



Regulatory Impact Statement

Dairy Industry Restructuring Act

Prepared by the Ministry for Primary Industries

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Agency Disclosure Statement

1. This Regulatory Impact Statement (RIS) has been prepared by the Ministry for Primary Industries (MPI).
2. The analysis in this RIS is limited to specific sections of Subpart 5 and 5A of Part 2 of the Dairy Industry Restructuring Act 2001 (DIRA) and the associated Dairy Industry Restructuring (Raw Milk) Regulations 2012 (Raw Milk Regulations).
3. The expiry of key contestability and efficiency provisions is embedded in the DIRA. These provisions will expire in the South Island if legislative change is not enacted prior to 31 May 2018.
4. This RIS considers whether expiry of the DIRA regime should be prevented, and if so, what measures (if any) should be put in place to provide a transition pathway to deregulation in the future. It does not seek to undertake a first-principles review of the regulatory settings for competition in the dairy industry and efficient entry conditions.
5. The Commerce Commission's review of the state of competition in the New Zealand dairy industry informed MPI's analysis of options. The scope and process of the review is prescribed in the DIRA.
6. At the initial stages of MPI's analysis, other options identified by the Commerce Commission were considered, specifically allowing trading of regulated milk entitlements and creating an auction system for regulated milk. Due to the greater complexity of these options and the time constraints posed by the default expiry of the DIRA regulatory provisions, MPI decided not to proceed with these options at this time, and they are therefore not analysed in this RIS.
7. MPI's early scoping also determined that changes would not be considered to:
 - The milk price monitoring regime, which is intended to promote the setting of the farm gate milk price that bolsters Fonterra's incentives to operate efficiently while also providing for contestability in the market for farmers' milk.
 - The 20 percent rule, where Fonterra suppliers can divert up to 20 percent of their milk solids to another processor.
8. The consultation package of options included an option to reduce the regulated milk entitlements of Goodman Fielder and other processors to encourage the development of a factory gate market, in line with the Commerce Commission's finding that there was little competition in this market.
9. Consultation has provided new information about potential impacts of this option on downstream domestic markets. MPI must better understand the future state of the domestic downstream market and the role regulated raw milk plays in ensuring competition for New Zealand consumers before developing and assessing options to proceed in this area. This option is therefore not considered in the options analysis set out in this RIS.

10. Despite the uncertainty around downstream domestic markets outlined above, we consider there is sufficient information to make some changes to regulated milk entitlements, where these would not detract from the contestability and efficiency objectives and/or signal direction towards deregulation in the future.

Jarred Mair
Director Sector Policy

7 September 2016

Executive summary

11. The Dairy Industry Restructuring Act 2001 (DIRA) allowed for Fonterra's creation, and imposed provisions to promote the efficiency and contestability of the New Zealand dairy industry.
12. The market share of independent processors other than Fonterra collecting milk from farmers in the South Island triggered a statutorily mandated review of the state of competition in the New Zealand dairy industry in mid-2015.
13. The Commerce Commission was commissioned to undertake the review, and released its report (the Commerce Commission Report) on 1 March 2016, in line with the requirements of the DIRA.
14. The Commerce Commission Report found that the current state of competition is not yet sufficient to ensure the efficient and contestable operation of dairy markets in the absence of the DIRA regulatory regime. The review also recommended that any transition pathway to deregulation should take a staged approach and involve removing elements of the regulatory regime that contribute least to efficiency and contestability first.
15. Overall, the Commerce Commission considered that the efficiency costs and benefits of the DIRA regulation are finely balanced, but that the risks of removing it too soon outweigh the risks of it remaining longer than it should.
16. MPI considered the Commerce Commission Report and released a discussion document to seek feedback on options relating to:
 - Retaining the DIRA regulatory regime at this stage to ensure the efficient operation of New Zealand dairy markets, with a provision to review the state of competition in the near future.
 - Amending the Dairy Industry Restructuring (Raw Milk) Regulations 2012 (the Raw Milk Regulations) to reduce reliance on regulated raw milk and stimulate a factory gate market.
 - Allowing Fonterra discretion to accept applications to become shareholders from newly converted dairy farms.
17. MPI received 105 submissions from dairy farmers, independent processors, Fonterra, Federated Farmers, rural groups and the retail industry.
18. MPI has incorporated information from submissions in its analysis, and has substantively amended its recommendations in light of a key issue raised. Independent processors raised concerns about the likelihood of a functioning factory gate market emerging as a result of the proposed volume reductions for Goodman Fielder and other independent processors. They also provided new information about how regulated raw milk is used and potential impacts of the proposed options on downstream domestic markets.

19. We have therefore removed consideration of the option to reduce regulated milk entitlements for independent processors including Goodman Fielder. MPI must better understand the future state of the domestic downstream market and the role the DIRA regime plays in ensuring competition for New Zealand consumers before developing and assessing options to proceed in this area.
20. Having considered submissions, MPI now proposes that a package of options be progressed to:
 - ensure the efficient operation of New Zealand dairy markets by retaining the DIRA regulatory regime at this stage, with a provision to review the state of competition in the near future;
 - smooth the pathway towards future deregulation by removing elements of the regime that contribute least to its efficiency and contestability objectives; and
 - further signal future deregulation by managing industry's expectations about availability of raw milk under the Raw Milk Regulations.
21. To ensure the efficient operation of New Zealand dairy markets, we consider the DIRA regulatory regime should be amended to:
 - extend the application of the DIRA regulatory regime by removing the default expiry provisions and the market share thresholds;
 - require a review of the state of competition to commence in 2020/21, and at five yearly intervals thereafter if competition has not yet been considered to be sufficient;
 - provide more flexibility in relation to the scope and process provisions of future state of competition reviews; and
 - enable monitoring of the factory gate market through improved information-collecting powers to inform any future policy proposals.
22. To smooth the pathway towards future deregulation by removing the provisions that contribute least to efficiency and contestability, we consider that the DIRA regulatory regime should be amended to:
 - allow Fonterra discretion to accept applications to become a shareholder from newly converted dairy farms; and
 - reduce the flexibility currently available to independent processors in purchasing raw milk from Fonterra under the Raw Milk Regulations.
23. To signal the removal of the current DIRA regulatory regime in the future, we consider that the maximum volume of regulated raw milk that Fonterra has to make available in a season should be reduced from 795 million litres to 600 million litres. This change signals to stakeholders that the availability of regulated milk is being managed downwards, while not having a significant impact on the ability of independent processors to obtain raw milk necessary for them to compete in dairy markets.

24. To further signal the eventual end of the current DIRA regulatory regime, the entitlement to regulated milk of large, export-focused processors could be removed. This would have no impact on six out of seven existing processors, as from the beginning of the 2017/18 season, they will not be entitled to regulated milk in any case. [REDACTED]. However, this proposal may make future entry by larger export-focused processors slightly more expensive.
25. As a package, these changes extend the application of the efficiency and contestability provisions of the DIRA regulatory regime, while removing provisions of the regime that contribute least to efficiency and contestability. They also signal deregulation to manage expectations around access to regulated milk.

Status quo and problem definition

The Dairy Industry Restructuring Act 2001

26. The DIRA provided for an authorisation under the Commerce Act 1986 to allow the amalgamation of New Zealand's two largest dairy cooperatives and the Dairy Board to form 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.
27. 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.
28. A co-operative in a dominant market position could "lock in" its suppliers by:
 - declining applications for new supply;
 - paying inefficiently high milk prices to existing suppliers; or
 - retaining the value of the exiting supplier's capital contributions for as long as possible after they ceased to supply milk.
29. Such actions would create significant barriers to entry for independent processors seeking to compete for farmers' raw milk (the farm gate market), and allow Fonterra to operate inefficiently but nevertheless remain in business.
30. To address this concern, and promote efficiency and contestability of the New Zealand dairy industry, the DIRA places regulatory requirements on Fonterra. Specifically, Subparts 5 and 5A of Part 2 of the DIRA provide that:
 - Fonterra must accept all applications to become a shareholding farmer and must accept all milk supplied by shareholding farmers (open entry);
 - Fonterra must allow shareholding farmers to withdraw from the co-operative without unreasonable restrictions or penalties (open exit);
 - Fonterra shareholding farmers can allocate up to 20 percent of their weekly production to independent processors (the 20 percent rule); and

- Fonterra must publish a milk price manual and detail how the farm gate milk price in each dairy season is calculated. The Commerce Commission reviews both the manual and setting of the base milk price.

