Fonterra
Dairy for life

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 REVIEW OF THE DAIRY INDUSTRY RESTRUCTURING ACT 2001 AND ITS IMPACT ON THE DAIRY INDUSTRY: DISCUSSION DOCUMENT

We welcome the opportunity to submit on the Government's review of the Dairy Industry Restructuring Act.

DIRA has been critical to the performance of the New Zealand dairy sector since its passage in 2001. The formation of Fonterra has created wealth for New Zealand and New Zealanders. It has improved social and economic outcomes for New Zealand's dairy farmers and their communities. The evolution of the industry since 2001 has had a significant impact with dairy exports growing from $6.3b in 2001 to $17.1b in 2018.

The legislation has achieved what it set out to - create competition. Farmers now have choices in who they supply their milk to and New Zealand consumers have many choices when purchasing dairy products.

Since the passage of the legislation, our Co-operative has created a transparent milk price calculation that is the envy of farmers the world over. Through our Co-operative and a strong transparent milk price the entire New Zealand dairy industry has benefited. Where once, Kiwi dairy farmers were paid approximately half that of their European or US peers, New Zealand farmers are now consistently paid at parity, or more. Fonterra farmers are paid the maximum sustainable price for their milk by their Co-operative.

Fonterra remains a New Zealand owned co-operative. The money our farmers are paid for their milk and the profits their Co-operative makes, remain in New Zealand. The majority of it goes into our rural communities, where our farmers spent roughly 50 cents of every dollar they earn.

DIRA has the dual objective of establishing a strong exporter at scale taking New Zealand's products to the world, and protecting New Zealand dairy farmers and domestic

consumers. It is critical for the evolution of the legislation that both are kept in focus and neither is prioritized over the other.

Our Co-operative continues to work to develop a modern and world-leading dairy sector where our products are desired in markets around the globe and where consumers are prepared to pay a premium for New Zealand products. We also want domestic consumers to have choices when feeding their families.

Fonterra's performance is not solely driven by DIRA, however a modernised DIRA will contribute to delivering our shared vision for the future of the industry.

Our Co-operative wants an industry that promotes investment in regional New Zealand and where profits are kept at home for the benefit of all New Zealanders. We want an industry where farmers are paid good money for their milk and the unique attributes of New Zealand's environment are protected and enhanced.

New Zealand farmers also want certainty about the future of their industry so they can make informed investment decisions and be able to determine their own destinies.

It's difficult for New Zealanders to achieve scale when marketing their products to the world. The Government helped to achieve this by allowing the formation of Fonterra. It recognised the value it could bring New Zealand. But it also recognised that certain safeguards were needed.

Some safeguards are still critical today, and they should be expanded to be a requirement of every dairy processor. Others are inadvertently tipping the playing field in favour of foreign exporters, at the expense of kiwi farmers.

For the dairy industry to continue to succeed, some aspects of DIRA must be modernised, as set out below. Our position on the issues raised in the Discussion Document is briefly summarised below.

DIRA OPEN ENTRY REQUIREMENTS	
Issue: The DIRA open entry requirements play a key role in the wider open entry and exit regime and its effectiveness in managing Fonterra's dominance.	**Fonterra's position:** 1. We seek the removal of open entry and the non-discrimination rule. 2. As a second preference, we support the removal of open entry, and the non-discrimination rule in any region where our market share drops below 75% and nationwide removal for new conversions and applications we consider unlikely to comply with our terms of supply. 3. Our third preference is for an exception to open entry and the non-discrimination rule for new conversions and applications we consider unlikely to comply with our terms of supply.

ACCESS TO REGULATED MILK	
Issues: a) The DIRA original rational for providing large dairy processors with access to regulated milk from Fonterra, while they are establishing own supply, may no longer stand b) The DIRA ensures that there is viable competition in the New Zealand consumer dairy markets, but it	**Fonterra's position:** We support a strong, competitive domestic market. We do not support milk being given, effectively at cost, to new processors who are focused on exporting their products.

may also be facilitating a long term, and potentially undue, dependency on regulated milk from Fonterra	

BASE MILK PRICE CALCULATION	
Issue: The DIRA may be able to promote greater confidence in the base milk price calculation outcomes.	**Fonterra's position:** We support the current regime. Efficiency and informed decision-making by farmers would be improved if the transparency of price setting and payments was spread throughout the industry. We support all processors being required to publish the average price they pay to farmers, the key parameters of their milk price and examples showing the payout that would be received for different parameters, in a way that is consistent across processors to allow proper comparison.

DIRA REVIEW AND EXPIRY PROVISIONS	
Issue: The need for the DIRA is contingent on Fonterra retaining its dominant position. While it appears that the DIRA is still needed at this stage, there is a risk that DIRA could be kept in place for longer than necessary.	**Fonterra's position:** We want a clear pathway to deregulation. We recognise the significant danger of having legislative constraints when they are no longer required. The industry requires and deserves clarity as to inform future investment decisions. We support a further review of DIRA three years after change is effective.

Please find attached Appendix A – which sets out our specific proposals for change on one page and provides a brief overview of those changes, and Appendix B – a substantive response to the questions posed in the Discussion Document. Also accompanying our submission are reports by NERA Economic Consulting and NZIER.

We look forward to working with the Government over the coming months as the review progresses and to supporting a fair outcome that is in the interests of all dairy farmers and New Zealand.

Yours sincerely

Miles Hurrell
Fonterra CEO

Note: We request that all of the information deleted from the "public version" of this submission (shown as █ in the confidential version) be treated as confidential, on the grounds that it is commercially sensitive. Disclosure of that information would be likely to unreasonably prejudice our commercial position. If you receive any requests under the Official Information Act, please contact us.

APPENDIX A: PROPOSALS FOR CHANGE (to be effective 1 June 2020)

<table>
<tr><th colspan="2">DIRA OPEN ENTRY REQUIREMENTS AND THE NON-DISCRIMINATION RULE (sections 73, 74 and 106)</th></tr>
<tr><td>First preference
• Repeal in full.</td><td>Option 4.1.2</td></tr>
<tr><td>Second preference
• Repeal of open entry, and the non-discrimination rule in any region where our Co-op’s market share drops below 75%.
• Exceptions to open entry and the non-discrimination rule:
  ◦ for new conversions;
  ◦ in respect of applications from new and existing farmers if we consider their supply is unlikely to comply with our terms of supply.
• Requirement that our Co-op continue collecting milk from existing farms that continue to supply us while open entry remains in other regions.</td><td>Option 4.1.3, and new</td></tr>
<tr><td>Third preference
• Exceptions to open entry and the non-discrimination rule:
  ◦ for new conversions;
  ◦ in respect of applications from new and existing farmers if we consider their supply is unlikely to comply with our terms of supply.</td><td>Option 4.1.3, and new</td></tr>
<tr><th colspan="2">DIRA OPEN EXIT REQUIREMENTS (sections 97 and 107(3))</th></tr>
<tr><td>• Repeal in any region where our Co-op’s market share drops below 75%.</td><td>New</td></tr>
<tr><th colspan="2">ACCESS TO REGULATED RAW MILK FOR LARGE DAIRY PROCESSORS (EXCEPT GOODMAN FIELDER)</th></tr>
<tr><td>• Exclude large, export-focused processors, being processors that:
  ◦ source 30m litres/year of their own raw milk; or
  ◦ have capacity to process more than 30m litres/year, and export 20% or more of their processed volume.</td><td>Option 4.2.2 and new</td></tr>
<tr><th colspan="2">BASE MILK PRICE CALCULATION</th></tr>
<tr><td>• Status quo.
• All processors publish the average milk price they pay to farmers, the key parameters for their milk price and examples of the payout for different parameters.</td><td>Option 4.3.1 and new</td></tr>
<tr><th colspan="2">ACCESS TO REGULATED RAW MILK FOR GOODMAN FIELDER AND SMALLER PROCESSORS</th></tr>
<tr><td>• Status quo for Goodman Fielder and smaller processors, plus additional fee of around 12c per kgMS.
• Regulation 4 - regulated raw milk should have to be processed into finished consumer or foodservice products.
• Regulation 10(3) – limit the variation in processors’ one-week estimates for supply to 20% more or less than the earlier three-month estimate.
• Regulations 21(1) and 21(2) – limit the variation of the contracted volume to between 90% and 110% of the one week estimates for supply.
• Regulation 11(2)(a) – extend 18 month notice for requiring winter milk supply above 20,000 litres per day to 24 months.
• Regulation 11(3) – limit the variation in processors’ one-week estimates for winter milk supply to 10% more or less than the earlier 24-month estimate.
• Regulation 21(5) – allow take or pay requirements in respect of supply of winter milk premium.
• Regulation 6(1) –amend the October rule to include the winter months.
• Regulation 6(3) – remove the potential for “gaming” the own-supply limits by skipping one year of supply and re-starting the three year period (only relevant if our preference regarding access to regulated raw milk for large processors is not adopted).</td><td>Option 4.4.1, part of option 4.4.2 and new</td></tr>
<tr><th colspan="2">DIRA REVIEW AND EXPIRY PROVISIONS</th></tr>
<tr><td>• Review of DIRA (to the extent provisions are not repealed earlier) every three years after any change is effective.</td><td>Option 4.5.2</td></tr>
</table>

BRIEF SUMMARY OF ISSUES

Raw Milk Regulations

1 We agree with MPI that support for larger export-focused processors who are capable of sustaining their own supply is now unnecessary, and it risks creating long-term regulatory dependence.

1.1 Kiwis will benefit the most if we're backing dairy companies that supply the domestic market and putting New Zealand first.

1.2 We have always supported a strong, competitive domestic market – which is present in New Zealand. That includes support for Goodman Fielder, and for processors supplying the domestic market who need a leg-up.

1.3 If the raw milk entitlements are removed for processors with significant own-supply, and other large processors that are focused on exports, we have no objection in principle to the removal of individual supply limits for smaller independent processors and those who supply the domestic market, provided there are considered and appropriate safeguards around this including an overall cap of 650 million litres (which is approximately the total size of the domestic market, including our own domestic division sales).

1.4 We have always supported ensuring Goodman Fielder remains a viable, large-scale domestic competitor [redacted] However, given the flat profile of Goodman Fielder and other processors supplying the domestic market, we support an additional fee of around $0.12 per kgMS to contribute to the additional costs of a flat supply curve and the additional costs of running a milk sourcing operation.

Milk price

2 The current regime is robust and works well, supporting an efficient and transparent milk price.

2.1 Given the level of competition in the market and that independent processors compete effectively and sustainably, there is no clear basis for a lack of confidence in the milk price regime.

2.2 In that context, the options to increase regulation by adding to the regime or by having the Commerce Commission set our milk price, would be counterproductive and contrary to the policy direction.

2.3 As shown in its latest review, the Commerce Commission is satisfied that our calculation of the milk price is largely consistent with both the efficiency and contestability purposes of DIRA, and that our assumptions, inputs and costs (other than the asset beta used in the calculation of the WACC component of our milk price) meet the "practically feasible" standard. We are actively working to resolve the Commission's issues with the asset beta used in our milk price calculation.

2.4 Efficiency and informed decision-making by farmers would be improved if the transparency of price setting and payments was spread throughout the industry. We support all processors being required to publish the average price they pay to farmers, the key parameters of their milk price and examples showing the payouts that would be received for different parameters, in a way that is consistent across processors to allow proper comparison.

Open entry and exit

3 Open entry has helped bring about the vibrant and competitive dairy sector we have today – in this respect, DIRA has done its job. It seems it is also no longer being relied upon to the same extent it might once have been.

3.1 Removal of open entry would help our Co-operative achieve our vision and control our strategic direction. Decisions on whether to build new manufacturing sites need to be based on the real world and not because a company is getting a leg up at the expense of farmers and their families.

3.2 The downsides of open entry should not be under-estimated, particularly for the environment, and sustainability more generally, and the risk of industry-wide over-capacity:

(a) Strong healthy local environments and communities are the foundation for sustainable, profitable dairy farming and removal of open entry would better enable our Co-operative to be a *leader* on the environment.

(b) Industry-wide over-capacity could lead to industry-wide low returns as milk growth drops. This could result in a long period of stagnation in the sector – as we have seen with the red meat processing industry. Eventually players might capitulate and close plants. While this would "fix" the over-capacity problem, it would itself have serious negative consequences for the individuals and communities affected.

