PUBLIC VERSION

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Ministry for Primary Industries
Pastoral House
25 The Terrace
Wellington
New Zealand

By email: dira@mpi.govt.nz

Dear Sir / Madam

FONTERRA CO-OPERATIVE GROUP LIMITED – RESPONSE TO TERMS OF REFERENCE FOR THE REVIEW OF THE DAIRY INDUSTRY RESTRUCTURING ACT 2001 AND ITS IMPACT ON THE DAIRY INDUSTRY

1 Thank you for the opportunity to respond to the DIRA Review Terms of Reference. We welcome and value this opportunity.

2 Our initial answers to your questions follow this letter – however, we also wanted to provide a brief upfront summary of what lies at the heart our answers. And that is:

- What the New Zealand dairy industry and Fonterra have achieved through DIRA so far and what this has given New Zealand;
- The opportunities that lie ahead for the Co-operative, our industry and New Zealand; and
- Where we believe there are opportunities for us to work together with the Government.

3 We also recognise that we are not always completely understood in New Zealand and would like to start with providing a brief introduction to who we are and what we do.

Who is Fonterra and what do we do?

4 We're a co-operative and a global nutrition company owned by 10,000 New Zealand farmers and their families.

5 On average, our farmer owners have about $800,000 invested in Fonterra and they rely on their farms for more than 90 per cent of their income.

6 We exist, constitutionally, to maximise that income by delivering the highest possible total payout for our famers – that's in the form of the Farmgate Milk Price and the dividend.

7 This has flow on benefits for the wider New Zealand economy because for every dollar a farmer earns he or she will spend 46 cents in his or her local community.

8 To generate this income, we take their milk to more than 100 markets around the world. These products include sought after milk powders and milk proteins, rapid maturing mozzarella, and advanced paediatric and medical ingredients, like complex lipids, inhalable lactose, and probiotics.

9 We add additional value to around 70 per cent of these products and do this through product innovations, brands, partnerships and services we have developed.

10 All of this is only possible because of New Zealand's pasture fed dairy model that puts our products in demand around the world, significant research and development in the science of milk, the support of the Government through the DIRA, the commitment of our farmers and our 22,000 employees, of which 12,000 are based right here in New Zealand, as well as the backing of the New Zealand public.

11 Fonterra has a goal to be processing 30 billion litres of milk a year by 2025 – most of this growth will be coming from overseas milk pools. By 2025 we want to be earning $1.20 a litre in revenue from that milk – making us a $35 billion business. To achieve this we will need to further grow our Consumer, Foodservice and Advanced Ingredients businesses. To put these growth ambitions in context, in the 2017 financial year we processed 22.9 billion litres and earned about 85 cents a litre.

12 To make this growth a reality, we need to be focusing on three horizons, creating:

- A Strong Co-operative focused on driving greater volumes of milk to higher value products at velocity (we call this our "V3 strategy") which sets the foundations for the future
- An Innovative Co-operative – continuing to invest in new technologies, disruptive business models, process and product innovations, and partnerships - which will enable us to lead the future.
- A Sustainable Co-operative – building a business for future generations of our farming families through providing leadership in nutrition, making and delivering on commitments to protect and regenerate the environment, and enhancing the lives and livelihoods of our staff, farmers and our communities – which will ensure the future.

13 We're working on all three today.

14 And we are acutely aware that to be successful globally, we first need to be a sustainable business here in New Zealand meeting the expectations of our farmers, employees, investors, customers and the New Zealand public.

What the New Zealand dairy industry and Fonterra have achieved through DIRA so far and what this has given New Zealand

15 When the Government passed DIRA back in 2001 there were five clear benefits they believed DIRA could achieve:

- The ability for dairy food processors to go direct to market around the world and not having to work through a single dairy board for their marketing and export functions.
- Expansion of the niche dairy product sector.
- Improved market signals in the industry and some rationalisation as a result of integrating dairy processing and market.
- The industry using the full disciplines of the Commerce Act.
- Farmer support of the proposal.

16 All of these have been achieved.

17 Farmers gave their support to the proposal based on a business case that identified a series of initiatives that could be implemented within three years and would result in specified financial benefits for the dairy industry. These were also achieved well within the expected timeframes.

18 More broadly DIRA has enabled New Zealand's dairy sector to grow and become more competitive and this has delivered flow-on benefits to the country. For example:

- Dairy now contributes $8.2 billion[1] to New Zealand's GDP and remains the country's largest export sector.
- Dairy provides jobs and incomes for over 38,700 NZ workers (26,500 on farm and a further 12,200 in dairy processing).[2]
- Dairy employment has grown faster than total employment since 2001 (3.0% per year compared with 1.7% per year).[3]
- The dairy sector paid $2.2 billion in wages to dairy farming and processing workers in 2017.[4]
- Dairy plays a crucial role in supporting regional economic development, providing over 1 in 5 jobs in three territorial authority economies (Waimate, Otorohanga, Southland); and over 1 in 10 in a further eight (Matamata-Piako, South Taranaki, Hauraki, Waipa, South Waikato, Clutha and Kaipara).[5]

19 From a Fonterra perspective, DIRA has also given our Co-operative the foundation to deliver value to our many stakeholders.

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[1] NZIER proprietary database. Year ended March 2017.

[2] Business Demography Statistics, Statistics New Zealand. Year ended Feb 2017.

[3] Ibid.

[4] LEED, Statistics New Zealand. Year ended March 2017.

[5] NZIER, *Dairy trade's economic contribution to New Zealand* (February 2017), i.

20 Our farmer owners are better off than they were before Fonterra was formed. The New Zealand milk price has effectively doubled since the formation of Fonterra, making it competitive globally and higher than the EU and US. This is good for Fonterra farmers and all New Zealand dairy farmers and their families. Farm values have also increased off the back of the strengthened milk price with farm land values increasing at almost similar rates to New Zealand house prices.

21 For our employees, this growth in our scope and scale has given them exciting careers and work opportunities. Fonterra is one of New Zealand's largest investors in research, development and innovation and our employees have delivered world-leading practices and products across our value chain.

22 The DIRA has supported the development of real and sustainable competition both for farmers' milk and consumers.

23 Increased competition in the New Zealand domestic market has also led to more innovation. This means there is substantially more choice for consumers today.

24 We know that some New Zealanders, including some of our farmer owners, have a view that Fonterra should have grown its Consumer, Foodservice and Advanced Ingredients business faster. They want to see us getting the most from our farmers' milk. We don't disagree.

25 One of the big challenges for us in doing this has been the open entry requirement. It makes it compulsory for Fonterra to pick up milk from any new farm (subject to some very limited exceptions) unlike our competitors who get to pick their suppliers based on factors like location, efficiencies and demand.

26 During the period of high dairy growth in New Zealand (between the 2008/09 and 2014/15 seasons) this greatly influenced our investment decisions. We had to make these decisions based on forecasts of milk growth, regardless of whether the milk was to eventually come our way or not. We had to have assets on the ground to process the large volumes of milk during the peak of the season and those assets had to make products that were already in demand. And at the time, the most predictable demand was for milk powder which could also be produced efficiently and quickly.

27 With New Zealand milk volume growth flattening over the last four years, we have not had to invest as much to prepare for further volume growth and instead we've been able to develop customer demand and innovations for more high-value products and services. The result of this is our more recent capital investments have been in value-add manufacturing facilities, such as our recent investment in a new $240 million IQF mozzarella plant at our Clandeboye site, which is the single largest foodservice investment in the history of New Zealand's dairy industry, and a $150 million two-stage project to build two new cream cheese plants using Fonterra-first technology at Darfield.

The opportunities for our Co-operative, our industry and New Zealand

28 Today we are operating in a very different world to 17 years ago. Competition is established and here to stay. Sustainable food production is an everyday conversation topic. And in key export markets we are seeing a growing middle class wanting Western diets. This, along with breakthroughs in milk nutrition, is driving demand for more high-value dairy products.

29 This review gives us a unique opportunity to ensure the dairy industry is relevant to this new world and allows the industry to fulfil its potential, providing benefits to all its stakeholders here in New Zealand and overseas.

There is an opportunity to shore-up the longer-term contribution of the dairy industry to New Zealand and further the Government's policy objectives

30 Today, competition is flourishing and healthy. Open entry has contributed to this – but it also has created some significant risks for the industry's future. There is an opportunity through this review to examine and mitigate these risks to create a sustainable dairy industry that farmers, those employed in the industry, consumers and the New Zealand economy and environment can all benefit from today and into the future.

31 One of those risks relates to how open entry distorts entry decisions, incentivising entry where it might not otherwise be rational.

32 In the dairy sector, manufacturing capacity is a significant investment that is recovered over a long time horizon. If retained open entry could result in inefficient entry and investment. A new independent processor has an inefficient incentive to build a plant. First, it will have a right to obtain regulated raw milk from us under the Raw Milk regulations. Secondly, it will have a head start in attracting farmers, as it can encourage farmers to take a chance and supply it, on the basis the farmer can return to us if the risk does not pay off. This does not boost productivity, but only gives processors a free pass to invest where that might not otherwise make sense.

33 This is of course what DIRA was originally designed to do, but with the proliferation of vigorous, economically sustainable competition, those benefits are now largely exhausted. As time goes on, open entry has the clear potential to incentivise significant excess capacity in the industry, creating a risk of a downward spiral of low-margin competition, inability to move up the value chain and factory closures. This is the opposite to what DIRA set out to achieve and counter to regional economic development objectives and the long term sustainability of the dairy sector.

34 A second risk is around the environmental impact of dairy farming.

35 Our country is known for the lifestyle it offers. As you move down the mountains towards the coast you pass through commercial forestry, agriculture, horticulture, towns and cities. This is where so many New Zealanders have turned dreams into reality, grown the economy and now have thriving communities. Dairy farmers have been no different.

36 Looking back, we can see that open entry had unintended consequences for some parts of the New Zealand environment as it incentivised some dairy farmers to enter the industry when it may not have made environmental sense. Unfortunately, we can't go back today, but what we can do is:

- Ensure we learn from the past and under this review take a future-proofing approach for our environment.
- Affirm the part our sector must play to address the impact dairying has had on the environment – particularly, our waterways and demonstrate responsibility in helping to restore them.
- Continue to place sustainability at the centre of our Co-operative's strategy and recognise the importance of this to the New Zealand dairy industry, including its social licence to operate.

37 Dairy farmers have already invested over $1 billion in on-farm environmental improvements but we will be doing more. This focus on sustainability is also

important to our customers and consumers who are placing increasing importance on knowing their food is produced this way.

38 Open entry also requires Fonterra to accept supply from new farmers that may not meet our standards of good farming practice (including in relation to environmental, animal welfare, hygiene and health and safety compliance) impacting the reputation of the Co-operative, all other Fonterra farmers and the dairy industry.

39 In any industry regulatory certainty gives confidence in continued investment.

40 The sunset provisions in DIRA have been the subject of a number of alterations. These have resulted in a successive "shifting of the goalposts". This has generated uncertainty as to whether the policy intention of deregulation will be implemented.

41 In the long term interests of the New Zealand dairy industry, clear signals are required that the industry should plan for a move off the regulated platform – meaning Fonterra will not be required to invest in over-capacity resulting from our milk pick-up obligations, or be required to provide a leg-up via the supply of raw milk at a regulated price to our competitors indefinitely. In Fonterra's view, a key opportunity for this review will be to identify the appropriate thresholds and triggers to the deregulation pathway.

There is an opportunity to give New Zealand-owned dairy companies a fair go on the international stage – rather than New Zealand dairy farmers having to subsidise foreign-owned companies

42 The Raw Milk regulations require Fonterra to supply raw milk, at a regulated price, to other independent processors. This requirement gives a leg up to all new dairy processors in the New Zealand market until the new processors effectively obtain their own milk supply.

43 The Raw Milk regulations stimulated competition in the domestic retail market which is good for the consumer. It is a dynamic that encourages innovation. And Fonterra welcomes it.

44 Where we do not see it being in the interest of New Zealanders, is that it also requires Fonterra to provide our farmers' milk effectively at cost to new processors who are typically backed by foreign capital and existing global businesses. They receive our farmers' milk with what some would call a subsidy, process it and then use it to compete with Fonterra and other New Zealand owned dairy businesses in export markets.

45 This is a dynamic that disadvantages New Zealand as it limits the milk available for Fonterra to add value to and bring more value back into the New Zealand economy. But most importantly it is seeing New Zealand farmers helping foreign-owned businesses compete against New Zealand-owned business.

Taking these opportunities will support the New Zealand dairy industry in tackling some of the big challenges that lie ahead for all food industries

46 We face a world of increasing complexity and change. Climate change presents a significant challenge that the food sector must meet. Food production makes up 30 per cent of global greenhouse gas emissions, and climate change is expected to impact food production through the possibility of increased flooding of low-lying areas, the increased frequency and severity of droughts and storms, and potential decreases in attainable crop yields.

47 Food security and productivity are big issues, with the world's population projected to reach 9.6 billion by 2030 which is expected to drive a 50 per cent increase in demand for food. The resurgence of nationalism brings additional uncertainty to

global trade on which the New Zealand economy relies. By unleashing the full potential of the New Zealand dairy industry it will help us work even harder to address these challenges.

Where we believe there are opportunities for us to work together with Government

48 The review provides the opportunity to look at how to capture the most value from our farmers' milk and for the New Zealand economy. We want a sustainable dairy industry that delivers affordable, quality dairy nutrition here and across the world and provides far-reaching benefits for New Zealand.

49 To achieve this, we are asking for the Government's help in three areas:

- The removal of open entry.
- Greater certainty in the sunset provisions for the DIRA.
- Changes to the Raw Milk regulations so that Fonterra no longer needs to supply new processors that are primarily focused on export markets.

50 With competition established and here to stay, we believe these are the right steps to take towards the ultimate goal of a deregulated dairy industry and enabling the New Zealand dairy industry to reach its full potential.

51 The driver of the DIRA is to establish a pathway to deregulation but we recognise that needs to be done in a way that maintains the confidence of farmers, consumers and processors. The history of changes to DIRA to date reflects this evolutionary approach.

52 We look forward to working with MPI and other stakeholders during this process. We will be interested to hear what stakeholders across the sector have to say, and we acknowledge that views are likely to differ. We are ready to be part of the conversation.

53 Fonterra requests that all of the information deleted from the "public version" of this submission be treated as confidential, on the grounds that it is commercially sensitive to Fonterra. Disclosure of that information would be likely to unreasonably prejudice Fonterra's commercial position in terms of section 9(2)(b) of the Official Information Act 1982. If you receive any requests under the Official Information Act 1982 for any of that information please contact us.

Yours sincerely

Mike Cronin
Managing Director Corporate Affairs

APPENDIX: RESPONSE TO TERMS OF REFERENCE QUESTIONS

Contents

Export-oriented dairy sector

Question 1

To what extent have the anticipated benefits of the 2001 industry structure been realised, both at the sector and company-specific level? What, if any, are the barriers and their underlying drivers to achieving those benefits, both at the sector and company-specific level?

1.1 The anticipated benefits of the 2001 industry structure have been realised. The objectives that were set by the parties making the key decisions at the time of reform – the Government and the co-operative shareholders of New Zealand Dairy Group (*Dairy Group*) and Kiwi Co-operative Dairies (*Kiwi*) – were realised in the years after the merger, at a faster rate than expected.

1.2 The dairy sector did not rest on its laurels, and in the following years performed well, and in excess of the goals that were set in 2001.

1.3 Looking forward, the dairy sector has new, challenging goals, which we discuss in subsequent sections.

The anticipated benefits of the 2001 industry structure have been realised

The context in 2001

1.4 Prior to the Dairy Industry Restructuring Act 2001 (*DIRA*), the regulated structure of the New Zealand dairy industry was widely acknowledged as unsustainable and no longer in the industry's long-term interests. It is difficult now to recall the full inefficiencies, instabilities and risk for New Zealand inherent in the previous structure. Industry aggregation had resulted in a "semi-integrated" industry structure of two very large, separately owned, co-operatives, both owning and simultaneously required to market and export through the New Zealand Dairy Board (*Dairy Board*). All three were significant entities in their own right, with separate management, separate strategies, and separate incentives.

1.5 As a result, by the late 1990s the New Zealand dairy industry had reached a limit. It could not access further production efficiencies. It could not co-ordinate from farm to consumer in a way demanded by international markets. It could not make decisions as fast as competitors in international markets. It could not commit to an overarching investment and research and development (*R&D*) strategy in a way that competitors could. And New Zealand's most important export sector was locked into this structure by legislation.

Government objectives

1.6 The cabinet papers and parliamentary papers that introduced the DIRA, and facilitated the move to the current industry structure, reflected this starting point. From the Government's perspective the main benefits of the merger proposal, as stated in the cabinet papers approving the industry reform, were:[6]

(a) Moving within a relatively short timeframe to allow dairy food processors to directly manage their overseas marketing and exporting

[6] Cabinet paper, *Cabinet paper one: facilitation of the proposed dairy industry merger* (9 April 2001).

(and all of the associated costs, risks and potential benefits). In short, removing the requirement for processors to operate through a producer board.

(b) This could be expected to result in the rapid expansion of the niche dairy product sector.

(c) Exposure of the industry to the full disciplines of the Commerce Act (the Dairy Board's pricing behaviour was exempt from the Commerce Act).

(d) The early integration of processing and marketing activities, which would facilitate improved market signals in the industry and some potential for rationalisation.

(e) Broad shareholder and farmer support for the proposal, including the removal of the single desk (producer board).

1.7 Clearly these objectives have been met, and were met in the years shortly following the passage of DIRA. For the first time in nearly a century, dairy sector participants could go to the world directly rather than through a producer board. This facilitated rapid expansion in the number of niche processing competitors, and indeed scale competitors too.[7] The merger proposal had broad shareholder and farmer support, and the merger facilitated the integration of processing and marketing, allowing Fonterra to achieve its merger efficiency gains (discussed below). Going forward, all sector participants were subject to the full disciplines of the Commerce Act.

Farmer shareholder objectives

1.8 At the same time as the cabinet papers were articulating the Government's objectives, a report was provided to the shareholders of Dairy Group and Kiwi, to inform the shareholder vote on the move to the new structure. This was the basis upon which farmers decided to commit their investment, and the future of their families, to the merger.

1.9 The report, *The Business Case for Global Dairy Company* (26 February 2001), identified and estimated three sources of benefits likely to flow from the merger:

(a) Annual cost savings of $120 million that would come from the rationalisation and optimisation of the production facilities and other operations of the two co-operatives. In the first year the cost savings were expected to be offset by the costs of the merger.

