Review of the Dairy Industry Restructuring Act
Submission of Open Country Dairy

Open Country Dairy Limited (**Open Country**) welcomes the opportunity to participate in the review of the Dairy Industry Restructuring Act 2001 (**DIRA**). This submission sets out Open Country's response to the *Terms of Reference for the Review of the Dairy Industry Restructuring Act 2001 and its Impact on the Dairy Industry.*[1]

Open Country firmly believes that the Dairy Industry Restructuring Act 2001 (DIRA) is demonstrably not working as effectively as it should and that greater integrity, transparency and objectivity in the setting of the farm gate milk price is now necessary. This submission outlines our specific concerns and provides recommendations to align the regime much more closely with regulatory best practice.

In summary, our views are that:

(a) The process for setting the farm gate milk price is flawed, and the monitoring regime overseeing that process is ineffective. As a result, the farm gate milk price does not represent the most accurate approximation of a market-derived price.

(b) The broad structure of the DIRA regime is appropriate by it has been implemented with transitory mindset. Market power issues are persistent and this transitory mind set is misplaced.

(c) A monopoly position for Fonterra without effective regulation will not achieve a strong dairy industry. The open entry and exit requirements therefore need to be retained.

We recommend that:

(a) the farm gate milk price setting and monitoring regime is strengthened to bring it more in line with regulatory best practice by establishing a new Dairy Authority to either:

(i) approve the milk price manual and other inputs used by Fonterra to set the farm gate milk price; or

(ii) actually determine the price-setting methodology itself;

1 Ministry for Primary Industries (MPI Information Paper No 2018/02, Wellington, 9 May 2018).

(b) regulation reflects the long-term high market concentration of the NZ dairy industry by establishing an independent specialist Dairy Authority with more influence; and

(c) no change is made to the current open entry and exit requirements.

Open Country looks forward to discussing these issues further with the Ministry over the course of the DIRA review.

1. Fundamental proposition

Open Country firmly believes that New Zealand needs a strong dairy sector. The New Zealand dairy sector employs 50,000 people and contributes over $12 billion annually to the New Zealand economy.

Fonterra was formed by state involvement through the passing of DIRA with the goal that it would be a "national champion" business which would drive economic growth through exploiting global scale in commodities to grow quickly in value-added products.

While some small steps have been made in this direction over the last 20 years, the growth opportunities afforded to a national champion are yet to be realised. Our concern is that a monopolistic Fonterra cannot achieve this.

The broad structure of DIRA could possibly work but in its current form it is fundamentally flawed for the single reason that the milk price setting regime does not result in an accurate approximation of market derived price.

The effects of this flaw include:

(a) A small inaccuracy in the milk price has a disproportionately high impact on the value add business performance (a 1% inaccuracy in the milk price can have a 15% impact on the value add business return)[2];

(b) Weakened efficiency incentive for Fonterra, as artificially inflated milk price weakens contestability;

(c) The integrity of the dairy futures market is undermined;

(d) The Fonterra share price is undervalued;

(e) Artificially inflated milk price causes marginal land being converted to dairy, more intensive farming and inflated farm values over time;

(f) The lack of transparency in the milk price is recognised by overseas dairy industry players and undermines the integrity of NZ Inc on the world stage.

[2] 'Fonterra's Milk Price – The Facts', retrieved on 06/06/2018 from https://www.fonterra.com/content/dam/fonterradotcom-www2/files/financial-docs/milk-price-methodology/Milk+Price+Questions+and+Answers+1+Aug+2011.pdf

To unlock the full potential of the New Zealand dairy industry the incentives on the industry to invest in growth and innovation need to be right. This in turn requires that the Fonterra farmgate milk price should be set by high-quality regulation which leads to a price set with integrity, transparency and objectivity. This is what we are concerned to ensure the DIRA Review achieves.

2. Fonterra's incentives

Fonterra is a complex business, and its managers and executives face a complicated mix of long-term and short-term incentives. It is no longer controversial that the role of DIRA is to mitigate against any short-term incentive Fonterra has to impede contestability and compromise on efficiency in its commodity processing business. The stronger these short-term incentives, the stronger DIRA regulation needs to be in order to counter-act those incentives.

For example, in a low-price period in the commodity price cycle Fonterra has a short-term incentive to maintain its farmgate milk price in order to ensure its factories remain full and high yielding. In a high-price period in the commodity price cycle Fonterra would similarly have a short-term incentive to maintain the price in order to attract more milk supply to maximise its short-term profit.

Fonterra also has incentives to pursue long-term growth and innovation. This is often what the industry means when it discusses Fonterra's "value-added" business initiatives. These longer-term incentives have the potential to deliver real benefits to New Zealand's dairy industry, and to our economy and society as a whole. The mix of long-term and short-term incentives that Fonterra faces is therefore critical to calibrating the DIRA regulatory regime responsibly and effectively.

More specifically, the long-term growth and dynamic efficiency of the New Zealand dairy industry could be impeded by Fonterra, as the dominant firm in the market, having:

(a) incentives and the ability to put up significant barriers for dairy farmers seeking to switch to its competitors, thus impeding entry/expansion by existing or future competitors in the market for farmgate milk supply; or

(b) fewer incentives to drive cost-efficiencies and invest in value add, as it could use its market position to retain dairy farmers even if they were dissatisfied with the company's performance, thus creating a risk of waste, inefficiency and suboptimal investment decisions.