3.3 In that context, removal of open entry would not entail the costs and risks it may have once done and the benefits are materially depleted; the costs of open entry now outweigh the benefits.

3.4 Given the importance of environmental/sustainability considerations and the regulatory burden, for the next phase of the development of the dairy industry and our Co-operative, we need to be in a position to exercise more meaningful control over our volumes. Contrary to MPI's view, we can't (for a number of good reasons) control our volumes by manipulating the milk price. The milk price regime and Trading Among Farmers (TAF) in fact prevent us from manipulating our farm gate milk price to control the volume of milk we receive. If we were to use our price to control the volume of milk we receive, we would need to breach both our own constitution and the requirements of DIRA (which are monitored by the Commerce Commission).

3.5 The most effective way to provide control is to remove open entry. This is low-risk given competition is well-established, and open entry's role in safeguarding pricing has been superseded and replaced by the milk price regime and TAF, which have more force given they prescribe what we need to do rather than relying on the incentives of open entry and exit.

3.6 However, if MPI considers it too soon to remove open entry altogether, we propose open entry falling away in any regional council region where our market share drops to 75% or less, with nationwide exceptions to open entry for new conversions and (as MPI suggests) for suppliers who will not be in a position to meet our terms of supply.

3.7 Our estimates based on DairyNZ data for 2017/18 suggest our market share is already below 75% in the Greater Auckland ([redacted]%) and Westland ([redacted]%) regions, and is near that level in the Canterbury ([redacted]%), Horizons (Manawatu-Whanganui) ([redacted]%) and Southland ([redacted]%) regions. A regional approach would provide assurance that the Co-operative is still bound by open entry in areas where competition is not yet as well developed. If there are outlier farmers in any such region that do not have a viable alternative processor, we would commit to pick up the milk for so long as the farm remains a supplier to our Co-operative, while open entry remains in other regions.

3.8 As a final back-stop if MPI does not agree with the above, we would support a discretion to not accept supply from new conversions (effective from the start of the 2020/21 season), and (as suggested by MPI) from suppliers who will not be in a position to meet our terms of supply.

3.9 We also propose open exit falling away in any regional council region where our market share drops to 75% or less. In this case, it is important to bear in mind that we would continue to be subject to the Commerce Act, which protects against the misuse of market power.

Review and expiry provisions

4 We agree with MPI that having no review and expiry provisions creates a risk of regulating for longer than is necessary; it results in the potential for unnecessary and costly long-term dependence on regulation.

4.1 There needs to be a path to deregulation to provide certainty and so the dairy industry can start working towards it.

4.2 We support a further review of DIRA three years after change is effective, given the process of review and implementation of any change can take two years.

4.3 Market share thresholds for expiry would not need to be added to the periodic review requirement if our preferred changes are implemented.

APPENDIX B: RESPONSE TO DISCUSSION DOCUMENT QUESTIONS

Chapter 2: Performance of the dairy industry

1	*Do you agree with our description of the DIRA regulatory regime and its original policy rationale? Do you consider the original policy rationale is still valid?*

1.1 The Discussion Document does not accurately describe the DIRA regime or capture its original policy intent. We also query the extent to which this question is even relevant, given the 2012 DIRA Amendments which incorporated significant changes in respect of the milk price regime and Trading Among Farmers (TAF).

1.2 The key statement that is incorrect is "the chief way DIRA intervenes in industry dynamics is by incentivising Fonterra to use price signals as the means of managing the volume of its milk supply" (at p13).

1.3 The rules and incentives of the milk price regime and TAF in fact purposely *prevent* us from using our farm gate milk price to control the volume of milk we receive. If we were to manipulate our price to control the volume of milk we receive, we would breach both the milk price requirements of DIRA (which are overseen and monitored by the Commerce Commission) and our own Constitution. We address this point here, and separately address factual errors in the relevant section of the Discussion Document below in response to Q10.

We cannot use our milk price to influence supply volumes

The milk price regime and TAF do not allow us discretion to use the farm gate milk price to control the volume of milk we receive

1.4 The purpose of the milk price regime is to promote the setting of a base milk price that provides an incentive for our Co-op to operate efficiently while providing for contestability in the market for the purchase of milk from farmers (we discuss the statutory milk price regime in more detail in response to Q12 below).

1.5 There are several safeguards that ensure the farm gate milk price complies with the prescribed purpose.

1.6 First, the milk price regime (which was introduced in the 2012 DIRA Amendment and enshrined our existing milk price regime):

- requires our Co-op to maintain and publish a Milk Price Manual which describes the calculation of the base milk price;
- requires the base milk price to be calculated consistent with certain principles;
- establishes an independent Milk Price Panel, which oversees calculation of the base milk price; and
- provides for Commerce Commission oversight by requiring the Commission to review and report on the extent to which the Milk Price Manual and the milk price are consistent with specified principles in DIRA. We are also obliged to explain publicly any deviations from paying the base milk price calculated in accordance with the Milk Price Manual.

1.7 While the Commerce Commission does not have a formal enforcement role, departing from the base milk price solely to meet commercial strategic objectives in terms of volume would be viewed as contrary to the purposes of the DIRA because it would undermine contestability in New Zealand dairy markets (and

would potentially be anti-competitive e.g. if we paid a higher milk price with the purpose of thwarting other processors' ability to compete in the market). Any deviation from the base milk price would need to have a justification that outweighs these factors. Non-compliance, particularly if it is repeated, also risks more intrusive price regulation, as well as significant reputational damage with a wide range of stakeholders. We discuss the constraints imposed by the Commerce Commission monitoring regime in detail in response to Q12 below.

1.8 In addition to regulatory oversight, our Constitution requires that we comply with the milk price principles, including the obligation to pay the maximum milk price that our Co-op, as a properly managed and efficiently run sustainable co-operative, could pay. We explain our Constitution, and the strength of our co-operative model, further in response to Q2.

1.9 Finally, the Milk Price Manual, which was introduced in 2008/09 and built on existing practice, ensures the calculation of an efficient milk price. The base milk price calculation is broadly based on notional revenue, assuming our entire New Zealand milk volume is processed and sold as commodity products that would be likely produced by an efficient near-term competitor to our Co-op for raw milk in New Zealand (currently, whole milk powder and skim milk powder and their by-products buttermilk powder, butter and anhydrous milkfat), minus the notional manufacturing costs of an efficient competitor.

1.10 The Milk Price Manual can only be amended or replaced with the approval of at least 75% of our Co-op's board, including at least a majority of independent directors (section 3.3.5 of the Fonterra Shareholders' Market Rules on the NZX website), and must remain consistent with the DIRA principles.

1.11 Alongside the milk price regime, TAF was introduced in 2012 and established:

- a Fonterra Shareholders' Market, a private market regulated and monitored by NZX and the Financial Markets Authority on which farmer shareholders can trade Fonterra shares; and
- the Fonterra Shareholders' Fund (*FSF*), a registered scheme under the Financial Markets Conduct Act 2013 listed on the NZX and ASX, in which external investors can buy units and enjoy certain economic rights in our Co-op shares.

1.12 Under TAF, external unit-holders as well as farmer shareholders have an interest in our share value and dividend payments. Our share value is directly impacted by the milk price (which is our largest input cost). For our Co-op farmers holding shares in excess of their production (referred to as "dry" shares) and for external investors holding units in the FSF, there is no offsetting benefit to them of a higher milk price. TAF accordingly embeds incentives on our Co-op to determine an efficient milk price, and to be transparent in our milk price-setting process.

1.13 In summary:

- the milk price regime, including Commerce Commission oversight, ensures we pay an efficient price for milk;
- scrutiny from external investors provides an additional material constraint on our ability to over-pay for milk; and
- scrutiny from farmer suppliers provides an additional material constraint on our ability to under-pay for milk.

1.14 So the logic of the milk price regime and TAF are to ensure we set an efficient milk price; we do *not* as MPI has described it, have the ability to set and maintain a different price to achieve a specific volume outcome. We cannot sustain a price deliberately set above or below that equilibrium because of the safeguards described in this section.

1.15 The Discussion Document seems to suggest that we should have set a lower milk price to manage volume growth (see for example p25). However, if we did so we would be answerable to the Commerce Commission, and we would not be acting in the best interests of our Co-op or our farmer shareholders (in breach of company law), since we would be disincentivising the supply of milk that, if supplied, would result in higher overall returns both on-farm and for our Co-op. Equally, while the Discussion Document does not seem to suggest we should have set a higher milk price, if we did we would be answerable under the milk price regime, and we would be incentivising the supply of milk that could not be sold for the price paid for it, resulting in lower returns for our Co-op and farmers overall.

Milk price would not be an effective tool to influence supply volumes

1.16 Even if we could alter our milk price to control volume for strategic purposes, it would be ineffective because:

- the final milk price is announced after the end of the season, and therefore always comes after milk volume has been produced;
- any steps to change volumes within a season based on forecast milk price would be at the margins and would need to factor in other costs, such as the price of supplementary feed (which can rise in response to a high milk price and increased demand); and
- there is unlikely to be any effect on incentives to leave or join our Co-op because other processors would likely benchmark against our milk price, as they do currently, and would therefore look to match the revised price.

1.17 In practice, for such a strategy to be effective in altering supply volumes we would need to signal an intention to pay a milk price materially in excess of, or below, the base milk price over multiple seasons. In addition to that not being financially prudent (particularly given the volatility of global dairy commodity prices), it would require our Co-op to set aside materially adverse implications under the milk price regime (i.e. there would be serious questions as to whether the Milk Price Manual and the calculation inputs were delivering a price that meets the section 150A purpose), our Constitution and would likely cause our directors to breach their legal duties to the Co-op and its shareholders.

1.18 MPI acknowledges (at p25) that "adjusting the milk price to manage the volumes of milk [we receive] presents a significant management challenge for a large co-operative company, with a significant existing investment in highly efficient commodity processing assets, a highly seasonal milk supply, and a highly diffused and relatively risk-averse supplier-shareholder base." While correct, this materially understates the practical issues and challenges with what MPI is proposing.

Original policy rationale behind the DIRA

1.19 The purpose of DIRA (section 4) was to promote the efficient operation of dairy markets in New Zealand by regulating the activities of our Co-op to ensure New Zealand markets for dairy goods and services were contestable. In our view, this policy rationale remains valid in that we need to ensure New Zealand markets for dairy goods and services remain contestable, but the tools regulating the activities of our Co-op require a refresh to ensure they remain fit for purpose.

Original intention of open entry and exit to incentivise an efficient milk price

1.20 Originally, DIRA's primary intervention was open entry and exit – encouraging new processors to enter by giving farmers confidence to "take a chance" on a new processor.

1.21 Open entry and exit were conceived as an alternative to price regulation to mitigate the risk of our Co-op manipulating the milk price and/or our share value to create barriers to new milk suppliers joining our Co-op or switching to other processors, by incentivising us to set an efficient milk price. As Evans and Quigley explain in their 2001 paper, "Watershed for New Zealand Dairy Industry" (at p 9), the free movement of milk volumes as a result of open entry and exit required efficient pricing, as follows (see also the Compass Lexecon Report "The Effectiveness of DIRA in Fostering Competition and Economic Efficiency in New Zealand Dairy Markets, 20 July 2011, pp 10 – 11):

- if we set *a milk price that was too high, and a share value that was too low*, it would result in our Co-op making payments for milk in excess of economic earnings, and thus over time lead to a deterioration in our capital base. New entrants would be attracted by the high milk price and low equity required, increasing the number of suppliers who must be paid at these prices. This would produce a level of entry that would be unsustainable (and would result in a wealth transfer from existing to new suppliers);
- if we set *a milk price that was too high, and a share value that was too high*, it would result in payments for milk in excess of economic earnings and payments to exiting suppliers that are in excess of the true value of their capital. This would deplete our balance sheet and may lead to a run on our Co-op by suppliers attempting to exit in anticipation of our collapse;
- if we set *a milk price that was too low, and a share value that was too low*, it would result in an accumulation of profits in our Co-op, which would make the low equity price increasingly unrealistic. Suppliers would enter in anticipation of obtaining a share of retained profits, and increase pressure on our Co-op to pay a higher return on capital; and
- if we set *a milk price that was too low, and a share value that was too high*, it would incentivise suppliers to exit our Co-op in response to low returns for milk and a high equity pay out (leading to a wealth transfer from remaining to exiting suppliers).