The Dairy Industry Restructuring (Raw Milk) Regulations 2012 (the Raw Milk Regulations)

31. In addition to the 'open entry and exit' regime, the Raw Milk Regulations require Fonterra to on-sell a small proportion (up to 5 percent) of the raw milk it collects from farmers to other processors at an agreed or regulated price, with the objective of:
 - providing an entrance pathway for independent processors into the farm gate market; and
 - supporting competition in downstream domestic markets for dairy products.
32. The regulated price for raw milk supplied by Fonterra, under the Raw Milk Regulations, is made up of the price Fonterra pays its farmers (the farm gate price) plus reasonable transport costs.
33. The volume of regulated raw milk available to an independent processor is currently limited to 50 million litres per season (1 June to 31 May), with the total volume cap currently set at 795 million litres per season.
34. Monthly volume limitations apply, and processors wishing to purchase regulated raw milk must provide Fonterra with forecasts of their intended purchases. The exception to this is Goodman Fielder, which is entitled to up to 250 million litres per season under the Raw Milk Regulations, taken as a level supply throughout the year, rather than along the seasonal curve that other processors must adhere to. This entitlement provides for competition in the domestic consumer dairy market, which would otherwise be dominated by Fonterra.
35. From 1 June 2016, an independent processor ceases to be eligible for regulated milk once its own supply from farmers has reached 30 million litres for each of the previous three consecutive seasons. This provision ensures that regulated milk is not supplied to large dairy processors beyond their initial set up stages.
36. In the coming season, Fonterra expects to supply regulated milk to Goodman Fielder, one large processor, and 19 smaller processors. The largest of these 19 took 16 million litres of regulated milk in the 2015/16 season. All of the smaller processors combined took just over 50 million litres of regulated milk in the 2015/16 season.
37. There are currently seven large independent processors operating in New Zealand, apart from Fonterra and Goodman Fielder. Six source their raw milk from farmers, process well in excess of 100 million litres of raw milk a year, and export more than 50 percent of their production. Five of these became ineligible for regulated milk on 1 June 2016, and a further one is expected to lose its entitlement under the current regulations on 1 June 2017. [REDACTED]. All other processors are much smaller, and do not collect enough own supply to lose their entitlements.

Current expiry and review provisions

38. The DIRA regulatory regime was intended to be temporary. The regulatory 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. Once that point is reached, competitive pressure rather than regulatory provisions would drive the efficiency of the dairy industry.
39. Until that time, the DIRA regulatory regime is necessary to mimic competitive drivers in the dairy industry. This is achieved by minimising barriers to entry and expansion by dairy farmers and other processors (which could arise as a result of Fonterra's dominance), thus creating incentives for Fonterra to operate efficiently and allowing resources (raw milk) to flow to their highest value use.
40. As a result, the DIRA includes a review that is triggered either on 1 June 2015 or when independent dairy processors collect more than 20 percent of milk solids in either the North or South Island in any season. The latter trigger also begins a process for automatic expiry of the regulatory provisions in the relevant island. Both triggers were reached in 2015.
41. The Minister for Primary Industries commissioned a review of the state of competition in the New Zealand dairy industry from the Commerce Commission on 2 June 2015, as required by Subpart 5 of Part 2 of the DIRA.
42. The purpose of the report was to provide an assessment of the state of competition in the dairy industry; advise the Minister as to whether the market share thresholds should be reset; and advise the Minister as to options for a pathway to deregulation (if any).
43. The report was primarily focused on the two key markets that the DIRA directly regulates:
 - the farm gate, where farmer suppliers sell raw milk to processors.
 - the factory gate, where processors sell raw milk to other processors.
44. The Commerce Commission Report was completed on 1 March 2016 and found that:
 - there was some competition in the farm gate market, although not sufficient competition to remove the efficiency and contestability provisions, and that the market share threshold should be amended;
 - there was little competition at the factory gate and Fonterra would have significant market power in the absence of the raw milk regulations;
 - if deregulation is to be pursued, a staged approach should be considered, including options to stimulate the factory gate market; and
 - the option of no longer requiring Fonterra to accept applications to become shareholders from newly converted dairy farms should be considered.

45. On 13 August 2015, the Minister for Primary Industries also certified that the market share threshold in the South Island was met in the 2014/15 dairy season, with 22 percent of milk solids collected by independent processors. This triggered a default expiry process.
46. Specifically, the provisions that would expire in the South Island are:
 - the requirement for Fonterra to accept applications to become a shareholder (open entry);
 - the requirement for Fonterra shareholders to leave the co-op without penalty (open exit);
 - the ability for Fonterra suppliers to provide up to 20 percent of their milk to another processor (the 20 percent rule); and
 - the milk price monitoring regime, which promotes the setting of the farm gate milk price that provides an incentive to Fonterra to operate efficiently while providing contestability in the market for the purchase of milk from farmers.
47. The expiry of these provisions will create two separate regimes, with the North Island continuing to be subject to the full DIRA requirements until 20 percent of milk solids in the North Island is collected by other processors.
48. The key policy concern at present is that on 31 March 2018 the DIRA regulatory provisions will cease to apply in the South Island, despite the Commerce Commission's finding that there will not be sufficient competitive pressure on Fonterra from other dairy processors. Allowing the DIRA regulatory provisions to expire would therefore impair the efficient operation of dairy markets in New Zealand.

Objectives

49. The primary policy objective is to ensure that an effective DIRA regulatory regime is in place until Fonterra faces sufficient competition from existing and potential future competitors; and the efficiency of dairy markets is provided for by competitive forces rather than a regulatory regime.
50. The secondary policy objectives are to:
 - smooth the pathway towards future deregulation by removing elements of the regime that contribute least to its efficiency and contestability objectives; and
 - clearly signal the eventual removal of the DIRA efficiency and contestability provisions.
51. This RIS also assesses options' impact on:
 - Fonterra's compliance costs;
 - other processors' costs; and
 - the Government's compliance costs.

Options and impact analysis

52. As outlined above, the Commerce Commission's review of the state of competition in the New Zealand dairy industry has found that despite the market share thresholds being met in the South Island, Fonterra still has significant market power on a national level (collecting around █ percent of milk solids in New Zealand), and could still use this market power to close out competitors. Therefore, the expiry of the efficiency and contestability provisions in the South Island could lead to inefficient operation of New Zealand dairy markets.
53. The provisions are necessary for independent processors to be able to attract new farmer suppliers in order to either establish in New Zealand or expand their operation. Without these provisions Fonterra could restrict farmers' ability to switch to new processors by requiring them to sign up to long-term supply contracts and by threatening them with not being able to return.
54. As the expiry of contestability and efficiency provisions is embedded in the DIRA, legislative change would have to be enacted prior to 31 May 2018 if these provisions are to apply beyond that date.
55. This RIS also considers options relating to a number of other issues emerging from the Commerce Commission Report and MPI's own analysis. These issues are further detailed in the relevant sections, but can be briefly summarised as:
 - a. Default expiry of the DIRA regulatory regime is a very blunt instrument that does not allow for a smooth transition from regulation to deregulation. Providing for a more gradual transition process would minimise the risk of significant impacts on dairy processors, farmers, and consumers.
 - b. Although competition is not yet sufficient to fully deregulate at this time, a future review will be needed to ensure that regulation does not continue longer than necessary.
 - c. The open entry provisions may be encouraging uneconomic conversions to dairying, which could have environmental and financial stability risks to New Zealand without providing contestability benefits.
 - d. The need to provide large, export-focused processors with access to regulated milk as an entrance pathway has diminished.
 - e. The forecasting allowances for regulated milk may be artificially encouraging dependence on regulated milk, and imposing costs on Fonterra, potentially leading to inefficiency.
 - f. Some processors appear to be reliant on regulated milk and have not identified alternative sources of supply, despite being aware of the DIRA regime being temporary.
 - g. The current statutory process for and scope of the review of the state of competition may unnecessarily constrain analysis and recommendations.

56. These issues have been considered in three distinct parts, relating to different provisions in the DIRA and the Raw Milk Regulations, and are outlined below as follows:

- Part 1: Legislative expiry provision and review trigger.
- Part 2: Legislative requirement for Fonterra to accept all milk (open entry).
- Part 3: Requirements of the Raw Milk Regulations.