(b) Annual revenue and productivity gains of $70 million that would come from vertically integrating the global marketing and distribution activities of the Dairy Board with the production and planning activities of the two co-operatives.

(c) Strategic benefits of $120 million per year that would come from being more competitive in global markets compared to the dysfunction of the semi-integrated structure.

1.10 In the years that followed the merger, Fonterra rigorously reported back to our shareholders on progress against these objectives. In Fonterra's 2004

[7] See from paragraph [2.2] below.

Annual Report, we reported that the business case objectives had been achieved, and achieved earlier than originally envisaged. Deloitte, engaged as independent auditor, confirmed that by 31 May 2004 the programme put in place to deliver on the merger business case savings had achieved savings of more than $310m on an annualised basis.[8]

The dairy sector has performed well since 2001, and in excess of the original goals

1.11 While the objectives set by those making the key decisions to reform the industry structure were achieved relatively quickly in the years that followed the merger in 2001, industry participants have, since then, continued to invest, take risks, challenge and grow. As a result, the dairy sector has made a significant contribution to New Zealand over that time.

Export contribution

1.12 Dairy export revenue growth has been strong, with annual growth of almost 5%. This is ahead of most export products, and ahead of total export revenue growth of just above 3%.[9]

1.13 The sector is exporting to more markets, with a 19% increase in the number of export markets since 2001.[10] It is also diversifying into more sizeable export markets and increasing the number of dairy product lines exported to reduce risk.[11] There has been steady increase in the number of product lines exported since 2001.[12]

Productivity contribution

1.14 Dairy products generated more revenue growth per tonne than most other sectors between 2001 and 2018, with 0.21% annually compared with 0.18% for beef and lamb, 0.84% for kiwifruit, -0.53% for wool and -0.27% for seafood.[13]

1.15 Cow productivity has also improved since 2001, and more real export revenue is generated per cow.[14] Land productivity has gone up by 70% and labour productivity has increased by 50% since 2001.[15]

Contribution to regional economies

1.16 Dairy jobs have been growing faster than other agriculture and manufacturing jobs, and so have dairy wages.

1.17 Annual wage growth for both dairy farming jobs (7.7%) and dairy processing jobs (6.5%) has exceeded that in other agriculture (4.1%) and other food and beverage manufacturing (2.7%), since 2001.[16] In addition, since 2001, dairy

[8] Fonterra Annual report 2003/04, 10 and 11

[9] Percentage figures are based on a three-year rolling average compound annual growth rate (*CAGR*) of export earnings, between 2001 and the year ended June 2017. NZIER *Assessing Fonterra's performance* (June 2018), 4. A copy of this NZIER report is attached as Annex 2.

[10] NZIER *Assessing Fonterra's performance*, 16.

[11] Ibid, 16-18.

[12] To the year ended April 2018. Ibid, 19.

[13] Based on a three-year rolling average CAGR of real export revenue per tonne, between 2001 and the year ended April 2018, at 2001 prices. Ibid, 22.

[14] Ibid, 22.

[15] For the year ended February 2017. Ibid, 23-24.

[16] Based on a three-year rolling average CAGR of annual wages, between 2001 and the year ended March 2017. Ibid, 27.

processing jobs have grown at 2.7% per year and dairy farming jobs at 3.1% per year, compared with other agriculture jobs at -0.2% and other food and beverage manufacturing jobs at 0.5%.[17]

Overall contribution

1.18 The dairy sector has served New Zealand well over the 2001 to 2018 period. As a result, the dairy sector accounts for 20%[18] of New Zealand's goods and services exports and 3.1%[19] of New Zealand's GDP.

1.19 The New Zealand dairy sector has outperformed the dairy sectors in comparator countries. For example, taking Australia, Denmark and Ireland:[20]

(a) Growth in the value of New Zealand milk production (495%) has been significantly larger than the growth experienced by Australia (56%), Denmark (19%) and Ireland (-3%) since 2001.

(b) Producer returns in New Zealand have experienced a 3-year rolling average CAGR of 7.3%, compared with 5.5% in Australia, 3.3% in Ireland and 2.8% in Denmark.

(c) New Zealand's share of global milk production has increased from 1.5% in 2001 to 1.7% in 2016 whereas, Australia's share has dropped from 1.3% to 0.7%, Denmark's share has dropped from 1.2% to 0.6% and Ireland's share has dropped from 1.1% to 0.6%.

(d) New Zealand's share of global dairy exports has increased from 6.4% in 2001 to 9.7% in 2017. In contrast, Ireland's share dropped from 4.4% to 3.9%, Denmark's share dropped from 3.5% to 3.3% and Australia's share dropped from 3.3% to 2.9%.

1.20 This sector performance exceeds the benefits that were anticipated when we moved to the current industry structure in 2001.

1.21 We agree that now is a good time to take stock, look forward, and ask whether DIRA is right for today's dairy sector, the challenges that lie ahead, and where the dairy sector needs to be a decade from now.

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[17] Based on a three-year rolling average CAGR of jobs, between 2001 and year ended February 2017. Ibid, 26.

[18] NZIER, based on Statistics New Zealand export data for the year ended June 2017.

[19] NZIER proprietary database for the year ended March 2017.

[20] NZIER *Assessing Fonterra's performance*, 5-8.

Question 2

To what extent and in what way is the DIRA contestability regime contributing to and/or impeding the sector's performance? Specifically, to what extent do the DIRA contestability provisions (vis-à-vis other industry and wider regulatory settings) impact on, and drive, the choice of business strategies, company structures, governance and ownership arrangements, value creation, investment in innovation and research and development and the environmental performance of the dairy industry (both at the production and processing levels of the New Zealand based dairy supply chain)?

2.1 In summary:

(a) The key goal of the DIRA regime[21] – contestability – has now largely been achieved.

(b) As a result, the balance of benefits and costs of the regime has changed; some aspects are working against efficiency and other policy and strategic objectives, including environmental protection.

(c) Other aspects continue to serve a useful purpose even if in some cases there are still costs (both economic and environmental) associated with them.

(d) DIRA has always anticipated deregulation over time as dairy markets evolved. This was built into the original structure and is fundamental to DIRA. Fonterra supports a staged approach to deregulation, focusing first on addressing provisions where the costs now materially outweigh any remaining benefits.

The dairy sector has developed real contestability under DIRA

2.2 The DIRA contestability objective has contributed to the performance of the New Zealand dairy sector by facilitating the development of real competition from a variety of businesses with different strategies, structures, governance and ownership arrangements.[22]

Independent processors are numerous, sustainable and exercise a real competitive constraint on Fonterra

2.3 Other processors are now well-established and economically sustainable (with some backed by large global players). Fonterra's share of milk processed in New Zealand fell from 96%[23] to 82%[24] nationally between 2001 and 2017.

2.4 Entrants have tended particularly to target, and been successful in obtaining, market share in the South Island. Fonterra's market share in the South Island has declined from approximately [redacted] to approximately [redacted]% since

[21] Specifically, DIRA, Part 2, Subparts 5 and 5A, and the Dairy Industry Restructuring (Raw Milk) Regulations 2012 (*Raw Milk regulations*).

[22] In 2016, the Commerce Commission accepted there are signs farm gate markets are contestable, and that new independent processors have been entering, and existing processors expanding: Commerce Commission, *Review of the state of competition in the New Zealand Dairy Industry: final report* (1 March 2016), [4.9]. The Commerce Commission's recommendations for deregulation were narrower than what Fonterra is now proposing, but it is also important to note the much narrow scope of that review.

[23] NERA *Assessment of Competition in Raw Milk Markets and Costs and Benefits of the DIRA Provisions* (17 August 2015), 8.

[24] NZIER *Assessing Fonterra's performance*, 2.

2001.[25] Fonterra's market share is now well below the statutory threshold which, without Government intervention, would have triggered deregulation in the South Island under DIRA.[26] In other words, the market share of independent processors has exceeded what was, as recently as 2011, considered sufficient for the DIRA contestability regulation to be removed in the South Island.

2.5 Even in the North Island, Fonterra's market share has declined from [redacted] to approximately [redacted] since 2001. Again, this has been due to competition.[27]

2.6 Fonterra's decreasing market share is attributable to the rise of independent processors such as Westland Milk Products (*Westland*), Synlait and Open Country Dairy (*OCD*). Most independent processors have increased their market share significantly over the last few years.[28]

2.7 Independent processors have been successful in contracting farms close to their plants, and can often offer higher farm gate prices where transport costs are lower than Fonterra's national average. Independent processors generally have significantly higher shares relative to their national shares in their collection zones. For example, Fonterra estimates that:

[redacted]

2.8 Ownership structures of the independent processor sector vary widely, from co-operatives (e.g. Westland and Tatua), to New Zealand-owned, unlisted companies (e.g. OCD), to publicly listed companies (e.g. Synlait). Some

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25 Source: Fonterra estimates based on DairyNZ data for the 2016/17 season.

26 Initially, the 2001 thresholds were set to automatically expire where independent processors collect in a season:

- at least 65 Million kilograms of milksolids (*kgMS*) (estimated to be approximately 11%) 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.

However, in 2011 – when the existing thresholds were set to expire imminently - the thresholds were pushed out to instead require review when independent processors collected 20% or more of milksolids from either the North or South Island (or both), and no later than 1 June 2015. Notably, once the amended thresholds were reached they would no longer automatically fall away, but rather would be subject to further review (see the now-repealed sections 147, 148B, 148A, 148(4) to (8) and 149).

27 Source: Fonterra estimates based on DairyNZ data for the 2016/17 season.

28 The main exceptions are New Zealand Dairies Limited (*NZDL*) (which went into receivership in 2012 and whose manufacturing assets were subsequently purchased by Fonterra) and Tatua Co-operative Dairy Company Limited (*Tatua*), which does not accept new supply.

have significant foreign financial backing (e.g. Synlait, Oceania, Miraka and Yashili).[29]

2.9 Likewise, business strategies have varied widely, from commodities through to consumer products e.g. OCD is predominantly a low-cost producer of low-value products (although it has recently referred to higher value product development projects)[30] while Tatua focuses on high value ingredient products.[31]

2.10 The collective size of the independent processors is approximately $3 billion in sales revenue, and they process more than 3.5 billion litres of milk per annum; the independent processors are approximately 40% of the size of Australia's total milk processing volumes. OCD and Synlait together had milk processing volume growth of 15% in 2017.[32]

2.11 In line with these features, independent processors have been in a position to invest; approximately $3 billion has been invested by these processors since 2001.[33] Investments have been spread across commodities, ingredients and consumer businesses.

2.12 It is clear that the key contestability goal of the DIRA (to facilitate entry) has been met, in that real competition is now taking place and is sustainable.

Independent processors are well-placed to continue to grow, and the landscape supports new entry

2.13 But to be confident real competition has been achieved it is worth examining the future prospects of the independent processor sector in New Zealand.

2.14 Many independent processors are well-established and stable (with some backed by large global players). They are well-placed to continue to expand their presence.

2.15 It is also clear that the landscape supports entry and expansion.[34] Farmers are now used to new independent processors entering the market, and remaining viable, and are open to switching if presented with a compelling business case.

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29 NERA *Assessment of Competition in Raw Milk Markets and Costs and Benefits of the DIRA Provisions* (17 August 2015), 20.

30 NBR *Open Country Revenue tops $1b* (2 February 2018), https://www.nbr.co.nz/article/open-country-revenue-tops-1b-b-212175.

31 See https://www.tatua.com/business-units/ .

32 TDB Advisory, *New Zealand Dairy Companies Review (*April 2018), 7.

33 Ibid, 16.

34 Recent examples include: a new Synlait plant in Pokeno scheduled to open 1 June 2019; the OCD Horotiu plant expected to process from 1 August 2018; Mataura Valley plant in McNab, near Gore, expected to process from August 2018; the second stage of Oceania development commissioned; Happy Valley planning to build two eight-tonne dryers and a processing and canning facility, targeting A2 and organics in Otorahonga; Kawerau Dairy in Bay of Plenty is expected to begin producing in early 2019; and Milk New Zealand currently exporting UHT and fresh milk to China under "Theland" brand (manufactured by Miraka) and announced plan to list a company on the NZX within 3-5 years.

"Open entry" imposes significant potential economic and environmental costs on New Zealand

2.16 In this section, Fonterra demonstrates that:

(a) The benefits of open entry have been largely exhausted, given contestability has been achieved, and the contestability and efficiency of Fonterra's milk price and the ease for shareholders of entering and exiting Fonterra are protected by the milk price regime and TAF respectively.

(b) Open entry drives significant negative economic and environmental costs to New Zealand. These have always been present; however, in previous reviews the environmental impact has not been seriously addressed, and Fonterra believes the economic costs have been significantly under-estimated.

(c) If open entry were removed, Fonterra would be able to make a better contribution to New Zealand.

Background

2.17 Open entry, by guaranteeing farmers can enter Fonterra, was originally intended (along with open exit) to:

(a) be the primary mechanism to achieve contestability for the supply of milk from farmers;

(b) safeguard accurate and efficient pricing of Fonterra shares and farm gate milk; and

(c) facilitate the entry of independent processors.

2.18 Open entry requires Fonterra to accept applications to supply milk from new farmers as shareholding farmers,[35] and applications from existing shareholding farmers to increase the volume of milk supplied.[36] The obligation to accept supply is subject only to limited exceptions. These play a very small role, and the obligation to accept supply is in practice almost absolute.

The role of open entry has been exhausted

2.19 As competition has developed and become more robust and sustainable, the need for open entry to protect the entrance pathway has significantly reduced. Independent processors no longer require a "leg up", and farmers are protected:

(a) There is material competition for farm gate milk in a number of regions (as set out above), and competition for their supply protects farmers.

(b) In regions where there is no alternative to supply by Fonterra (Northland and Wairarapa), farmers are protected by the co-operative structure and the equal treatment it affords suppliers. That is, Fonterra is committed to equal treatment of its farmers, which means that our

[35] DIRA, section 71(b). The obligation to accept supply (including its exceptions), and other key aspects of the DIRA regulation, are described in Annex 1.

[36] Ibid, section 73.

farmer shareholders throughout New Zealand benefit from competition in any region (see further below at paragraph 2.50).[37]

2.20 Local market shares are a better indicator of the real competitive impact of independent processors than North and South Island or national market shares. Because Fonterra's co-operative structure promotes equal treatment among farmer shareholders, the benefit of any efficiencies driven by competition in a particular area will flow to farmer shareholders nationwide. This also means that suppliers in the few areas where there are currently no independent processors (Northland and Wairarapa) benefit from the effects of competition in other areas. As a result, Fonterra's national and North Island market shares understate the competitive impact of independent processors.

2.21 Another motivator for the open entry obligation was to ensure accurate and efficient pricing of Fonterra's shares. That rationale is no longer of significance given the advent of the milk price regime and Trading Among Farmers (*TAF*, both discussed below see paragraphs 2.83 and 2.97).

Open entry restricts Fonterra, strategically and commercially

2.22 Open entry has and will continue to materially influence the strategic decisions that Fonterra makes. It pervades our decision-making, causing us to make decisions that an unencumbered corporate strategy would not contemplate.

2.23 For example, in an environment of increased competition, farmers typically face a choice of processors to which they may offer new supply. Similarly, farmers currently supplying processors other than Fonterra may choose to switch to supplying Fonterra. Fonterra must assume that we would need to accept all such supply, whereas in practice it might be offered to another processor, in whole or part. This creates significant inefficiencies in managing capacity utilisation in existing plants.

2.24 More specifically, the obligation to accept supply drives Fonterra to invest in new capacity that would ensure we are able to accept all potential new supply. This:

(a) Creates risks of stranded assets when supply conditions change. The potential consequences of this could be felt much wider than Fonterra itself. In particular, in many small regional communities individual factories can be a crucial employer. Asset stranding that leads to factory closures could have negative effects on families' and communities' livelihoods.

(b) Creates inefficiency by distorting the priority Fonterra would place on investing in new processing capacity, compared with other investments. This works against Fonterra being able to make the highest returning and most efficient investments in manufacturing capacity.

(c) Alters the capacity mix that Fonterra would otherwise maintain under its commercial strategy (particularly, incentivising dryer plants over higher value manufacturing capacity), driving inefficient investment.

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[37] NERA, *Assessment of competition in raw milk markets and costs and benefits of the DIRA provisions* (17 August 2015), 2.

2.25 In contrast, independent processors are able to compete to secure new supply, and to retain existing supply, in a manner that suits their commercial strategy. That includes both contracting for longer terms to support investment and turning down supply that would result in inefficient investment.

2.26 These issues have other significant implications, for example in R&D spend. While our V3 strategy has been moving to a more demand-led strategy, open entry has forced Fonterra to be production led. This has narrowed Fonterra's realistic R&D opportunities. Specifically, disproportionate investment has been in made in R&D projects that deliver innovations at scale, as opposed to smaller-scale innovations that may be scaled up if successful. There have been significant benefits in this R&D, and Fonterra has delivered material R&D success (see paragraph 4.19), but our scope to choose and thus pursue the highest value innovations has been limited.

2.27 Another way to illustrate the costs of open entry is to observe a period of time when the obligation has had less effect. Specifically, since the 2014/15 season, milk growth has slowed and therefore the pressures created by open entry have eased (because Fonterra has not been forced to invest in capacity simply to cope with the volume, or potential volume, of milk being supplied). As a consequence, Fonterra has had more freedom to choose its commercial strategy. Since 2014 Fonterra has invested in a number of new plants and equipment, including cream cheese, lactoferrin and mozzarella. Fonterra has not commissioned any new commodity milk powder dryer plants since 2014. In other words, in the absence of volume pressure Fonterra's investment behaviour has shifted in favour of higher value products.

2.28 Regulating in a way that incentivises such a large business to invest sub-optimally has a real impact on New Zealand's productivity performance. Furthermore, as regulatory settings around climate change and other issues (rightly) increase the costs of environmental protection, it will be even more important that Fonterra is able to generate as much efficiency as possible in its operations, including the efficient allocation of its capital.

Open entry encourages inefficient investment decisions, which could stymie the sector's development over the longer term

2.29 Today, as set out above, competition is flourishing and healthy. And as we have also outlined above, we acknowledge that open entry has contributed to that outcome. However, it must be borne in mind that open entry does distort entry decisions, incentivising entry where it might not otherwise be rational.