If these incentives are dominant in the short term, then Fonterra's pricing and investment decisions will not be aligned with its value-added strategy. Despite the attraction of higher margins from value-added business ventures, Fonterra can simply squeeze "value" in the short term by simply holding on to as much commodity milk supply as possible.

This mix of incentives, where short-term supply hoarding risks crowding out long-term value-added investment, potentially results in a number of detrimental outcomes for the sector and the wider New Zealand economy:

(a) Fonterra's competitors (independent processors) will receive less farmgate supply than is efficient. Fonterra can use higher farmgate milk prices to secure more farmgate milk supply than is efficient, impeding the efficient allocation of farmgate milk supply among all processors in the market. Over time, these misaligned allocation incentives can lead to (productively inefficient) over-investment in commodity processing facilities by Fonterra, and under-investment in its value-added business.

(b) Artificially inflated farmgate milk prices impact on Fonterra's ability to deliver real growth and dynamic efficiencies (innovation and value-added investment). Even if Fonterra can deliver world-leading cost efficiencies in respect of commodity processing because of its scale and ability to secure supply, it can risk leaving value on the table by not preferring its growth and value-add business. That type of decision is one that will ultimately cost all New Zealanders over the long term.

It is a misrepresentation to suggest that because there are incentives both ways, Fonterra's mix of incentives is 'balanced' and therefore appropriately attuned to competitive markets.[3] The reality is that different incentives will dominate at different times, and the available evidence strongly suggests that short-term supply hoarding incentives have been dominant over at least the last 6 years.

Fonterra's current business model is demonstrably based on securing a large, sustainable milk supply. Fonterra's constitution expressly states that its overriding consideration is maximisation of the farm gate milk price:[4]

> *"[T]he Milk Price should be the **maximum amount** that the Company, reflecting its status as a properly managed and efficiently run sustainable co-operative, could pay ... ."*

We see clear evidence of this in Fonterra's own statements to the market and its investors. Fonterra's chairperson has stated that:[5]

> *"... 46c had migrated from earnings to milk price over the years and been baked in but there is nothing inherent in the Milk Price Manual that means only 10c, 20c or 30c will always be left over for dividend."*

See also:[6]

> *"But Wilson also pointed out that 46c has migrated across from earnings to milk price by several tweaks to the [Milk Price Manual]."*

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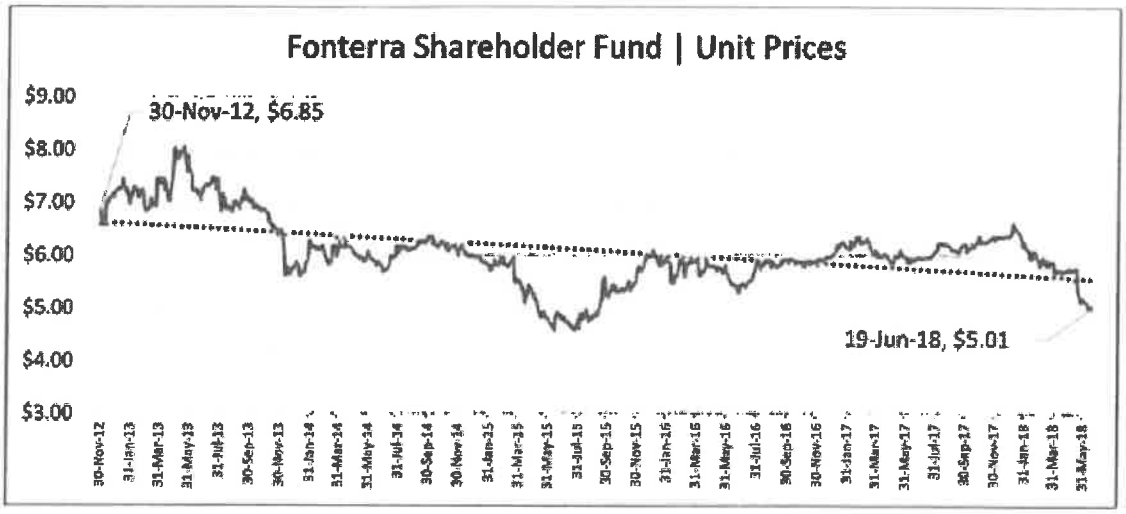
3 See for example NERA Economic Consulting *Estimating Asset Beta for the Notional Processor* (2018) at paragraph 9.

4 Constitution of Fonterra Co-operative Group Limited at page 49.

5 Retrieved on 6 June 2018 from https://farmersweekly.co.nz/section/dairy/view/wilson-spierings-argue-valid-comparisons-value-adds

6 Retrieved on 11 June 2018 from https://farmersweekly.co.nz/section/dairy/spierings' Fonterra has created two new food categories

This is consistent with Fonterra's share price performance since 2012:



This also contextualises more recent statements that Fonterra is achieving higher prices than its competitors in the current season by a significant measure ($100-$400 per tonne of milk solids), which appears to blur the lines between commodity and value-added business activities. Fonterra's chairperson has stated:[7]

> *"I say **it's wrong now to talk about Fonterra products as commodities.** Fonterra products are largely ingredients and when you think about the plants built over the last seven or eight years, these are producing high-spec ingredients for our customers."*

While these statements are partly rhetoric, they show the difficult of distinguishing between commodity and value-added products on an objective and transparent basis. Gains of "$100 to $400 per tonne more than the same milk powder products are fetching for its competitors" that result in "a positive impact of 20c-40c/kg milksolids on the milk price to farmers" suggests that non-commodity elements are shaping the product mix that determines farm gate milk price. Because Fonterra determines the milk price in its discretion based on its own commercially sensitive information, we simply do not have a way of testing whether these types of market outcomes are consistent with DIRA or not.