Part 1: Legislative expiry provisions and review triggers

Issues

57. As outlined above, independent processors collected 22 percent of milk solids in the South Island in the 2014/15 season, triggering the default expiry of most of the efficiency and contestability provisions in the South Island on 31 May 2018. An amendment to DIRA is required if the default expiry is to be prevented.
58. The Commerce Commission has found that there is not currently sufficient competition to allow the DIRA provisions to expire, i.e., the farm gate and factory gate markets are currently more efficient with regulations in place. It considered that the efficiency costs and benefits of the DIRA are finely balanced, but that the risks of removing it too soon outweigh the risks of it remaining longer than it should.
59. MPI also considers that the automatic expiry of DIRA provisions is not an effective way to deregulate the industry. A market share threshold in and of itself is not evidence that there is sufficient competition to remove the efficiency and contestability provisions. Automatic expiry is resource-intensive and costly in the event that competition is found to be insufficient to justify deregulation, and creates expectations amongst stakeholders about how much competition might be 'sufficient'.
60. Three options are considered below:
 - Option 1: Status quo – do not amend the default expiry provisions.
 - Option 2: Remove default expiry and reset the market share threshold for review at 25 percent, with a time bound review at 2021/22, and at five yearly intervals thereafter if competition is not sufficient.
 - Option 3: Remove default expiry and reset the market share threshold for review at 30 percent, with a time bound review at 2021/22, and at five yearly intervals thereafter if competition is not sufficient.
 - Option 4: Remove default expiry and market share threshold for review, with a time bound review at 2020/21, and at five yearly intervals thereafter if competition is not sufficient (preferred).

Option 1: Status quo - do not amend the default expiry provisions

61. Under this option, the open entry and exit provisions, 20 percent rule and milk price monitoring regime will no longer apply in the South Island from 1 June 2018. The Raw Milk Regulations would continue to apply in both Islands.
62. The status quo is not desirable as there is not yet sufficient competitive pressure on Fonterra to ensure efficient dairy markets in the South Island without the DIRA efficiency and contestability provisions.
63. These efficiency and contestability provisions are fundamental for independent processors to be able to attract milk supply from farmer suppliers to either enter or expand. Without these provisions Fonterra could restrict farmers' ability to switch to

new processors by requiring them to sign up to long term supply contracts and by threatening to not let them back in. They also bolster Fonterra's incentives to set an efficient farm gate milk price.

64. Under the status quo, the market share of independent processors in the South Island would be likely to decrease as farmers may choose to switch back to Fonterra ahead of open entry and exit provisions expiring after 31 May 2018. Independent processors would find it difficult to attract new farmers without the surety of open entry and exit.
65. Expiry of the 20 percent rule in the South Island would increase costs to South Island processors which rely on the 20 percent rule for supply.
66. North Island farmers and processors would not be directly impacted, as all of the existing efficiency and contestability provisions would continue to apply there until a 20 percent market share of independent processors is met in the North Island. The market share of independent processors in the North Island was [REDACTED] in the 2015/16 season.

Option 2: Remove default expiry and reset the market share threshold for review at 25 percent, with a time bound review at 2021/22

67. This option would replace the default expiry provision with a new provision to review the state of competition at the end of the 2021/22 season, or when a 25 percent share of milk solids is collected by independent processors in either the North or South Island. Future reviews would be required at five yearly intervals thereafter if competition is not sufficient.
68. This would prevent the default expiry of key efficiency and contestability provisions in the South Island in 2018, thereby extending the application of the DIRA regulatory regime and ensure the efficient operation of New Zealand dairy markets.
69. MPI considers that the default expiry provision should be removed, as automatic expiry is resource-intensive and costly in the event that competition is insufficient to justify deregulation.
70. Deregulation is better progressed deliberately and in stages to manage the transition and provide certainty, rather than through a blunt default expiry mechanism that results in rapid changes and costs to the industry. The automatic expiry provision has also created expectations amongst some stakeholders that when the market share threshold is reached, expiry will occur, whereas the intent of the legislation is to allow the regime to expire only if it is first determined that there is sufficient competition in the dairy industry.
71. This option, and option 3 below, retain Island-based regional markets for the purposes of assessing market shares. While competition is currently insufficient in either Island for deregulation to occur, the removal of efficiency and contestability provisions in one Island only may be appropriate in future.
72. Submitters had a range of views on the appropriate trigger for the next review:

- Farmers generally submitted that there should be no change to the current 20 percent market share thresholds, which would allow the current default expiry to come into effect in the South Island.
- [REDACTED] stated that its view depended on whether changes to open entry were widened to allow [REDACTED] discretion to accept supply from farmers switching back from supplying other processors, but nonetheless considered that the threshold should be no higher than 25 percent market share.
- [REDACTED] supported the Commerce Commission's recommendation of a 30 percent market share threshold and removing the default expiry. Many expressed concern about the cost and uncertainty caused by reviews being held too frequently.

73. This option is consistent with the example proposed in the discussion document, and would involve a future review taking place when independent processors collect 25 percent of milk solids produced in either the North or South Island. A review would be triggered by the start of the 2021/22 season if the market share trigger is not reached before then.
74. In the South Island, independent processors collected [REDACTED] of milk solids in the 2015/16 season. It is likely that a 25 percent market share will be reached within five years. Two large new entrants in the South Island sourcing all of their supply from farmers currently supplying Fonterra would push the market share over 25 percent in the absence of any other changes in the industry. MPI is aware of one potential entrant in the South Island, but does not have details as to intended timing or source of supply.
75. Given that no significant changes to the form of the DIRA regime are being proposed at this point, there is value in having a further review sooner rather than later. This option is more likely to be triggered by the market share threshold being reached, whereas option 3 is more likely to be triggered by the time bound threshold (i.e. 2021/22).
76. MPI does not expect that a review of the state of competition held at a 25 percent market share will necessarily find that there is sufficient competition. A further review so soon after the most recent one would also cause some cost and uncertainty to the sector. However, the next review of the state of competition should have a different scope, and possibly process, to the review just held. This will allow the next review to sufficiently consider the relationship between the DIRA and downstream markets, particularly the downstream domestic market, and means that it is likely to have different findings and recommended options from the most recent review.

Option 3: Remove default expiry and reset the market share threshold for review at 30 percent, with a time bound review at 2021/22

77. This option would replace the default expiry provision with a new provision to review the regime at the end of the 2021/22 season, or when a 30 percent share of milk solids is collected by independent processors in either the North or South Island. Future reviews would be required at five yearly intervals thereafter if competition has not yet been considered to be sufficient. The analysis of the option is largely similar to option 2 above, other than the benefits and costs of the different market share threshold.
78. Providing a clear time frame for the review gives the industry and Government the ability to plan for the review and anticipate the timing of any potential changes in the regulatory regime. The end of the 2021/22 season balances the need for review with the cost and uncertainty that a review causes. The 30 percent market share threshold would provide a trigger for earlier review should the market share change more quickly than expected.
79. The Commerce Commission Report considered it important to have sufficient time between one review ending and another beginning, and recommended the new threshold be set at 30 percent. The Commission felt it appropriate for the time limit provision to be reached first, and that the market share threshold should act as a backstop if significant changes take place in the market. In recommending 30 percent, the Commerce Commission took into account:
- that market share thresholds are simple but imperfect proxies for competition. However, the market share thresholds trigger a competition review rather than automatic deregulation;
 - that an effective market share threshold should reflect the asymmetric risks of deregulation;
 - that its 2015 review suggests the current market share thresholds are too low;
 - submissions on the draft report and wider contextual factors such as Fonterra's co-operative structure; and
 - historic observation and judgement to project future market shares.
80. The majority of those who supported resetting the market share threshold considered a 30 percent market share threshold, in line with the Commerce Commission's recommendation, would be preferable. They considered that a 30 percent threshold would be consistent with the intent of the threshold to be the secondary trigger that captured significant change in the industry. They also submitted that this would avoid triggering another review too soon, causing them and the Government significant cost and uncertainty. The view of many in the industry was that the 25 percent threshold was likely to be reached before the 2021/22 time frame.
81. The Commerce Commission also considered that a five-year period before the next review was appropriate in order for changes to stimulate the factory gate market to bed in and affect efficiency and contestability in the industry. However, the changes that would have most stimulated the development of the factory gate market (i.e. making

substantial reductions to existing regulated milk entitlements) are now not being progressed at this time. Given this, a five-year period may be too long to wait before undertaking a comprehensive review of the DIRA regime.

82. This option provides less uncertainty to industry than option two above, but it carries a risk that regulation is left in place for too long.