2.30 In the dairy sector, a new independent processor faces an inefficient incentive to enter and build a plant. First, it will have a right to obtain regulated raw milk from us under the Raw Milk regulations. Secondly, it will have a head start in attracting farmers, as it can encourage farmers to take a chance and supply it, on the basis the farmer can return to us if the risk does not pay off. This does not contribute to the productivity of the sector. Instead, as noted above, it distorts entry decisions, incentivising entry where it might not otherwise be rational.

2.31 Where a processor does make an inefficient decision to enter, and its investment case turns out not to stack up, it will be reluctant to exit because its significant investment is largely sunk and will be lost.

2.32 As time goes on, the result could be a sub-optimal situation where returns on investment are lower than they would be in a more competitive market.

Those in the market would tread water, occasionally seeking to under-cut each other but mainly looking to stay in the market until a competitor drops out, rather than focusing on maximising their return on investment. Essentially, competitors would be "stranded" in the market, fighting to recover their investment on low margins.

2.33 This might initially look like competition (and what DIRA was originally designed to do), because processors would be competing hard for supply, but in fact it would be drawing the sector into a downward spiral of low-margin competition and consequent inability to invest to move up the value chain.

2.34 This would lead to participants in the New Zealand dairy sector compressing margins to stay in the market while they wait for a competitor to blink first and exit (which could itself mean factory closures with resulting disruption for regional economies).

2.35 It would not benefit NZ Inc., regional development objectives or the long term sustainability of the dairy sector. New Zealand is a capital-shallow economy, which challenges productivity and ultimately living standards, making it particularly important that capital is allocated efficiently. It is critical that open entry is not retained longer than it is needed.

Open entry imposes significant environmental costs

2.36 Looking back, Fonterra can see that DIRA, specifically the open entry obligation, has had unintended adverse consequences for the environment. That is because it provides an incentive for farmers to produce dairy – with a relatively high value to land ratio – knowing it will be accepted by Fonterra under open entry.

2.37 While growth in dairy production has been permitted under environmental regulation to date and valuable in terms of the dairy industry's economic growth contribution to New Zealand, Fonterra can see this has meant dairy growth has gone further and grown faster than in some cases, the land and environment could perhaps tolerate.[38]

Open entry requires Fonterra to accept supply from new farmers that may not meet Fonterra's standards for supply (including environmental, animal welfare, hygiene, and health and safety requirements)

2.38 Given the very limited exceptions to the open entry obligation, Fonterra is required to accept applications from farms that may not meet Fonterra's standards of supply (including around environmental, animal welfare, hygiene and health and safety compliance), impacting the reputation of the Co-operative, all other Fonterra farmers and the dairy industry as a whole.

2.39 While Fonterra is entitled to suspend collection of milk from an existing supplier that does not comply with Fonterra's terms of supply, under open entry Fonterra must accept applications for new supply from farms that it anticipates would be non-compliant. Allowing such a farm to become part of the Co-operative risks sends the wrong message to farmers about the conduct Fonterra accepts. Furthermore, once such a farm is part of the Co-

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[38] There is also an economic efficiency cost where open entry incentivises dairy conversions over an alternative land use. Following recent reviews the Commerce Commission and cabinet (following the Ministry for Primary Industry's (*MPI*) work) considered open entry should not apply to new conversions (see Commerce Commission, *Review of the state of competition in the New Zealand dairy industry: final report* (1 March 2016), [X13]; Cabinet paper, *Efficiency and contestability of the New Zealand dairy industry*: *Amendments to the Dairy Industry Restructuring Act 2001 and the Dairy Industry (Raw Milk) Regulations 2012* (October 2016), [11]).

operative, it directly impacts the reputation of Fonterra and that of its farmers.

2.40 In practice, Fonterra invests significant time and effort (often over the winter months before milk supply commences) to help farmers meet Fonterra's supply terms. Suspending collection of milk is used only as a last resort. In addition to imposing a cost on Fonterra, open entry is also an opportunity lost to incentivise farmers to meet appropriate on-farm standards before they join the Co-operative.

Fonterra's ways of operating in the absence of open entry would be better for New Zealand and for the Co-operative

2.41 In the absence of the obligation to accept supply, constraints on Fonterra would remain and barriers to entry would not increase materially. In particular:

(a) Fonterra would not generally be in a position to decline applications by existing farmer shareholders to increase supply from existing farms[39] due to our co-operative structure. NERA has advised MAF that Fonterra is partially "constrained by the overall co-operative desire to treat suppliers equally" (see also below at paragraph 2.50).[40] Fonterra considers that a key benefit to shareholders of our co-operative form is the ability to grow and that this is intrinsic to the value we offer to farmer shareholders (although, where existing farmer shareholders situated in environmentally sensitive catchments seek to increase their supply, Fonterra would be particularly vigilant about ensuring environmental compliance).

(b) Fonterra often faces a strong commercial imperative to accept applications for new supply. Fonterra has an economic incentive to accept milk provided the incremental revenue from that milk exceeds the incremental cost.

(c) Fonterra has agreed a transition plan with Federated Farmers that would apply if the open entry obligation were removed. Specifically, if open entry were removed, Fonterra would continue to accept supply in relation to farms that were supplying Fonterra on a share-backed basis when Fonterra's open entry obligation ceased, and which continue to supply Fonterra. This commitment would continue until the remainder of the DIRA contestability regulations fell away.[41]

2.42 In the absence of open entry, Fonterra would be in a better position to align our capital investment with customer demand (because the supply-side driver would be reduced). Fonterra would be likely to use the discretion afforded by removing open entry in the following ways:

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[39] Constitution of Fonterra Co-operative Group Limited (*Fonterra's constitution*) does provide for a discretion to accept increases in supply due to a "Material Change", but Fonterra notes that it is rare for a farmer shareholder to apply to increase supply. Typically, in practice, farmer shareholders increase their supply without making a formal application.

[40] NERA, *An Assessment of the DIRA Triggers – Ministry of Agriculture and Forestry* (30 March 2010), 17.

[41] Federated Farmers' and Fonterra's proposal for staged removal of statutory "open entry requirements" (12 June 2017), available at http://www.fedfarm.org.nz/FFPublic/Policy2/Policy_Factsheets/Proposal_for_staged_removal_of_statutory_open_entry_requirements.aspx?WebsiteKey=00ff782d-8ff5-4a81-ae69-785972132c32.

(a) Fonterra may choose to decline applications to supply by new entrants for commercial reasons. This may occur, for example, where the supply would not be efficient from a capacity management perspective (such as because it would not be efficient to build new capacity in a particular area and transport costs mean it would not be efficient to utilise existing capacity).

(b) Fonterra may choose to decline applications by new entrants for environmental reasons. For example, we have recently advised a farmer of our reluctance to facilitate expansion of dairying in the McKenzie Basin and surrounding areas, but we are unable to decline that farmer's application because of open entry. We may also choose to decline applications to supply where we have good reason to consider the farmer would not meet Fonterra's terms of supply (including animal welfare, hygiene, and health and safety requirements), for example because of a history of repeated disregard for such standards.

(c) Alternatively, in some cases Fonterra may wish to accept new supply, but based on altered commercial terms, for example a fixed period of commitment to supply Fonterra with specific environmental performance and compliance terms. (This may also have implications for the non-discrimination rule, the right to withdraw and the 160km rule – addressed below.)

2.43 Therefore removing open entry would:

(a) Make a real difference to Fonterra being able to choose our strategy and direction, as well as, day-to-day, an increase in the efficiency of managing and planning processing capacity and logistics.

(b) Remove an incentive for new farmers to convert to or initiate producing milk that is not necessarily valuable to Fonterra or good for the environment or good farming practice.

(c) Not materially increase barriers to entry or expansion for independent processors, which are well placed to compete.

(d) Not be detrimental to farmers, which are protected by competition for their supply, and Fonterra's co-operative structure.

(e) Not compromise the original goals of the obligation to ensure an appropriate price point for the value of Fonterra shares to facilitate switching. This purpose is fulfilled by the process of setting the milk price (which is buttressed by the fact that the milk price regime is enshrined in DIRA) and TAF – see below at paragraphs 2.83 and 2.97.

2.44 We can't go back and eliminate the costs open entry has contributed to date in terms of the environment and good farming practice, but what we can do now is:

(a) Ensure we learn from the past and under this review, take a future-proofing approach for our environment and good farming practice. We believe this can be achieved by removing our open entry obligation. This would provide constraints for production of new dairy beyond what the environment can sustainably tolerate and dairying that does not otherwise meet good farming practice.

(b) Affirm the part our sector must play to address the impact dairying has had on the environment – particularly, our waterways and demonstrate responsibility in helping to restore them.

(c) Continue to place sustainability at the centre of our Co-operative's strategy and recognise the importance of this to the New Zealand dairy industry, including our social licence to operate. Our farmers have already invested over $1 billion in on-farm environmental improvements but we will be doing more. This focus on sustainability is also important to our customers and consumers who are placing increasing importance on knowing their food is produced this way.

The non-discrimination rule is no longer justified if open entry is removed

2.45 In this section, Fonterra shows:

(a) The non-discrimination rule is closely linked to open entry and would impose real cost on Fonterra and on farmers, if open entry were removed.

(b) Without the non-discrimination rule, Fonterra would be free to make nuanced supply decisions in the best interests of the Co-operative, potential farmer suppliers and New Zealand.

(c) Removing the non-discrimination rule would not leave farmers vulnerable, or have negative consequences for contestability.

Background

2.46 The non-discrimination rule provides that Fonterra must ensure the terms of supply for a new entrant are the same as those for a farmer shareholder in the same circumstances, or differ from the terms that apply to a farmer shareholder in different circumstances only to reflect the different circumstances.[42]

Without open entry the non-discrimination rule would be detrimental, for Fonterra and for farmers

2.47 The non-discrimination rule is closely linked to open entry, because it prevents open entry from being "gamed". The concern is that if Fonterra did not want to take supply from a farmer, it could impose onerous conditions on the supply. That would effectively shut out the farmer, even though the open entry obligation had not technically been breached. Accordingly, if open entry is considered justified then the non-discrimination rule is also likely to be justified.

2.48 But where open entry is no longer considered necessary, Fonterra considers the non-discrimination rule also does not make sense.

2.49 Specifically, if open entry were removed, Fonterra could choose to accept or turn down new supply. But in some circumstances it might be efficient for Fonterra to accept supply, but only if it could do so on altered terms that reflected the value of the additional supply to Fonterra (or required environmental performance and good farming practice requirements). Those altered terms might well be beneficial to farmers, giving them the opportunity to supply Fonterra rather than being turned down. However, altering terms

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42 DIRA, section 106.

based on the value of the supply to Fonterra would contravene the non-discrimination rule.

2.50 In the absence of the non-discrimination rule, Fonterra considers that:

(a) We would be constrained from discriminating among existing farmer shareholders by:

(i) our contracts with existing farmer shareholders. For farmer shareholders, supply terms are contained in Fonterra's constitution, the Farmers' Handbook, standard form "share up over time" contracts (if applicable), specific terms for specialty milks (such as winter milk and organic milk), and any policies set by the board. These terms are not supplier-specific.

(ii) the co-operative structure of Fonterra, which places significant constraining power in the hands of farmer shareholders. Fonterra is constrained by the collective views of farmer shareholders.

(iii) Fonterra's co-operative principles and more broadly our institutional form as a co-operative.

(b) In relation to new supply that the non-discrimination rule renders inefficient to accept, Fonterra would have a discretion to pay for supply at a price that reflects its incremental value to Fonterra (noting that Fonterra could also impose additional environmental or other conditions). This would allow Fonterra to manage supply and volume uncertainty by requiring a longer period of supply commitment, or to pay for supply or impose charges (e.g. based on transport costs) in a way that reflected the true value of that additional supply. It would also allow farmers to participate in supplying Fonterra, even where to do so on standard terms would not be economic for Fonterra.

2.51 For the same reasons as are given above for open entry, Fonterra considers the removal of the non-discrimination rule would not materially raise barriers to entry or expansion.

"Open exit" and the "160km rule" impose costs, but allow some offsetting flexibility

2.52 In this section, Fonterra shows:

(a) The right to withdraw and the 160km rule impose material costs on Fonterra.

(b) That said, the obligations do allow Fonterra some flexibility and Fonterra currently manages to compete effectively within their constraints.

Background

2.53 Open exit provides that a farmer shareholder has a right to cease or reduce supply to Fonterra (*right to withdraw*).[43] Additionally, DIRA, in combination with Fonterra's constitution, restricts the proportion of milksolids that can be supplied on contract in a given year (*160km rule*).

[43] Ibid, section 97. For more detail, see Annex 1.

2.54 Along with open entry, the goals of open exit were originally to:

(a) achieve contestability for the supply of milk from farmers;

(b) safeguard accurate and efficient pricing of Fonterra shares and farm gate milk; and

(c) facilitate the entry of independent processors.

The right to withdraw and the 160km rule impose material costs

2.55 Without the right to withdraw and the 160km rule, Fonterra would have greater ability to present a range of offers to existing and potential suppliers as well as make more efficient planning decisions. For example, the business case for a new plant would be materially strengthened by supply certainty over a 5-year period. Similarly, certain production benefits from winter milk supply, and again, five-year local winter milk supply commitments would materially improve the business case for such production. Organic plants need to be capable of processing organic product, and with a three-year lead-in for organic conversions security of supply is extremely valuable.[44]

2.56 The cost of the inefficiencies created by these rules are material.

2.57 Fonterra understands that our competitors frequently secure 5-year commitments from their suppliers, which illustrates that this would be a useful and valuable tool, which farmers may well be willing to contemplate. Note though that Fonterra's freedom to do so would always be subject to the equality of treatment effectively demanded by our co-operative model – e.g. Fonterra's constitution provides that the aggregate amount of milksolids obtained from shareholders in a season on contract supply cannot exceed 15% of the total milksolids supplied by shareholders in the preceding 12 months.[45]

But Fonterra is able to compete within the constraints

2.58 The open exit rules in practice allow Fonterra some flexibility in our supply contracts. Fonterra has been able to develop and make offers to present more, and more attractive, options to suppliers and meet competition. In addition, longer supply term commitments allow Fonterra some certainty to support our capacity and other investment decisions.

2.59 In particular, Fonterra has offered suppliers options to "share up" (in other words, purchase sufficient Fonterra shares to support their volume of milksolids supply) over longer periods, including three, 6 or 10 years. These offers entail some degree of commitment to supplying Fonterra for the share up period.

2.60 Fonterra also developed our MyMilk offer in order to meet competition in the South Island. Specifically, in introducing the MyMilk offer, Fonterra sought to attract valuable new milk, provide a stepping stone for potential new co-operative members, match some of the value propositions of independent processors, and secure additional supply from farmers who support a strong

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[44] Fonterra currently has a two winter notice period for winter milk, and one to three seasons (depending on when the organic milk contract was signed) for organic milk.

[45] Fonterra's constitution, clause 3.22.

New Zealand-owned co-operative but are at the stage in their business where sharing up is not within their reach.[46]

2.61 Finally, the redemption risk that was generated by the open exit obligation has been alleviated by the development of TAF (discussed below from paragraph 2.95).

2.62 As a result, while the right to withdraw and the 160km rule result in inefficiencies, Fonterra currently manages to operate and compete within the constraints.

The Raw Milk regulations impose material costs, which are no longer justified in the case of larger processors other than Goodman Fielder

2.63 In this section, Fonterra shows:

(a) The obligation to supply still has net benefits for Goodman Fielder and smaller, niche processors but is no longer justified for large, export-focused processors.

(b) Similarly, the regulated price for supply is warranted for Goodman Fielder and smaller, niche processors but no longer for large, export-focused processors.

(c) Other aspects of the Raw Milk regulations impose unnecessary costs.

Background

2.64 The Raw Milk regulations oblige Fonterra to supply raw milk, at a regulated price and on other regulated terms, to independent processors. Supply to Goodman Fielder is also specifically provided for.[47]

The obligation to supply still has net benefits for Goodman Fielder and smaller processors

2.65 The role of the Raw Milk regulations in facilitating contestability has been achieved with the advent of independent processors that have secured their own supply and present a sustainable competitive force in the farm gate market, such as OCD and Miraka.

2.66 NERA has described barriers to entry into the farm gate market as resulting from a "catch 22" whereby investors in independent processing plants are reluctant to invest without a secured supply of milk, and farmers (who have

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[46] The key features of this offer are:

- Farmers supply MyMilk, which is a Fonterra subsidiary, which in turn supplies Fonterra but holds no shares.
- Supply to MyMilk is on an annual basis (suppliers may leave at the end of any season, with notice given prior to 31 December), and supply is at a price set at the end of the season. The maximum level of the price is equivalent to the farm gate milk price, and the minimum is the lower of the farm gate milk price and 15 cents below the Fonterra contract milk price (less any contract fee). The Fonterra contract milk price is the price that applies to contracted, rather than share-backed, supply, and is currently equivalent to the farm gate milk price.
- Participation in MyMilk is limited to a maximum of 5 years (after which its suppliers must find an alternative processor or commence to supply Fonterra in the ordinary way) and MyMilk is currently limited to 5% of Fonterra's total supply. These limits were placed on the MyMilk offer in recognition of Fonterra's co-operative structure and in particular that suppliers to Fonterra should hold shares in proportion to the milk they supply.
- Although suppliers may exit at the end of any season, MyMilk commits to accept the supply for the full 5-year period.
- Fonterra does not (and has no desire to) use MyMilk as a tool to secure long term milk supply. As noted above, suppliers may leave at the end of any season.

[47] For more detail, see Annex 1.

sunk assets and a perishable output) are reluctant to contract with processing plants until they are established in the market.[48]

2.67 Given there is now a strong history of sustainable entry and self-supply by independent processors, suppliers can be expected to be willing to offer to supply entrant independent processors, even in their early stages. Furthermore, the majority of entrants have entered on the basis of a combination of regulated raw milk and direct supply, which calls into question the significance of the "catch 22".

2.68 Moreover, it remains open to all independent processors to secure factory gate supply on commercial terms from Fonterra and, increasingly, other independent processors. For example, Fonterra understands OCD supplies raw milk to Yashili's Pokeno plant. Without the Raw Milk regulations, Fonterra (and other independent processors) might engage in more such arrangements, to the extent they were compensated for their opportunity cost in doing so (and these arrangements would be subject to the Commerce Act). In this respect, the market might well be more efficient in the absence of the Raw Milk regulations.