The best objective evidence we have of the impact of Fonterra's mix of incentives is the Commerce Commission's recent detailed inquiry into Fonterra's determination of the asset beta used to derive the farm gate milk price.[8] This analysis has systematically demonstrated that Fonterra has set the asset beta too low to be practically feasible, raising the farm gate milk price in the process by around 5.7 cents. The effect of this mispricing is that around $441 million has been incorrectly paid by Fonterra through the milk price and not to value added returns since independent processors, including Open Country, first raised the issue of a low WACC with the Commission.

7 https://www.nzherald.co.nz/business/news/article.cfm?c_id=3&objectid=12070048

8 Commerce Commission *Review of Fonterra's 2017/18 base milk price calculation: Emerging views on asset beta*. The asset beta is a specialised measure of business risk, which in part determines the return on capital needed to attract investment.

At the very least there is a risk that Fonterra is satisfied with returns drifting to farmer-suppliers through a higher than competitive farm gate milk price, rather than assessing the value of commodity processing business on an objective, efficient basis. The available evidence raises the distinct concern that this is indeed where Fonterra's dominant incentives currently lie under the DIRA regime, and it is acting on those incentives. Either way, New Zealand needs to know for certain. This is precisely the issue that DIRA is intended to address but is not addressing. A robust regulatory regime needs to be established to effectively resolve this in the interests of New Zealand's long-term economic growth.

3. Transitory mindset is misplaced

DIRA is designed to mitigate short-term incentives in order to better promote efficiency and contestability over the long term. Its implementation and application should occur with a long-term view in mind. This is, in fact, essential for DIRA to operate effectively. Long-term incentives for growth and innovation cannot be delivered with a short-term mindset. This is the market-based problem that DIRA is intended to address.

If regulation is implemented with the same short-term mindset, then all DIRA can do is substitute a market failure for a regulatory one. Only a long-term regulatory mindset can effectively address a market failure that results from disproportionately powerful short-term incentive.

However, our experience with the implementation and application of DIRA is that its effectiveness is compromised because it has been treated as a short-term, transitionary regulatory regime in precisely this way. While the long-term goals of the regime are clear and relatively well understood, both substantive and formal features of the regime and the market it regulates can work against those long-term goals:

(a) Substantively, the dairy industry is not a traditional natural monopoly sector. Natural monopolies exist where an incumbent's sunk investment effectively prohibits economic entry or expansion by the incumbent's (potential) competitors. Entry and expansion is theoretically possible in the dairy industry in the absence of regulation no matter how unlikely.[9] Indeed, the contestable markets framework that DIRA sets up is premised on the possibility of entry and expansion.

(b) Formally, the DIRA price-setting regime has always been subject to sunset provisions in the form of a statutory market share threshold for review. This approach implicitly contemplates the rollback of the regime at some future point.

Focusing on these features has obscured that the underlying economic policy problems persist. Despite a degree of successful entry in both the North Island and South Island,

9 Indeed, as noted below, the contestable markets framework that DIRA sets up is premised on the possibility of entry and expansion, although notably DIRA moves away from theoretical standards and towards real-world impacts by requiring the regulator to consider "practical feasibility".

Fonterra is still the monopoly in several regions.[10] Understanding Fonterra's dominance in terms of these regional markets are critical, because the location of processing facilities close to supply are essential to cost efficiencies. This is especially the case for new entrant and expanding challengers, who cannot rely on Fonterra's titanic scale. Claims that new entry and expansion have occurred under the current DIRA regime, and that this proves the contestability of the national market, often ignore the limited geographical nature of those limited examples.[11] If the market were truly contestable, entry and expansion would be widespread.

Even nationally Fonterra still has between 70% and 80% of the total milk supply. This is well in excess of the Commerce Commission's market concentration thresholds, which indicate that competitive market pressures tend to break down when the dominant player has 40% of the market.[12]

Independent processors have won a significant share of new milk that has come onstream, but very little of Fonterra's existing supply base. Now that milk growth in NZ appears to have plateaued it is simply infeasible that Fonterra's dominance will be competed away to more competitive market levels in the short-to-medium term. The DIRA regime must reflect the long-term necessity of regulation in both design and implementation if the benefits to New Zealand of more contestable markets are to be realised.

We note that this long-term approach is particularly important given the lack of alternative legal avenues to deal with Fonterra's market power. Ideally, the DIRA regime would be complemented with an effective economy-wide prohibition on monopolisation and the abuse of market power. However, in New Zealand the reality is that the Commerce Commission considers that the monopolisation provisions of the Commerce Act are not fit for purpose and will not be invoked for the foreseeable future. This is a contestable claim that has been widely debated in other contexts, and we do not engage in the detail of that debate here and the complex questions of possible reform that it raises. However, we simply must underscore that if the Commission refuses to bring legal action against monopolists who damage competition, challengers in highly concentrated markets are especially likely to suffer and New Zealand will lose the benefits of competition. This includes in the New Zealand dairy sector.

These points are underlined by Fonterra's complete lack of incentives to self-regulate in response to the limited guidance offered by the Commission. Pleas for further transparency with respect to the underlying inputs into the farmgate milk price have simply been ignored. For example, the three key variables that drive the farm gate milk price each year are sales phasing, product mix, and foreign exchange hedging.[13] Fonterra has complete discretion as to how it determines these factors impact on the milk price, and can in fact change its working assumptions throughout the season without notice. Market participants are left to model these assumptions throughout the season against a set of goal posts that are both moving and invisible.