Option 4: Remove default expiry and market share threshold for review, and set the trigger for next review at 2020/21 time bound provision

83. This option would replace the default expiry provision with a new time bound provision for a review of the DIRA to commence during the 2020/21 season. Future reviews would be required at five yearly intervals thereafter if competition is not sufficient.
84. As with Options 2 and 3 above, this option would prevent the default expiry of key efficiency and contestability provisions in the South Island in 2018, thereby extending the application of the DIRA regulatory regime and ensuring the efficient operation of New Zealand dairy markets. However, unlike Options 2 and 3 above, this option would provide for the next review of the need for the DIRA regulatory regime to take place at a pre-determined time, not linked to either of the Islands' market share thresholds.
85. The Commerce Commission considered that it is appropriate for the time limit provision to be reached first, and chose a 30% market share as a backstop to bring forward the review should competition accelerate faster than expected. This option moves forward by a year the time bound trigger suggested by the Commerce Commission, to reduce the risk of regulating for longer than necessary, and reduces uncertainty by removing the backstop market share trigger.
86. Market share thresholds, although simple, are imperfect proxies of competition. Linking the next review to such market share thresholds creates expectations amongst some stakeholders that when the market share threshold is reached, expiry will occur; whereas the intent of the legislation is to allow the regime to expire only if it is first determined that there is sufficient competition in the dairy industry.
87. Compared to Options 2 and 3, this option provides the dairy industry with the most regulatory certainty. Given the inherent uncertainty as to the future developments of the dairy markets, this option ensures that the timing of the next review is well signalled to the industry. As with Options 2 and 3, this option would provide for the next review to have a different scope, and possibly process, to the review just held.
88. Under this option, the next review will occur when independent processors' market share in the South Island is likely to be somewhere between 25 and 30 percent (if their current growth continues at the same rate).
89. This option has not been explicitly consulted on as part of MPI's consultation process. If proceeded with, stakeholder views will be sought during the Parliamentary Select Committee processes.

90. The key risk with this option is that the regulatory regime may remain in place for longer than necessary. If competition in the farm gate milk market accelerates in the coming seasons, Fonterra may be faced with the unnecessary regulatory requirements until the next review commences in 2020/21. To address this risk, MPI will need to monitor the developments in the dairy industry quite closely and be prepared to recommend an ad hoc, non-statutorily mandated, review to be carried out ahead of the 2020/21 season.

Part 2: Legislative requirement for Fonterra to accept all milk (open entry)

Issues

91. The open entry provisions are a core part of the efficiency and contestability provisions under subpart 5 of the DIRA regime. They require Fonterra to accept all applications to become a shareholding farmer, except where:
 - the volume of milk solids supplied by the applicant in a season is less than 10,000 kg, or
 - the cost of transporting the milk of the applicant exceeds the cost of transporting the most expensive current shareholding farmer's milk.
92. The DIRA also contains open exit provisions. Fonterra must:
 - allow shareholding farmers to withdraw from the co-operative without unreasonable restrictions or penalties; and
 - ensure that in any part of New Zealand a third of all milk solids produced within a 160km radius are supplied to independent processors, or supplied to Fonterra under contracts that expire, or can be freely terminated by the supplier, at the end of each season.
93. The open entry and exit provisions are the cornerstone of the efficiency and contestability provisions in the DIRA. They aim to reduce farmers' switching costs to enable independent processors to obtain access to raw milk, which lowers barriers to entry for independent processors. The open entry and exit provisions also incentivise Fonterra to set an efficient farm gate milk price.
94. Fonterra maintains that there is a significant cost involved with having to accept new suppliers, as Fonterra needs to provide capacity to process this milk in a nearby plant with no guarantee that the newly converted farmer will continue to supply Fonterra in the long term ("stranded asset" risk).
95. The Commerce Commission found that these costs on Fonterra were not significant, but also conceded that there may not be a significant benefit in requiring Fonterra to accept milk supply from new dairy conversions. The Commerce Commission otherwise recommended that the open entry and exit provisions remain in place for the time being, as they generally provide net efficiency benefits.
96. MPI considers that guaranteed acceptance of milk supply from new dairy conversions may also have perverse outcomes in encouraging inefficient land use changes to dairying. A farmer who knows that their milk will almost certainly be collected by Fonterra may have less incentive to investigate other uses of the land that would be more efficient in the absence of the DIRA regulation. Fonterra can mitigate some of the costs of accepting shareholders who are some distance away from existing processing facilities by charging transport costs, but chooses not to because of its co-operative structure.

97. Three options are considered below. All assume that legislative change will prevent the expiry of open entry and exit provisions in the South Island:

- Option 1: Status quo – do not amend the open entry and exit provisions.
- Option 2: Fonterra no longer has to accept applications to become shareholders from newly converted dairy farms (preferred).
- Option 3: Fonterra no longer has to accept applications to become shareholders from farmers outside its existing collection footprint.

Option 1: status quo

98. Under the status quo, the open entry and exit provisions would continue to apply, requiring Fonterra to accept all shareholders, with the exceptions currently provided for in the DIRA.

99. Fonterra argues that the requirement for it to accept all supply creates a risk that it has to build capacity to process this supply, without any way of ensuring new suppliers will remain Fonterra suppliers for more than one year, leading to potential unutilised capacity. However, the Commerce Commission did not find evidence to suggest that these provisions currently impose material costs, and any costs must be considered in the context of Fonterra's market dominance.

100. There is a risk that open entry provisions may encourage inefficient dairy conversions via the expectation of guaranteed acceptance by Fonterra. The Commerce Commission considered that open entry for new conversions contributes little to supporting competition at the farm gate, and noted that it potentially imposes costs on Fonterra, although the Commerce Commission could find no evidence of material costs.

Option 2: Fonterra no longer has to accept applications to become shareholders from newly converted dairy farms (preferred)

101. Under this option, farms that are defined as 'new conversions' to dairy would not be subject to open entry provisions. Fonterra would have discretion to accept or reject applications, but no other changes to open entry or open exit would be made.

102. 'New conversions' would be any land that has not been used for dairying in the past five years and is converted to dairy from the 2018/19 season onwards. Beginning from the 2018/19 season would provide for conversions that are now underway with the expectation of the current open entry provisions.

103. Once Fonterra accepted a newly converted dairy farm as a shareholder, the non-discrimination rule would apply and these shareholders would be treated the same as any other – i.e. Fonterra would not be able to pay a lower price, or require long-term contracts in breach of the DIRA's 33 percent rule. This would avoid the possibility of creating a class of farmer not subject to the other protections of open entry and open exit.

104. This option would not prevent landowners from converting to dairying, as Fonterra and other processors may still choose to accept supply from new conversions. However, people looking to convert to dairy in areas where it would be uneconomical for processors, including Fonterra, to accept supply may not find any buyers for their milk. Reference to “the past five years” means that a farm converted to dairy after the 2018/19 implementation date would no longer be considered a new conversion after five years of operation. We are confident that this does not provide a back door for inefficient conversions, as they would have to find a processor to accept their milk for five seasons before Fonterra would be obligated to accept them under open entry.
105. This option still captures the benefits from the open entry regime, but has the added benefit of not encouraging inefficient dairy conversions via the expectation of guaranteed acceptance by Fonterra.
106. With the exception of some independent processors, most submitters supported this option, recognising that open entry could cause costs to Fonterra in terms of asset stranding and the collection of potentially uneconomic milk. Some submitters also considered removing open entry for new conversions could have positive environmental impacts, by no longer artificially incentivising conversion to dairying.
107. As mentioned above, open entry and exit provisions incentivise Fonterra to set an efficient farm gate milk price. The 2012 DIRA amendments, which enabled Trading Among Farmers and introduced the farm gate milk price monitoring regime, further bolster Fonterra’s incentives to set an efficient farm gate milk price. The open entry and exit provisions are therefore no longer the sole mechanism for incentivising Fonterra to set efficient farm gate milk price, and can therefore be relaxed somewhat.

Option 3: Fonterra no longer has to accept applications from farmers outside its existing collection footprint

108. This option was raised by a number of submitters, including [REDACTED] and Fonterra suppliers. Under this option, Fonterra would have discretion as to whether or not to accept applications from farmers outside its collection footprint. That is, Fonterra would continue to be required to collect milk from its currently supplying farms including where that farm is sold to a new shareholder. Fonterra would have discretion over any other applications to become a shareholder.
109. Fonterra preferred the overall removal of open entry provisions and considered that being required to accept supply from such farmers causes uncertainty and constrains Fonterra’s strategic flexibility, resulting in a risk that Fonterra has to invest in more processing capacity than is commercially optimal. However, the Commerce Commission was not convinced that these costs to Fonterra are material.