2.69 Against this background, there is little justification for mandating the supply of regulated milk to established independent processors, particularly where they have little or no participation in domestic downstream markets. Instead, they benefit from the opportunity to add value to the raw milk (an opportunity Fonterra misses out on) purchased effectively at cost and use that milk to compete with Fonterra in highly competitive export markets.

2.70 Nevertheless, the Raw Milk regulations may have some ongoing legitimate role. Specifically, without the Raw Milk regulations, the factory gate market may not allow smaller niche suppliers to secure supply on terms that would facilitate their entry and sustainable participation in downstream domestic markets.

2.71 Fonterra also acknowledges the comfort that stakeholders take from the fact that there is regulated raw milk supply to a key downstream competitor, Goodman Fielder, safeguarding a level of downstream domestic competition.

2.72 Retaining regulated raw milk supply to Goodman Fielder and smaller niche competitors while they do not have their own supply, protects the current level of competition in downstream markets. As is described further below, there is no evidence to suggest downstream markets require additional intervention.[49]

2.73 That said, it is important to acknowledge some of the costs to Fonterra in meeting our obligations to Goodman Fielder. Notably, Fonterra must provide continuous supply over the year and is not able to price in the costs to it of the seasonal milk curve.

2.74 Additionally, Fonterra notes that Goodman Fielder is currently exempt from the rule that makes other processors no longer eligible for supply under the regulations if their own supply of raw milk in each of the three consecutive previous seasons was 30 million litres or more. Although not currently in

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48 NERA, *An assessment of the DIRA triggers – Ministry of Agriculture and Forestry* (30 March 2010), 4.1.1.2.

49 See also Commerce Commission, *Milk Markets: consideration of whether to initiate a Commerce Act Part 4 inquiry into milk prices* (August 2011).

contemplation, there may come a point where Goodman Fielder is considered able to operate without regulated assistance, and where requiring it to do so would not disturb public confidence in downstream domestic competition.[50]

2.75 At this stage, the requirement to supply Goodman Fielder remains important for public confidence in downstream wholesale and retail markets and there is still a case for smaller, niche processors that do not have their own milk supply having access to Fonterra raw milk. However, it is difficult to justify making raw milk available to other larger, export-focused processors.

The regulated price for supply creates inefficiencies, but these may be justified for Goodman Fielder and small, niche domestic processors

2.76 The milk price regime (discussed below) has a role in the factory gate market in that it forms the basis for the price at which raw milk must be supplied under the Raw Milk regulations.

2.77 The price for supply under the Raw Milk regulations, which is likely to be lower than Fonterra's other option for that milk potentially creates cost for Fonterra, particularly in the context of supply to larger independent processors. The regulated milk price may result in Fonterra shareholders subsidising entry, which could in turn lead to inefficient entry. A milk price below opportunity cost could also limit the incentives for independent processors to trade raw milk, thus working against independent processors entering the factory gate market. In a context of markets that are already, and increasingly, contestable, this is particularly undesirable and unnecessary.

2.78 However, to the extent there remains an ongoing justification for particular types of supply under the Raw Milk regulations, the regulated price may be considered warranted for those smaller, niche suppliers and for Goodman Fielder (while they do not have their own supply).

There are other regulated terms of supply that impose unnecessary costs

2.79 The Raw Milk regulations allow independent processors to vary the estimates of the quantity of raw milk they intend to purchase by a wide range and up until very close to the time they receive the supply, creating significant cost for Fonterra and unnecessary inefficiencies. This is primarily in the form of opportunity cost to Fonterra in terms of alternative, higher value use of the milk, and inefficiency in the form of not being able to optimise production relative to supply. Independent processors effectively have a free option to vary the milk they take from Fonterra at peak such that Fonterra bears the risk of forecasting peak supply. These freedoms are not connected to any countervailing need on the part of independent processors.

2.80 In particular:

(a) Tolerances in relation to independent processors' estimates of the quantity of raw milk they anticipate purchasing should be reduced, as they have a significant combined effect.[51] Fonterra is generally able to

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[50] Note the Commerce Commission in its recent review recommended the Minister consider the option of reducing Goodman Fielder's entitlement to regulated milk, and MPI subsequently consulted on this option: see Commerce Commission, *Review of the state of competition in the New Zealand dairy industry: final report* (1 March 2016), [X10.3]; MPI, *Discussion Document: Proposed changes to the Dairy Industry Restructuring Act 2001 and Dairy Industry Restructuring (Raw Milk) Regulations 2012* (May 2016), [65], [86] and following.

[51] Raw Milk regulations, regulations 10(3), 21(1) and 21(2).

cope with these during "shoulder" months but faces significant costs and challenges dealing with the potential variability of demand during "peak" months. Fonterra agreed with MPI's proposals to address this issue in the previous DIRA review.[52]

(b) Currently, independent processors must give 18 months' notice of requiring winter milk supply above 20,000 litres per day.[53] A period of 18 months is insufficient for Fonterra to source new supply and for successful applicant farmers to alter calving patterns in order to supply milk in June and July (changing calving patterns itself takes at least 18 months).

(c) There is currently a large tolerance for winter milk supply quantity estimates.[54] Fonterra must contract winter milk from our suppliers at a premium. If independent processors do not purchase the winter milk they have forecast to purchase Fonterra must nevertheless pay the premium to suppliers. Although Fonterra is able to process the milk we do not recover the winter milk premium. For the same reason, it does not seem appropriate for the take or pay prohibition[55] to apply to (at least) winter milk.

2.81 Fonterra also notes that winter months are currently excluded from the months that are subject to maximum monthly volume limits (the "October rule") and there does not appear to be any basis for this. Fonterra is able to obtain a winter milk premium, which reflects the cost to Fonterra of sourcing that milk, but in our view paying this premium does not justify allowing independent processors to purchase unlimited volumes.[56]

2.82 Separately, there is an ambiguity in the drafting of the Raw Milk regulations. Specifically, it could be argued they allow independent processors to forego their supply of milk under the Raw Milk regulations for a season, which would allow them to re-start the three-year supply period and circumvent the Raw Milk regulations.[57]

The milk price regime continues to support market efficiency, transparency and public confidence

2.83 In this section, Fonterra shows:

(a) In the absence of the milk price regime Fonterra's conduct would be largely unaltered.

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[52] MPI, *Discussion Document: Proposed changes to the Dairy Industry Restructuring Act 2001 and Dairy Industry Restructuring (Raw Milk) Regulations 2012* (May 2016), [97] and following. MPI's proposals would have limited:

- Independent processors' one-week estimates to 20% more or less than the earlier three-month estimate.
- The variation of the contracted volume to between 90% and 110% of the one-week estimated volume.

[53] Raw Milk regulations, regulation 11(2)(a).

[54] Ibid, regulation 11(3).

[55] Ibid, regulation 21(5).

[56] Ibid, regulation 6.

[57] Regulation 6(3) provides for the limit on supply to independent processors whose own supply in the prior three seasons was greater than 30 million litres, "as specified in the returns provided" to Fonterra under regulation 18(2). However, under regulation 18(2) an independent processor is only required to provide Fonterra with a return if it requires supply in the current season. If the independent processor wishes to purchase milk in a subsequent season, it will not have submitted a return and yet might have had more than 30 million litres of its own supply in the three preceding seasons.

(b) Nevertheless, the market and public confidence generated by having the milk price regime enshrined in law, with Commerce Commission oversight, are real benefits.

(c) In fact, farmers would stand to benefit if all processors were subject to milk price transparency requirements.

Background

2.84 The key components of regulation of the milk price under DIRA (*milk price regime*)[58] provide for a consistent and transparent setting of the farm gate milk price (which is intended to result in an efficient milk price that reinforces contestability).

2.85 The level of the farm gate milk price that Fonterra pays its farmers was not originally regulated by DIRA, and when the milk price regime was introduced to DIRA in 2012[59] it effectively enshrined Fonterra's pre-existing practice in relation to the setting of the milk price. The most significant change brought about when the regime was brought into DIRA was the addition of Commerce Commission oversight.

In the absence of the milk price regime Fonterra's conduct would be largely unaltered

2.86 Fonterra expects that in the absence of these aspects of DIRA's pro-competition provisions our conduct would be largely unaltered. This is borne out by:

(a) Our method of arriving at a farm gate milk price prior to the enshrinement of the milk price regime, which was generally consistent with the milk price regime (and was generally considered to be satisfactory, and effective in establishing a price that would arise in a competitive market).

(b) Fonterra's constitution, which incorporates elements of the milk price regime. For example, Fonterra's constitution requires Fonterra to determine the farm gate milk price on the basis of the methodology set out in the Milk Price Manual.[60] Fonterra must set the methodology and policies in the Milk Price Manual with reference to Fonterra's milk price principles.[61] Fonterra's constitution also provides for the establishment of the Milk Price Panel to supervise the calculation of the milk price.[62]

(c) The structure of Fonterra as a co-operative body, which largely eliminates the prospect of exercising market power against farmers. The Commerce Commission has observed in the past that principles of fairness and equality to all shareholders are entrenched in Fonterra, due to the overlap of supply and ownership. The Commission has noted that this structure constrains Fonterra's commercial ability and incentive to discriminate against particular shareholder suppliers.[63]

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58 For more detail, see Annex 1.

59 Introduced in the Dairy Industry Restructuring Amendment Act 2012.

60 Fonterra's constitution, clause 10.2.

61 Ibid. The milk price principles are set out at Annexure 1 to Fonterra's constitution.

62 Ibid, clause 10.3.

63 *Fonterra Limited and New Zealand Dairies Limited (in receivership)* [2012] NZCC 21, [26]-[27] and [81]-[88]. Some time ago (between 2007 and 2009), Fonterra engaged in "tactical pricing" in a limited way – by offering some

(d) The imperative generated by TAF to operate transparently (discussed below), providing comfort to investors under the TAF structure that Fonterra is not unfairly favouring our suppliers over them.

(e) Fonterra's internal co-operative principles,[64] which provide that "financial benefits and obligations that arise from cornerstone activities are allocated to supplying shareholders in proportion to their total milksolids supplied."[65]

(f) Strong commercial incentives to act prudently in evolving our milk pricing arrangements. Changes to reflect, for example, the location of farms, may result in significant value shifts among shareholders and could hamper Fonterra's ability to locate sites optimally (since this would affect the regional pattern of farm gate pricing). In general, the economies of scale of building large plants more than offset incremental costs of drawing milk from a wider catchment.

The milk price regime has real benefits for market and public confidence

2.87 Fonterra acknowledges that the milk price regime could be said to facilitate entry and exit by safeguarding the level at which the milk price is set, as well as ensuring a high degree of transparency and a level of public confidence. For example, it avoids concerns that Fonterra may, if faced with competitive pressure, be incentivised to pay farmers a higher than efficient milk price in order to encourage entry to, and discourage exit from, Fonterra in the short to medium term.

2.88 In its reviews to date, the Commerce Commission has concluded that the Milk Price Manual has been generally consistent with the s150A purpose. That is, the Milk Price Manual incentivises Fonterra to operate efficiently (i.e. drive cost efficiencies) while providing contestability in the market for the purchase of milk from farmers.[66] Nevertheless, the Commission's oversight is challenging and robust, and consequently performing the role intended. For example, Fonterra is currently in an ongoing process with the Commission examining whether Fonterra's estimate of asset beta – a measurement of systematic risk used by Fonterra in the calculation of the farm gate milk price – is too low (resulting in a too-high farm gate milk price). In other words, there is an appropriately high degree of scrutiny.

2.89 In Fonterra's view, the farm gate milk price that results from the application of the milk price regime is robust and performing the role intended.

Farmers would benefit from all processors providing transparency in their milk price

2.90 Fonterra understands there have been instances of farmers feeling misled about the milk price they could potentially achieve by supplying to certain other processors. Yet Fonterra is currently the only processor that must provide milk price transparency.

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farmers in specific areas who were considering leaving (or were at risk of leaving) a bespoke contract, which was non-shareholding. As observed by the Commission these tactics were not favoured by shareholders (ibid, [26]).

64 Fonterra's constitution, clause 16.1(a) provides that the Shareholders' Council's functions include working with the board to develop Fonterra's Co-operative Philosophy.

65 Fonterra, Co-operative Philosophy, Co-operative Principle 5.

66 See previous reviews at http://www.comcom.govt.nz/regulated-industries/dairy-industry/review-of-fonterra-s-farm-gate-milk-price-and-manual/.

2.91 Fonterra considers that greater milk price transparency throughout the industry (rather than only on the part of Fonterra) could well be beneficial for farmers. In particular, it would enable farmers to better understand and assess their options, and accordingly further promote contestability.

2.92 In its report on its dairy inquiry, the Australian Competition and Consumer Commission (*ACCC*) found that farmers are disadvantaged by information asymmetries with processors. Farmers have little insight into how farm gate prices are set, relying heavily on estimates set by processors, which often change without consulting farmers. Farmers can suffer significant loss through these changes to estimated price, and their lack of information throughout the process can leave them unprepared. Further, processors are better informed about the minimum price that farmers are likely to accept, than farmers are about the maximum price that processors are willing to pay.

2.93 Overall, these issues and farmers' lack of bargaining power result in practices that transfer disproportionate level of risk to farmers and soften competition between processors. The ACCC considered that processors should publish information identifying how their pricing offers apply to individual farm production characteristics to enable better farm income forecasts. This could be achieved through an interactive online model which allows farmers to enter their own production characteristics and obtain a reliable estimate of the final income to be received. [67]

2.94 Fonterra endorses this sentiment, and considers the provision of milk price transparency throughout the industry (rather than only by Fonterra) could improve the bargaining power of farmers and enhance competition among processors.

Trading Among Farmers contributes to market transparency and efficiency

2.95 In this section, Fonterra shows that TAF[68] provides a number of benefits.

Background

2.96 A significant consequence of open entry and exit was redemption risk – being the potential impact on Fonterra's capital from having to pay out farmers when they exited Fonterra, or when they reduced their milk supply (including, for example, due to a drought). A core objective of TAF was to address this redemption risk and stabilise Fonterra's capital base. In addition, TAF facilitates ease of entry and exit for Fonterra's farmer shareholders by providing a transparent, stable and liquid market for their shares that delivers well-discovered prices for those shares.[69]

TAF provides benefits

2.97 The introduction of TAF has stabilised Fonterra's capital base. This is illustrated by the following chart.

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67 ACCC, *Dairy Inquiry: final report* (April 2018), xiii, xxvi, [2.5.3], [3.3.2].

68 TAF was not contemplated in the original DIRA pro-competition provisions; Fonterra shareholders voted in favour of its introduction in June 2010. Relevant aspects of the 2012 DIRA Amendment were implemented in order to enable TAF (rather than specifically for a pro-competitive purpose) (See DIRA, sections 109A to 109N). For more detail, see Annex 1.

69 See, for example, Fonterra Co-operative Group Limited, *Submission of Fonterra Co-operative Group Limited on MAF Discussion Paper No. 2012/01: Dairy Industry Restructuring Amendment Bill 2012* (24 February 2012), page 2; explanatory note to Dairy Industry Restructuring Amendment Bill 2012.

[redacted]

2.98 TAF is linked and complementary to, the milk price regime. Under TAF, external unit-holders as well as farmer shareholders receive dividends. The amount paid is directly impacted by the efficiency of the milk price. TAF strengthens incentives for Fonterra to determine an efficient milk price, as external investors' interests are in a clear and objective identification of the milk price. Scrutiny by external investors also encourages Fonterra to be transparent in our milk price-setting process.

2.99 In practice, TAF also achieves its objective of facilitating entry to and exit from Fonterra for farmers by providing liquidity and good price discovery. Fonterra's exiting shareholders are able to sell all of their shares, or sell down their shares over three seasons[70] (as well as retaining an ongoing ability to participate in the Fonterra Shareholders' Fund) which further facilitates switching.[71]

2.100 Fonterra's farmer shareholders have made real gains through greater flexibility as a result of TAF. For example:

(a) Prior to TAF's introduction, farmers faced rigid capital rules, with all share transactions made via Fonterra on an annual basis and shares tied to milk supply. The introduction of TAF has allowed farmers to manage their equity throughout the year as they require. While the share standard requires shareholding farmers to hold a minimum number of "wet" shares to reflect their milk supply, those farmers are able to hold shares over and above that minimum requirement ("dry" shares) up to certain limits. Farmer shareholders and investors (persons or entities that do not supply milk to Fonterra) can hold units in the Fonterra Shareholders Fund (which currently comprises around 7 – 8% of total capital).

[70] Fonterra's constitution, clause 3.10(d)-(f).

[71] Farmers may exchange units in the Fund for shares when they join or return as a farmer shareholder.

(b) Prior to TAF, a farmer who made productivity improvements and knew he or she would produce more milk in two years' time would not be able to purchase more shares until that time, which meant a large capital outlay was required in the relevant year. Now, the same farmer could begin to increase capital immediately, buying some dry shares, or units to convert into shares, in the years leading up to the relevant year.

The "20% rule" provides a backstop pathway for entrants

2.101 Farmer shareholders are entitled to allocate to independent processors up to 20% of their weekly production throughout the season (without exiting Fonterra) (*20% rule*).[72]

2.102 In practice the 20% rule is not widely used and in any event could be replaced with supply under the Raw Milk regulations or through the factory gate market (see above). It is therefore not a fundamental pillar of independent processors' ability to obtain supply and compete. As such the absence of the 20% rule would likely not make a significant difference in the market if Fonterra was to prevent our farmer shareholders from offering a proportion of their production to independent processors.

2.103 Nevertheless, Fonterra understands that there are independent processors that do use and value the 20% rule, and that it could be seen as a "backstop" pathway, or additional option, for entrant processors to establish an initial, or maintain a niche, presence. In addition, it does not impose material costs that make a compelling case for its removal.

The sale of milk vats rule is in use and does not cause material inefficiency

2.104 Fonterra must sell a milk vat situated on the farm of a withdrawing farmer shareholder to the farmer shareholder or an independent processor that has agreed to buy the milk vat.[73] The provisions governing the requirement to sell milk vats are used frequently, and disputes arise only rarely.

2.105 The requirement for Fonterra to sell milk vats is in use, and Fonterra does not consider material inefficiency arises out of it.

The levy on milksolids is calculated in a manner that is unfair

2.106 Under the Animal Products (Dairy Industry Fees, Charges and Levies) Regulations, Fonterra is required to pay a "large processor" levy. The levy is calculated based on milksolids collected, not milksolids processed. This means Fonterra pays the large processor levy on the raw milk it supplies to independent processors at cost under the Raw Milk regulations. It is not clear why Fonterra is required to bear the additional cost of the "large processor" levy on raw milk it does not process.