1.22 At the outset of DIRA, open entry and exit therefore incentivised our Co-op to price efficiently – by setting a milk price that accurately reflected the true marginal ex-farm value of milk, and leaving farmers to choose how to act on those incentives by making decisions regarding their level of milk production and whether to apply land to dairying or to alternative uses.

1.23 As NERA explains in its 7 February 2019 report "DIRA review: response to issues raised in the MPI discussion document", these incentives also addressed the "catch-22" of independent processors being reticent to invest in processing capacity without certain raw milk supply, and farmers being reticent to provide supply without investment in processing capacity (see section 2.1). The free movement of volume into and out of our Co-op disciplined price and ensured we paid farmers an "efficient" price for their milk (i.e. a price which reflected the value of that milk on international markets).

1.24 Efficient pricing should help to ensure the dairy industry's resources flow to their highest value use (although we are not aware that this was, as the Discussion Document describes (at p13), DIRA's core regulatory objective). We note that this

is not about incentivising dairying over alternative land uses; rather, it is about removing barriers to efficient competition within the dairy sector.

1.25 Open entry and exit also meant that we could not use price to influence supply volumes based on our commercial strategy. For example, if we sought to manage our open entry obligation by lowering our milk price to discourage further milk supply growth so that we would not have to invest in additional processing capacity, then we would create the following risks that could not be managed:

- destabilising transfers of wealth between suppliers as outlined above;
- even less certainty of volume of milk supply as we would not be able to predict when and how much volume would leave the Co-op in response to the lower prices, with potential to lead to underutilisation of existing capacity; and
- lower overall returns to our farmers.

1.26 So, the original logic of DIRA was the potential for the financial consequences of changes in milk volume to discipline price back to equilibrium; *not* as MPI has described it, that we would have the ability to set and maintain a different price to achieve a specific volume outcome. We could not, and cannot, sustain a price deliberately set above or below equilibrium because of the volume effects, and this is a deliberate outcome of the original DIRA regime.

1.27 The incentives created by open entry and exit were reflected in our original Constitution, which was part of the original DIRA legislation, and required calculation of a commodity milk price and a fair value for shares (applicable to both entry into and exit from the Co-op).

Milk Price Regime and TAF supersede and replace the open entry and exit incentives

1.28 When our Co-op was formed, we initially paid a bundled pay-out that did not differentiate between the milk price and a return on processing capital and other downstream returns. However, farmers sought greater transparency, and in 2007 we also began looking to bring in external investors to stabilise our Co-op's capital base and reduce the impact on our balance sheet of the Co-op being required to redeem shares where milk volumes reduced (e.g. due to weather conditions or suppliers switching to independent processors). This also required greater transparency around the calculation of our milk price to account to investors. The upshot was the Milk Price Manual, and later the milk price regime and TAF.

1.29 When the milk price regime and TAF were introduced and enshrined through the 2012 DIRA Amendments, they superseded and replaced the same pricing incentives that are generated by open entry and exit. In fact, the milk price regime and TAF have *more* force than open entry and exit because they rely on legal obligations, and additional oversight by a regulator and scrutiny from two types of investor, as opposed to incentives. They effectively require an efficient milk price, and do not allow for setting the farm gate milk price with the purpose of influencing supply volumes.

National Champion

1.30 As MPI notes (at p5), DIRA was also designed to facilitate our Co-op to be a national champion and a strong competitor in international markets. As a national champion, we support the New Zealand dairy sector and the economy as a whole, by opening up new markets and building the "NZ Inc." brand. All other New Zealand dairy exporters are able to benefit from this investment. Robust

competition in international markets also imposes disciplines on our Co-op (the Compass Lexecon Report at p52).

1.31 Our scale has also allowed us to take the lead on industry and social good projects, such as:

1.32 Fonterra Milk for Schools, which helps more than 140,000 school children aged 5-11 access milk for free every day.

1.33 Living Water, a partnership with the Department of Conservation focusing on 5 catchments to identify game-changing and scalable solutions that demonstrate dairying and freshwater can thrive together.

1.34 Fonterra Grass Roots Fund, through which we provide financial support for local initiatives that help make communities safer (e.g. we have provided grants for volunteer fire brigades, surf lifesaving and land search and rescue; through bulk buying we also provided more than 10,000 high visibility vests and 25 defibrillators to community groups).

1.35 More detail can be found in our 2018 Sustainability Report, available at https://view.publitas.com/fonterra/sustainability-report-2018/page/1.

1.36 For the reasons above, and as discussed further below, DIRA has achieved its purpose. It has created real competition in New Zealand dairy markets – farmers have choices in who they supply milk to, Kiwis have choices in terms of the dairy products they can buy and the contribution to New Zealand from dairy exports has grown from $6.3b in 2001 to $17.1b in 2018.

2	*Are there any other dairy industry developments or industry performance indicators that are not captured in Chapter 2, Appendix 1, or the reports by Frontier Economics?*

2.1 In this section, we comment on four themes which the Discussion Document either does not address, or which require clarification:

- value add and New Zealand's dairy export product mix;
- our investment in R&D and innovation;
- our Co-op's role as a national champion; and
- the strength of our co-operative model.

2.2 In addition, as the DIRA is no longer primarily about the restructure of the industry, it should be renamed the Dairy Industry Act.

Investment in value added production

2.3 MPI notes (at p16) that New Zealand's dairy exports remain strongly focussed on commodities and the focus on commodities is particularly evident in our export product mix. It is important to unpack this message, which in our view obscures some key factors and shifts in our business and the dairy sector.

2.4 Our Co-op's export product mix has increasingly moved to value add. In 2017/18, 45% of our raw milk was directed to value add products, up from 42% in 2016/17. Value add investments are typically longer term plays and take time to deliver higher returns. In addition, our size/scale and the volume of raw milk collected means we could never be a solely value add business, and commodities provide flexibility to allow for variation in year-to-year volumes. Value add products often

only use a proportion of the components in a litre of raw milk collected and the remaining components need to be optimised. We see this in the United States and Europe where industry sells fat as butter and cheese in the domestic market, and then exports the skim milk powder and whey powder by-products. However, as the figures above show, we are seeing a shift in the make-up of New Zealand's dairy exports to more value add.

2.5 It is also important to clarify that value add includes not only our consumer and foodservice business (which is the area most commonly understood to involve value add), but also advanced ingredients and logistics and other services, such as price risk management services, available to customers in connection with our products.

2.6 Advanced ingredients are differentiated products that attract premium prices over base ingredients through superior product performance, differentiated offerings (such as non-GMO or grass-fed milk) or claims that are backed by science. We have a continuous innovation pipeline of new, value-add ingredients – giving our customers new ways to differentiate their products with consumers. Examples include low lactose instant whole milk powder (which offers lactose intolerant people the chance to enjoy dairy), pastry butter (designed for exceptional performance in pastry and bakery applications), extra-stretch cheese, our Surestart™ range of science backed ingredients for infant and maternal nutrition and our Sureprotein™ range of high protein ingredients for sports and active lifestyles and medical nutrition applications. When we first started reporting Advanced Ingredients separately in 2017, sales had increased 9% on the prior year and comprised 19% of our total external sales volume.

2.7 Building on this, in 2018 we launched three dedicated business units focused on medical nutrition, sports and active lifestyle and paediatrics to further strengthen our focus on advanced ingredients solutions. Our functional Whey Protein Concentrate technologies are enabling high quality dairy proteins to be delivered for the first time in a more palatable format at the concentrated levels required by ready-to-drink Medical Nutrition products. Medical and active ageing nutrition are fast-growing sectors, as lifespans increase and as lifestyle-associated diseases emerge as the key global cause of death. The global medical nutrition industry is valued at $17.5 billion today and is expected to grow to almost $24 billion by 2020.

2.8 On the consumer products side, we are expanding both our Darfield cream cheese plant and our Clandeboye mozzarella plant to service growing demand for higher-value dairy products, primarily in China. Already, our cheese tops around 50% of pizzas sold in China, one of the fastest growing pizza markets in the world. Since entering the Chinese consumer UHT liquid milk market in 2014 sales have increased 630%, over the last 10 years our sales of consumer creams have increased 780%, and since 2011 our mozzarella sales have increased 50%.

2.9 Building on these consumer product developments, our foodservice business, Anchor Food Professionals, is now New Zealand's sixth biggest export business, having generated more than $2 billion in annual revenue over the past year (which is larger than the entire New Zealand wine industry). Globally, people are increasingly eating out and we are taking advantage of this trend. Anchor Food Professionals is currently growing around 10 times faster than the total global foodservice market.

Scope for more investment in value added production

2.10 That said, our view is that we could have invested more in value added production in the absence of open entry. During the period of high dairy growth in New

Zealand (between the 2008/09 and 2014/15 seasons), the requirement that we accept all milk required us to have assets on the ground to process large volumes of milk during the peak of the season and those assets had to make products that were already in demand. As with any corporate, the amount available for capital investment in any year is limited and at the time, with high milk growth, the most predictable demand (with consistent demand from China) was for milk powder which could also be produced efficiently and quickly. For example, approximately 30 - 40% more whole milk powder can be produced per hour than nutritional powders. We therefore invested more than NZ$1 billion in whole milk powder plants over this time.

2.11 Over the last decade there has been strong international demand for commodity products, so these investments have delivered growth and returns. Frontier also discusses (at p68 "Drivers of Industry Performance") the large and sustained increase in international demand for commodity dairy products, which rightly drove strategy in the New Zealand dairy sector. Frontier also notes that New Zealand did not (and still does not) have free trade agreements facilitating access to markets likely to demand more value add product (like Europe and the US). Dairy companies such as Friesland Campina and Arla are based in Europe with a population approximately 100 times New Zealand's population where there has been sizeable and strong local demand for value add products for some time. Europe also has much greater spending power than countries that import milk products, with, for example, a GDP per capita roughly four times that of China. But market conditions are changing, and preferences as to appropriate strategy will shift as well. With New Zealand milk volume growth flattening over the last four years, we have been able to continue to develop customer demand and innovations for higher-value products and services. As a result, our more recent significant capital investments have been in value-add manufacturing facilities, as discussed in our 29 June submission (at [27]).

2.12 As discussed further below, our firm view is that removing open entry would ensure that we are able to pursue a strategy that involves more value-add and less commodity processing. It would also support efforts to improve the dairy sector's environmental performance in a number of ways, including facilitating strategies and product offerings that require less milk volume growth.

Significant investment in R&D and innovation

2.13 The Discussion Document suggests that our Co-op has underinvested in R&D. We disagree. Our Co-op has made a significant contribution to R&D and innovation. In addition to our annual central R&D spend, we invest in innovation across our business, in collaborations with other research bodies, through joint ventures with other parties such as Agrigate, and on behalf of the industry as a whole. In particular, our farmers' contribution to DairyNZ accounts for most of DairyNZ's R&D spend, which benefits the New Zealand dairy industry as a whole.

2.14 Further, we think it is wrong to measure R&D simply by expenditure, as a lot of R&D expenditure can be wasted. What is more important is R&D outcomes. The Discussion Document seems to imply that we are not spending enough but there is no analysis of R&D outcomes per dollar spent.

2.15 We are also concerned with Frontier's R&D intensity comparison analysis (at p56 "Analysis of Industry Performance") which does not appear to have been normalised to account for different accounting policies and appears to involve companies in very different sectors and with different business models – which clearly limits the utility of the comparison.

2.16 Our R&D investments and their outcomes keep us competitive with other global food companies. [redacted]

2.17 In 2008 we launched our IQF mozzarella using world-leading patented technology developed at our R&D Centre, and supported by Transforming the Dairy Value Chain – a Primary Growth Partnership (*PGP*) programme between the Ministry of Primary Industries, Fonterra and DairyNZ. It has features that bind the topping to the base and provide colour and texture and extra stretch – a key part of the pizza experience. It's snap frozen at peak maturity to capture freshness and its authentic taste, and pre-shredded for ease of use. In September 2018 we commissioned a new $240 million plant to help meet growing demand – the single largest foodservice investment in New Zealand's dairy industry history, doubling our Co-op's capacity to produce this revolutionary mozzarella, which is made from milk in one day instead of the usual two to three months taken by conventional mozzarella processes.