110. [REDACTED]

111. Removing open entry provisions completely is not a feasible option given the state of competition in the farm and factory gate markets and the risk of inefficiencies. Losing the certainty of being able to return to Fonterra could have a significant impact on a farmer supplier's willingness to switch to a new or established independent processor and on competition at the farm gate.
112. While Fonterra note the costs of open entry, the number of farmers returning to Fonterra is very small [REDACTED]. Returning farmers must have the capital available to buy the required shares to supply Fonterra. This investment means that, while Fonterra has to accept supply and plan for added capacity, returning farmers provide significant investment in Fonterra to mitigate these costs.
113. Fonterra carries excess capacity [REDACTED]. Fonterra also needs the capacity to respond to increased volumes due to weather, increased production based on high milk prices, [REDACTED].
114. Open entry and exit is an important safeguard for farmers and processors, as it lowers barriers to entry for processors by allowing them to attract farmer suppliers; provides farmers with choice; and incentivises efficient pricing and utilisation of milk.
115. Considering the benefits to the contestability of dairy markets that are gained from an environment where farmers do not face penalties for switching processors against the relatively small cost to Fonterra of being required to accept supply from returning dairy farmers, MPI considers that this option should not be adopted.

Part 3: Amendments to the Raw Milk Regulations

A: Prescribed maximum volume available

Issues

116. The Raw Milk Regulations prescribe the total volume of raw milk that Fonterra must make available to independent processors. Section 115(2) of the DIRA states that the prescribed volume must not exceed five percent of the total amount of raw milk collected by Fonterra in a season. The Minister may review the prescribed maximum from time to time, but must review it at intervals of not more than three seasons. The prescribed volume must not exceed the statutory five percent limit, while also meeting demand from processors as far as possible within that limit.
117. The requirement to review the prescribed maximum applies regardless of the state of competition in dairy markets.
118. The Minister undertook a review in May 2016, an interval of three seasons from the last review. This showed that demand has been falling in recent years, as independent processors increasingly build their own supply. In the 2015/16 season, the total amount of regulated milk that Fonterra supplied to independent processors, including Goodman Fielder, was about 390 million litres, approximately 49 percent of the total regulated volume of 795 million litres. Fonterra's preliminary forecast demand for regulated milk for the current season is 355 million litres, about 45 percent of the regulated maximum.
119. The Commerce Commission did not make specific comment on the prescribed maximum volume in its review of the state of competition in the New Zealand dairy industry. There are no significant costs to Fonterra arising from the prescribed maximum volume, as any costs to Fonterra are a result of the actual volumes of regulated milk sold, rather than the theoretical maximum. Fonterra may incur some capital risk given the potential uncertainty around the volume of milk it may be required to supply, but this is likely to be very minor.
120. However, the maximum volume available is currently far in excess of expected or even possible demand for coming seasons.
121. Two options have been considered:
 - Status quo: the prescribed maximum volume would remain at 795 million litres.
 - Amend the regulations to reduce the prescribed maximum volume to 600 million litres.

Option 1: Status quo

122. Under this option, the prescribed maximum volume would remain at 795 million litres. Given that actual usage of regulated raw milk has been much lower than this in recent seasons, the maximum total volume is well in excess of current and potential future demand.
123. There may be some costs to Fonterra from having to factor a theoretical maximum of 795 million into its business planning and budgeting.
124. By leaving the total volume of regulated milk unchanged, the status quo does not signal the eventual intent to deregulate, and is not cognisant of the greatly reduced demand for regulated milk from large processors losing their entitlements to regulated milk from the beginning of the current season.

Option 2: Amend the regulations to reduce the prescribed maximum volume to 600 million litres

125. Under this option, the maximum amount of regulated milk available in each season would be 600 million litres. This reduced maximum would still provide adequate supply to accommodate uptake from further new entrants or if other existing users increased their volumes.
126. Demand for regulated milk has been falling and can be expected to fall further in the current season. This is regardless of any other regulatory changes that may arise from the review of the DIRA. There is a very slight risk that individual entitlements would be rationed if the maximum volume were reached, but demand is so far below the lower proposed maximum volume that this is unlikely.
127. Therefore, this proposal has no real impact on independent processors. Changing the prescribed maximum will not have a substantive impact on Fonterra as the supplier of regulated milk but may confer a small benefit in terms of planning supply requirements.
128. Under the Raw Milk Regulations, any independent processor is currently entitled to 50 million litres of regulated milk each season, while Goodman Fielder is entitled to 250 million litres. The Raw Milk Regulations were amended in 2012 so that independent processors with more than 30 million litres of their own supply for three consecutive seasons would lose their entitlement to regulated milk with effect from 1 July 2016.
129. Five independent processors became ineligible for regulated milk on 1 June 2016. Another is expected to lose its entitlement under the current regulations on 1 June 2017. Aside from Goodman Fielder, the remaining processors who purchase regulated milk are small scale, mostly niche processors, whose requirements are generally under 20 million litres per annum.
130. Given that demand in 2014/15 was under 400 million litres, a proposed new maximum of 600 million litres is well able to accommodate existing eligible processors, leaving around 200 million litres to cover any further demand from new entry, or from an existing processor that had not yet taken up its entitlement. [REDACTED] set up operations without purchasing regulated milk. Should the company wish to take up its maximum entitlement under the current

regulations, the 600 million quantity would accommodate this. There have been recent announcements of planned establishment of new processing facilities in Southland and the Waikato. The revised total would readily cover these, should these companies wish purchase regulated milk.

131. While its review did not specifically consider the total volume of regulated milk available, the Commerce Commission considered that making changes to signal the expiry of entitlements now may prompt processors to explore unregulated alternatives.

B: Provision of regulated raw milk to large export-focussed processors

Issue

132. The provision of regulated milk under the Raw Milk Regulations serves two purposes:

- to provide an entrance pathway for processors into the farm or factory gate markets; and
- to support competition in the domestic dairy product market.

133. Fonterra is currently required to sell up to 50 million litres of raw milk per season to an independent processor at an agreed or regulated price, which is the price Fonterra pays its farmers (the farm gate milk price) plus reasonable transport costs. The 50 million litres must be taken in monthly amounts that mirror the seasonal milk curve. From 1 June 2016, any processor who has collected 30 million litres of milk from farmer suppliers for three previous consecutive seasons becomes ineligible for regulated raw milk.

134. Goodman Fielder has a separate entitlement of 250 million litres of regulated milk per season, which it does not have to take on the milk curve.

135. The Commerce Commission recommended that the Government consider amending the Raw Milk Regulations to facilitate the development of a functioning factory gate market and reduce dependence on regulated raw milk. The Commerce Commission considered that the availability of regulated milk has hindered the development of a factory gate market for the following reasons:

- the price of regulated milk is too low for anyone else to be interested in supplying unregulated milk; and
- the supply of regulated milk is too convenient (i.e., certainty about price, forecasting flexibility and regularity of supply) for anyone to look elsewhere.

136. The Commerce Commission also suggested that:

“There appear to be diminishing marginal benefits from further [independent processor] entry in some regions and at least the potential for existing [independent processors] to expand into other regions. In this context an option could be to remove DIRA entitlements, particularly for [independent processors] that are largely serving the competitive international markets.”

137. As mentioned in the agency disclosure statement, we consider there is risk to downstream domestic markets of changing regulated milk entitlements at this point – therefore no option making substantive changes is considered. However, we do think there is value in smoothing the pathway towards deregulation by removing provisions that contribute least to efficiency and contestability, and in signalling eventual deregulation, where any risks are well-understood and minor. The options below take this into account.

138. Two options are considered below:

- Option 1: status quo: no change to the requirement for Fonterra to supply raw milk to large, export-focused processors
- Option 2: remove requirement for Fonterra to supply raw milk to large, export-focused processors

Option 1: status quo – no change to the requirement for Fonterra to supply raw milk to large, export-focused processors

139. The status quo requires Fonterra to supply up to 50 million litres of regulated raw milk to all independent processors per season, subject to:

- the seasonal milk curve and the October rule (which provides that in any month a processor cannot take more than 110 percent of the volume of regulated milk that they took in October);
- the own supply rule (which provides that Fonterra is no longer required to supply regulated milk to an independent processor that has collected more than 30 million litres from farmers for three consecutive years); and
- forecasting requirements.

140. Allowing processors to access regulated raw milk provides a pathway for new entrants to establish and so provide competition to Fonterra at the farm gate milk market. Regulated milk allows new entrants some certainty of milk supply to give confidence to find financial backing and to attract farmer suppliers.