A clear pathway to deregulation is essential

2.107 It is integral to DIRA that deregulation occur over time as competition in dairy markets develop (this is also discussed below from paragraph 5.1 and from paragraph 7.1). This has always been clear on the face of the Act. The

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72 DIRA, section 108.

73 Ibid, section 109.

Commerce Commission proposed during its review the concept of staged deregulation, and Fonterra endorses that.[74]

2.108 A clear pathway to deregulation creates appropriate and important incentives.

2.109 It sends a signal to suppliers that they cannot rely on regulation long-term. This allows them to appropriately price in relevant risks. It sends a similar signal to independent processors, which are encouraged to prepare and provide for their independence in a future where they cannot rely on the Raw Milk regulations and open entry and exit.

2.110 The signals encourage the development of independent and sustainable competition.

2.111 Conversely, not signalling that DIRA is on a pathway to deregulation risks regulation becoming, or appearing to be, an entrenched and solidified position. This creates an environment that does not incentivise market participants to price in deregulation and prepare themselves for independence, undermining the development of sustainable competition – a key goal of the legislation.

2.112 Removing the clear pathway to deregulation risks making deregulation more difficult to achieve:

(a) Suppliers and independent processors may rely on the (long-term) presence of the contestability regime when making decisions about entry and other matters, rather than planning for growth and sustainable independence.

(b) If deregulation is then attempted, those suppliers and independent processors will be in a position to point to loss or risk it will cause them.

[74] Commerce Commission, *Review of the state of competition in the New Zealand dairy industry: final report* (1 March 2016), [X71.1].

Question 3

Where/by whom are the benefits of the sector's performance being captured and the costs/risks incurred? What is the extent and distribution of the benefits and costs/risks across the dairy industry supply chain and the wider economy?

3.1 As outlined further in this section:

(a) The benefits of the New Zealand dairy sector's performance are largely captured within New Zealand.

(b) Dairy sector activity has a multiplier effect in regional economies.

(c) New Zealand consumers benefit from a competitive and open domestic supply chain.

(d) Fonterra and our farmers are focused on addressing the environmental effects of dairying.

A large proportion of the benefits of the sector's performance are captured in New Zealand

3.2 The performance of the dairy sector since 2001 is discussed above. It has been a success story and made a major contribution to New Zealand over that time. The New Zealand dairy industry added $8.2 billion of GDP in the year to March 2017,[75] and $17.2 billion[76] of exports in the year to April 2018, into the New Zealand economy. We agree it is useful to also ask how those benefits are distributed, and whether the benefits are evenly distributed with the costs and risks in the sector.

3.3 As a New Zealand-owned company, Fonterra's revenue and profits largely benefit New Zealanders and the New Zealand economy. Fonterra's farmer shareholders are based in New Zealand, and specifically regional New Zealand. More than 60% of the current investors in the Fonterra Shareholders' Fund (which currently comprises around 7 – 8% of total capital) are also based in New Zealand.

3.4 In terms of the sector more broadly, a number of Fonterra's key competitors are also New Zealand-owned or largely so (e.g. OCD, Tatua, Miraka and Westland).

3.5 While the profits of foreign-owned firms are not retained within New Zealand, the domestic economy nevertheless benefits from employment and other benefits. All dairy manufacturers employ New Zealanders, contribute to the New Zealand economy and process milk supplied by New Zealand farmers.

3.6 Furthermore, for the period January 2013 to December 2015, foreign direct investment in the dairy sector was $1.24 billion.[77]

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[75] NZIER proprietary database.

[76] NZIER, based on Statistics New Zealand export data.

[77] KPMG *Foreign Direct Investment in New Zealand: trends and insights into OIO decision summaries (2013 to 2015)* (October 2016), 27, available at https://assets.kpmg.com/content/dam/kpmg/nz/pdf/November/KPMG-FDI-Thought-Leadership-Web.pdf.

Dairy sector activity has a multiplier effect in regional economies

3.7 Dairy sector activity has flow on benefits by stimulating economic activity in the regions.

3.8 For every dollar of output generated by dairy farmers, 42 cents is spent on inputs from other industries in New Zealand, many of which will be locally sourced.[78]

3.9 Fonterra employs more than 11,700 people in New Zealand,[79] and our farmer shareholders also employ people in New Zealand.

3.10 We have 23 manufacturing plants in regional New Zealand. Each of these major production centres supports service providers, suppliers, and regional businesses that serve our employees and farmers in the regional economy.

New Zealand consumers benefit from a competitive domestic market

3.11 As discussed in detail in response to questions 8-12 below, the domestic dairy sector is competitive and open. New domestic and international suppliers of consumer products enter the New Zealand market constantly. New Zealand consumers benefit from competitive prices, product choice, and innovation.

Fonterra is focused on addressing the environmental effects of dairying

3.12 Fonterra acknowledges the environmental effects that arise from dairying. We know this is of central importance to New Zealanders. It is of central importance to us too. We are taking a broad view of what being a sustainable co-operative means, and we are committed to doing what it takes get there.

3.13 Fonterra's farmers have recognised the need for change and over the last 15 years have made far-reaching changes to farm management systems often requiring large investments and often in the face of significant uncertainty. Fonterra is reporting publicly on progress. Our Sustainability Report, released last year, reported that we checked every one of our farms for compliance with regional rules (especially around effluent management). Last year, just 3.2% of those farms were referred to a sustainable dairying advisor because of non-compliance where in 2011; when we ran our first checks, the figure was 26%.[80]

3.14 For farmers, where the primary driver used to be production and productivity, it is now equally sustainability. Farmers can be proud of the difference they have made to our environment and the communities in which we live.

3.15 Today, 98.4% of waterways on our farms are fenced to keep cows out.[81] Collection of milk was suspended at 78 Fonterra farms in the past season due to non-completion of fencing to keep stock from waterways.[82] And 95%

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[78] Statistics New Zealand *National Accounts Input-Output Tables: year ended March 2013* (April 2016).

[79] Fonterra Annual Review, 2017.

[80] Fonterra, *Sustainability Report for the year ending 31 July 2017*, 28.

[81] Ibid, 22.

[82] Ibid, 28.

of our farms in New Zealand are participating in nutrient management reporting and benchmarking.[83]

3.16 R&D is a critical part of sustainable farming and has been a key focus of the Dairy Primary Growth Partnership (*PGP*), the single largest R&D programme to date in New Zealand (see further below at paragraph 4.24).

3.17 Each year the bar of community expectations gets lifted a little higher and, with the right levels of investment into innovation, farmers will keep rising to that challenge. By supporting farmers for future changes, and investing in the right technology and science-backed solutions, we can continue to have a productive agricultural sector and positive environmental outcomes.

3.18 We also set sustainability targets for our manufacturing operations. This includes a 30% greenhouse gas reduction target in our manufacturing operations by 2030, and a target of net zero emissions by 2050.[84]

3.19 Over recent years, Fonterra's water efficiency has remained largely static with performance improvements through investments in new resource-efficient plants[85] countered by inefficiencies which occur when milk volumes are lower. We have set a new target to reduce water use by 20% per cubic metre of milk at all New Zealand sites by 2020 (against a 2015 baseline), investing in wastewater treatment to bring all our manufacturing sites to leading industry standards.[86]

3.20 As part of our sustainable co-operative strategy Fonterra is also taking seriously the challenge of climate change.

3.21 Our starting point is a good one. By world standards, New Zealand has relatively low greenhouse gas (GHG) emissions per litre of milk collected (0.85 per kgCO2/kgFPCM).[87] A target of climate neutral growth for on the farm emissions by 2030 has been set against a 2015 baseline.[88]

3.22 In addition, the GHG impact of producing milk is lower than alternative proteins. The following chart shows the comparative GHG impact of 1g of protein from cow's milk and two commonly available milk substitutes:[89]

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[83] Ibid, 30.

[84] Ibid, 15.

[85] See Ibid, 54. One example is Fonterra's Pahiatua plant, where the site team developed an innovative way to reuse water from condensation that's produced during milk powder manufacture saving half a million litres of Pahiatua groundwater (equivalent of 18 milk tanker loads) a day (see http://www2.nzherald.co.nz/the-country/news/article.cfm?c_id=16&objectid=12074189).

[86] Ibid, 54-55.

[87] Ibid, 18.

[88] Ibid, 15.

[89] Compiled using data from: Clune, S et al, *Systematic review of greenhouse gas emissions for different fresh food categories* (2017) 140 Journal of Cleaner Production 766 – 783; and *Milk and milk alternatives: Nutrition comparison*: http://www.healthline.com/health/milk-almond-cow-soy-rice#Overview1.

Product	Average Carbon Footprint (kg CO2 eq./kg)	Average Protein Content (g/kg)	Carbon Footprint of ONE gram of Protein (g CO2 eq./g Protein)
Cow's Milk: Australia & New Zealand	1.19	36.1	33.0
Cow's Milk: North America	1.34	36.1	37.1
Cow's Milk: Europe	1.32	36.1	36.6
Cow's Milk: South and Central America	1.69	36.1	46.8
Cow's Milk: Asia	2.53	36.1	70.1
Cow's Milk: Africa	3.34	36.1	92.5
Cow's Milk: world average	**1.39**	**36.1**	**38.5**
Almond, Coconut milk	0.42	4.4	95.4
Soy-milk	0.88	22.0	40.0

Question 4

What, and how strong, are the existing incentives and disincentives for the dairy industry to transition to higher value New Zealand based dairy production and processing that global consumers seek out for a premium? What, and how strong, are the incentives and disincentives for organics and alternative dairy production methods and product manufacturing? What is the role of government in strengthening these incentives and/or reducing/removing the disincentives?

4.1 In summary:

(a) The dairy industry is focused on maximising the value of New Zealand milk. Transitioning to higher value production and processing is about building a sustainable, high performing business. Through our V3 strategy, Fonterra is focused on and has seen sustained growth in value-add across our products, services and processes, in both our consumer and food service, and our ingredients, businesses. There is an incentive to produce commodity dairy products through strong continuing global demand for them. Higher value processing tends to be riskier and more capital intensive, which also imposes a constraint.

(b) Organic and alternative production methods are currently a small but valuable part of Fonterra's wider portfolio.

(i) Organic production is increasing in New Zealand. However, demand for organic product is strongest in the US and Europe, where New Zealand continues to face market access constraints. These markets are highly competitive, with an oversupply of organic product in both the US and Europe markets. There are also challenges in becoming organically certified. Fonterra has recently introduced an Organic Milk Price (which is typically higher than the conventional Milk Price), and a transition arrangement to facilitate organic conversions.

(ii) In February, Fonterra announced a strategic relationship with The a2 Milk Company (*a2MC*) and we have started sourcing A2 milk for a2MC products in New Zealand. This is intended to significantly expand over time to help meet the growing demand for a2MC products.

(c) Global demand for food is likely to be met by a range of sources, and we're exploring the potential opportunities of the complementary ingredients sector.

(d) In Fonterra's view, the Government could help with a continuing shift to higher value dairy production by creating a level playing field, allowing market incentives in favour of higher value and organic production to drive behaviour. For New Zealand's dairy sector to remain competitive, it is critical that the market continues to be demand-led rather than supply driven.

Creating value is at the core of Fonterra's strategy

4.2 Fonterra's strategy is focused on maximising the value of our farmers' milk. Value creation is about innovation in all parts of our business, from leveraging the inherent value of NZ Inc. and through our global reach to capitalise on market opportunities. It means investing in higher value consumer products, and generating value premiums on our dairy ingredients.

4.3 In addition to growing consumer demand for higher value and premium products, in some markets there continues to be strong demand for commodity products (see further below at paragraph 4.27). Global dairy markets are highly competitive, and Fonterra's strategy recognises the need for continual innovation and improvement within our ingredients business too, ensuring we remain at the leading edge.

Fonterra leverages brand and scale to grow international markets

4.4 Internationally, customers pay a premium for our products because of our pasture-based system, sustainable practices and animal welfare standards. Fonterra's Trusted Goodness™ programme is our promise to New Zealand and the world that we're providing a world class product. Launched in 2016, it is one of our most important initiatives and helps us to earn additional premiums on our farmers' milk. Our electronic traceability programme, part of Fonterra's Trust in Source global food safety and quality strategy, is another way we create value by ensuring confidence and trust. Fonterra's sustainability initiatives (discussed in response to question 3 above), also support Fonterra's ability to earn premiums.

4.5 Fonterra operates in over 100 countries, and employees 22,000 staff globally. Our scale, experience and expertise around the world allows us to identify and maximise international market opportunities to achieve greater returns for our farmer shareholders.

4.6 The Anchor™ brand is now available in over 160 products and 80 countries globally, and launched in Australia and Ethiopia in 2014. Fonterra is actively growing markets in Africa (Algeria is already New Zealand's third largest export market for dairy). In 2018, Fonterra launched an exciting new fresh milk product in China in partnership with Hema Fresh, Alibaba's innovative new retail concept which combines traditional bricks-and-mortar shopping with a digital experience

4.7 In 2008, Fonterra established Global Dairy Trade (***GDT***), now the leading international trading platform for dairy products, enabling the discovery of a true market price for commodity ingredients products.

4.8 As noted in response to question 1 above, the sector as a whole is also exporting to more markets, with a 19% increase in the number of export markets since 2001.[90] It is also diversifying into more sizeable export markets and increasing the number of dairy product lines exported to reduce risk.[91] There has been steady increase in the number of product lines exported since 2001.[92]

Production is shifting to food service and consumer segments

4.9 While milk production in New Zealand has increased by 5% since 2013/14, there has been 40% growth in the consumer and food service segment in New Zealand.[93]

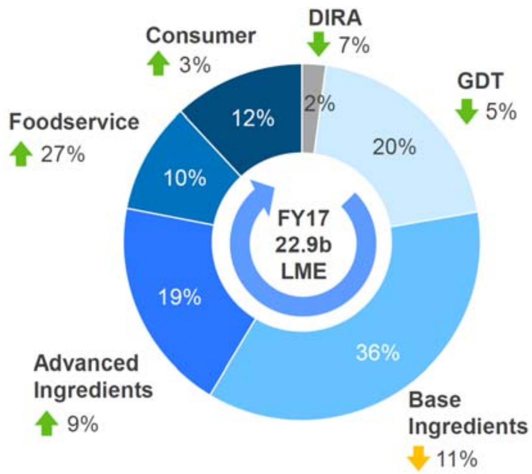
[90] NZIER *Assessing Fonterra's performance*, 16.

[91] Ibid, 16-18.

[92] Ibid, 29.

[93] Ibid, 10 and 11.

4.10 Between FY14 and FY17, the share of Fonterra's output that went to our Consumer and Food Service segment grew from 15% to 22%. In FY17, Fonterra shifted over 570 million LMEs[94] into our Consumer & Foodservice segments. The chart below shows a FY17 snapshot of Fonterra's progress in moving up the value chain (or as we refer to it, "turning the wheel"):[95]



4.11 In the FY14 to FY17 period Consumer and Food Service grew from less than $150 million in EBIT to more than $614 million.

4.12 Over the last four years (as milk volume growth has eased), Fonterra has been more able to focus on developing customer demand and innovations for higher-value products and services. The result of this is our capital being invested in more added-value manufacturing facilities, such as our recent investment in a new $240 million IQF mozzarella plant at Fonterra's Clandeboye site which is the single largest foodservice investment in the history of New Zealand's dairy industry. We have also invested over $200 million in new cream cheese plants in the last two years.

4.13 Our brands are getting global recognition, winning 48 awards in the 18 months to December 2017.

4.14 Looking ahead, demand for consumer and foodservice products in global markets will surpass Fonterra's New Zealand supply – supporting demand-led choices for our New Zealand milk. Our ambition in the consumer and food service segment will require organic and inorganic growth, with an aim to almost double our output to 10 billion LMEs by 2025.

4.15 Fonterra is accelerating this growth through a consumer-led innovation pipeline of >$1 billion, focusing on winning on taste and the right product and service portfolios for consumers of the future. Our four key areas of growth are: acceleration in China, global foodservice, affordable nutrition and partnerships.

4.16 Other processors have also signalled a shift to higher value consumer products. For example OCD, which is a low-cost processor, has invested in

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[94] Liquid Milk Equivalents, a standard measure of the litres of milk allocated to each product based on the amount of fat and protein in the product relative to standardised raw milk.

[95] Fonterra Investor Day presentation (December 2017), 14.

increased cheese capacity and has recently referred to higher value product development projects.[96]

Fonterra generates value from dairy ingredients

4.17 Fonterra is a global leader in identifying and enhancing dairy components to make products with unique health benefits. The chart above also shows that in FY17, Fonterra shifted around 430 million LMEs to our Advanced Ingredients[97] segment.

4.18 We make significant investments in R&D and innovation to unlock the maximum value of our farmers' milk and meet the needs of our customers. We have made scientific and engineering breakthroughs for better milk powders and new milk proteins, advanced paediatric and medical ingredients, like complex lipids, inhalable lactose, and probiotics. Some recent examples include:

(a) NZMP (responsible for Fonterra's global brand of dairy ingredients) has refined whey protein isolates and milk protein concentrates, which can be included in products that require sterilisation (i.e. the protein isolates withstand heat treatment, unlike competitors' products). Fonterra's unique milk protein concentrates can also be included in products for elderly people who cannot consume significant volumes of food, and are being treated for conditions such as sarcopenia.

(b) NZMP has isolated and developed a number of probiotic strains to be used in human supplements and dairy products, including HN001 and HN019 – these strains have been licensed to global probiotics manufacturers for use in paediatrics and supplements. Over 70 research papers have been published on the benefits of probiotics developed by Fonterra; the benefits include reductions in the burden of childhood eczema, gestational diabetes, and post-natal depression.

(c) Fonterra is currently conducting clinical trials into the effectiveness of Milk Fat Globule Membrane (*MFGM*), a complex milk lipid ingredient with likely benefits in respect of paediatric brain function. Two large clinical studies on the impact of MFGM supplementation during pregnancy, and in infant formula, are underway, with results expected later in 2018. MFGM has been included in the ANMUM range in key markets (China, Hong Kong, Malaysia, Indonesia, Vietnam, Thailand).

Fonterra is investing in R&D

4.19 R&D is a critical part of sustainable farming and unlocking the maximum value of our farmers' milk.

4.20 The scale and integration along the supply chain following the establishment of Fonterra has enabled a more successful and efficient innovation and R&D approach.