2.18 Another example is our complex milk lipids made at our Edgecumbe site. We add complex lipid ingredients to our maternal, infant and older adult products generally for cognitive benefits and also mobility (joint and muscle). Complex milk lipids can also be used for gut health and we are actively exploring new applications and benefits.

2.19 Frontier also refers to our milk "finger-printing" technology developed in 2015, which led to our research and development arm winning the Innovation Excellence in Research award at the 2015 New Zealand Innovators Awards. The milk finger-printing technology cuts some testing costs by more than 99 per cent and significantly reduces the time required for processing results. Instead of some tests taking days or weeks we can test hundreds of samples in seconds, cutting processing times and cost. However, its benefits go far beyond ensuring a quality, safe supply of dairy nutrition. The composition of milk varies seasonally, and between farms and regions. This means milk from one of our farms may be better-suited to one specific product rather than another. Milk finger-printing provides information about each farm's milk so rapidly that when combined with our sophisticated tanker scheduling system, we can now send our milk to the manufacturing site that will get the most value out of every drop. The development of milk fingerprinting was partially funded by Transforming the Dairy Value Chain – a PGP programme between the Ministry of Primary Industries, Fonterra and DairyNZ that aims to create new products, increase on-farm productivity, reduce environmental impacts and improve agricultural education.

2.20 We also note that Frontier (at p50 "Analysis of Industry Performance") states that Glanbia invests a similar proportion of its revenue in R&D as we do. However, Glanbia is identified as "moving up the value chain". As NERA notes (at [46]), analysis of the Glanbia annual report suggests that the R&D expenditure figure may refer to the R&D figure for Glanbia PLC (a separate company to the co-op which has external investors) rather than the co-op itself. We understand that Glanbia is also a closed co-operative, ie, it has control over who supplies it (NERA, [47]).

Scope for more investment in R&D

2.21 Like value add investments, we could have made a larger contribution to R&D and innovation in the absence of open entry and the attendant volume pressure. As discussed, open entry requires that we invest in sufficient processing capacity to meet all potential new supply, crowding out investment in higher value producing plant or R&D.

Our value as a national champion

2.22 The Discussion Document notes that foreign ownership of other processors has provided links to particular foreign companies and their marketing and customer network, and we agree, although it is questionable whether these links have to date provided additional value to the New Zealand sector. But it is important to acknowledge that our scale allows us to contribute to "NZ Inc" and our Co-op has facilitated access to foreign markets for other New Zealand companies – for example, by building demand for dairy in China and more generally building the New Zealand provenance story, which we have invested in heavily and which all New Zealand-origin dairy and other products benefit from.

2.23 In the absence of our Co-op, New Zealand branding investments would be under-provided for, since they suffer from a free-riding problem (i.e. all players benefit from one player's investment, so no one player has an incentive to invest). Our size and scale address this, at least to some degree (NERA, [55]).

2.24 Our Co-op also provides input and support on New Zealand trade negotiations and broader trade policy issues. We also support DCANZ's trade policy work on behalf on the New Zealand dairy sector.

2.25 In the context of free trade agreement (FTA) negotiations, our unique commercial perspective informs New Zealand's FTA priorities for dairy. We provide direct commercial insights into market trends, consumer perceptions, growth in domestic consumption for markets across key products and future trade opportunities. We are also uniquely positioned to advise on technical disciplines, such as tariff quota administration and safeguards, given our in-market and trade policy expertise.

2.26 We play a key role in broader advocacy on trade, with offshore trade strategy roles based in Europe (Amsterdam), the US (Chicago) and South East Asia (Malaysia). Recent examples include our advocacy for the CPTPP Agreement in Washington and for high-quality EU-NZ and UK-NZ FTAs. We have participated in UK Select Committee hearings on a potential future UK-NZ FTA, and have advocated strongly for such an FTA to be launched and deliver high-quality results for the New Zealand dairy sector. Another example is our recent participation in RCEP FTA negotiations, where we engaged in industry discussions on market access and non-tariff barriers (*NTBs*), including with Lead Negotiators.

2.27 Through our local subsidiaries, we are also members of key trade-related organisations across different countries, including Eucolait (the European dairy processors association), IDFA (the US dairy processors organisation) and the Federation of Malaysian Manufacturers, where we contribute to better outcomes on issues such as non-tariff barriers. We have also recently taken a lead role in successfully opposing the Chilean Government's proposed imposition of safeguards on imports of key dairy products.

2.28 Given the broad nature of our export markets and our network, we are often an "early warning system" for the New Zealand Government and other New Zealand dairy exporters on barriers faced in overseas markets (subsidies in the EU, US

and Canada are a good example). We do our best to provide accurate and timely information to the New Zealand Government on key trade-related issues.

2.29 Through our in-house trade team, we are also actively engaged on critical trade policy and strategic issues here in New Zealand.

2.30 From a food regulatory perspective, our Co-op is also actively involved in working with the New Zealand government to shape the global regulatory environment. We provide expert advisers to participate in standards development processes in international organisations such as the Codex Alimentarius Commission and the International Standards Organisation. We also work with MPI and colleagues and stakeholders in offshore markets to monitor and influence the development of country-specific standards that could impact on exports of dairy products out of New Zealand. We are also closely engaged in regional and international trade associations such as the International Dairy Federation and Food Industry Asia, where we aim to ensure that the positions and activities of these bodies support agricultural and food production processes that are used in New Zealand.

2.31 These are all examples of the value our Co-op, as a national champion with significant critical mass, brings to New Zealand.

The strength in our co-operative model

2.32 The Discussion Document and Frontier reports do not comprehensively address or take into account the rationale for our co-operative model, and we think it is important to do so. There are significant and continuing economic and social advantages in our co-operative model, including distributive implications.

2.33 Firstly, the Discussion Document states that DIRA does not require us to take any particular corporate form (at p26). This is incorrect. While the DIRA does not specifically require us to be a co-operative company, DIRA is premised on our existence as a co-operative. For example, the requirement in section 73 to accept applications to become a shareholding farmer only make sense if we continue to exist as a co-operative. Similarly, section 81 relates specifically to the price of a “co-operative share”. Section 106 enshrines the principle of non-discrimination between new entrants and shareholding farmers, consistent with our being a co-operative subject to open entry obligations. Accordingly, any change to our corporate form would in our view require significant legislative amendment. A change away from the co-operative model would also fundamentally change the structure of the New Zealand dairy sector and would have major (including potentially unforeseen) consequences.

2.34 Secondly, the Discussion Document also does not acknowledge or address the advantages of the co-operative form for our Co-op, our farmers and New Zealand. The co-operative model ensures co-op farmers are able to elect directors, hold management to account and have a say in business decisions – and it ensures that profits from the sale of dairy products are returned to farmer suppliers, rather than to external (potentially overseas) investors. This has flow on benefits for the wider New Zealand economy because for every dollar a farmer earns he or she will spend around 50 cents in his or her local community. The co-operative structure has a long history and continues to be important in enabling dairy farmers to succeed in New Zealand.

2.35 In 2001, Evans and Quigley explained these benefits as follows (at p5 "Watershed for New Zealand Dairy Industry"):

> Processor co-operatives were principally established by farmers to avoid being at the mercy of a monopoly purchaser they could not control. If suppliers do not control the monopoly processor they will be paid just the minimum to ensure supply, and they miss out on the surplus profit – rent – resulting from the monopoly's restriction of output. Co-operative processors solve this problem by making the suppliers the shareholders. Thus, if there are any surplus profits they are returned to suppliers in proportion to the milk that they have contributed.

2.36 Others in the industry have recognised the value of a strong Fonterra and the strength of our co-operative model. For example, in its submission on the Terms of Reference, Tatua stated (at [1.7] and [5.3]):

> Tatua believes a strong Fonterra Co-operative is good for New Zealand. The co-operative model provides an essential risk management function for the whole dairy sector, because it passes the effects of market volatility onto the farming sector which has the greatest financial value and resilience. In the absence of a dominant Fonterra Co-operative, and Fonterra reference milk price there is a real risk that long term farm returns would diminish, resulting in erosion of farm resilience, and at the extreme, failure of the farm-gate milk market in some regions…
>
> In the absence of a co-operative Fonterra, milk producers supplying independently owned processors would likely bear the impact of global market and foreign exchange downturns, but not necessarily obtain the full rewards of positive market performance. In dairying regions with no or little farm-gate milk competition this could lead to an erosion of long term returns and reduced on-farm resilience.

2.37 The Australian dairy industry provides a useful comparison. In 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 that can change without consulting farmers. Farmers can suffer significant loss through these changes to 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.

2.38 Overall the ACCC concluded that these issues and farmers' lack of bargaining power result in practices that transfer a 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.

2.39 In contrast, our co-operative model ensures fairness in our supply chain. It constrains our milk pricing, and ensures we do not have an incentive to exercise market power against our farmer suppliers. The Commerce Commission, in its "2016 Review of the State of Competition in the New Zealand Dairy Industry" (at [X30.1]), concluded that the co-operative structure protects farmer suppliers from our market power in relation to milk purchases, because the suppliers ultimately control the decisions of the company. Australia is currently considering a mandatory industry code of conduct to address some of these concerns.

2.40 Our co-operative model also helps to drive the dairy sector's contribution to New Zealand, and particularly regional New Zealand, by ensuring farmers are treated fairly and profits are directed widely into the community, particularly regional communities. The October 2018 NZIER report entitled "How does the dairy sector share its growth? An analysis of the flow-on benefits of dairy's

revenue generation" commissioned by DCANZ identifies some of the key benefits to New Zealand from the dairy sector, and these illustrate the way these benefits are both large but also broadly distributed:

- Dairy farming is the top income generator in Waikato, West Coast, and Southland. The dairy sector accounts for 14.8% of Southland's economy, 13.4% of the West Coast economy, 11.2% of the Waikato economy, 11.1% of Taranaki's economy and 6% of Northland's economy (at (i));
- The dairy sector accounts for $8.2 billion (3.1%) of New Zealand's total GDP (at p8);
- Dairy employment was 38,700 in February 2017, and dairy supports jobs in other sectors of the economy (at p10);
- The dairy sector's contribution to national employment has steadily increased over time. Since 2000, dairy sector employment has grown by an average of 3.1% per year, compared to 1.8% for total employment (at p11);
- Dairy sector wages almost tripled between 2001 and 2017, with $2.6 billion delivered in wages in 2017 (at p12);
- Dairy farming and dairy processing are the largest purchasers of output from seven and six industries respectively in the New Zealand economy. This means the wider dairy sector is vitally important as a purchaser of goods and services from around a third of all industries in the New Zealand economy (40 industries for dairy farming accounting for 41% of GDP, and 33 industries for dairy processing accounting for 29% of GDP) (at p17);
- The dairy industry is amongst the top 10 employers in more than half of New Zealand territorial authorities (at p26); and
- About 80% of all dairy wages ($2.1 billion) are earned in rural areas (at p31).

Chapter 3: The effects of the DIRA and other factors on industry performance

3	*Do you consider the DIRA has been effective at achieving its core regulatory objective of preventing Fonterra from using its dominance to create barriers to farmers' milk and land flowing to their highest value uses? If not, please provide reasons and supporting information/evidence.*

3.1 As discussed in response to Q1 above, DIRA's core regulatory objective is to promote efficiency and contestability in New Zealand dairy markets.

3.2 In our view, DIRA regulation has worked well. The incentives initially created by open entry and exit, and then subsequently the milk price regime and TAF, have ensured efficient pricing (and mean that, as discussed in Q1 above, we cannot use pricing signals to influence volumes) – and, as a consequence, have enabled dairy resources to flow to their highest value uses. DIRA has fostered contestability and enabled both small and large processors to enter.

3.3 Competition in New Zealand's dairy markets is robust and sustainable. The risk of our Co-op using our position to dampen competition has materially decreased. Any residual risk is, in our view, now effectively managed by the milk price regime, TAF, and ongoing support to participants in the domestic consumer market. DIRA's objectives have been largely achieved and so the full costs of the regime are no longer justified.

3.4 In the absence of DIRA regulation going forward, we would not have the ability or incentive to frustrate entry by new processors. This is supported by the Commerce Commission's recent findings (in its "2016 Review of the State of Competition in the New Zealand Dairy Industry" at [5.165]–[5.167]), that, in the absence of DIRA, we would not have a strong incentive to frustrate entry by new processors because:

- while we 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; and
- independent processors that did not have access to alternative supply collectively accounted for a small market share, and our Co-op may not obtain a benefit from their foreclosure.