141. The own supply rule means that independent processors do not continue to receive regulated milk once they have established ongoing own supply. This requirement, introduced in 2012 and in effect from 1 June 2016, appears to have worked well. All but one of the big processors have lost their entitlement at the start of this season or are expected to lose it next season and are now well-positioned to operate without regulated milk. [REDACTED]

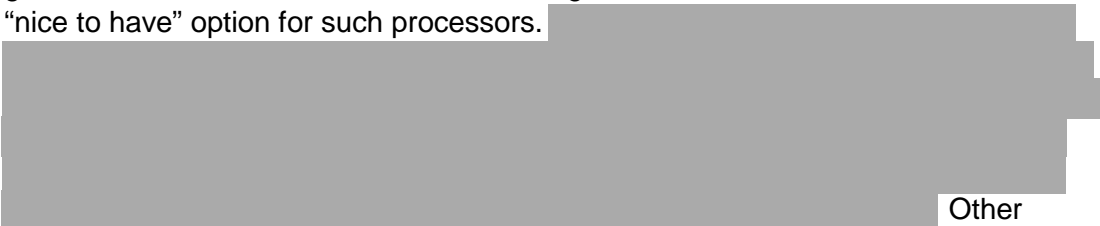
142. MPI considers that maintaining the status quo provides some incentive to transition away from reliance on regulated milk, in that the existing own supply rule has forced large processors to seek unregulated milk, leading to greater competition at the farm gate. However, other processors remain reliant on regulated milk, and do not appear to have made arrangements for operating without it. Maintaining the status quo does not signal any end or change to regulated milk entitlements for these processors.

143. The status quo has not enabled a factory gate market to develop, as processors appear to prefer establishing their own supply rather than purchasing from other processors at the factory gate.

Option 2: Remove requirement for Fonterra to supply raw milk to large, export-focused processors

144. In the discussion document, MPI invited comment on a preferred proposal to remove the requirement for Fonterra to supply raw milk to large, export-focused processors, following on from the Commerce Commission's suggestion that this be investigated as an option. This option was part of a suite of options intended to facilitate development of the factory gate market as new entrant large, export-focused processors would have to purchase raw milk in the unregulated factory gate market or directly from farmers.
145. MPI suggested that "large, export-focused processors" be defined as processors that have a processing capacity of over 100 million litres of milk in a year, and export more than 50 percent of their production. MPI proposed that this change could take effect from the start of the 2019/20 season.
146. The export and domestic milk markets are very different. By producing long-life product in bulk, export-focused processors are well equipped to deal with New Zealand's milk production curve and can therefore rely on supply directly from farmers. Domestic-focused producers, however, tend to require a 'flat' supply of milk across the season in order to keep short-life products (particularly fresh milk) on supermarket shelves year-round. This makes it more difficult for domestic-focused processors to establish their own supply from farmers – which is why some (particularly Goodman Fielder) appear to be more reliant on the Raw Milk Regulations. As discussed earlier in this RIS, officials need to do more work to better understand the relationship between the DIRA regime and downstream domestic markets.
147. The minimum economic size for a milk dryer is around 200 million litres, although many of the large independent processors have a much larger capacity of 300 to 500 million litres. Because the maximum 50 million litres of regulated milk would fill only a quarter of a 200 million litre plant (or a sixth of a 300 million litre plant, or a tenth of a 500 million litre plant), large processors must therefore also secure supply from farmers in order to run an economic operation.
148. Six out of seven existing processors captured by the proposed "large, export-focused" definition are set to lose their entitlements to regulated milk under the current Raw Milk Regulations because they have secured their own supply. [REDACTED]
149. [REDACTED]
150. The Raw Milk Regulations in part seek to address a potential entry barrier to new processors, that is: farmers wanting to see a processing plant before committing supply, and financiers wanting an assurance of sufficient milk supply before providing the finance for plant construction. The Raw Milk Regulations were therefore designed to provide large independent processors with access to a critical mass of raw milk on regulated terms for a short period of time, to help overcome this entry barrier.
151. The possibility of independent processor entry and expansion may be lowered if large, export-focused processors are not able to access regulated milk in their initial years. It

is now not clear whether a factory gate market will develop that could meet the needs of a large processor. Fonterra could remain a seller of unregulated milk at the factory gate market if it considered it economic to do so, but may increase the price of raw milk it sells to other processors.

152. However, MPI considers that the degree to which the original entry barrier exists for potential future entrants has diminished since the Raw Milk Regulations were introduced.
153. In the 2014/15 season the average dairy farm produced around 1.8 million litres of milk, whereas a large dairy farm could produce around 6.5 million litres. This means that a future large, export-focused processor looking to enter the farm gate milk market would need to convince 28 average dairy farmers or only eight large ones to secure the same volume of regulated milk they would have been entitled to under the Raw Milk Regulations (50 million litres).
154. Moreover, a recent example of a large export-focussed processor entering the farm gate milk market indicates that access to regulated milk is not critical but more of a “nice to have” option for such processors.  Other processors have entered New Zealand without accessing regulated milk, using milk powder instead.
155. This demonstrates that the original entry barrier does not appear to have caused any issues for this processor, and that strategies are available to future processors to help prove credibility with farmers other than access to a critical mass of regulated milk from Fonterra. Processors replacing regulated milk with supply from farmers will also increase competition at the farm gate.
156. Furthermore, given the now relatively long history and demonstrated commitment of the existing large export-focused independent processors to the farm gate milk market, dairy farmers are likely to be less wary of supplying such processors in the future. At the time the Raw Milk Regulations were introduced, supplying independent processors was a risky novelty for farmers. Since then, six large export-focused processors have entered, and all but one (NZ Dairies) have managed to establish and maintain credibility with farmers.
157. The open entry and exit provisions of the DIRA regulatory regime safeguard the ability of large, export-focused independent processors to enter the farm gate milk market by making it possible for them to contract for their own farmer supply. In contrast to access to regulated milk, the open entry and exit provisions are crucial for large export-focused independent processors’ ability to enter the farm gate milk market and fill their processing capacity. The open entry and exit provisions are the cornerstone of the efficiency and contestability objectives of the DIRA regulatory regime and are being retained largely unchanged.

158. Submitters to MPI's discussion document generally supported this proposal, although some independent processors observed that it could lead to fewer new processors entering the market in the future. As outlined above, access to regulated milk is not pivotal to large export-focused processors' decisions to enter the New Zealand farm gate milk market, and the risk of this proposal impacting negatively on any future market entry decisions is therefore low.
159. Reference to exported product in this specific class of processors aims to avoid inadvertently excluding any potential domestic market facing competitors to Goodman Fielder and Fonterra Brands from entering or expanding their operations in the domestic consumer market. While processors that currently provide competition to Goodman Fielder and Fonterra Brands in downstream domestic markets are much smaller, it is important to retain an entrance pathway for a potential larger processor that could act as a competitor in the domestic consumer market. Reference to size means that smaller export-focused processors are not affected by this proposal.
160. It is anticipated that the next review of the DIRA may more closely investigate downstream markets, as well as the farm and factory gate markets. If this option is not progressed now, it could be considered as part of the future review.

C: Forecasting flexibility for regulated milk

Issue

161. Independent processors wanting to purchase regulated milk must provide Fonterra with an estimate for supply at certain times prior to supply. Processors have prescribed allowances for variances in these forecasts, and some flexibility in the actual amount they purchase.
162. The current Raw Milk Regulations require independent processors wanting to purchase regulated milk, including winter milk, to provide Fonterra with an estimate for supply:
 - at least three months before the date on which the milk is to be supplied (or 18 months in the case of winter milk); and
 - at least one week before the date on which the milk is to be supplied.
163. The one-week estimate may be up to 40 percent more or 40 percent less than the three month estimate. Fonterra may require the purchase of up to 80 percent of the quantity of raw milk estimated one week prior by the processor, and the processor may require Fonterra to sell up to 120 percent of the quantity of raw milk estimated one week prior.

Option 1: status quo – do not reduce forecasting flexibility

164. The status quo results in regulated milk being artificially attractive, because processors are allowed flexibility that they would not necessarily be able to get if they were buying unregulated milk.
165. Fonterra currently carries the cost of this flexibility - if a processor chooses not to take all the milk that they have forecast they will need, Fonterra has to process that milk at short notice. The Commerce Commission estimated that the uncertainty created by the need to supply regulated milk has a direct cost in the region of \$6 million a year on Fonterra in terms of the excess capacity Fonterra must hold to manage it.
166. However, Fonterra, with its large and distributed processing capacity, is better-placed to deal with unexpected fluctuations in supply than are small processors, most of which have only one processing facility. Flexibility is likely to be more important for new entrants, which may not have yet established stable operations, and so may have less certainty about the amount of milk they will need in three months' time.
167. Given that all existing large processors will have no entitlement to regulated milk from the start of the next dairy season, the cost of the uncertainty from forecasting flexibility to Fonterra will decrease significantly.