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10 Fonterra is the sole processor in Northland, Gisborne, Hawke's Bay, Marlborough and Nelson-Tasman.

11 For example, NERA Economic Consulting *Estimating Asset Beta for the Notional Processor* (2018) at paragraph 19.

12 Commerce Commission *Merger Review Guidelines* (Wellington, 2003).

13 See Synlait *Focus on Transparency*, available http://comcom.govt.nz/dmsdocument/15478

The Commission has noted on numerous occasion that the DIRA regime would benefit from Fonterra increasing its transparency. For example:[14]

> *"We note the arguments made by IPs about the regulatory risks faced by IPs and other market participants and the impact this has on the market. However, our role is limited to reviewing Fonterra's Manual for the current season, and the Calculation for the past season. It is not our role, nor is it within our powers, to actively seek information that does not relate to our review process from Fonterra. We also do not have an educative or advocacy function under DIRA. The regime was not established by us and we cannot amend it. However we recognise the disclosure of this information could promote efficiency and contestability of NZ dairy markets and we therefore continue to encourage Fonterra to release information that would reduce the regulatory risk faced by market participants. Based on IP's previous submissions, we understand that the most useful information is sales phasing and exchange rate information. We also continue to encourage both IPs and Fonterra to engage with each other on this issue going forward."*

We believe it is important to question why this has not occurred. There is very little that is commercially sensitive about these assumptions, as they do not allow for Fonterra's competitors to take any action that might impact Fonterra's commercial operations and they are ultimately disclosed at the end of the season in any case when the final milk price calculation is published.

It is ironic that the persistent assumption that entry and expansion is technically possible, and therefore that regulation will be short-lived, has been used as a justification for not addressing the underlying issues about sustained, long-term abuse of market power in dairy markets. The failure to address those long-term issues effectively has allowed market power issues to persist for much longer than is necessary. DIRA needs to be implemented with a long-term mindset to be effective, and that may require change to the form and the statutory language used to describe regulatory obligations.

4. Dairy Industry Restructuring Act

DIRA has an important, long-term role to play in promoting outcomes in dairy markets that benefit New Zealanders. Open Country considers that the broad structure of the DIRA regulatory regime is appropriate, but refinement is needed to ensure it is effective and to reflect market developments.

The basic policy approach has been to promote **contestability** in relevant markets. This is a specific form of market dynamics where:

(a) the market can sustain only a few viable competitors, and there is an associated risk that transitory or ongoing market power is abused;

14 See for example Commerce Commission *Review of Fonterra's 2017/18 Milk Price Manual* (15 December 2017).

(b) entry and exit are relatively easy, meaning the threat of new entry or expansion keeps market power in check.

We consider that the contestability standard remains appropriate as dairy markets in New Zealand are likely to be defined by having only a few viable competitors for the foreseeable future. The contestability framework is also appropriate because it implicitly recognises the risk of Fonterra's harmful, short-term incentives is related to impeding entry and expansion by its competitors.

The DIRA regime is designed to rebalance Fonterra's incentives to avoid these problems. The regime does not directly intervene in Fonterra's milk and share price setting processes. Instead, through its freedom of entry and exit requirements, it underpins and strengthens Fonterra's commercial incentives to price its milk and shares efficiently over the long term.

The DIRA regime seeks to strengthen Fonterra's commercial incentives to price its farmgate milk supply (and shares) efficiently over the long term, and therefore promote greater contestability in dairy markets, through two principal mechanisms:

(a) open entry and exit requirements; and

(b) a farmgate milk price monitoring regime.

4.1. Open Entry and Exit

Open entry and exit is the fundamental building block for contestability. Open entry and exit is sometimes understood as describing a relationship between Fonterra and farmer suppliers. The essence of that relationship is that Fonterra is required to accept new supply from farmer-suppliers and allow those farmer-suppliers to leave Fonterra if they choose to do so.

However, the open entry and exit arrangements are essential to the contestability of New Zealand dairy markets more broadly. These arrangements facilitate the ability of farmer-suppliers to enter into supply arrangements with Fonterra's competitors, because there is an acceptable level of risk if these new competitor relationships fail. If the arrangements with the competing processor are not ultimately successful, then the farmer-supplier can return to Fonterra without fear of facing a punitive penalty.

This is a real fear. In the case of *McIntyre and Williamson Partnership v Fonterra Co-operative Group Limited* [2015] NZHC 3012 the High Court found that Fonterra sought to impose "penalties" on suppliers who did not have open entry rights as punishment for having left Fonterra for a competitor who ultimately failed.[15]

Open entry and exit arrangements protect against this type of opportunistic behaviour and have allowed several smaller competitors to enter the milk processing market in New

15 At [113]. The result in this case was appealed by Fonterra but upheld in the Court of Appeal in *Fonterra Co-operative Group Ltd v McIntyre and Williamson Partnership* [2016] NZCA 538 and in the Supreme Court in *Fonterra Co-operative Group Ltd v McIntyre and Williamson Partnership* [2017] NZSC 197.