3.5 As NERA notes at [7], [12] and [15], since that report, competition has developed further, with Fonterra's national market share continuing to fall from 85% in the 2014/15 season to 81-82% now.

3.6 In the absence of open entry and exit in particular, we would continue to operate largely as we do now:

- In an environment of low to flat milk growth and significant invested capital, we would have limited interest in turning away milk.
- The Commerce Act, as well as the material competitive constraints we now face, would limit our ability to tie up milk supply where our contracting substantially impacted competition in the farmgate milk market (see the discussion below on the Commerce Act constraint in response to Q5).

3.7 The primary difference under the removal of open entry is that we would refuse applications to enter our Co-op or increase supply where there was a reputational

issue in collecting the milk (for example, because a farmer would not meet our environmental or animal welfare standards). In our view, this would be a positive step for the industry as a whole. Further, we would have the ability to respond to any new unforeseen developments in the dairy industry.

3.8 We would otherwise continue to collect from all our existing farmers. Furthermore, we would not expect this to have a material impact on existing shareholders' ability to increase their supply, in the ordinary course of business. That is, we calculate share requirements based on a rolling three-year average of supply, so farmers typically manage their increased supply without making an application to increase their supply (under section 73(2)). In fact, in 2017 and 2018 we received only 5 and 8 such applications, respectively. Therefore, removal of open entry would only potentially affect existing farmers where they applied to provide new supply (e.g. as a result of buying a farm and converting it to dairy).

3.9 We may refuse to collect new or increased supply (to the extent it requires an application) where it is uneconomic to do so, for example from geographically remote farms. But as NERA notes, even in the absence of the open entry requirement it is unlikely our Co-op would refuse to accept farmers that wished to switch from an independent processor. Independent processors have invested in New Zealand’s primary dairy areas, and so their farmers are likely to also be proximate to our existing plants (at [20]).

3.10 In the absence of open entry, we would also have greater ability to evolve in response to other changes in the domestic and global dairy industry (for example, new environmental threats).

3.11 We are conscious of the public perceptions around our historical behaviours such as when NZDL went into liquidation in 2012 (at the time TAF was being introduced). Although we negotiated a deal to acquire the plant on terms which enabled the ex-NZDL suppliers to be paid the significant amounts owed to them by NZDL for milk, we also contracted the ex-NZDL suppliers on non-standard terms. We acted in good faith and genuinely believed these non-standard terms reflected their different circumstances. The Courts ultimately found otherwise, and we have learned from that experience.

3.12 Other DIRA backstop protections could remain in place, including the open exit obligations (being the right to withdraw and the 160km rule) until a regional market threshold is reached, as discussed below, the milk price regime, TAF and certain entitlements under the Dairy Industry Restructuring (Raw Milk) Regulations (*Raw Milk Regulations*).

4	*Do you think Fonterra is still dominant in the market for farmers’ milk, at the national and regional levels?*

4.1 As discussed above in response to Q3, we do not consider that we have the ability or incentive to use our position to frustrate entry by new processors and we also have no ability or incentive to exercise market power against farmers.

4.2 At a national level, our market share dropped from 96% in 2001 to, according to the Discussion Document at p19, 80.5% in 2018 in a market that has grown significantly, which indicates the existence of sustainable competition. Our calculations indicate our national market share is currently around 81- 82%.

4.3 National market shares also understate the competitive impact of independent processors (NERA, [16]). Under our co-operative structure we adopt uniform pricing and average transport costs across all of our suppliers. This means that

we must respond to regional competitive pressure on a national basis – so competition in just some areas benefits all of our suppliers (NERA, [85]). In any event, there is robust and sustainable competition in most regions in New Zealand, where our market share is around 85% and falling.

4.4 That said, we understand there might be some reluctance to rely on our co-operative structure to protect farmers in regions where competition has not yet developed materially. On a conservative basis therefore, we consider below whether our Co-op has market power based on regional council region market shares (calculated using New Zealand Dairy Statistics data and overlaying our collection data).

Regional Council Region	Fonterra Market Share % (2017-2018)
Northland	
Auckland	
Waikato	
Bay of Plenty	
Taranaki	
Horizons (Manawatu-Whanganui)	
Hawke's Bay	
Greater Wellington	
Tasman	
Marlborough	
Westland	
Environment Canterbury	
Otago	
Environment Southland	

4.5 In the dairy sector and our experience, independent processors can exert significant competitive pressure with market shares of 5% or 10% in a region. For example, there is more than one independent processor, and our Co-op is subject to effective and sustainable competition, in the Waikato, Horizons, Canterbury and Southland regions. Based on this, a conservative view is that sustainable competition exists in regions where independent processors have a share of 15% or more.

4.6 While robust competition has developed in some regions, we acknowledge that MPI may wish to recommend open entry remains in those regions where limited competition has developed to date. Our strong preference is for the removal of open entry (the obligation to accept supply, as well as non-discrimination) entirely, but we have also proposed as a second preference in response to Q23 below a new possible option for regional expiry of open entry and exit (the right to withdraw and the 160km rule) when a 75% market share threshold is met.

4.7 NERA notes that in 2010 they recommended a 75% market share threshold for review of DIRA, by Island. Since then, the number of independent processors has increased, and we can be much more confident about the sustainability of independent processors (at [86]). In their view, 75% continues to be an appropriate threshold for removal of open entry (NERA, [64]).

5	*Do you think the DIRA imposes unreasonable costs on Fonterra? If so, please provide supporting information/evidence.*

DIRA imposes unreasonable costs on our Co-op

5.1 In our view, DIRA imposes material costs on our Co-op and has served its purpose. Therefore, those costs now materially outweigh the benefits, and are in our view unreasonable. The key costs are the following:

- At its broadest, open entry has and will continue to materially influence the strategic decisions that our Co-op makes. It pervades our decision-making, causing us to make decisions that an unencumbered corporate strategy would not contemplate. In this regard, the costs of DIRA are material, though difficult to estimate because the costs flow from constraints on our Co-op's strategic orientation.
- Open entry encourages inefficient investment decisions. NERA identifies two (interrelated) categories of costs of open entry: excess capacity on the part of our Co-op, due to uncertainty, and crowding out of investment in higher value producing plant (at section 3.2). Open entry has required our Co-op to build and maintain a large footprint to ensure we can process all milk that could come our way. This means that capital has been directed away from other, potentially higher-value uses. It has also constrained capital investments in R&D and innovation, as discussed above. In addition, NERA identifies the broader risk of inefficient independent processor entry and potentially industry over-capacity (at [57]). We discuss this issue in more detail in Q8 below.
- Open entry has imposed reputational costs, as well as time and resource costs, requiring our Co-op to deal with farmer suppliers that do not meet our standards and damage our brand in the market. For example, our staff and management invested significant time and made numerous visits, phone calls and emails in respect of the 98 farms issued with suspension notices due to stock exclusion in the 2017/18 season.
- Open entry also imposes significant environmental costs, which we discuss in detail at Q14 below.

5.2 Against this, open entry is no longer required to ensure contestability in the New Zealand dairy sector. Open entry was originally intended to:

- solve the "catch-22" described above (new independent processors' reluctance to invest without raw milk supply, and farmers' reluctance to supply without independent processor investment); and
- ensure efficient pricing (see NERA, section 2, and our response at Q1 above).

5.3 These two objectives are now secured in other ways. Competition is robust and sustainable, and there is no longer a "catch-22" constraining independent processor investment. Several independent processors are now well established and farmers can rely on their track record and reputation in their decision-making around who to supply. In addition, the milk price regime and TAF ensure efficient pricing. In this context, the benefits of open entry have, in our view, fallen away. We also support ongoing obligations to supply raw milk to processors supplying the domestic consumer market, providing additional protection for New Zealand consumers.

5.4 In 2016, the Commerce Commission found the costs and benefits of DIRA to be "finely balanced", in a context where the Commission had, in our view, under-

estimated the costs, and over-stated the benefits (at p7 "Review of the State of Competition in the New Zealand Dairy Industry").

5.5 Competition has developed further since the Commerce Commission's report (the Commission's assessment of competition was undertaken between June and November 2015). As NERA describes , there is now robust and sustained competition in the dairy sector, with double the number of competitors in the farm gate market as there was prior to the formation of our Co-op. NERA's view is that "*IPs have developed to the point that there is unlikely to be a material catch-22 problem today"* (at [7]).

5.6 Given that the policy rationale for open entry has fallen away, the costs of DIRA outlined above now clearly outweigh the benefits, and are therefore unreasonable.

5.7 There is no evidence new processors consider they need open entry to become established in New Zealand. MPI notes in the Discussion Document that independent processor investment is unlikely to be based just on open entry and exit (indeed, it suggests that DIRA protections are likely to have a limited role in such investment decision-making) (at p30). NERA states that independent processors investment suggests a high degree of confidence and it is interesting to consider what role DIRA plays in this (at [9]). They note that presumably continued investment by a processor does not depend on continued access to DIRA (regulated) raw milk, because we are not obliged to supply raw milk to an independent processor that has collected 30 million litres or more of its own supply for three consecutive seasons.

5.8 Farmers have not expressed a strong desire to retain open entry, and there is no evidence that the ability to return is a material factor in farmers' decision go to another processor.

5.9 NERA also notes that a key aspect of the "catch-22" problem was farmers' uncertainty around an independent processor's track record/reputation (at [11]). As NERA notes, there are now a number of well-established independent processors. There also appears to be an emerging trend of global food and dairy companies vertically integrating upstream into New Zealand by taking material ownership stakes in independent processors: "*Because this is upstream vertical integration, these investors will be less concerned about finding output markets for their processing investments. This is turn will provide some comfort to farmers about the sustainability of these processors*" (at [13]).

5.10 Other stakeholders also support removal of the open entry requirements, at least in part, including other processors Synlait and Westland (which supports removal of open entry in relation to new conversions).

Capacity constraint notices do not mitigate the cost of open entry

5.11 The Discussion Document refers to capacity constraint notices as a mechanism to minimise the costs of DIRA to our Co-op. Capacity constraint notices do not effectively mitigate the costs of open entry. Capacity constraint notices allow us to defer collection in an area for one year only. But capacity build decisions (and all of the pre-work needed to make those decisions) need to be made more than one year out.

5.12 Our Co-op must plan for capacity investments at least three years out, which means we cannot rely on capacity constraint notices as a mechanism to mitigate the costs of the open entry obligation.

Commerce Act constraints

5.13 Finally, the Discussion Document asks whether, in the absence of DIRA, the Commerce Act could be relied upon to manage our Co-op's dominance. As noted above, we support retention of key aspects of DIRA, including the milk price regime and aspects of the Raw Milk Regulations.

5.14 That said, our view is that the Discussion Document under-estimates the effectiveness of the Commerce Act as a constraint. We are very mindful of the Commerce Act which we see as one of the key regulatory constraints on our activities. It is an important and well-established regulatory framework, backed up with an effective independent regulator, and accordingly should not be under-estimated.

5.15 Section 36 is designed to prevent unilateral anticompetitive behaviour by firms with a significant degree of market power. It captures players that use their market power for certain anticompetitive purposes, to:

- restrict a person from entering into a market; or
- prevent or deter a person from engaging in competitive conduct in that or any other market; or
- eliminate a person from that or any other market.

5.16 Section 36, in our view, provides a real constraint on market power, and the provision is backed by a significant body of regulatory and judicial guidance. For example, we apply a Commerce Act analysis in addition to the restrictions under section 107 of the DIRA when we are making decisions whether to contract supply for more than one season.

5.17 Section 36 is currently under review by MBIE. At this stage, MBIE proposes to amend section 36 to bring it into line with the recent reforms of the parallel provision in Australia. MBIE considers the changes will "level the playing field again by preventing powerful businesses from harming their competitors in ways that produce no benefit to consumers" (MBIE, "Review of Section 36 of the Commerce Act and other matters – summary", (January 2019)). In other words, the impetus behind the proposals has been to tighten the (in our view already effective) provision vis a vis companies with a substantial degree of market power.

6	*Are there ways for the costs imposed on Fonterra to be mitigated without impacting on the effectiveness of the DIRA regulatory regime? If so, please provide supporting information.*

6.1 Yes, we consider that there are amendments to the DIRA regime which could mitigate the costs imposed on our Co-op without impacting on the effectiveness of the regime in promoting efficiency and contestability.