Option 2: Reduce forecasting flexibility (preferred)

168. The Commerce Commission found that the forecasting flexibility available to processors when purchasing regulated milk may dampen the demand for non-regulated milk. The Commerce Commission also considered that making changes to signal the expiry of entitlements now may prompt processors to explore unregulated alternatives.
169. This option would reduce forecasting flexibility as follows:
 - The allowed variance between the three month and one week estimates would be reduced from plus or minus 40 percent to plus or minus 20 percent.
 - The variance between the one week estimate and the volume actually taken would be reduced. Currently, Fonterra may require processors to take up to 80 percent of the volume estimated one week earlier, and the purchaser may require from Fonterra up to 120 percent of the volume estimated. This would be reduced to up to 90 percent and up to 110 percent respectively.
170. This option was presented in the discussion document, but not recommended. Some independent processors considered it should not be adopted, as Fonterra is better-placed to deal with unexpected volumes from processors changing their estimated requirements. Other submitters, including ██████████ considered that the allowed flexibility leads to inefficient outcomes and does not give Fonterra certainty about its own supply.

171. Having considered feedback, MPI now recommends this option be progressed as a means of improving the efficiency of the DIRA regime without reducing regulated milk entitlements.
172. This option would give Fonterra greater certainty about the amount of milk it may be required to supply, allowing it to reduce costs from unneeded capacity or unanticipated extra supply. However, with the large processors losing entitlement to regulated milk this year or next, the actual level of benefit for Fonterra may not be very high.
173. This option would lead to independent processors bearing greater risk around incorrectly estimating their own requirements than they do under the status quo, in that they may find they have to purchase more or less milk than they need. However, this risk is a reasonable part of doing business, and the flexibility around forecasts for regulated milk may have helped make its use artificially attractive. Reducing this benefit to processors of accessing regulated milk could potentially shift processors to access unregulated milk.
174. The reduced flexibility may also spur a small level of trading at the factory gate, where processors have purchased more milk than they need, or alternatively find themselves in a shortfall position.

Part 4: Process and scope of future reviews, and ability to gather information

Issues

175. The DIRA sets out the process to be followed in commissioning a review of the state of competition, and specifies what the terms of reference for the review must include. It requires the agency undertaking a review of the state of competition to also recommend options (if any) for a pathway to deregulation if competition is found to be insufficient.
176. The current statutorily mandated process and scope may constrain the ability to make suitable recommendations on the way forward following a review of the state of competition. For example:
- Changes may only be recommended to markets that the DIRA already regulates (i.e. the farm and factory gate markets). This could prevent a future review from recommending that a different approach to regulation of the dairy industry be pursued.
 - The agency carrying out the review of the state of competition is currently required to also recommend options (if any) for a pathway to deregulation. In practice, the agency carrying out the technical competition analysis function may not be best-placed to make public policy recommendations.
177. The Commerce Commission's recent review of the state of competition has made it apparent that MPI needs access to accurate data about the factory gate market to supplement its existing monitoring of the farm gate market.
178. It may be appropriate for the DIRA to allow for greater flexibility in the process and scope it establishes for future reviews. It may also be appropriate for the DIRA to specifically provide for the provision of information beyond the existing provisions.
179. Four options are considered below:
- Option 1: status quo: no changes to the scope and process of review, and no additional monitoring powers.
- OR
- Option 2: amend the DIRA to ensure sufficient flexibility for future reviews (preferred).
- AND
- Option 3: rely on voluntary provision of information by stakeholders in response to requests.
- OR
- Option 4: amend the DIRA to include a regulation making power to gather information on other dairy markets (preferred).

Option 1: Status quo: no changes to the scope and process of future reviews, and no additional monitoring powers

180. The status quo would retain the existing review process and scope provisions.
181. There is a risk that the next review is unable to follow the most appropriate process or make appropriate recommendations for proceeding through being unnecessarily constrained by the requirements that the DIRA establishes around the review. For example:
- In recommending options for proceeding, the review currently cannot take into account markets that are not directly regulated by the DIRA, but are nonetheless affected by it, most particularly downstream domestic markets.
 - The DIRA requires the review to include options for a transition pathway to deregulation (if any). This implicit assumption that deregulation will occur may prevent the development of other options that would better contribute to the efficiency and contestability of the dairy industry.
182. The status quo would not establish any additional information-gathering abilities for MPI to monitor dairy markets. Currently, the Minister can require information from independent processors necessary to monitor the market share of independent processors at the farm gate market only.
183. The Government would continue to monitor the farm gate market, as now, by requiring record-keeping and provision of information on the collection of milk solids at the farm gate only.
184. This approach would mean that no additional compliance costs in the form of record-keeping and reporting requirements were placed on independent processors. However, it would require the Government to rely on anecdotal data to assess how a factory gate milk market was developing and the extent to which it contributed to the objectives of the DIRA regulatory regime.

Option 2: Amend the DIRA provisions to ensure sufficient flexibility for the future reviews

185. This option would revisit the current legislative requirements specifying the scope of the review to ensure that future reviews are not unnecessarily constrained.
186. This option does not prejudge the findings of, or indeed terms of reference for, future reviews of the state of competition. Instead, it provides for sufficient flexibility to ensure recommendations for proceeding are not unnecessarily constrained. For example, the scope of a review should not prevent it from making recommendations on markets that are not directly regulated by the DIRA, but are nonetheless affected by it. As mentioned under option 1, this option could also remove the presupposition that deregulation will be the most appropriate course of action.
187. This option would also unbundle the highly complex and technical competition analysis function (i.e. the question of whether or not there is sufficient competition in dairy

markets) from the public policy advice function that would follow (i.e. what should the nature of government intervention be if the level of competition is insufficient).

Option 3: Rely on voluntary provision of information by stakeholders in response to requests

188. Under this option, MPI would seek information from stakeholders on a voluntary basis to monitor the developments in the dairy markets.
189. This would most likely be implemented by undertaking interviews with stakeholders and requesting information in the context of any future reviews. This option would mean that information on dairy markets was obtained only when a formal review of the DIRA was triggered (at five yearly intervals), as opposed to collecting information on an ongoing (seasonal) basis.
190. There would be few compliance costs to stakeholders. Some processors may prefer not to share this information if it is voluntary, because they either do not collect the information, or would like to keep their operations confidential. The Government's ability to analyse trends in dairy markets on the basis of comprehensive data would therefore be constrained.

Option 4: Amend the DIRA to include a regulation-making power to gather information on other dairy markets (preferred)

191. This option would involve including a new regulation-making power in the DIRA that would retain the current requirements for monitoring the farm gate, and mirror these to monitor other dairy markets as well. Regulations could subsequently be made to require companies to provide information to the Minister on request, as is currently the case for milk solids collected at the farm gate. Penalties for non-compliance would apply as is currently the case regarding the farm gate market.
192. This option would involve some compliance costs on processors, in the form of annual information returns. We do not consider these costs to be onerous. Suppliers of raw milk will need to maintain records for normal business purposes, and the Ministry's annual survey provides a relatively simple and streamlined basis for reporting information. Additionally, processors must already supply information to the Minister on milk collected from farmers.
193. There may be concerns over commercial confidentiality if such information (rendered anonymous) was made available to parties other than the Minister. This risk would be managed by treating the information as commercial in-confidence.

Consultation

194. MPI released a discussion document seeking feedback on proposed amendments to the sunset provisions, the Raw Milk Regulations, open entry for new conversions, and monitoring of the factory gate market.
195. Public meetings were held in Wellington, Hamilton, Stratford, Christchurch and Invercargill. These meetings were well attended, with between 20 and 70 attendees. Participants were a mix of dairy farmers, representatives from Fonterra and other processors, and other interested parties. Individual meetings were held with Fonterra, Goodman Fielder, Federated Farmers and the six largest independent processors.
196. Submissions could be made over a four week period ending 29 June 2016 through standard post, email and via a survey on MPI's website. MPI received 105 submissions. These submissions expressed a range of views, from those that believed competition was sufficient and that the DIRA provisions should be allowed to expire in the South Island or removed entirely, to those that advocated no lessening of the DIRA requirements.

Default expiry and market share thresholds

197. Submitters were divided between those such as [REDACTED] and Fonterra suppliers who wanted the DIRA provisions to expire in the South Island (the status quo) and those such as [REDACTED] who wanted default expiry to be removed and a further review to be triggered at the end of the 2021/22 season or when independent processors collect 30 percent of milk solids in either Island.
198. The key concern of those who preferred a 30 percent threshold was that a further review could be triggered too soon, given that independent processors already collect 22 percent of milk solids in the South Island and some forecasts anticipate that a 25 percent threshold could be hit as early as 2017/18. This would create uncertainty and be costly, both for Government and for the industry.
199. MPI considered the concerns raised carefully. We consider the market share threshold trigger creates uncertainty and is frequently misinterpreted. We therefore consider that a timebound trigger should trigger the next review of the state of competition.