Zealand. These arrangements remain an essential component of the regime going forward. In regions where Fonterra is still dominant, these regulatory arrangements continue to facilitate new entry or expansion from existing competitors. Fonterra's own advisors have acknowledge that this is the case, pointing out that the obligation to accept supply tempers Fonterra's incentive to raise the farm gate milk price above competitive levels.[16]

We recognise that there is a perception that regulating for open entry and exit leads to unintended consequences because the full financial and environmental impacts of the decision to convert are not internalised by farmer-suppliers. These detrimental effects are actually driven by weaknesses in other aspects of the DIRA regime. In particular:

(a) an artificially high farm gate milk price leads to Fonterra having to invest more in stainless steel processing facilities at the cost of developing its value add business;

(b) an artificially high farm gate milk price leads to marginal land being converted to dairy and more intensive farming. A more accurate farm gate milk price would ensure that dairy conversions occur on marginal land where there is genuine value to be realised; and

(c) targeted environmental regulation is needed to address the environmental effects of dairy intensification.

Attempting to address these externalities by removing open entry and exit requirements will not have the desired economic and environmental impact, because other incentives will often dominate. Those externalities need to be addressed directly (and Open Country is very supportive of that occurring). But attempts to shape the incentives of farmer-suppliers to consider environmental impacts by removing open entry and exit will only serve to damage the market contestability.

Fonterra has in the past expressed a concern that the need to over-invest in commodity processing arises from the implicit guarantee it has to give farmer-suppliers to accept their milk supply.[17] A more accurate farmgate milk price year-on-year would place appropriate incentives on farmer-suppliers to adjust stock and land levels appropriately. We take these Fonterra complaints as a tacit admission that the farm gate milk price is not well set, and the milk price monitoring regime that governs it from a regulatory perspective is not currently fit for purpose. We address those issues in more detail in the following section. In any case, we note that whether Fonterra is actually required to over-invest is an

16 NERA Economic Consulting *Estimating Asset Beta for the Notional Processor* (2018) at paragraph 8.

17 See New Zealand Herald "Fonterra wants law change to end milk pick up obligation", available here.

empirical question. Under the co-operative structure new milk that Fonterra is required to accept comes with more capital than is required for processing facilities[18], and even if it has been an issue previously, the forecast plateau in New Zealand's domestic milk supply is highly likely to supersede any concerns that Fonterra has.

4.2. Farmgate Milk Price

The base milk price calculation regime is intended to complement open entry and exit by aligning the incentives for entry with efficient investment. It does so by determining the farm gate milk price with reference to commodity prices, which serves at least the following key functions:

(a) Farm-gate milk prices are determined with reference to commodity products, whereas equity returns paid to farmer shareholders are determined with reference to value-added products. Linking the milk price to commodity products therefore ensures a fair split between the milk price and the shareholder dividends.

(b) A 'notional producer' construct encourages efficient entry (and expansion) into the domestic milk processing market. Entry and expansion occurs where a competitor to Fonterra can 'beat' the commodity-derived milk price through its own value-added investments or greater efficiencies.

(c) Paying for milk at the accurate market price leads to appropriate levels of investment in value-added activities.

(d) An accurate market price leads to the development of exchange-traded FGMP derivatives allowing the dairy industry as a whole to reduce volatility.

These benefits can only be derived if the base milk price is determined in a manner that is transparent so that independent processors, investors in the Fonterra Shareholder's Fund and farmer-suppliers can see commodity prices throughout the season and reasonably predict the final milk price and the share price. It also needs to be an objective price so that Fonterra does not set the final milk price in a manner that favours its own operations over its competitors, for political gain or for some other non-market reason.

While at a conceptual level the DIRA regime appears to be consistent with efficient and contestable market outcomes, there are a number of critical decisions that remain with Fonterra when calculating the farm gate milk price which have a material impact on achieving those goals. Depending on the mix of short-term and long-term incentives that Fonterra faces, these specific assumptions and decisions have the potential to impact the milk price so that it acts as a barrier to efficient entry and expansion.

These assumptions and decisions include:

(a) choice of the product mix and conversion of global prices into revenue;

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[18] See OCD, Synlait and Miraka Submission to the Commerce Commission Regarding the Dry Run Testing of Fonterra's Farm Gate Milk Price 4 April 2012 page 12

(b) selection of the appropriate scale and location of plant in the hypothetical business;

(c) technical assumptions such as the assumed plant yield;

(d) determination of the cost of capital and depreciation schedules; and

(e) development of consistent definitions of ancillary costs, such as overheads.

DIRA aims to control for these risks by having Fonterra publish its Milk Price Manual at the start of the season, and to have both the Milk Price Manual and the final farmgate milk price reviewed by the Commerce Commission for consistency with efficiency and contestability standards.

The fundamental flaw with the DIRA regime is that these protections are inadequate, allowing Fonterra to act on its short-term incentives to raise the farmgate milk price to levels where it acts as an effective barrier to entry and expansion. This occurs for a number of reasons:

(a) **Lack of meaningful regulatory powers.** There are no material consequences that flow from the Commission's review of Fonterra's farmgate milk price. The Commission does not provide its own view on the correct farmgate milk price, so there is no comparison between Fonterra's price and an objective, market-consistent price. Close scrutiny of any divergence might put political pressure on Fonterra if a comparison could be drawn, but this is currently absent from the regime. Further, there is no threat of escalating the regulatory interventions that Fonterra is subject to, so there is no incentive for greater accuracy in the farmgate milk price over time. The Commission's role is limited to assessing for consistency with the 'efficiency' and 'contestability' standards set out in DIRA, but even where Fonterra departs from these standards the Commission often merely states that it lacks sufficient information to conclude definitively. This can in practice be worse than no review at all as it has the effect of legitimising the Fonterra milk price without true interrogation of that price or power to correct it when found wanting.