6.2 The primary change is removal of open entry (the obligation to accept supply and the non-discrimination rule), which would reduce the costs on our Co-op without adversely impacting competition in the New Zealand dairy markets. In the absence of open entry, we would still be incentivised to accept milk consistent with our co-operative principles and to utilise already existing capacity. In addition, there are now several well-established and sustainable competitors, which give

farmers choice in who they supply to. The viability of these competitors would not be affected by removal of open entry.

6.3 In addition, as NERA explains, the Raw Milk Regulations impose a cost on our Co-op, because on an expectations or systematic basis the regulated price will be lower than our opportunity cost (at [78]). To the degree that price is less than opportunity cost, then our Co-op investors are subsidising processor entry (at [80]). Further, independent processors can materially vary their forecasts at short notice which creates uncertainty for our Co-op regarding the amount of milk we are required to process, leading to, for example, potential plant overbuild or other inefficient operating decisions. This issue is particularly costly for our Co-op at peak. As NERA notes: "*this flexibility grants IPs a free option to vary milk taken from Fonterra at peak, which transfers the risks IPs would otherwise face around forecasting peak supply onto Fonterra*" (at [87]).

6.4 Changes to the Raw Milk Regulations (to remove entitlements for large export-focused processors) and the return of a clear pathway to deregulation would mitigate the costs on our Co-op without reducing the competitiveness of the dairy sector or allowing any misuse of market power. We discuss these proposals further below in our responses to Q18, Q29-31 and Q40-43.

6.5 As noted above in response to Q5, capacity constraint notices are not a practical mitigation for the costs of open entry, since we cannot decline to accept new supply, and the maximum deferral period of 12 months is too short a period to build new capacity.

6.6 MPI has also pointed out that we could charge actual transport costs to our farmer suppliers. While theoretically possible, we do not see this as a viable option for the following reasons:

- There are practical difficulties associated with calculating and applying actual transport costs which would be prohibitive – it is not a simple "distance" multiplied by "transport charge" calculation as the actual costs would depend on other factors including how many other farms the tanker visited, the nature of the terrain (i.e. hilly or flat), whether there were any delays at the farm, and the condition of the roads.
- In our view, such an approach would run counter to our co-operative principles and DIRA.
- Such an approach would likely have unintended consequences, such as an impact on land values and significant lobbying from our shareholder base on where to build new plant or whether to close a site which would distract from making decisions for the benefit of the broader Co-op.

7	*Are there any other regulatory tools that, in your opinion, would be more effective than the current DIRA provisions at managing Fonterra's dominance? If so, please provide examples and supporting information/evidence.*

7.1 In our view, DIRA continues to be an important framework for the New Zealand dairy sector. As above, we support retention of open exit (the right to withdraw and the 160km rule) until a market threshold in a region is reached, and certain of the Raw Milk Regulation obligations, the milk price regime, TAF, the 20% rule and provisions concerning the sale of milk vats.

7.2 However, we also support a clear pathway to deregulation to provide certainty and sustainability in the sector. Over time, as DIRA regulation falls away, our view is that the Commerce Act framework (an important and well-established regulatory

framework) and the extent of sustainable competition in the day industry will be sufficient to ensure efficiency and contestability in the dairy sector.

8	*Are there other factors you consider need to be taken into account when considering the effectiveness of the DIRA regime and whether it is still needed?*

8.1 It is important to consider:

- Where our Co-op and the industry could be in the absence of open entry. Removal of the open entry obligation would allow our Co-op to better manage volumes and invest more in value added production, R&D and innovation. It would also ensure we can manage reputational concerns associated with new farmer suppliers who do not meet our standards.
- The original rationale for open entry: addressing the “catch 22” associated with new independent processor investment, and ensuring efficient pricing. Both objectives are now met in other ways, through the level of sustainable competition in the dairy sector, and through the milk price regime and TAF. There is no compelling rationale for retention of open entry in this context.
- The constraints and incentives imposed by our co-operative model. As noted in response to Q1, DIRA is built on the structure and incentives created by our cooperative model. Furthermore, for the reasons given in response to Q2, we consider our co-operative model to be a source of strength for us, for our farmers and for the New Zealand industry as a whole.

8.2 In addition, there are real risks associated with the continuation of open entry. In particular, entry-facilitating policies like open entry (and the Raw Milk Regulations) could result in inefficient independent processor entry, and potentially an industry with over-capacity, as the meat industry has faced many times (NERA, [57]).

8.3 As NZIER discuss in their 1 February 2019 report “Indicative estimates of the economic impacts of over-capacity”, industry over-capacity could result in under-utilised plants being kept in service (due to the large sunk investments they entail, and the consequent reluctance to exit), causing a period of stagnation and low returns. Even when this problem ultimately “corrects” by some plants closing, this in itself creates negative consequences for the employees and communities affected. Tatua also perceives a risk of over-capacity, and negative consequences arising from it (see their submission on the Terms of Reference at [3.6]):

> With static or declining milk volumes, and the very real likelihood of excess processing capacity, it is more likely that some companies will pay more than they can afford in the long term to secure milk in the short term. i.e. a procurement war similar to what has been seen in the meat industry at various times. This could escalate until one or more firms actually fails.

8.4 NZIER has modelled the potential impact of a decrease in capital investment and productivity as a result of over-capacity, indicating that a 1%, 5% and 10% capital productivity decrease would result in New Zealand’s GDP falling by $149 million, $276 million and $441 million relative to business as usual. This excludes the social and human cost of such a process.

9	*Do you agree with our preliminary assessment of the extent to which the DIRA encourages industry growth? If not, please provide reasons and supporting information/evidence.*

9.1 In our view, the Discussion Document understates the importance of DIRA as a standalone factor encouraging industry growth. DIRA ensures that farmers have a guaranteed buyer for their product – incentivising dairying over alternative land uses. The concern here is not that independent processors will increase their relative share, which is an issue on which policymakers should be neutral. Rather, the concern is that DIRA directly contributes to inefficient new capacity and inefficient new conversions. This is expanded, including with reference to the work carried out by NZIER, below in response to Q13.

9.2 We had [redacted] new dairy conversions join our Co-op for the current season, across both the North and South Islands. NERA also describes the magnitude of new conversions as a result of DIRA (at [39]), noting that between the 2009/10 and 2017/18 seasons:

- [redacted] new farms joined Fonterra, [redacted] of which were new conversions, these new farms represent an increase in yearly production of about [redacted] m kgMS;
- Of those [redacted] new farms, only [redacted] remain with Fonterra today (i.e., [redacted] have joined Fonterra and then subsequently left), in 2017/18 these remaining farms represent an annual production of [redacted] m kgMS; and
- Annual supply from the remaining [redacted] farms that were existing in the 2009-10 season has grown over the same period by about [redacted] m kgMS.

9.3 As discussed above in response to Q8, the risks in retaining DIRA entry assistance also include the potential to incentivise inefficient new capacity, which may lead to over-capacity and under-utilisation.

9.4 The growth incentives created by DIRA are also an environmental concern, as discussed in response to Q15 below.

10	*Do you agree with our preliminary assessment of the extent to which Fonterra can influence milk supply volumes through price, notwithstanding the DIRA open entry requirements?*

10.1 No, we do not agree with MPI's preliminary assessment of the extent to which our Co-op can influence milk supply volumes through price. We have addressed this issue in detail in response to Q1 above. There are, however, some factual errors in this section of the Discussion Document that we address below.

10.2 On p24 of the Discussion Document, MPI states that New Zealand dairy farmers' milk production decisions are sensitive to price and suggests that supply volumes fell in 2013/14 in response to lower global demand and commodity prices. This is not correct:

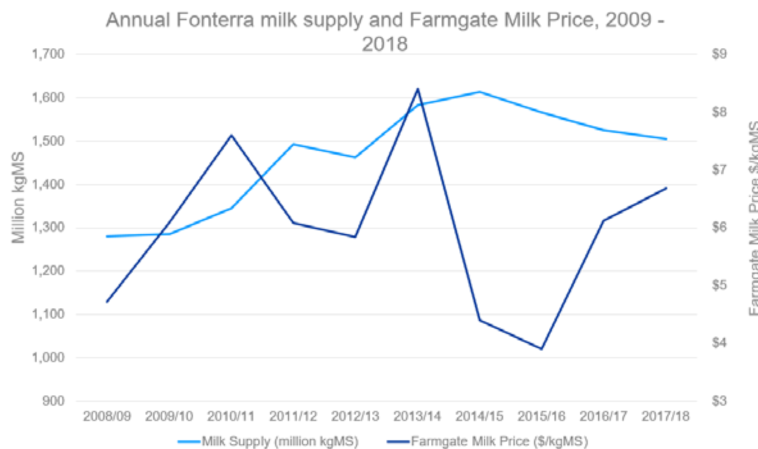
- In FY14, the farm gate milk price was $8.40. Very good conditions, contrasted with poor conditions the previous season, contributed to production increasing to 1,584 million kgMS – 8% more than the previous season.
- In FY15, the farm gate milk price was $4.40 (compared to an initial forecast of $7), but again milk supply increased, by 2% to 1,614 million kgMS.

- It was not until F16 that volumes started to fall. In F16, with a farm gate milk price of $3.90, farmers decreased production to 1,566 million kgMS, down 3% on the previous season, but only down 1% on the FY14 season.

10.3 This indicates that, within a given season, a low farm gate milk price leads farmers to control costs (e.g. reduce stocking rates and/or supplementary feed), but does not result in major shifts in volume – i.e. within a season, farmers are unlikely to enter or exit the dairy sector as a result of price changes. This supports our view set out in response to Q1 above, that even if we were free to deviate from the base milk price to pursue commercial strategies (which we are not), the milk price would not be an effective tool to influence supply volumes on a season by season basis.

10.4 The graph below further demonstrates the lack of clear correlation between price and volumes:

Milk supply and Farmgate Milk Price data, 2009 - 2018



10.5 This lack of correlation (particularly on a timely basis, and given the myriad of other factors involved) is another reason why, even if we were able to change the milk price with the intention to change milk supply volumes, it is highly unlikely it would be effective. This is in addition to considering the many other reasons that we do not and cannot manipulate volumes using the milk price.

10.6 On p25, the Discussion Document suggests that we could deviate from the base milk price where we are facing intense competition for supply (by raising our price) or where we wish to reduce supply to pursue a value add strategy (by lowering our price).

10.7 These suggestions are unrealistic. As explained in response Q1, manipulating the milk price to control volumes would breach both our own Constitution and the requirements of DIRA. Departing from the base milk price solely to meet commercial strategic objectives in terms of volume would be viewed as contrary to the purposes of the DIRA because it would undermine contestability in New Zealand dairy markets (and would potentially be anti-competitive e.g. if we paid a higher milk price with the purpose of thwarting other processors' ability to compete in the market). We do not believe that we could do this legally and have certainly never done so. Secondly, and for the reasons given above, we do not consider that the farm gate milk price has a significant effect on volumes within a season. Further, to the extent that the absolute level of the farm gate milk price does impact volumes for a season, it is not possible to accurately predict the impact before or early in the season, because the forecast farm gate milk price is by its nature subject to at times material variation across the season until it is finalised after the season ends.

10.8 The only situations in which we have deviated from the base milk price (in 2013/14 and 2017/18) have been when the Co-op's wider financial circumstances have meant we could not afford to pay the benchmark price.

10.9 There are also some specific flaws in the Frontier analysis relating to our ability to control the milk price, including an apparent belief that we can manipulate the Milk Price Manual and inputs, without affecting our credibility (p16ff and p53ff "Drivers of Industry Performance"). This is not correct.

10.10 Any change to our Milk Price Manual requires approval from at least 75% of our Co-op's board, including at least a majority of independent directors, and must remain consistent with the DIRA principles. These requirements are set out in the Fonterra Shareholders' Market Rules (regulated by NZX), and our Constitution (which is not simple to change). Any changes to Part A of our Constitution (which includes the provisions relating to the milk price) first require majority support of the Shareholders Council (Constitution, cl 18.1). Then, in accordance with the Companies Act, at least 75% of the shareholders voting must approve the change. Constitutional change can take time - for example, it took over two years to finally pass previous capital structure changes. Further, DIRA requires the Commerce Commission to review the Manual for consistency with the DIRA regime every season.