Open entry

200. Submitters were divided into three clear groups on the proposed changes to open entry and exit:
 - a. Some of the independent processors who submitted did not want to see any change to the open entry and exit regime, considering this fundamental to the DIRA and arguing that if Fonterra had discretion to turn down newly converted farms, then overall competition might decrease.
 - b. Most farmers, [REDACTED] supported the preferred option to no longer require Fonterra to provide open entry to newly converting dairy farms, considering that it could provide an artificial

incentive to convert to dairy and recognising the cost to Fonterra of continuing to provide capacity for new conversions.

- c. Some farmers and [REDACTED] felt that open entry should be further relaxed or removed entirely. One specific proposal from farmers was that Fonterra could have discretion about whether or not to accept applications from farmers wanting to return to supplying Fonterra from other processors.

201. The Commerce Commission investigated the cost to Fonterra of being required to accept returning farmers, but determined that other influences, such as the weather and milk price, had a much greater impact on Fonterra's need to maintain excess capacity than the potential of returning farmers.

202. We have considered the greater changes to open entry proposed by Fonterra and some farmers, but consider the costs to efficiency and contestability would far outweigh any savings to Fonterra.

Raw milk regulations

203. Independent processors, and parties with an interest in retail markets, raised significant concerns about the impacts of reducing regulated milk entitlements on downstream domestic markets. As a result, MPI proposes that entitlements are not changed at this point, pending further work.

204. MPI has also proposed that an option to reduce forecasting flexibility for regulated milk be adopted, to drive efficiency.

Changes to proposals arising from consultation

205. Based on feedback from consultation, the options analysed in this RIS differ from those in the consultation document:

- a. A new option of having just a timebound trigger for the next review of the state of competition, and no market share threshold, was considered, and is recommended.
- b. A new option allowing Fonterra to reject applications from farmer suppliers wanting to return from supplying another processor was considered, but not recommended.
- c. Proposed changes to regulated milk entitlements were deferred to allow for more in-depth analysis of the impact on the domestic market
- d. The option to reduce forecasting flexibility was reconsidered and is now recommended.

Prescribed maximum volume available

206. This proposal was not part of the public consultation on other changes to the DIRA, as the DIRA establishes a separate process for its review. The Minister reviewed the maximum prescribed volume in mid-2016, and determined that the maximum volume should be reduced. No consultation is required, but Fonterra has been consulted and agreed to the change.

Conclusions and recommendations

207. The Commerce Commission Report on the state of competition in the dairy industry found that, at the time the DIRA regulatory regime is currently set to expire, Fonterra will not face sufficient competitive pressure from other processors. Therefore, allowing the DIRA regulatory regime to expire as currently planned will impair the efficient and contestable operation of dairy markets in New Zealand. MPI therefore recommends that the DIRA regulatory regime is extended, and not allowed to expire in the South Island.
208. In addition, having considered the nature of a number of the DIRA regulatory provisions, MPI recommends several changes to smooth the pathway towards future deregulation by removing elements that contribute least to efficiency and contestability.
209. Costs to independent processors have been greatly reduced from the package of proposals that was consulted on, given that entitlements to regulated milk are not being reduced at this point. Future large export-focused entrants may face higher costs than under the status quo, as they will have either no or reduced access to regulated milk.
210. Independent processors will bear some additional costs from reduced forecasting flexibility, and new reporting requirements around factory gate market trading. Landowners intending to convert to dairying may face decreased land values as they lose the certainty of being able to supply Fonterra.
211. Fonterra will bear slightly reduced costs (compared to the status quo). The amendment to open entry slightly decreases risks of inefficient supply, and guards against potential stranded asset risk arising from large conversions. The amendments to the Raw Milk Regulations give Fonterra greater certainty about the volume it is required to supply on both a seasonal and shorter-term basis.
212. Fonterra will continue to incur costs arising from its obligations under the efficiency and contestability provisions of the DIRA, but MPI considers that the efficiency and contestability benefits outweigh these costs.
213. Other changes signal the intent to deregulate in future, to reduce reliance on regulated milk in the long term.
214. The proposed package of changes is set out below.

Part 1: Legislative expiry provisions and review triggers

215. We recommend that option 4 be adopted, to extend the application of the DIRA regime, to remove the default expiry, and to require a time bound review at 2020/21, and at five yearly intervals thereafter if competition is not sufficient.
216. Automatic expiry is a very blunt regulatory instrument, and runs the risk of DIRA provisions expiring before there is sufficient competition. Automatic expiry has also created expectations that expiry will occur when the market share threshold is reached.

217. We consider that the next review should commence during the 2020/21 season, in order to reduce uncertainty for the industry. We consider that the next review should have the ability to have a wider focus than the most recent one, to investigate the DIRA's influence on downstream markets, particularly the downstream domestic market.

Part 2: Legislative requirement for Fonterra to accept all milk (open entry)

218. We recommend that option 2 be adopted, to provide that Fonterra no longer has to accept applications from newly converted dairy farms to become shareholders.

219. This option captures the benefits from the open entry regime, while not encouraging inefficient dairy conversions via the expectation of guaranteed acceptance by Fonterra.

Part 3: Requirements of the Raw Milk Regulations

A: Prescribed maximum volume available

220. We recommend that option 2 be adopted, to amend the Raw Milk Regulations to reduce the prescribed maximum volume of regulated milk that Fonterra can be required to provide to other processors in a season to 600 million litres.

221. The proposed new maximum is well able to accommodate existing eligible processors, while leaving a buffer to provide for any future demand. Reducing the maximum volume will confer a small benefit to Fonterra in terms of planning supply requirements, and will signal to the industry that the regulated milk entitlements established by the current DIRA regime are not permanent.

B: Provision of regulated raw milk to large export-focused processors

222. The original provision of regulated milk to large processors was designed to help overcome an entry barrier faced by newly established processors (whereby farmers did not want to commit to a new processor without seeing a processing plant built and financiers wanting an assurance of sufficient milk supply before providing the finance for plant construction). However, the degree to which this entry barrier exists in the current market has diminished since the Raw Milk Regulations were introduced.

223. Removing the requirement for Fonterra to supply raw milk to large export-focused processors may make it more difficult for future processors to enter, but is unlikely to deter such entry completely. It would signal the eventual end of the existing regulatory regime.

C: Forecasting flexibility for regulated milk

224. We also recommend that option 4 be adopted, to reduce forecasting flexibility for volumes of regulated milk taken by independent processors.

225. Reducing independent processors' flexibility around the volume of regulated milk they require will lower costs and uncertainty to Fonterra and increase efficiency.

Part 4: Process and scope of future reviews, and ability to gather information

226. We recommend that option 2 be adopted, to ensure that future reviews of the state of competition and resulting recommendations for proceeding are not unnecessarily constrained by the existing process and scope established in the DIRA.
227. We also recommend that option 4 be progressed, to provide the Government with comprehensive, ongoing information that would enable developments in the factory gate market to be assessed, and to inform further thinking on the effectiveness of the DIRA regime for promoting efficiency in dairy markets.

Implementation plan

228. A legislative amendment is required to extend the application of the DIRA regulatory regime, reset the triggers for a future review and remove the requirement for Fonterra to accept milk from new dairy conversions. It is expected that the Dairy Industry Restructuring Amendment Bill will be introduced towards the end of 2016 calendar year and passed in 2017, with most changes taking effect in the 2018/19 season.
229. The remaining changes will be given effect by amending the Raw Milk Regulations through an Order in Council process, with changes to the overall volume cap on the regulated raw milk anticipated to apply to the 2016/17 dairy season. No transitional arrangements are anticipated to be needed, at this stage.
230. MPI will communicate the changes to all affected parties as soon as Cabinet approvals are obtained. This should give dairy farmers, Fonterra and other dairy processors sufficient time to adjust their operations, if needed.

Monitoring, evaluation and review

231. Progress towards the market share threshold will continue to be monitored through the milk solids monitoring regime established under section 47(4) of the DIRA.
232. We have also proposed a new regulation-making power in the DIRA to provide for regulations requiring companies supplying milk solids through factory gate transactions to provide information to the Minister on request, as is currently the case for milk solids collected at the farm gate.
233. We will use industry data and other sources to monitor any impacts of the changes on the rate of new conversions to dairy.
234. A review of the efficiency and contestability provisions in the DIRA, including any changes made as a result of this process, will start following the end of the 2021/22 dairy season, unless the proposed new market share threshold is met prior.

235. MPI will draw on learnings from the most recent review of the state of competition, and from findings of further work around downstream markets, when establishing the terms of reference and process of the next review of the state of competition.