(b) **Lack of time to undertake a meaningful assessment.** For example, the Commission is given an extremely short timeframe of only 6 weeks to consider Fonterra's farmgate milk price for the season before issuing a draft report. It then has only 2 weeks to invite comment on the draft report and address any outstanding issues. These timeframes are hardwired into the statutory framework, and there is no room for flexibility. This further contributes to the 'once over lightly' approach that the Commission adopts in its regulatory assessment, discussed below.

(c) **Lack of accountability.** There is precious little opportunity for the Commission to test Fonterra's position or its own views with third parties that have the requisite knowledge to do so quickly and effectively (principally independent processors and farmer-suppliers). This is exacerbated by a complete lack of any statutory requirement to engage with or consult affected third parties. In practice the Commission has sought to include interested parties in the process, but time restraints necessarily mean that this engagement is cursory. Crucially the legal thresholds judicial review of either the Commission's or Fonterra's decision-making with respect to the farmgate milk price are very high, resulting in a lack of meaningful accountability within the regulatory regime.

(d) **A lack of resources to review Fonterra's processes effectively.** The Commission has limited practical knowledge of the variables used to determine the farmgate milk price over the season and has less than 3 FTE staff working on these issues (including legal and economic resource). (Compare this to over 30FTE working in electricity). This has resulted in much of the detail of the farmgate milk price setting process being 'outsourced' to the Milk Price Panel, all of whom are appointed by Fonterra and which is therefore not sufficiently independent. The Commission's review is limited in practice to a 'once over lightly' assessment, looking for obvious errors and often not being able to conclude on issues that are contested.

As a result, the current application of the DIRA regime fails to ensure Fonterra sets an efficient farm gate milk price. This results in the inefficiencies and misaligned incentives described throughout this submission, but key is the softening of dynamic efficiency incentives internally at Fonterra. This is where real long-term gains to the New Zealand economy are being foregone.

DIRA also lacks the transparency to demonstrate or ensure that Fonterra is meeting the requirements and objectives of DIRA each season through the milk price If the DIRA regime was well-attuned to dairy markets, this would be obvious both through the season as commodity products are exported and at the end of the season when the farmgate milk price is confirmed. At present the process of setting the farmgate milk price is so opaque, it is impossible to know if DIRA is having its intended influence. This is itself a fundamental failure of the regime that requires urgent remedial action.

5. Specific impact of the flaws

5.1. Asset beta

There is not control over the methodologies Fonterra uses to set the milk price, and no meaningful review to demonstrate where the divergence lies. Where the Commission disagrees with Fonterra the Commission is virtually powerless to do anything about it.

It has taken over 5 years from the issue of an artificially low WACC first being raised with the Commission[19]for the Commission to issue an "emerging view" for consultation that agrees with this. Despite the Commission issuing the independent report on asset beta on 11 April 2018 a final paper is not due to be published until 14 September 2018. Even if the Commission's emerging view is confirmed there is no compulsion for Fonterra to adopt

[19] See OCD, Synlait and Miraka Submission to the Commerce Commission Regarding the Dry Run Testing of Fonterra's Farm Gate Milk Price 4 April 2012 page 2

it, and certain to be no retrospective compensation volunteered by Fonterra despite the amount misapplied as between milk price and dividend adding up to $441 million over that 6 year period.

5.2. Superficial efficiency assessment

At a general level, these flaws in the DIRA farmgate milk price setting regime have led to the goals of DIRA being reinterpreted. DIRA is intended to influence substantive market outcomes. This is made clear in the statutory purpose statement, which unequivocally provides that DIRA is to "promote the efficient operation of dairy markets in New Zealand by regulating the activities of new co-op to ensure New Zealand markets for dairy goods and services are contestable".[20] Influencing substantive market outcomes requires the farmgate milk price to be set at a specific level. For example, a lower price will better incentivise Fonterra to invest in its value-added business, increasing the dynamic efficiency of the dairy sector as a whole. A higher price will soften those dynamic efficiency incentives, all things being equal. Getting this balance right is what DIRA is supposed to do.

In practice, under the current DIRA regime, the Commission does not engage with this kind of substantive market analysis when 'monitoring' Fonterra's farmgate milk price. In fact, it is not directly interested in the level at which the price is set, which results in it being indifferent towards the dynamic efficiency incentives Fonterra faces. The Commission has interpreted the efficiency standard in a rather narrow way, understanding it to be limited to productive efficiency in the context of Fonterra's commodity processing business only.

This limited interpretation of productive efficiency can be achieved simply by ensuring that inputs into the final farmgate milk price are 'notional' rather than derived from Fonterra's actual performance. This gives Fonterra a production standard to beat in order to increase the profitability of its processing activities. But this can be achieved regardless of the level at which the final farmgate milk price is set. The issue is not so much that the Commission wishes to incentivise productive efficiency, but that it sees this as the exclusive role of regime in terms of efficiency analysis. The wider efficiency implications of the level of the farmgate milk price, including the dynamic efficiency incentives on Fonterra to invest in its value-added business, are simply ignored under the Commission's current approach.

These wider efficiency and incentive effects cannot be ignored in any responsible regulatory regime that is intended to be effective. These efficiencies and incentives produce actual market outcomes, and so are far more important in practice than Fonterra's efficiency at processing commodity products. That said, we do not wish this to be interpreted as a criticism of the Commission. The Commission is responding to a regulatory framework that lacks the time and resource to engage in substantive analysis, does not require engagement with market participants impacted by Fonterra's pricing, and lacks any power to actually promote substantive market outcomes through regulatory

20 Dairy Industry Restructuring Act 2001, section 4(f).

intervention. All this shows that the regulatory framework is not fit for purpose despite its broad parameters being largely appropriate.