10.11 Accordingly, our compliance with the milk price regime is closely monitored both internally, in accordance with our Constitution, and externally by the Commerce Commission in accordance with DIRA. We are required to publicly explain any deviation from the Milk Price Manual. It is wrong to suggest that our Co-op has broad or unlimited discretion when it comes to setting the milk price; it is quite the opposite, as we explain below.

10.12 We discuss the statutory regime that governs the milk price in response to Q12 below.

We cannot use our terms of supply, shareholding requirements or dividends policy to control volume

10.13 The Discussion Document also suggests that we could use our terms of supply, shareholding requirements or dividends policy to control volume. This is incorrect.

Terms of supply

10.14 MPI has suggested that we could use our terms of supply to control volumes – for example, by setting a volume threshold on suppliers, after which a lower price kicks in – to encourage farmers to reduce supply.

10.15 In our view, for the reasons below it is not practical for us to attempt to control volumes and growth through our terms of supply in this way. It would also, in our view, be contrary to the purpose of DIRA and our co-operative structure (because it would have a differential effect on our farmer suppliers). NERA notes that this approach would have unintended consequences and a differential effect, penalising large farmers (in the case of an absolute volume threshold) or penalising small farms (in the case of a relative volume threshold) (at [35]).

10.16 It would also likely be contrary to the requirement in our Constitution that we pay the maximum sustainable price for milk under the milk price principles in our Constitution.

10.17 Our terms of supply are intended to govern the commercial relationship between our Co-op and our farmer suppliers and establish our minimum operating

standards (on environment, animal welfare etc.). Given DIRA, our terms of supply are not intended to operate as a strategic lever that we can pull in order to achieve a particular volume outcome – in our view, this would amount to gaming the open entry protections. While we review our terms of supply each season, any changes are incremental and designed to facilitate our supply chain and ensure our standards evolve. Any changes to our terms of supply are also subject to robust review and challenge by our Shareholders Council on behalf of our farmer shareholders.

10.18 It would be inappropriate to attempt to use our terms of supply to achieve a volume outcome that is otherwise prohibited under DIRA, including by open entry and exit, the milk price regime and TAF.

10.19 The appropriate and most straightforward way for our Co-op to influence volumes is to remove open entry.

10.20 To be clear, despite the above, DIRA does not prevent us from altering our payment structures for all farmers, for example, to incentivise our farmers in relation to environmental performance (a point about which MPI expresses uncertainty – see p29 of the Discussion Document).

10.21 Note that at p26 MPI indicates that colostrum is paid a premium. This is incorrect – we do not collect colostrum, which is instead kept separate from farmers' supply and fed to calves.

Shareholding requirements and dividend policy

10.22 The Discussion Document states (at p26) that:

> The number of Fonterra shares that farmers must purchase and hold per kgMS is determined by Fonterra, at its complete discretion. Where the number of shares that must be held per kgMS is high, the cost to farmers of supplying milk to Fonterra is high. Fonterra can influence farmers overall profitability of supplying milk to Fonterra by increasing or decreasing the numbers of shares it requires its suppliers to hold per kgMS. It appears that since 2013 Fonterra has undertaken a number of initiatives that have made it cheaper for farmers to supply more milk...

10.23 We do not agree. Importantly, shareholding requirements are not a "cost" to farmers: shares are an investment, and if our earnings are returning the appropriate amount for the risk of holding our Co-op shares, then holding shares is not a "cost".

10.24 The number of shares required to be held (1 share/kgMS) is enshrined in our Constitution. It has not changed since our formation and given it is in the Constitution it is not something that can be easily changed season to season. As outlined above at paragraph 10.10 constitutional change can be difficult to achieve and can take considerable time.

10.25 In the context of growing competition, farmer supply growth and increasing global demand for dairy products we sought to ease cash flow and capital investment pressure on farmers who needed to purchase shares to enter our Co-op or expand their volumes, through tools such as milk growth contracts and MyMilk. The bonus share issue (following the launch of TAF) was to ensure there were sufficient shares on issue above minimum shareholding requirements and contribute to ongoing liquidity in the Fonterra Shareholders' Market and the Fonterra Shareholders' Fund.

10.26 We also do not agree with the statement at p27 of the Discussion Document that we can use our dividend policy to influence milk supply volumes or that our dividend payout ratio has been trending upward over time (as demonstrated by the decision to pay no final dividend for FY18, which reflected financial discipline in our Co-op and had nothing to do with the milk price). Our dividends are not a payment for milk supplied – they are a cash dividend return on equity capital invested in our Co-op.

10.27 It is also important to note that under TAF, the return on the capital investment is applied equally to unit holders – i.e. our dividend policy applies to the unit distributions received by non-supplying unit holders, as well as to shares held by supplying farmers.

10.28 Our financial performance and balance sheet position (including our capacity to fund future growth) are the most important factors influencing dividend policy. Further, to the extent earnings are retained (i.e. not paid as dividends), our equity capital amount increases. If the equity holder does not receive returns as a cash dividend, they remain entitled to any dividend in the future, or they benefit through the share value, as demonstrated by listed securities where the share price adjusts ex-dividend.

11	*Are there other factors that you consider should be taken into account? Please provide detailed comment in support of your views.*

11.1 No.

12	*Do you consider that the DIRA provisions governing Fonterra's base milk price calculation and Commerce Commission monitoring may be preventing or disincentivising Fonterra from deviating from the base milk price calculation for strategic or commercial reasons?*

12.1 Yes, the milk price regime and Commerce Commission monitoring, together with TAF, prevent our Co-op effectively deviating from the base milk price calculation purely for strategic or commercial reasons. These constraints mirror (and replace the need for) open entry and exit as a constraint on our milk pricing. The constraints are evidence of the system working as it should, ensuring that we pay a contestable and efficient milk price.

DIRA milk price regulation

12.2 Our Co-op is subject to price regulation under the DIRA milk price regime. The current regime is enshrined in DIRA, Part 2, Subpart 5A and provides an effective control on our base milk price calculation.

12.3 DIRA states the purpose of the milk price regime is to promote the setting of a base milk price that provides an incentive for our Co-op to operate efficiently while providing for contestability in the market for the purchase of milk from farmers (section 150A(1)). It requires the base milk price to be set in accordance with the principles in section 150C.

12.4 DIRA requires that we establish and maintain a Milk Price Panel to supervise the calculation of the base milk price, advise us on the application of the Milk Price Manual, and recommend the base milk price (section 150D). We are required to publish the Panel's terms of reference (section 150D(5)). The chair and majority of Panel members must be independent (section 150E).

12.5 DIRA also requires that we maintain the Milk Price Manual, setting out how the base milk price is calculated (section 150F). The terms of the Manual need to reflect the principles in section 150C. We are required to publish the Milk Price Manual. We are required to publicly explain any deviation from recommendations of the Milk Price Panel (section 150G).

12.6 It is a criminal offence for our Co-op to fail to comply with key aspects of the milk price regime (see, e.g. sections 150E(3), 150F(3), 150N).

12.7 The Commerce Commission is required each season to review the Milk Price Manual (section 150H) and report on the extent to which the Manual is consistent with the purpose of the milk price regime (section 150I). DIRA sets out the procedure for the Commission's review of the Manual (sections 150K – 150M).

12.8 The Commerce Commission is also required review our calculation of the base milk price (section 150O) and report on the extent to which the assumptions adopted and the inputs and processes we use in calculating the base milk price are consistent with the purpose of the milk price regime (section 150P). DIRA sets out the procedure for the Commerce Commission's review of the base milk price calculation (sections 150S – 150U).

12.9 In relation to Commerce Commission reviews under the milk price regime, DIRA imports relevant provisions of the Commerce Act 1986, including information gathering powers (section 150V).

12.10 We are required to publicly explain any change to the base milk price made after the Commerce Commission publishes its report (section 150R).

12.11 The statutory milk price regime, together with Commerce Commission monitoring, provides an effective constraint on our price setting; clearly, this is reinforced with a constant underlying threat of more intrusive regulation if explanations for deviations are not accepted.

Additional constraints on milk price setting

12.12 Our Constitution, TAF, and co-operative structure also effectively constrain our ability to deviate from the base milk price. This is discussed in response to Q1, but in summary:

- The milk price regime is further reinforced by our Constitution (which implements the statutory regime), and the interests of our stakeholders, including farmer suppliers and our investors – both external investors and farmers holding dry shares. Our Constitution requires that we comply with the milk price principles, including the obligation to pay the maximum milk price that our Co-op, as a properly managed and efficiently run sustainable co-operative, could pay. The Commerce Commission noted in 2016 that our co-operative structure and stakeholder base create balanced incentives with respect to setting our base milk price (at p14 "2016 Review of the State of Competition in the New Zealand Dairy Industry").
- Under the Fonterra Shareholders Market Rules, the Milk Price Manual can only be amended or replaced with the approval of at least 75% of our Co-op's board, including at least a majority of independent directors, and our Constitution requires that the Manual must remain consistent with the DIRA milk price principles.
- The milk price directly affects our share value. The milk price regime (including monitoring by the Commerce Commission) provides assurance to external

investors (and farmers holding 'dry' shares) that we are not strategically inflating the milk price.

Our compliance with the milk price regime

12.13 As noted above, we have only deviated from the base milk price calculation twice – in 2013/14 and in 2017/18, both during difficult financial periods where our Co-op could not afford to pay the price calculated under the Milk Price Manual. (see our 22 August 2018 response to MPI's request for information, at paragraphs 14 – 17 and Appendix 2). In both of those cases, explaining our reasoning to the Commerce Commission, and having the Commission accept that reasoning, was an essential part of the process. In performing its oversight role, the Commission receives regular and extensive disclosure from our Co-op with respect to the milk price.

12.14 We engage actively with the Commerce Commission in setting our milk price, and the Commission tests the assumptions and judgements underpinning our milk price calculation. For example, we are currently engaging with the Commission regarding the asset beta used in our milk price calculation. This is an example of the milk price monitoring regime working in a robust way, with the Commission openly challenging assumptions and judgements made as a part of our milk price calculation.

12.15 There are good reasons for these constraints, and we support the retention of the milk price regime.

13	*If the DIRA is not driving Fonterra's business and investment strategy, what is? Please provide detailed comment in support of your views.*

13.1 While not the only driver, DIRA has and continues to play a significant role in the orientation of our business and investment strategy. The primary influence is open entry, and the limited control we have over our milk supply volumes.

13.2 Note that Frontier (at p33 "Analysis of Industry Performance") attempts to summarise our business growth strategy, describing it as "Volume and Value", but does not accurately reflect the documents it references. Further, in the last 6 months we have announced a number of changes. At our 2018 annual meeting we dropped our volume-based ambition to achieve $35 billion in revenue from 30 billion LME (Liquid Milk Equivalents) by 2025 because it placed too much emphasis on volume. We also outlined a plan to lift our business performance by taking stock of the business and re-evaluating all investments, major assets and partnerships to ensure they meet our needs today, focusing on getting the basics right and ensuring more accurate forecasting.

13.3 Open entry has acted as a constraint on our investment strategy, as well as individual investment decisions. It drives us to invest in sufficient processing capacity to be able to accept all potential new supply, which exceeds the buffer capacity that we would build into our investment plans in the ordinary course of business (NERA at [45]). With New Zealand milk volumes increasing quickly, particularly between the 2008/09 and 2014/15 seasons, we were required to weight investment in whole milk powder and skim milk powder plants to ensure we had the capacity to process significant volumes of milk. Similar strategic constraints could arise again, with increases in supply due to weather conditions, on-farm productivity gains, or one or more competitors exiting the market.

13.4 This creates risks of stranded assets when supply conditions change. It creates inefficiency by distorting the priority we would place on investing in new processing

capacity, compared with other investments. It also alters the product mix that our Co-op would otherwise maintain under our commercial strategy.

13.5 The risk of over-capacity goes beyond our Co-op to other industry participants, in part because of the inefficient entry incentives created by DIRA and the Raw Milk Regulations. This leads to industry, and community, problems to the extent that industry over-capacity results in under-utilised plants being kept in service (due to the large sunk investments they entail, and the consequent reluctance to exit), causing a period of stagnation and low returns. Even when this problem ultimately "corrects" by some plants closing, this in itself creates negative consequences for the employees and communities affected. NZIER in its 1 February 2019 report has modelled the potential impact of a decrease in capital investment and productivity as a result of over-capacity, indicating that a 1%, 5% and 10% capital productivity decrease would result in New Zealand's GDP falling by $149 million, $276 million and $441 million relative to business as usual. This excludes the social and human cost such a process would exact on communities.