4.21 Prior to the formation of Fonterra R&D investment across the Dairy Board, Kiwi, Dairy Group and NZDRI (central R&D) and the various subgroups those entities funded was over $130 million. There was duplication, disconnects,

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96 NBR *Open Country Revenue tops $1b* (2 February 2018), https://www.nbr.co.nz/article/open-country-revenue-tops-1b-b-212175.

97 Advanced Ingredients are differentiated products that attract premium prices over base ingredients through superior product performance, and include higher-protein milk, pharmaceutical lactose, sports nutrition powder and extra-stretch cheese.

competition and lack of scale in the R&D projects (for example, in some instances two independent Dairy Board teams had to be established to work on identical products due to competition between the dairy companies).

4.22 Today, the Fonterra Research and Development Centre (*FRDC*, formerly NZDRI), based in Palmerston North, is one of the world's largest dairy research institutes. Fonterra's investment in R&D at FRDC is [redacted] (but additional R&D investment occurs on-farm, at manufacturing sites, offshore and in collaboration with other research institutes). Recent developments include SureProtein Fast MPC 4868, an optimal source of rapidly digestible milk proteins, and SureStart Lipid 100, a paediatric ingredient used to more closely mimic breast milk composition.

4.23 The following table shows some of the key innovations that have been delivered in the last 17 years, which illustrate Fonterra's contribution to R&D.

2000	First functional Milk Protein Concentrates (*MPC*), which is valuable for medical nutrition.
Early 2000s	Probiotics developed – thousands of good bacteria identified and stored, including probiotic bacteria that can improve immune and other health functions.
2006	Fonterra and Dutch dairy co-op FrieslandCampina establish DFE Pharma, the world's largest producer of pharmaceutical lactose, used in medical tablets and capsules, and dry powder asthma inhalers.
2008	IQF mozzarella launched – production time reduced from 3 months to 6 hours.
	First functional Whey Protein Concentrate (*fWPC*)
2009	NZMP launch ClearProtein product – whey protein ingredient specifically designed for sports beverages.
2012	Anchor™ launched zero lactose milk in New Zealand.
	Low viscosity fMPC developed to enable protein-fortified beverages required by medical patients for general nutrition.
2014	Low viscosity fWPC developed to improve the flavour and nutrition profile of protein-fortified beverages required by medical patients.
	"Milk Fingerprinting" technology developed – high speed diagnostic test that analyses milk composition and can help determine which product the milk is best suited for.
2016	Launch of Gold Instant Whole Milk Powder, designed for fast, easy reconstitution, specifically for the African markets. SureStart Lipid 100, a paediatric ingredient used to more closely mimic breast milk composition (which won an innovation aware in 2017).

2017	Clean flavour fMPC developed to enable customers to market cultured products at elevated protein levels without compromising consumer sensory experience.
	NZMP launch SureProtein Fast Milk Protein – a fast-digesting milk protein concentrate that quickly provides muscles with essential amino acids.
	NZMP launch Low Lactose Instant Whole Milk Powder.
	NZMP launch non-GMO ingredient range in North America.
	Launch of innovative white butter product in Middle East.

4.24 The PGP (see also above at paragraph 3.16) is the largest R&D programme to date in New Zealand, totalling more than $170 million of investment over 7 years. It is on target to deliver $2.7 billion in benefits to New Zealand every year from 2025. Fonterra is the major partner in this programme – along with DairyNZ, Livestock Improvements and Synlait among others.

4.25 Three innovations from this programme in the consumer and food service segments have won New Zealand Innovation Awards – Milk Finger Printing Complex, IQF Mozzarella and Complex Milk Lipids. The PGP has also produced improvements in genetic gain for the national herd, increases in on-farm productivity, and research into pasture persistence, resulting in improvements in farm management and plant breeding.

The dairy sector faces challenges in moving up the value chain

4.26 There are challenges for the dairy sector in transitioning to higher value production.

4.27 Globally, while consumer preferences in some markets are shifting to higher value or premium products, demand for commodities remains strong, particularly in large markets in Asia, the Middle East and Africa. New Zealand's largest Asian markets are China and Japan for whom commodity demand has grown has grown by 20.0% and 1.1% per year, respectively, since 2001. In the Middle East, demand for commodities in the two largest markets, the United Arab Emirates and Saudi Arabia, has grown by 12.6% and 5.1% per year, respectively, since 2001. Additionally, New Zealand's dairy exports to the two largest African markets, Algeria and Egypt have grown by 11.1% and 6.6% per year, respectively, since 2001.[98]

4.28 Higher value investments also typically entail greater risks and are more capital intensive than commodities.

4.29 From Fonterra's perspective, and as discussed above, open entry has acted as a constraint on Fonterra's investment strategy, as well as individual investment decisions, i.e. it has required Fonterra to retain sufficient processing capacity to deal with increased supply. With New Zealand milk volumes increasing quickly, particularly between the 2008/09 and 2014/15 seasons, Fonterra was required to weight investment in whole milk powder

[98] To the year ended April 2018. NZIER *Assessing Fonterra's performance*, 17.

and skim milk powder plants to ensure it had the capacity to process significant volumes of milk.

4.30 Fonterra has commissioned no new dryer plants since 2014, and there has been increased investment in processing capacity for higher-value product like cream cheese and mozzarella (see also above at paragraph 2.27).

4.31 This shift towards higher value processing investments has taken place at the same time as a levelling off in milk growth in New Zealand since 2015. This demonstrates that, when volume pressure eases, Fonterra can and does invest in higher-value production.

Organic and alternative dairy production are small but valuable

4.32 The organic sector forms a small but valuable part of the wider Fonterra portfolio.

4.33 Fonterra has made significant changes to our organic programme over the last 3 years, including the introduction of the Organic Milk Price in the 2016/2017 season. The Organic Milk Price is market-linked, and is historically higher than the conventional Milk Price. The Organic Milk Price can be significant enough to offset the drop in production for organic farmers.

4.34 Fonterra also offers specialist support within Farm Source, and a 45c/kgMS conversion incentive over the conventional milk price, to farmers converting to organic. Greater commitment from Fonterra has helped to move towards a change in perception from positive to negative. There are now more organic certified inputs and this is continuing to grow. Fonterra's Organic Programme currently comprises [redacted] producing approximately [redacted]

4.35 There are challenges in converting to organic production, including:

(a) The initial drop in milksolids production.

(b) A lack of on-farm R&D to date.

(c) A knowledge gap for farmers when converting with the risk of losing the ability to leverage experiential learning and repeating the mistakes of those who have converted before them.

(d) A lingering level of scepticism from conventional farmers to their organic colleagues (although many conventional farmers are becoming more informed about organics).

(e) Significant difficulty in finding supplements when there are critical weather events (as experienced by organic Taranaki farmers this year).

4.36 On the export side, the global organic dairy market is growing and is being led by the US and Europe.[99] However, in addition to market access barriers, the vast majority of organic dairy is sold as fresh chilled products such as milk, yoghurt and fresh cheeses. This part of the market is almost

[99] Collectively, these two markets represent 83% of organic retail sales. Euromonitor International, *Certified Organic: Opportunities in food and beverages* (July 2017).

exclusively served by locally produced milk, given the logistics challenge of exporting perishable, fresh New Zealand product to market offshore.

4.37 Production of organic milk is growing in the US and Europe with those two markets now in oversupply, resulting in price softening. As with conventional dairy, oversupply in these markets tends to spill into the global market putting downward pressure on pricing.

4.38 Ingredient products, in which New Zealand has a significant share, are only a small part of the sale of organic products globally. Ingredients are a larger share of the organic market segment outside of the US and Europe, and are subject to strong competition with exports from the US and Europe.

4.39 On the domestic consumer side, the New Zealand domestic market for organics is a very small proportion of New Zealand consumption. Overall market size is difficult to assess due to the large number of independent farm-scale operators that currently focus on fresh milk and yoghurt. Fonterra has launched two branded organic milks and cheese in the last three years with limited volume growth.

4.40 In the Fonterra context, the domestic organic market opportunity represents less than 5% of overall sales. The remainder is processed into a variety of organic ingredients for sale into export markets.

4.41 While New Zealand farms enjoy some advantages in the process of becoming organically certified, challenges and disincentives remain. Organic systems are generally lower input than conventional systems, but many of the available inputs are more expensive than the conventional alternative. There is also generally a reduction in productivity. Audit and compliance activity adds significant complexity to these farming businesses.

4.42 Competition for organic milk supply has developed over the last four years. For example, OCD is actively growing organic supply from within its own supply base. The Organic Hub has also recently acquired additional supply that may imply a move from a domestic milk supplier into a mixed domestic/export operator.

4.43 In relation to alternative production methods, as mentioned above at 4.1(b)(ii), in February, Fonterra announced a strategic relationship with a2MC and we have started sourcing A2 milk for a2MC products in New Zealand. This is intended to significantly expand over time to help meet the growing demand for a2MC products. The cost of production for farmers is higher for A2 milk, as they have to breed a specific A2 herd and segregate it from any non-A2 milk pool. There are stringent testing requirements, and additional collection and processing costs due to segregation. The process is similar to organic testing, with a further test at the end of production.

Global demand for food likely to be met by a range of complementary sources

4.44 The world is facing a significant challenge in feeding its growing population, with increasing demand for higher protein and energy diets. At the same time, consumers' are increasingly favouring foods which are produced as naturally and sustainably as possible. That's both an opportunity and challenge for food producers, and one we're well placed to help address.

4.45 As a global dairy nutrition Co-operative, we're committed to innovative, sustainable food production and providing strong returns to our farmers and unitholders. That's why we're exploring the potential opportunities of the complementary ingredients sector, and the way in which they might provide customers and consumers with more options and help meet the world's growing global demand for protein.

4.46 Dairy is much more than just a source of protein. It has a unique, complex mix of proteins, fats, lactose, minerals and other nutrients which will ensure global consumers continue to seek it out as a premium source of nutrition. However, it alone will not be able to meet the increasing demand for protein.

4.47 We're proactively working with a wide range of world-leading organisations, including Universities and established food companies to explore the potential of plant nutrition and fermentation-derived nutrition, and over time these ingredients may play a role in our business alongside our core natural dairy business.

4.48 As a country, we produce some of the world's best dairy, and when combined with Fonterra's reputation in dairy nutrition and protein, and our global supply chain, we believe we're well positioned to explore the potential of this complementary sector.

Government role in incentivising higher value production

4.49 It is difficult for the government to directly incentivise market behaviour, but it can focus on removing undesirable incentives and creating a level playing field. For example, as discussed above in response to question 2, the requirement to accept all supply has been a demanding one and has constrained Fonterra's investment decisions. While open entry has been a beneficial part of the contestability framework, it has now served its purpose. Removing open entry would ensure that Fonterra has confidence and flexibility into the future to direct our capital towards the highest value investments, in the same manner as our competitors.

Question 5

Does the DIRA regulatory objective of ensuring "contestability for the supply of milk from farmers' remain fit for purpose, given the sector's current performance and its underlying drivers, global and domestic challenges and opportunities facing the industry, the wider regulatory system within which it operates, and the Government's policy objectives?

5.1 In summary:

(a) The regulatory objective of contestability for the supply of milk from farmers remains fit for purpose and there is a high degree of contestability and actual and sustainable competition in the farm gate milk market.

(b) The DIRA should continue to provide a clear pathway to deregulation. This is a process of evolution, not revolution.

(c) The dairy sector must address significant challenges, such as climate change and environmental sustainability, through specific and prominent regulatory frameworks, as currently proposed, and not folded into DIRA.

The objective of contestability remains fit for purpose and DIRA should continue to provide a pathway to deregulation

5.2 A key focus of DIRA is on increasing contestability for the supply of milk from farmers, and maintaining a pathway to deregulation as competition develops (see also above at paragraph 2.107).

5.3 This clarity and certainty of regulatory objective has given farmers, manufacturers and distributors the long-term certainty to make large investments and commit to growing the sector.

5.4 The level of competition and dynamism in the dairy sector has been a key driver of its success and contribution to New Zealand since 2001. There is a real variety of competing, established business models and investment strategies in the sector.[100] The farm gate milk market has a high degree of contestability and there is actual and sustainable competition.

5.5 In our view, this level of competition is an important part of why the dairy sector is well placed for the next decades. It will be important that the objective of the regulatory framework is maintained (even as the sector moves toward deregulation), so that investors continue to have the confidence to make long term commitments in the dairy sector.

5.6 It's important that as the sector develops, there is a consistency of regulatory settings and the ongoing commitment to a deregulation pathway. That said, one of the roles of the DIRA has been to maintain confidence in the market rules applying in the dairy sector.

5.7 Fonterra continues to discuss evolution of regulation, rather than revolution. This is because deregulation needs to be done in a way that maintains the confidence of farmers and processors. The history of DIRA amendments reflects this evolutionary approach.

[100] See [2.2] – [2.15] above.

5.8 When considering the pathway to deregulation, a theme that may have greater relevance now than it did in 2001 is, where possible, all sector participants having the same disciplines and incentives to improve productivity and to innovate. The sector has a duty to look ahead and make the investments and changes required to make the maximum contribution to New Zealand. Where possible, all competitors should face the same rules and constraints.

5.9 With this in mind, the following sections set out Fonterra's proposals for the future of DIRA, which are about safeguarding contestability, increasing value-added production and ensuring environmental sustainability, as well as providing a clear pathway to deregulation in the dairy industry.

The dairy sector's other challenges should be addressed in specific regulatory frameworks

5.10 As discussed in other sections, Fonterra agrees the dairy sector will need to address significant global and domestic issues in the decades ahead. Key challenges that are already being grappled with include climate change, environmental sustainability, the potential for disruption from high tech alternative foods, and shifting animal welfare standards.

5.11 Each of these is an important issue in its own right. The current approach is to address each issue in its own regulatory context, such as zero carbon legislation and the Resource Management Act. Fonterra endorses that approach; it's the most effective course. Regulatory frameworks with clear purpose and objectives are likely to be more accessible and understandable to stakeholders when planning for the future and making investment commitments. Folding multiple purposes into a single regulatory framework is likely to result in a lack of clarity and accountability. Sector participants should be expected to, and already do, engage on these important issues and look ahead to where the dairy sector needs to be in the future.

Question 6

If so, what changes, if any, are required to ensure that:

6.1 ***the individual provisions of the DIRA contestability regime remain fit-for-purpose and are consistent with the Government's wider policy objectives? For example, should large export-focused dairy processors continue to be able to purchase milk from Fonterra on regulated terms?***

6.2 ***the extent of any unintended consequences, which may have arisen as a result of the DIRA contestability provisions, is reduced/removed, while any impact on the regime's ability to deliver on its policy objective is minimised? For example, should the requirement for Fonterra to accept all milk supply offers from shareholding farmers and the ability for farmers to exit Fonterra be reconsidered (e.g. removed, modified or replaced with some other regulatory tool aimed to ensure contestability for the supply of milk from dairy farmers)? In the event of modifications to the current regulatory arrangements, what, if any, safeguards might be required to protect the long-term interests of farmers and consumers?***

Question 7

If not, what should the alternative and/or new regulatory objectives be, and what changes to the industry and/or the DIRA regulatory regime would be required to ensure that the DIRA regulatory regime supports a well-functioning and high performing New Zealand based dairy production and processing industry, which manages resources effectively (including land, water, and capital) to produce high quality, high value dairy products?

7.1 As set out above in response to questions 2 and 5, our view is that it's important that DIRA retains its focus on contestability, and on a clear pathway to deregulation. In this section, we elaborate on the following points:

(a) Staged deregulation can progress with this review, with future deregulation being signalled.

(b) Certain aspects of DIRA could be safely removed now, specifically open entry and the regulated raw milk supply to large, export-focused processors.

(c) Remaining aspects of DIRA could remain in place for now, but a clear process should be included in the legislation, setting out a pathway to deregulation.

Staged deregulation can progress, with future deregulation being clearly signalled

7.2 There are some existing DIRA provisions where the costs materially outweigh the benefits and these should be addressed in the current review.

7.3 In the case of other provisions, benefits, including safeguarding public confidence, currently remain. So we don't consider these provisions an immediate priority for change.

7.4 Nevertheless, it is important for certainty, to maintain market and public confidence, and to ensure appropriate incentives are in place (as set out above) that future steps towards deregulation are clearly signalled.

7.5 Currently, there are no sunset provisions in place as these were removed by the most recent amendments to DIRA.[101] While Fonterra acknowledges this has occurred as part of the review process, we don't think it should become permanent. A fundamental tenet of the original legislation was that there would be a pathway to deregulation, the catalyst being sustained competition (with market share thresholds acting as a proxy for the development of competition). Permanent removal of sunset provisions would contradict a fundamental part of the compact with the industry that underlay the original legislation's purpose and framework.

7.6 In our minds, the question is what level of sustainable competition is needed to trigger deregulation, and how could that be assessed? The sunset provisions in DIRA have been the subject of a number of alterations. These have resulted in a successive "shifting of the goalposts". This has generated uncertainty as to whether the policy intention of deregulation will be implemented. In the long term interests of the New Zealand dairy industry, clear signals are required that the industry should plan for a move off the regulated platform – meaning Fonterra will not be required to invest in over-capacity resulting from our milk pick-up obligations, or be required to provide a leg-up via the supply of raw milk at a regulated price to our competitors indefinitely. In Fonterra's view, a key part of the present review will be to identify the appropriate thresholds and triggers to the deregulation pathway.

Priorities for change

Open entry and the non-discrimination rule are priorities for change

7.7 For the reasons given in more detail above, Fonterra considers that the costs of open entry now significantly outweigh the benefits. Specifically:

(a) The premise of open entry is now redundant given the depth of healthy existing competition.

(b) Removal of open entry would not result in changes to Fonterra's behaviour that would materially raise barriers to entry.

(c) Open entry can constrain Fonterra's overall strategy and success, which impacts the economy.

(d) The sustainability of our environment needs to be front of mind.

7.8 The non-discrimination obligation is closely linked to open entry. As well as not being unable to turn down new supply, Fonterra is unable to take supply on terms that reflect its true value to the Co-operative.

7.9 We are asking that the full open entry regime, as well as the non-discrimination obligation, be repealed.

The Raw Milk regulations are justified for supply to Goodman Fielder and smaller, domestic suppliers, but not for other large suppliers

7.10 Fonterra knows there is comfort for stakeholders in our obligation to supply raw milk to a key downstream competitor, Goodman Fielder, safeguarding a

[101] Dairy Industry Restructuring Amendment Act 2018.

level of robust domestic competition. Fonterra is comfortable with no change to the regulation of supply to Goodman Fielder.