5.3. Ambiguity of 'practical feasibility'

We do note that DIRA provides that efficiency incentives on Fonterra is the focus of the farmgate milk price monitoring regime, and early in this submission we have discussed a much broader range of market efficiency considerations. These include – importantly – allocative efficiency in the supply of milk to independent processors, and productive efficiency for farmer-suppliers. There is a superficial argument that these wider market efficiencies are beyond the scope of DIRA's price-setting regulation. This argument ignores the role of these wider efficiency consideration in securing contestability in dairy markets.

Static efficiencies across the wider market help ensure that entry and expansion is efficient, and the supply is 'right-sized'. Market contestability is therefore linked to wider efficiency considerations, making the substantive impact of the level of the farmgate milk price doubly important. However, the Commission is faced with a curious statutory requirement that contestability is deemed to be achieved where "notional costs, revenues, or other assumptions taken into account in calculating the base milk price are **practically feasible** for an efficient processor". This formulation of the practical feasibility standard is ambiguous. When applying the standard, the regulator may:

(a) emphasise the "notional costs, revenues and other assumptions" part of the formulation, which suggests the relevant standard is one of technical or theoretical feasibility; or

(b) emphasis the redundant language of a standard that is both "practical" and "feasible", but suggests the relevant standard is one based on real-world feasibility in the context of actual dairy markets.

The first standard involves a more superficial assessment, as a range of assumptions may be technically feasible in theory. Again, the Commission has tended towards this more superficial assessment under the current regime, although it claims technical feasibility is not its main focus. It has understandable reasons for doing so. Targeting substantive outcomes that actually shape dairy markets requires time, resource, engagement and regulatory tools exercised on the basis of considered and informed judgement. DIRA sets itself up in contrast to those requirements, and so a superficial 'theoretically possible' standard is applied almost by default.

For the DIRA price-setting regime to work as intended, the practical feasibility standard would need to signal to both Fonterra and the Commission that entry and expansion – the defining features of a contestable market – are actually achievable in the real-world context of New Zealand's actual dairy markets. Entry and expansion is not to be treated as some theoretical standard based on econometric abstractions or isolated actual Fonterra data points that result in hyper-efficient assumptions.[21] Even relying on Fonterra's performance as a reference point sets the bar too high for actual entry and

21 For example, plant assumed to be operating year-round at full capacity on the basis of a limited window of observation at the peak of the season.

expansion as no real-world challenger can take advantage of Fonterra's scale. The ambiguity in the current formulation of the standard means that actual market outcomes are overlooked when any assessment is made. This need to be rectified in any amendment to the DIRA regime.

5.4. Off-GDT Sales

In 2016 Fonterra announced that it had commenced including off-GDT Sales in the milk price calculation, with an impact that season of increasing the milk price by $0.04 - $0.05. In 2017 the Commerce Commission held that the inclusion of off-GDT Sales was "largely consistent" with the statutory criteria[22] on the basis that "GDT will continue to be the primary reference point for prices". The Commission acknowledged that greater transparency may better promote the statutory purpose and provide greater confidence in the milk price monitoring regime, however it did not feel that the lack of transparency had hindered it in its role. [23]

Off-GDT Sales have since become more and more significant to determining the milk price. The formal position of Fonterra is that off-GDT Sales are now adding $0.07c to the current milk price and have stated that with volumes being sold through GDT much smaller now off-GDT Sales are consequently having a bigger influence on the milk price. Despite the Commission encouraging Fonterra to do so no more transparency of the detail of off-GDT Sales has been provided.

That the Commission could hold that the inclusion of off-GDT Sales was "largely consistent" with the statutory criteria relying on vague notions of GDT "still being the primary reference point for prices" and an acknowledged lack of transparency, when even a $0.05c move in milk price can have transfers of values worth hundreds of millions, strongly suggests the impact of the flaws identified above.

For the current season and likely future seasons (unless there is regulatory change or some other intervention) market participants will have little or no transparency regarding an ever more significant input into the milk price, even less confidence in the milk price monitoring regime and the statutory purpose will have even more limited promotion.

6. Strengthening price monitoring within the DIRA regime

Open Country strongly believes that regulatory tools used in other sectors can be employed to strengthen the DIRA price monitoring regime to overcome the issues raised above. In particular, we recommend the establishment of a new Dairy Authority that is dedicated to ensuring the objectivity and transparency of the farm gate milk price. This new Authority would be able to invest in developing the expertise to apply purpose-built regulatory tools, including:

(a) upfront methodologies should be developed or approved by the new Dairy Authority to inform the setting of the farmgate milk price, rather than leaving this completely to Fonterra's discretion; and

[22] Final Report on Fonterra's 2015/2016 Base Milk Calculation 15 September 2016
[23] Final Report on Fonterra's 2017/18 Milk Price Manual 15 December 2017

(b) the setting of the farmgate milk price should be followed by more detailed information disclosure, so that any remaining decisions made, or assumptions employed by Fonterra acting on its own discretion – and, critically the impacts of those decisions – are made plain to interested and affected parties.

The use of upfront methodologies determined by the Dairy Authority would allow for contentious issues such as the cost of capital to be set at efficient levels and would allow for season-by-season consistency with respect to other key inputs. Under this model, greater objectivity through the development of upfront input methodologies that Fonterra would have to apply when determining the milk price. These methodologies can be developed by Fonterra and approved by the Authority but would not be able to be changed without a transparent, consultative process (and the methodologies could not be changed mid-season).

