders) supported an extension of the DIRA regime in its entirety;
- one (Federated Farmers) did not support the extension of the open entry and exit regime, citing the countervailing powers of the cooperative as sufficient to protect farmer interests;
- seven (most were Fonterra farmers) while silent on the open entry and exit provisions, opposed the extension of the Raw Milk Regulations;
- Fonterra submitted that consideration of whether the DIRA regulatory regime should be extended is best deferred until the current Fonterra capital restructuring process has been finalised.

Those in favour of extending the DIRA pro-competition provisions suggested the new expiry thresholds should fall between 50–75 percent of Fonterra’s share in the market for farmers’ raw milk. There was also strong support for geographical thresholds, e.g. North and South Island.

The key concern raised during the consultation process was around the proposed extension of the Raw Milk Regulations and was largely due to the historical mispricing of this milk. This issue is currently being addressed with the Raw Milk Regulations being amended to replace the current pricing formula for calculating the milk price with a new formula, of “farm gate +10c” which goes a long way to address the issue. The amended Raw Milk Regulations will take effect from 1 June 2010.

Conclusions and Recommendations

At the time the DIRA pro-competition regime is currently set to expire, there is a reasonable likelihood that neither existing nor potential competitors, backed only by the Commerce Act, would be in a position to place sufficient competitive pressure on Fonterra to drive long term growth and dynamic efficiency of the New Zealand dairy industry. An extension of the DIRA pro-competition provisions is therefore recommended.

PROPOSED NEW THRESHOLDS

Competition agencies overseas tend to apply 70 percent market share as a threshold above which investor-owned firms are likely to be presumed to have significant market power. This level of market share is not, however, considered to be appropriate for Fonterra because:

- Fonterra’s co-operative form, to some extent, mitigates its market power in the market for farmers’ raw milk;

- there are likely to be economies of scale in transportation, processing and marketing of New Zealand dairy products; and
- the export-oriented nature of the New Zealand dairy industry exposes Fonterra to strong competitive pressures in global dairy markets.

Although the NERA report suggested that a 75 percent market share threshold might be appropriate, in light of considerations specific to Fonterra, the structure of the New Zealand dairy markets, and the process for a comprehensive competition analysis, as outlined below, a threshold of 80 percent for Fonterra's share in the market for farmers' raw milk in each of the North and South Islands, and excluding the boundaries of the Westland Regional Council, is preferred. Given the current rate of independent processor entry and expansion, the proposed new thresholds could potentially be reached in five to ten years time.

Thresholds based solely on Fonterra's market share are too simplistic an indicator of sufficient competition in the market. The new market share thresholds are therefore proposed to be used not for automatic expiry of the DIRA pro-competition provisions, but rather as a trigger for a comprehensive competition analysis to determine the state of competition in the dairy industry.

It is proposed that the Minister of Agriculture, in consultation with the Minister of Commerce, would devise and publish the terms of reference for such analysis. Depending on complexity, depth of analysis and information requirements, as specified in the terms of reference, the Ministers would be able to instruct either the Commerce Commission or officials to produce a report on the state of competition in the dairy industry. Upon the receipt of the report, the Minister of Agriculture would be required to notify in the Gazette his/her response to the report. Following this notification, the DIRA pro-competition provisions would lapse at the end of the dairy season following the season in which the announcement is made or earlier if specified in the Gazette notice. It is proposed that no further consultation with the industry be required at this stage. If the conclusion was that the state of competition in dairy industry was insufficient to justify the removal of the DIRA pro-competition provisions, the Minister of Agriculture would have sufficient time to promote a new Bill in Parliament that would enable some or all of the DIRA pro-competition provisions to be extended further.

Implementation

A legislative amendment is required to extend the DIRA pro-competition provisions. The DIRA pro-competitive provisions would continue to apply in their current form, with the Commerce Commission continuing in its role of being the enforcement agency for disputes arising in relation to these provisions.

Monitoring, evaluation and review

The recommendation that the new market share thresholds would not be used for automatic expiry of the DIRA pro-competition provisions, but rather as a trigger for a comprehensive competition analysis, provides for a review of the need to have the DIRA pro-competition provisions in place at the time the proposed new market share thresholds are reached. Standard competition analysis frameworks would be applied at the time of the review.