7.11 There is also still a case for smaller, niche processors that do not have their own milk supply to have access to regulated raw milk. For these players, entry and sustainable participation may not be possible without the regulations. Fonterra proposes no change for those players and fully supports the role they play.

7.12 However, the costs outweigh the benefits for larger processors (other than Goodman Fielder), particularly those focused on exports: those players can obtain their own supply, and our supply of regulated milk does not serve the interests of NZ Inc. Fonterra asks that provision under the Raw Milk regulations be removed for those players.

7.13 In addition:

(a) Fonterra agreed with MPI's proposals in the previous DIRA review,[102] which would have limited:

(i) Independent processors' one-week estimates to 20% more or less than the earlier three-month estimate.

(ii) The variation of the contracted volume to between 90% and 110% of the one-week estimated volume.

(b) Fonterra asks that:

(i) Independent processors be required to give a longer notice period (of 21 months) for requiring winter milk supply above 20,000 litres per day.[103]

(ii) The tolerance for winter milk supply quantity estimates[104] be removed, and the take or pay prohibition[105] not apply to (at least) winter milk.

(iii) Winter months be subject to maximum monthly limits (the "October rule").[106]

7.14 The drafting ambiguity that arguably allows independent processors to forego their supply of milk under the Raw Milk regulations for a season (which would allow them to re-start the three-year supply period and circumvent the Raw Milk regulations) should in Fonterra's view be amended.[107]

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[102] MPI, *Discussion Document – Proposed changes to the Dairy Industry Restructuring Act 2001 and Dairy Industry Restructuring (Raw Milk) Regulations 2012* (May 2016), 17.

[103] Raw Milk regulations 2012, regulation 11(2)(a).

[104] Ibid, regulation 11(3).

[105] Ibid, regulation 21(5).

[106] Ibid, regulation 6.

[107] Regulation 6(3) provides for the limit on supply to independent processors whose own supply in the prior three seasons was greater than 30 million litres, "as specified in the returns provided" to Fonterra under regulation 18(2). However, under regulation 18(2) an independent processor is only required to provide Fonterra with a return if it requires supply in the current season. If the independent processor wishes to purchase milk in a subsequent season, it will not have submitted a return and yet might have had more than 30 million litres of its own supply in the three preceding seasons.

Aspects of DIRA that Fonterra considers should be retained at this stage

Despite inefficiencies, Fonterra is comfortable at this stage to retain open exit and the 160km rule

7.15 There are material inefficiencies associated with open exit and the 160km rule. However, Fonterra has some flexibility to mitigate their negative effects and so, in the short term, Fonterra is comfortable for them to remain in place.

The milk price regime should be retained – it supports efficiency and public confidence

7.16 Fonterra would not operate in a materially different way if the milk price regime were repealed. However, there are no significant problems with the regime, Commerce Commission oversight operates well and is robust, and the regime supports market efficiency, transparency and public confidence.

7.17 Fonterra requests that steps be taken to encourage greater transparency of milk price from all market participants to support farmers' choice and bargaining power, and overall competition at the farm gate.

TAF should be retained – it has contributed additional market transparency and efficiency

7.18 TAF strengthens incentives on Fonterra to determine an efficient milk price, and scrutiny by external investors encourages Fonterra to be transparent in our milk price-setting process. It has also alleviated the significant redemption risk Fonterra faced as a result of the open entry and exit regime.

7.19 TAF achieves its objective of facilitating entry to and exit from Fonterra for farmers by providing liquidity and good price discovery for their shares.

7.20 Fonterra considers that enabling TAF has contributed additional market transparency and efficiency, and that it should be retained.

The 20% rule supports smaller, niche suppliers

7.21 The 20% rule, while not widely used and arguably not strictly necessary, is nevertheless valued by some smaller processors and acts as an alternative pathway to establishing themselves in the market. Fonterra is comfortable with it being retained at this stage.

The requirement to sell milk vats should be retained

7.22 The requirement for Fonterra to sell milk vats is in use, and Fonterra doesn't experience any material inefficiency from it. Fonterra is comfortable with it being retained.

The levy on Fonterra should be re-configured

7.23 Under the Animal Products (Dairy Industry Fees, Charges and Levies) Regulations, Fonterra pays a "large processor" levy on milksolids collected, not milksolids processed. This means Fonterra pays the "large processor" levy for raw milk it supplies to independent processors under the Raw Milk regulations. For fairness, Fonterra asks that the calculation be changed to remove this regulated raw milk.

Domestically-focused dairy sector

Question 8

Is the domestically-focused dairy sector operating in the long-term interests of New Zealand consumers, in the terms of e.g. availability, quality, pricing and range of consumer dairy products, as well as investment in innovation and value creation?

8.1 The domestically focused dairy sector is operating in the long-term interests of New Zealand consumers, delivering range and choice in both affordable and premium products. The domestic consumer market is highly competitive. Businesses are investing in innovation to defend and grow their market shares and compete successfully against both established and new players.

Domestic consumer market is highly competitive

8.2 New Zealanders value access to affordable, high-quality dairy products. A key focus of DIRA has been to foster competition in the domestic consumer market. Since 2001 the domestic consumer market has developed to support a range of business models and strategies that are delivering value for New Zealand consumers.

8.3 The downstream domestic dairy market is highly competitive and contested by large players (Fonterra Brands (New Zealand) Limited (*FBNZ*)[108], Goodman Fielder and Synlait) as well as independent niche players (The Dairy Collective, Dairy Works, Lewis Road Creamery, Fresha Valley) and private label brands (Pam's, Signature Range, Budget, Home Brand). Imported dairy products, including those from large global players, are also available in several product categories, particularly specialty cheese (Costello, FoodSnob), ice cream (Unilever, Nestlé), lifestyle beverages (Coca Cola, Nippys), and butter (supermarkets).

8.4 Supermarket private label brands have become much bigger players in the last five years, and now have the largest market share in certain product categories – including fresh white milk and cream.

8.5 Goodman Fielder continues to be FBNZ's primary large competitor. Although the dynamics are shifting with Synlait recently announcing that it will enter the domestic market in the South Island, supplying Foodstuffs' South Island private label brands with fresh milk and cream.

8.6 The large global players that import their products, along with the entry and expansion of smaller players focused on premium product have significantly increased competitive pressures on both price and quality.

8.7 There are also more non-dairy alternative products available now, for example, coconut yoghurt and nut "milks", and that trend is expected to continue. We discuss the competitive role of these players in relation to particular product categories below.

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[108] Fonterra Brands (New Zealand) Limited (*FBNZ*) is the New Zealand consumer arm of Fonterra and comprises the New Zealand consumer brands business and a New Zealand foodservices business (as well as an export brands business, primarily focused on Asia/Pacific). FBNZ has a number of major brands in the New Zealand domestic market including Anchor™, Mainland, Fresh n' Fruity, Kāpiti™ and Tip Top™.

Private label brands are strong competitors

8.8 Supermarket private label brands compete vigorously in all product categories (except yoghurt where they have only a very small share of supply) and have the largest share of supply in fresh white milk, [redacted][109] Private label brands have more than [redacted] share by value of all dairy products,[110] and materially increase competition in relation to bulk and affordable dairy products.

8.9 Supermarkets invite their suppliers to bid to manufacture their private label products. FBNZ competes for these contracts with other large suppliers, including Goodman Fielder and, more recently, Synlait. Synlait entered the domestic market this year, winning the contract to exclusively supply Foodstuffs South Island's private label fresh milk and cream from early 2019.[111]

8.10 Supermarkets also have an unrivalled ability to promote their own products, on a price and non-price basis.

Goodman Fielder continues as FBNZ's major large competitor

8.11 Goodman Fielder continues to be FBNZ's main large competitor, and competes in all dairy product categories (except ice cream). [redacted] Goodman Fielder is also a primary competitor in bulk and speciality cheese ([redacted]). Goodman Fielder's proposed purchase of Lion's dairy business (Yoplait), [redacted].[112]

Niche processors continuing to make inroads and increase competition

8.12 Niche processors continue to make inroads in several product categories, including milk, butter, cheese, yoghurt and ice cream. Lewis Road Creamery™ is a good example. Lewis Road launched in 2012 with butter before moving into flavoured milk, premium/organic milk and other products including breakfast drink, sour cream, ice cream, chocolate liqueur and bread. Lewis Road is privately owned and has its products manufactured through third party manufacturers (Green Valley Dairies for milk, Canary Foods for butter). It is number one in premium milk and has increased its share of flavoured milk supply to [redacted] in the total category (on a moving annual total basis) since its entry in 2014.

8.13 Several other boutique milk processors have also entered the market, for example, Origin Earth, Jersey Girls and Aunt Jean's.[113] While small, these processors, including Origin Earth in the Hawkes Bay, and Wangapeka and Jersey Girls in Nelson, can be regionally disruptive. Fonterra understands that some of these processors (including Origin Earth and Jersey Girls) utilise the 20% rule to access on-farm supply.

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109 Fonterra estimates based on Nielson data.

110 Ibid.

111 Synlait intends to invest approximately $125 million in an advanced liquid dairy packaging facility to supply Foodstuffs South Island, with a minimum annual capacity of 110 million litres.

112 Fonterra estimates based on Nielson share data.

113 Other examples include Gizzy Milk, Walnut Tree Farm, Wild and Grace, Winiata Farm, Oaklands Farm, Windy Ridge Farm, Arran Farm, Gorge Fresh, Alt Energy Farm, Wind River Organics, Okoia Valley Milk, Dolly's Milk, Beach Road Milk, Nature Matters, Farm Fresh Milk, Village Milk, Aylesbury Creamery, The Cows, and Riverside Milk.

8.14 Similar dynamics exist in relation to cheese. While bulk products (e.g. 1kg blocks) are primarily supplied by FBNZ, Goodman Fielder, Dairyworks and private label brands, which put pressure on price and quality, independent processors have focused on providing specialty products and are growing their market share and exercising competitive constraint in those products.[114]

8.15 Independent processors have also continued to make inroads in ice cream. FBNZ's largest competitor in the ice cream category is Much Moore Ice Cream Company Ltd, a privately owned business established originally as Kiwi Ice Cream and based in Auckland.[115]

Imported products are increasing in several categories

8.16 Imported products are now important players in several product categories. This includes increasing competition from large importers like Castello cheese (Arla Foods Group) in the specialty cheese category, Coca Cola with its Barista Bros lifestyle beverages, and Movenpick (Nestlé) as well as Ben & Jerry's and Streets (Unilever) in the ice cream category. Smaller importers, such as New Zealand-based Food Snob, are also growing their market share in the specialty cheese category.

8.17 In addition, supermarkets are using their buying power and supply chains to import products directly, such as butter, putting further pressure on domestic suppliers. Given their sophistication and bargaining power, any deterioration in price and non-price terms to supermarkets could be expected to risk supermarkets seeking to bypass suppliers and obtain imports directly.

Non-dairy alternatives

8.18 Non-dairy alternatives, such as nut milk and coconut yoghurt, are playing an increasingly significant role in the domestic consumer market. Non-dairy yoghurts make up [redacted] of the yoghurt category by value and [redacted] of that category by volume. In the latest quarter, non-dairy yoghurts [redacted] in value and [redacted] in volume. [redacted]

8.19 Overall, there is a high level of competition in a number of categories from smaller niche players, imports and non-dairy alternatives.

Supermarkets constrain suppliers

8.20 Supermarkets hold a lot of bargaining power when it comes to suppliers. Supermarket chains Progressive Enterprises Limited (*Progressive*) and Foodstuffs NZ Limited (*Foodstuffs*) are the primary retail channels for dairy products in New Zealand. The supermarkets aim to get the lowest possible price from their suppliers, including FBNZ, so they can offer consumers the most competitively priced products.

8.21 Progressive and Foodstuffs both have a process for bidding for promotional slots for dairy products. At a high level, suppliers are required to submit annual, quarterly and ad hoc promotional plans which are agreed with supermarket product category teams. Supermarkets' promotional requirements have a significant impact on suppliers' pricing strategies.

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[114] Commerce Commission, *Review of state of competition in the New Zealand dairy industry: final report* (1 March 2016), [5.145] – [5.146].

[115] Ibid, [5.149].

8.22 Supermarket private label brands are also an example of supermarkets using their buying power to impose a competitive constraint on domestic consumer markets. As noted above, [redacted] This success shows supermarkets' ability to obtain competitive terms from suppliers.

8.23 Consumers also expect supermarkets to have a range of products in each category. This prevents suppliers from dominating a particular product category. Supermarkets could also sponsor the launch of new products so they can offer it to their consumers first. This has been done in non-dairy products and we see no reason why it could not also occur in dairy categories. Supermarket imports are another constraint, as discussed above.

8.24 There is notable evidence of price competition in particular regions (involving both supermarkets and other retailers), led by retailers themselves and which also puts pressure on suppliers. For example, non-supermarket retailers, particularly in the route market and large fruit and vegetable stores in Wellington and South Auckland, are starting to loss lead on milk (e.g. two 2L for $5 deals). These deals put price pressure on the local supermarkets, who may have to respond with an equivalent pricing offering (a recent example is PAK'nSAVE Petone, which responded to pressure from the route market). We are also expecting that with Goodman Fielder losing its Foodstuffs South Island private label contract to Synlait, it will be chasing volume in that region, putting increased price pressure on milk prices.

8.25 Against this background, Fonterra notes that in 2011 the Commerce Commission declined to launch a Part 4 inquiry into domestic milk prices, determining that the scope of rivalry between Fonterra and Goodman Fielder in the wholesale market, and between Progressive and Foodstuff in the retail market, exceeded the "little or no competition" standard. The Commission reiterated that view in its 2016 review of the state of competition in the New Zealand dairy industry, noting that the competitive dynamics in downstream domestic markets have been stable for some time.[116] Fonterra now sees an even greater level of competition in the downstream domestic market with the increase of niche players, imports and a new large entrant (Synlait) coming into the domestic market.

The market is delivering choice and variety for New Zealand consumers

8.26 There have been significant changes in the choice and variety of dairy products available to New Zealand consumers since 2001. There is an overarching trend towards premium products, which we are seeing in all product categories, from premium white milks, flavoured milks, Greek-style yoghurts, specialty cheese and more. This reflects changing consumer preferences, with an overall decline in dairy product consumption, and New Zealand consumers switching to premium products.

8.27 We are also seeing robust competition at the bulk end of the market, particularly with private label brands, providing affordable options for New Zealand consumers.

8.28 In the last 10 years, the price of white milk has increased only 9% (compared to an increase in average household income over the same period of 44%

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[116] Ibid, [X59], [5.141].

and inflation of 18.7%). This is largely in line with other grocery products that have, on average, increased by around 10% and meat, poultry and fish that have increased around 12%. Other dairy product categories have had more significant price increases. Butter has increased in price by 44% since 2008. This is largely due to global dairy pricing and the increased popularity and therefore demand for butter.

Competition and consumer preference driving innovation

8.29 Competition and consumer preferences are driving investments in innovation and value creation, with new players entering and established players innovating to bring new products to market. Competitive pressure is a constant for FBNZ and innovation is essential to maintaining shelf space and market share in the domestic dairy market.

8.30 Some recent examples of innovation within FBNZ include:

(a) development of the "light proof bottle" to improve taste;

(b) yoghurt pouches and Anchor Uno™ kids yoghurt;

(c) collaborations, including Tip Top™ collaborations with Griffins™, L&P™ and Primo™;

(d) Anchor Protein+™ range in yoghurt, milk and protein powders;

(e) snacking and other new product formats (e.g. sliced and grated cheese);

(f) ZeroLacto™ lactose-free milk and cheese;

(g) reduced added-sugar products (e.g. Uno™ yoghurt, Mammoth™ flavoured milks and Primo™ flavoured milks);

(h) premiumisation, especially in yoghurt (e.g. Anchor™ Greek yoghurt) and ice cream (new Kāpiti™ packaging);

(i) industry-wide reduction in plastic from milk bottle caps;

(j) longer shelf life / ambient product; and

(k) flavour rotation in existing product lines.

8.31 Our competitors are also innovating including in premium white milks, breakfast drinks and flavoured milks, collaborations (e.g. Lewis Road Creamery™ with Chelsea Winter and Whittaker's™), new flavours, single pot premium yoghurts and Greek-style yoghurts. We have also seen other innovations in the sector, for example, whipped feta dips.

Question 9

Are there significant economies of scale in the collection and processing of farmers' milk into domestic consumer dairy products, and the wholesale distribution of those products, given the small size of the New Zealand consumer market, its year-round demand characteristics and seasonal farmers' milk production (with the associated difficulties and costs of sourcing "winter milk")?

9.1 The increasingly competitive nature of domestic consumer dairy markets includes viable competitors of a range of sizes. As such, while economies of scale may exist, it is evidently possible for much smaller suppliers to flourish, and to exert material competitive pressure.

9.2 Goodman Fielder was originally established and guaranteed supply to ensure that Fonterra had a viable competitor at scale in domestic consumer markets. That objective has been achieved, and FBNZ and Goodman Fielder continue to compete vigorously in all product categories (except ice cream where large global players are present).

9.3 The growth of supermarket private label brands is also creating opportunities for participation by other large independent processors at scale, as with the recent Synlait contract with Foodstuffs South Island. Private label brands are increasing competitive pressure in all areas of the domestic dairy market (with the exception of the specialty cheese category, where European imports are significant competitors).

9.4 Further, the level of competition described in Question 8 above, including from niche processors, shows the very low barriers to entry. Existing and new players in the market have easy access to raw milk. As discussed above, the Raw Milk Regulations require Fonterra to supply certain competitors at a regulated price and on regulated terms. As a result, wholesale milk prices are transparent, creating a level playing field for FBNZ and competitors in the domestic market. Independent processors can also access supply from other processors in the factory gate market, or direct from farmers (including under the 20% rule).

9.5 In terms of the year-round demand characteristics and seasonal production, as discussed above in response to Questions 2, 6 and 7, Fonterra's obligation to supply regulated milk to independent processors imposes costs on Fonterra, particularly in relation to winter milk. Fonterra has requested a number of changes to the Raw Milk regulations. These include extending the notice period for independent processors requiring winter milk supply and requiring more accurate estimates from independent processors for the amount of milk they need during winter.

Question 10

What would the domestically-focused dairy sector look like (in terms of structure and range of business models) in the absence of the DIRA regulations? What (if any) are the barriers to such structure and business models developing over time? What is the impact of the current DIRA regulatory regime on such developments?