We recommend a new authority is established to signal the need to a reset in the current regulatory approach. The Commerce Commission has developed an institutional approach to dairy sector issues that will be difficult to displace even with new regulatory powers and duties. In particular, the view that market power issues in the dairy sector are transitory only, or that they are less exacting because they are not of the natural monopoly kind in respect of which the Commission has genuine expertise, must be completely severed from any new framework that is developed. To further clarify, we do not anticipate that a full spectrum of 'input methodologies' in the vein of Part 4 of the Commerce Act is necessary in this context. Rather, a single pricing methodology covering core matters such as the cost of capital, the portfolio of reference commodities and capacity utilisation assumptions would be sufficient to bring meaningful transparency and objectivity into the price setting process. The Dairy Authority would in effect replace the Milk Price Panel with a more robust, independent and transparent institution. Any increased costs for the dairy industry are therefore likely to be marginal.

Greater transparency would be achieved by requiring that Fonterra discloses additional information to the market at the end of the season, so that its performance can be assessed. This should cover:

(a) any further input and assumptions that determine the price;

(b) changes in approach from previous years; and

(c) basic financial information that enables interested persons to reconcile Fonterra's pricing with market conditions, and in particular to understand the impact of the farmgate milk price on incentives to pursue value-added initiatives.

We recognise that moving to a more transparent, objective regime would be a step change for the sector and will take a period of adjustment for Fonterra as the regulated party. In this regard we note that the regulatory model we have outlined here is similar to that employed for regulated airports in New Zealand (who through their roles act as national champions of New Zealand's biggest export earner, tourism), which appears to have worked well in that context. In particular, this model retains Fonterra's freedom to manage commercial arrangements, is already applied by listed businesses such as Auckland International Airport Limited and Infratil Limited (a major investor in Wellington Airport) and has been proven to promote transparency and confidence for regulators, competitors and suppliers to understand pricing decisions.

Critically, and unlike many other industries, the risk of excessive and value destroying fragmentation occurring because of more targeted, effective regulation is very low. This is because the starting point is an extremely high level of market concentration, which will ultimately be replaced by more contestable and competitive market pressures. From that perspective, the main objection to this approach is likely to be the potential release of commercially sensitive Fonterra information. We are confident that this concern can be mitigated in the following ways (as it is in the airports context):

(a) recognising the benefits that Fonterra receives through being a designated 'national champion' and the dominant player means there is a public interest in more transparency of Fonterra information;

(b) requiring disclosure only at the end of the season; and

(c) where absolutely necessary, limiting disclosure to the Dairy Authority on a confidential basis.

The benefits of this approach include moving beyond 'efficiency' and 'contestability' in a superficial sense to better ensure that the market impact of the farmgate milk price is one where entry and expansion is a credible option and efficient outcomes (rather than an 'efficient' milk price input) are achieved. These tangible benefits from reform include:

(a) Independent processors having appropriate incentives and the certainty to invest in entry and expansion.

(b) Fonterra having stronger, more appropriately targeted dynamic efficiency incentives, including better incentives to invest in its value-added business.

(c) All processors (Fonterra and independents), investors in the Fonterra Shareholders Fund, and investors in FGMP derivatives share gains with farmer-suppliers through accurate pricing. This in turn sends efficient price signals to farmers concerning the level of production they can sustainably achieve.

(d) Fonterra is limited in its ability to increase short-term profitability through manipulation of the base milk price. Any increased profitability is reward for its increased investment and competitive success. The sector can have confidence that Fonterra's farmgate milk price meets the DIRA regulatory objectives on a season-by-season basis.

Importantly, in other contexts achieving these specific market outcomes are expressly included in the purpose statement for the relevant regulatory regime. This provides guidance to both the regulated business when exercising any residual discretion and to the regulator when it exercises its powers of review. It also helps set a legal standard for the regulatory regime to comply with, which can be tested by affected parties through judicial review and other formal accountability mechanisms. We strongly recommend that any revision to DIRA incorporate express market outcomes of this type in the purpose statement that governs the price-setting regime.

7. Domestic dairy industry

We conclude our submission with some comments on the domestic dairy industry. We note that there has been aggressive entry at the premium end of the consumer market in recent years, and we support this diversification. However, mass market products are still dominated by Fonterra brands and its main rival, Goodman Fielder.

We do not know how the competitive dynamics in these retail markets will play out over time, but in the short term it seems clear that Goodman Fielder's presence is essential to maintaining workable competition. This requires the maintenance of large supply volumes of farmgate milk to Goodman Fielder.

If Goodman Fielder's current supply arrangements with Fonterra were to end, we anticipate that supply could be sourced from independent processors of Goodman Fielder was willing to pay an appropriate margin. If Goodman Fielder wishes to secure supply at the DIRA price, it will need to invest in self-sourcing its supply. If the open entry and exit provisions are maintained and greater robustness is applied to the farmgate milk price calculation, as we advocate for above, then we see no real impediment to Goodman Fielder taking such action.

8. Conclusion

We cannot emphasise enough how significant the outcome of this review will be of the future performance of the New Zealand dairy industry and its key role in our collective economic, environmental and social wellbeing as a nation. This review is long overdue, and it is critical that every necessary step is taken to achieve the right result which is transparency.

Open Country looks forward to discussing the issues raised in this submission further with the Ministry over the course of the DIRA review.

Best regards

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