10.1 Fonterra believes that:

(a) DIRA does not materially affect the various business models that participate in the domestic consumer sector. As a result, it is unlikely that the domestic sector would fundamentally change its character if DIRA no longer existed. As described above, the sector is supporting a variety of competing, sustainable business models and strategies. That said, Fonterra does believe there may be an ongoing role for the Raw Milk regulations in relation to regulated supply to Goodman Fielder and niche processors, as well as the 20% rule.

(b) The level of competition in domestic consumer markets is well established and this would likely be retained even in the absence of the DIRA regulations (although as above some aspects of DIRA continue to serve a purpose.

(c) DIRA is also not likely to be materially affecting the structure and range of business models involved in retail supply of dairy. As such, DIRA would not affect the likelihood of changes to retail models emerging (such as the entry of Amazon).

10.2 NERA's advice has been that, in the absence of DIRA, Fonterra's ability to raise wholesale prices above the competitive level would be limited because independent processors would have the ability to switch material levels of production to the factory gate market.[117] The Commerce Commission also determined that while Fonterra may have an incentive to foreclose downstream competitors in a deregulated environment, our ability to do so would be limited because many independent processors would likely have alternatives at the factory gate or be able to increase their own supply. Independent processors that did not have access to alternative supply collectively accounted for a small market share, and Fonterra may not obtain a benefit from their foreclosure.[118]

10.3 Despite this, as noted above in response to Questions 2, 6 and 7, Fonterra does not believe that without the Raw Milk regulations, the factory gate market is yet sufficiently developed to allow smaller, niche suppliers to secure their own supply from the farm gate or factory gate markets on terms that would facilitate their entry and sustainable participation in domestic consumer markets.[119] Fonterra is comfortable that the 20% rule should remain as it offers another option for small processors to access supply through the farm gate market.

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[117] See NERA Economic Consulting, *Assessment of Competition in Raw Milk Markets and Costs and Benefits of the DIRA provisions* (August 2015), 3.

[118] Commerce Commission, *Review of state of competition in the New Zealand dairy industry: final report* (1 March 2016), [5.165]–[5.167].

[119] See NERA Economic Consulting, *Assessment of Competition in Raw Milk Markets and Costs and Benefits of the DIRA provisions* (August 2015), [5.2.2].

10.4 Fonterra is also comfortable that the obligation to supply Goodman Fielder should remain as it recognises that it gives stakeholders comfort knowing that there is regulated raw milk supply to a key downstream competitor.

10.5 These requirements protect the current level of competition and ensure that new and existing players have an effective pathway to enter and sustainably participate in domestic consumer markets. In particular, they ensure smaller, niche processors can enter the market – as demonstrated by the entry and growth of niche processors in all product categories discussed above. The regulations ensure that regulated supply is available to small players, until they have demonstrated an ability to access sufficient own supply (see 7.11 above).

10.6 DIRA does not play a material role in the structure of retail businesses, or the types of retail models that can be supported. Accordingly Fonterra would not expect it to hinder or affect any new business models or innovation that may emerge in the retail sector (e.g. the entry of Amazon).

Question 11

Does the DIRA regulatory objective of ensuring "competition in the wholesale supply of domestic dairy products" remain fit-for-purpose, given the dynamics of the domestically-focused dairy sector?

11.1 Yes, the objective of ensuring competition in domestic consumer markets has delivered a vibrant domestically-focused dairy sector providing New Zealand consumers with an increasing amount of choice and increasing competition. As noted above, the sector is supporting a variety of competing, sustainable business models and strategies.

11.2 As noted in response to question 10 above, while Fonterra's position has been that certain aspects of the DIRA regulatory framework should be retained to give the public confidence in the competitiveness of domestic consumer markets, competition is established and here to stay, even in the absence of regulation. This means the benefits of DIRA regulations have reduced and it may be appropriate to reconsider some of them.

11.3 As noted above in response to question 5, the goals for the dairy sector are now broader than competition, and include innovation, value-added production and long-term sustainability. The focus on sustainability is also important to our customers and consumers who are placing increasing importance on knowing their food is produced this way. Innovation is central to Fonterra's overall strategy, and is being driven by Fonterra and other industry players. Environmental sustainability is also central to Fonterra's long term strategy, and Fonterra is supporting ongoing work to reduce the environmental impact of dairying. Fonterra supports the policy development underway to formulate New Zealand's response to climate change.

11.4 While DIRA is not the appropriate or primary vehicle to address all of these goals, it is important to ensure that the DIRA regulatory framework facilitates and does not impair the sector's ability to achieve them. Accordingly, Fonterra is seeking changes to the DIRA regulatory framework that would allow Fonterra (and the sector as a whole) to unlock additional potential, and allow it to take further environmental leadership steps (see response to questions 6 and 7 above).

Question 12

If so, what changes (if any) would be required to ensure that the DIRA regulatory regime supports a well-functioning domestically-focused dairy sector that operates in the long term interests of New Zealand consumers?

12.1 As discussed above, Fonterra is comfortable with aspects of DIRA being retained at this stage to ensure competition in the wholesale domestic market, including the requirement to supply Goodman Fielder and small domestic processors, and the 20% rule.

12.2 The requirement to supply milk to larger processors whose primary focus is on export markets is no longer necessary or efficient. Fonterra also believes other changes to the Raw Milk regulations should be made, including reducing the costs associated with winter milk supply (see response to questions 6 and 7 above).

LIST OF ANNEXES

ANNEX 1: SUMMARY OF DIRA REGULATIONS

Open entry

1 The open entry obligations are set out in sections 73-96 of the DIRA (noting that sections 77 to 85 and 88 to 93 do not currently apply as a result of the presence of the Trading Among Farmers regime).

2 Fonterra "must accept applications by new entrants and shareholding farmers to supply it with milk, as shareholding farmers".[120] Fonterra is required to accept an application to become a shareholding farmer that is made by a new entrant in an application period, and an application to increase the volume of milk supplied as a shareholding farmer to Fonterra that is made by an existing shareholding farmer in an application period.[121] An application period must span the dates 15 December until 28 February the following year, at a minimum.[122] This gives Fonterra a limited period of time before seasonal milk collection commences (which then escalates quickly to peak milk supply).

3 The obligation to accept supply is subject to only very confined limits and exceptions.

4 Fonterra may publish a capacity constraint notice in respect of a specified geographic area in circumstances where it reasonably expects processing the expected increase in the volume of milk supplied to it from that area in the next season cannot reasonably be managed. The notice may not apply to more than one season. In those circumstances, Fonterra may defer, for only up to the period of the notice, the commencement of supply pursuant to applications in the specified area. Fonterra has not published a capacity constraint notice to date. Since it does not allow Fonterra to decline to accept new supply altogether, and the maximum deferral period of 12 months is too short a period to build a new plant, Fonterra considers that the capacity constraint notice provisions in practice do not limit the obligation. Thus it does not assist Fonterra to manage its capacity investments.

5 Fonterra may reject an application by a new entrant or shareholding farmer on the basis of minimal supply (amounting to less than 10,000 kgMS in a season). In practice, Fonterra has not had cause to reject an application under this exception, but considers it useful in that accepting minimal supply could potentially result in inefficiency, with no meaningful countervailing benefit for competition.

6 Fonterra may reject an application by a new entrant on the basis of transport costs (transport exception). Specifically, the transport exception is triggered where the cost of transporting the milk of the new entrant exceeds the highest cost of transporting another shareholding farmer's milk to the same factory. In practice the transport exception is difficult to apply. It has not allowed Fonterra to control its transport costs; practicalities of calculating whether the transport exception applies have resulted in incremental expansion of the area of New Zealand from which Fonterra must accept supply, and Fonterra expects this to continue.

[120] DIRA, section 71(b).

[121] Ibid, section 73.

[122] Ibid, section 75. In practice, application periods have spanned the period 15 December until the last day of February (28 or 29 February) the following year.

7 In particular, the key components of the calculation are complex and uncertain. They include:

7.1 Distance and time, comprising driving to the farm (factoring in collection of milk from more than one farm on a route, and that the farms from which milk is collected alter daily depending on volumes collected) waiting while milk is pumped, and driving to the factory.

7.2 Estimated milk volumes, which change daily for each farm.

7.3 Furthermore, in many instances new milk may be routinely transported to more than one factory, which means more than one calculation must be made.

8 Thus in practice the calculation is an estimate; given that, Fonterra incorporates a margin of error to ensure it complies with the exception, which reduces the effect of the exception and results in incremental expansion of collection areas.

Non-discrimination

9 Fonterra must ensure that the terms of supply for a new entrant are the same as those for a farmer shareholder in the same circumstances, or differ from the terms for a farmer shareholder only to reflect the different circumstances (*non-discrimination rule*).[123]

Open exit and the 160km rule

10 A farmer shareholder who wishes to cease or reduce the supply of milk as a farmer shareholder may give a notice of withdrawal (or volume reduction); the right to withdraw is subject to the terms governing the relationship between Fonterra and the farmer shareholder (*right to withdraw*).[124]

11 Fonterra may offer new entrants and existing shareholders supply contracts with terms greater than one year subject to ensuring that, at all times, 33% or more of milksolids produced within a 160km radius of any point in New Zealand is either:

11.1 supplied to independent processors; or

11.2 supplied to Fonterra on contracts that expire or are terminable by the supplier at the end of the current season (without penalty) and on expiry or termination end all the supplier's obligations to supply milk to Fonterra (*160km rule*).

12 Fonterra's constitution also provides that the aggregate amount of milksolids obtained from shareholders in a season on contract supply cannot exceed 15% of the total milksolids supplied by shareholders in the preceding 12 months.[125]

Raw Milk regulations

13 The principal aspects of the Raw Milk regulations, which require Fonterra to supply raw milk to independent processors and others, are the following:

13.1 Fonterra must make up to 600 million litres of milk available to independent processors.[126] Additionally:

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[123] Ibid, section 106.

[124] Ibid, section 97.

[125] Fonterra's constitution, clause 3.22.

[126] Raw Milk regulations, regulation 5.

(a) Maximum supply to Goodman Fielder is limited to 250 million litres per season (and subject to monthly limits and forecasting and other requirements).

(b) Supply to each independent processor is limited to 50 million litres per season (and subject to certain maximum monthly limits and forecasting and other requirements).

13.2 Fonterra is not required to supply raw milk to an IP from the season beginning 1 June 2016 if the IP's own supply of raw milk in each of the three consecutive previous seasons was 30 million litres or more.[127]

14 The price for raw milk can be agreed between Fonterra and the independent processor (or Goodman Fielder); otherwise, it defaults to a price comprising the farm gate milk price, plus the reasonable cost of transporting the raw milk to the processor and, in the case of winter and organic milk, the additional cost of procuring and supplying that milk.[128] Alternatively, new independent processors or those whose own supply of raw milk in the previous season was less than 30 million litres can choose to obtain raw milk at a "fixed quarterly price", which is formulated by the same methodology as the default milk price, except that instead of the actual farm gate milk price, it is based on the most recent quarterly published forecast of the farm gate milk price.[129]

15 The Raw Milk regulations also cover a wide range of detail in relation to forecasting and other requirements.

Milk price regime

16 The key components of regulation of the milk price (*milk price regime*) are:

16.1 *Milk Price Manual* – The 2012 DIRA Amendment required Fonterra to establish, maintain and make publicly available a Milk Price Manual, which sets out how the farm gate milk price is calculated. The methodology for calculating the farm gate milk price must be consistent with certain principles.[130] A Milk Price Manual has been used by Fonterra for this purpose since August 2008, and Fonterra voluntarily made it public in 2011. Fonterra met its obligations under the 2012 DIRA Amendment using its pre-existing Milk Price Manual, with only minor amendments.[131] The Milk Price Manual may only be amended or replaced with approval of at least 75% of the Fonterra board, including at least a majority of Fonterra's independent directors.[132]

16.2 *Milk price* – The methodology for setting the farm gate milk price, which as noted above is largely in line with the methodology Fonterra applied prior to the 2012 DIRA Amendment, seeks to calculate the price that an efficient processor of Fonterra's scale could sustainably pay for the milk collected by Fonterra in New Zealand.[133] The farm gate milk price is set by reference to "Reference Commodity Products". In other words, the milk price regime assumes that Fonterra will use raw milk as an input into certain commodity dairy products (for example whole and skim milk powder). The list of Reference Commodity Products, which forms part of the Milk Price Manual, may only be amended or replaced with approval of at least 75% of the Fonterra board, including at least a

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[127] Ibid, regulation 6(3).

[128] Ibid, regulation 20.

[129] Ibid, regulations 19 and 24.

[130] DIRA, sections 150F and 150C.

[131] Commerce Commission, *Review of Fonterra's 2012/13 Milk Price Manual: Final Report* (14 December 2012), [3.7].

[132] Fonterra Co-operative Group Limited, *Fonterra Shareholders' Market Rules* (24 August 2012), [3.3.5(b)].

[133] See also the purpose statement in DIRA, section 150A.

majority of Fonterra's independent directors.[134] The farm gate milk price is based on:[135]

(a) notional revenue, calculated assuming Fonterra's entire volume of milk is processed and sold as Reference Commodity Products, primarily on the Global Dairy Trade auction platform; minus

(b) the notional manufacturing costs of an efficient competitor (including capital costs), and overhead, collection and other costs derived from Fonterra's actual costs.

16.3 *Independent Milk Price Panel* – The 2012 DIRA Amendment requires the establishment of a Milk Price Panel, which oversees the calculation of the milk price.[136] This essentially aligns with the arrangements Fonterra had already put in place or had intended to adopt upon the launch of TAF. The Milk Price Panel must at all times include a majority of members who are independent from Fonterra, including the chair.[137] Among other activities, the Milk Price Panel:[138]

(a) oversees the governance of the milk price and the Milk Price Manual, including undertaking reviews;

(b) supervises the calculation of the milk price and makes recommendations on it to the Fonterra board;

(c) makes recommendations to the Fonterra board relating to the Milk Price Manual, including recommendations that it should or should not be amended; and

(d) provides assurances to the Fonterra board that the Milk Price Panel is not aware that the milk price has been calculated incorrectly or that the Milk Price Manual ought to be changed.

16.4 If Fonterra sets a farm gate milk price other than in accordance with a recommendation by the Milk Price Panel (including where Fonterra receives no recommendation), certain disclosures are required.[139]

16.5 *Commerce Commission oversight* – The 2012 DIRA Amendment provided for the Commission to review and report on the extent to which the Milk Price Manual[140] and the milk price[141] are consistent with specific principles of DIRA. Regulatory oversight was of course not part of the milk price regime prior to the 2012 DIRA Amendment. The Commission must publish its final reports on the Milk Price Manual by 15 December each season and on the milk price by 15 September following the season to which the review relates. The Commission's timing enables its views to be known before Fonterra's annual results for the relevant season are finalised and announced.

17 In addition, Fonterra has a working group known as the Milk Price Group. Its head is independent of Fonterra's management and reports directly to the chair of the Milk

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[134] *Fonterra Shareholders' Market Rules*, [3.3.5(b)].

[135] Fonterra, *Farmgate Milk Price Manual – Part A: Overview* (1 August 2015), [4.1].

[136] DIRA, section 150D.

[137] Fonterra's constitution, clause 10.3(c)(ii) and (iv).

[138] DIRA, section 150D and Fonterra's constitution, clause 10.3(a).

[139] Ibid, section 150N.

[140] Ibid, section 150H.

[141] Ibid, section 150O.

Price Panel.[142] Among other things, the Milk Price Group ensures that the farm gate milk price is calculated in accordance with the Milk Price Manual, considers amendments to the Milk Price Manual and ensures amendments are consistent with the Milk Price Principles in Fonterra's constitution.[143]

18 Finally, under the Fonterra Shareholders' Market Rules, Fonterra is prohibited from making a decision to pay an aggregate amount for milk in excess of the amount calculated under the Milk Price Manual unless that decision is approved by at least 75% of the Fonterra board, including at least a majority of Fonterra's independent directors.[144]

Trading Among Farmers

19 TAF was not contemplated in the original DIRA regime; Fonterra shareholders voted in favour of its introduction in June 2010. Relevant aspects of the Dairy Industry Restructuring Amendment Act 2012 were implemented in order to enable TAF.

20 TAF comprises a number of inter-related arrangements that establish:[145]

20.1 A Fonterra Shareholders' Market, which is a private market on which farmer shareholders are able to trade Fonterra shares with one another (an appointed market maker also trades shares).

20.2 The Fonterra Shareholders' Fund. External investors are able to buy units in the Fonterra Shareholders' Fund, through which these investors may enjoy certain economic rights of Fonterra shares. The Fonterra Shareholders' Fund supplements liquidity in the Fonterra Shareholders' Market because units can effectively be "exchanged" for Fonterra shares by farmer shareholders, Fonterra and the market maker and vice versa.

21 TAF is interdependent with, and complementary to, the Milk Price regime. Under TAF, external unit-holders as well as farmer shareholders receive dividends. The amount paid is directly impacted by the efficiency of the milk price. TAF strengthens incentives upon Fonterra to determine an efficient milk price, as external investors' interests are solely focused on dividend payments (as opposed to farmer shareholders, who are incentivised to maximise the milk price). Scrutiny by external investors encourages Fonterra to be transparent in its milk price-setting process.

22 In practice, TAF also achieves its objective of facilitating entry to and exit from Fonterra for farmers by providing liquidity and good price discovery. Fonterra's exiting shareholders are able to sell all of their shares, or sell down their shares over three seasons[146] (as well as retaining an ongoing ability to participate in the Fonterra Shareholders' Fund) which further facilitates switching.[147]

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[142] *Farmgate Milk Price Manual – Part A: Overview*, [5.3] and [5.4].

[143] Ibid, [5.4].

[144] *Fonterra Shareholders' Market Rules*, [3.3.5(a)].

[145] The documentation constituting the TAF scheme includes Fonterra's constitution, and resulting Board policies, the Fonterra Shareholders' Market Rules, the structure and constitution of the Fonterra Farmer Custodian, the structure of the Fonterra Farmer Custodian Trust, the terms of the Custody Trust, the Unit Trust Deed for the Fonterra Shareholders Fund, the Authorised Fund Contract between Fonterra and the Fund, and the Registered Volume Provider Agreement.

[146] Fonterra's constitution, clause 3.10(d)-(f).

[147] Farmers may exchange units in the Fund for shares when they join or return as a farmer shareholder.

ANNEX 2: NZIER REPORT