13.6 Our recent investments demonstrate that, when volume pressure eases, we can and do invest in higher-value production. Our Co-op has commissioned no new dryer plants since 2014, and there has been increased investment in processing capacity for higher-value products like cream cheese and mozzarella.

13.7 As discussed above and in response to Q14 below, DIRA also has significant environmental implications, as open entry creates, among other things, an artificial incentive in favour of dairying over alternative land uses – encouraging new conversions and putting pressure on marginal land. It also raises potential environmental issues associated with surplus factories being built and a "race to the bottom" with respect to environmental standards when processors begin having to pay more for milk to fill their excess processing capacity, potentially paying less attention to environmental standards and farm practices with a view to obtaining or retaining milk supply.

14	*Do you agree with our preliminary analysis of the DIRA's impact on the industry's environmental performance? If not, please provide your reasons and supporting evidence.*

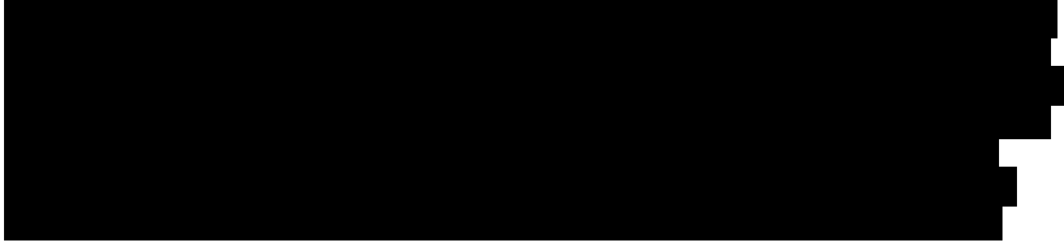
14.1 Although we agree that DIRA is not solely responsible for dairy conversions in environmentally sensitive areas, in our view the Discussion Document under-estimates the significance of the entry incentives created by DIRA.

14.2 As above, DIRA, and open entry in particular, creates an incentive in favour of dairying over alternative land uses, because it establishes a guaranteed buyer for farmers' milk. No other industry in New Zealand provides this type of incentive. It is important to note that this incentive carries with it no potential corresponding benefit for competition; DIRA is intended to safeguard entry and exit for existing farmers, not to encourage more participants to take up dairy farming.

14.3 As MPI notes, under open entry we are not able to decline an application from new or existing farmers on the basis that the applicant has a record of poor on-farm practice and will likely fail to meet our terms of supply. This means we cannot send the clearest possible signal to farmers about our, and the industry's, expectations around on-farm environmental performance. It also leads to reputational risk for our Co-op, as MPI has identified.

14.4 DIRA's impact on the industry's environmental performance should not just be considered at the farm land use level. Even if the environmental impacts from land use decisions were otherwise managed, there are other downstream

environmental impacts, such as those associated with our obligation to retain sufficient processing capacity to meet all potential new supply. This is an ongoing issue for our Co-op.



15	*Do you agree with our view that environmental issues are best dealt with through the Resource Management Act and not DIRA regime?*

15.1 We agree that the Resource Management Act (RMA) has an important role to play in dealing with environmental issues. It is New Zealand's primary mechanism for controlling the environmental impacts of land use.

15.2 But DIRA has a significant role to play as well. The removal of open entry would allow our Co-op to show leadership and to respond quickly as environmental issues arise. This is in contrast to the RMA and planning frameworks, which are generally reactive and slower to respond. Removing open entry would allow our Co-op to help lift standards, for our own suppliers and potentially across the industry.

15.3 We have strong incentives to improve the environmental performance of our Co-op and the dairy sector at large. Environmental performance is one of the most important reputational issues affecting our Co-op. We expect that, in certain cases, we would seek to impose higher environmental standards than required under the RMA.

15.4

15.5 Our Co-op needs to be responsive to consumers' and farmers' environmental concerns. The views of those groups move more quickly than legislation can, and in some cases impose different and more stringent standards than the RMA (which is focused on environmental effects). Our Co-op wants to be able to respond to those issues.

15.6 Additionally, our Co-op operates nationally while the implementation of the RMA takes place by region and district. This has implications for consistency, and knowledge of issues that span more than one area.

15.7 We are already investing significantly in improving our environmental performance and the environmental performance of our farmers. As noted in our most recent Sustainability Report for the year ending 31 July 2018, our Tiaki programme has already helped our farmers to develop over 1000 Farm Environmental Plans, and we are on track to meet our goal of a further 1,000 by 31 July 2019. These are tailored plans to improve on-farm environmental outcomes, utilising digital mapping tools and a suite of good management practices. On the processing side, our recent water recycling innovation at our Pahiatua manufacturing site will save about half a million litres of water a day. Our factory in Darfield also has new technology in place that will reduce the amount of groundwater drawn by around 70 per cent.

16	*Are there other environmental issues that you consider should be addressed either through the DIRA review or some other means?*

16.1 No, removing open entry is the primary way that review of the DIRA could help to address environmental issues associated with dairying.

17	*Do you agree with our preliminary analysis of the impact the DIRA has on new processor entry? If not, please provide your reasons and information/evidence in support of your views.*

17.1 DIRA has supported the development of competition in the New Zealand dairy sector. There are now a number of large well-established independent processors (as well as smaller independent processors) in the market. Milk supply growth has tapered off and there is now more than enough processing capacity across New Zealand. To the extent that DIRA continues to incentivise new processor entry, it creates an ever-increasing risk of overcapacity and under-utilisation. As discussed in response to Q8 above, this could have an adverse impact on the dairy sector and the economy at large.

17.2 MPI suggests in the Discussion Document (at p30) that the DIRA entry incentives were never, or are no longer, material to (large) processor investment decisions – given the complexity and scale of investment required for a new processor to enter. Reliance on these entry incentives may well have diminished (and if that is correct, then the value of retaining DIRA entry assistance, including open entry, must be reassessed for that reason). But for the reasons given above, the incentives it creates have material potential downsides that must be taken seriously.

17.3 Regulation, including DIRA entry assistance, imposes costs on regulated entities. Against the costs of regulation, there does not appear to be any good justification for retaining open entry. As discussed above, the role of open entry in ensuring that we price our milk efficiently has been replaced by the milk price regime and TAF, which are more effective than open entry as they rely on statutory obligations and regulatory oversight rather than incentives. In addition, there is now robust competition in the dairy sector with several large and well-established processors exerting significant competitive pressure in almost all regions. The “catch-22” that could have impaired independent processor entry in 2001 is no longer a concern. While DIRA has worked well at facilitating contestability in the dairy sector, it is time to reset our regulatory framework to enable the industry to continue to prosper.

17.4 It is also worth noting that even with the removal of open entry, independent processors would continue to have regulatory support to secure milk supply, through raw milk entitlements (although in our view, this should be limited to

smaller processors and those supplying the domestic market), open exit (subject to a market share threshold being met) and other safeguard provisions. We also support retention of the statutory milk price regime.

18	*Do you consider that large dairy processors should continue to be eligible to purchase regulated milk from Fonterra under the Raw Milk Regulations or not? Please provide detailed comment in support of your views.*

18.1 No – there is now a number of established large processors in the market, and the "leg-up" under the Raw Milk Regulations is no longer required for these processors.

18.2 Removing raw milk entitlements for large export-focused processors would ensure regulatory support is targeted to those smaller independent processors who need a leg up and to ensuring competition in domestic consumer markets. It would also enable development of the factory gate market, and longer term sustainability of the dairy sector.

18.3 We note MPI's preliminary analysis (at p31) that large New Zealand-based dairy processors are not necessarily our closest competitors in export markets, and are likely to provide a net gain for New Zealand, although the basis for this analysis is unclear. We query whether New Zealand sees the full benefits of or returns from exports by large foreign-owned independent processors. There are also real and significant risks to the New Zealand industry, such as overcapacity, while the profits are being made offshore by the parent companies.

18.4 We do agree that some large dairy processors have access to different foreign distribution channels that may not otherwise be available to New Zealand dairy products. However, the evidence of any resultant benefit to New Zealand, NZ Inc. or New Zealand farmers from this is lacking. In contrast, as discussed above in response to Q2, it is important to acknowledge the value of our Co-op as a national champion. We are now in over 100 markets around the world and help to facilitate access to new markets for other New Zealand companies and build the NZ Inc. brand.

18.5 Previous DIRA reviews have proposed removing entitlements for large export - focused processors. While large processors would no longer benefit from the DIRA entrance pathways, their established capital and demonstrated ability to attract suppliers will mitigate any risk to competition. Already, some large processors have entered the market without the need for supplies of regulated raw milk as they can source this directly from farmers (MPI Discussion Document: Proposed changes to the Dairy Industry Restructuring Act 2001 and Dairy Industry Restructuring (Raw Milk) Regulations 2012 (May 2016) at 13). Any additional costs to new entrants can be transferred to consumers in export markets and, to a lesser extent, in domestic markets (at 14).

18.6 The Raw Milk Regulations have prevented development of a functioning factory gate market, because DIRA requires us to sell raw milk at the farm gate milk price. However this does not account for costs incurred by our Co-op in terms of farmer support (including environmental and sustainability support) or milk quality programmes. As a result, buying raw milk at the farm gate milk price is effectively lower cost than what it would be for a competitor to operate their own milk supply.

18.7 NERA addresses MPI's assertion regarding the high opportunity cost for independent processors supplying the factory gate market (p79). NERA notes, correctly, that there is no relevant distinction between the business models of independent processors and our Co-op. The difference is that current regulations

require us to sell raw milk below our opportunity cost, which means that independent processors who may wish to compete in the factory gate market would be crowded out by regulated milk (NERA, at [77]–[89], the Compass Lexecon Report, p27). Removing the requirement on our Co-op to supply raw milk to large independent processors would remove a key barrier to developing a competitive factory gate market.

18.8 In our view, entitlements to raw milk should be removed for large export-focused processors. We would define a large processor as (i) a processor that sources 30m litres of its own raw milk, or (ii) a processor with the capacity to process more than 30m litres/year, which exports 20% or more of its production volume. The second limb is important as [redacted] does not currently process raw milk or have its own supply. It may choose to never source its own farmers, and could then, under the current regime, take and export raw milk from our Co-op in perpetuity (which it would be processing for export and not the domestic market). In our view, it is not appropriate that this scenario be treated differently from the large export-focused processors that do secure their own milk supply.

18.9 We also support tightening the forecasting requirements in Raw Milk Regulations. As we noted in our 29 June 2018 submission (at [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 our Co-op and unnecessary inefficiencies. This is primarily in the form of opportunity cost to our Co-op 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 us at peak such that we bear the risk of forecasting peak supply. These freedoms are not connected to any countervailing need on the part of independent processors. These and other minor improvements to the Raw Milk Regulations are set out in our response to Q36 below.

19	*Do you consider that greater confidence in the base milk price calculation outcomes could be achieved if additional legislative guidance on the term "practically feasible" were to be provided for in the DIRA? Please provide detailed comment in support of your views.*

19.1 In our view, additional legislative guidance on the term "practically feasible" is not required.

19.2 The Commerce Commission recently released a guidance note *Practical feasibility discussion: Our approach to reviewing Fonterra's Milk Price Manual and base milk price calculation* (August 2017). The note summarises the Commerce Commission's approach to interpreting the term "practically feasible" in section 150A of DIRA. The Commission states:

> Our interpretation is that practical feasibility under s 150A goes further than theoretical feasibility and technical feasibility. Subject to the safe harbours in s 150B and the mandatory requirements in s 150C, practical feasibility includes commercial feasibility in the sense that it must be possible for an efficient processor operating in New Zealand to replicate or achieve the component being assessed.
>
> In our view, there is clear evidence that a notional cost, revenue or other assumption is commercially feasible if it can be demonstrated that an existing plant, or processor, can achieve the revenue, cost or other assumption (e.g. the unit costs achieved at one existing plant, or the gross values achieved in a part of Fonterra's current business).

19.3 This guidance note, together with the Commerce Commission's body of previous decisions under the milk price regime, provide sufficient clarity and certainty around how this term will be interpreted. It is unlikely that amending s 150A would provide greater certainty, and it may in fact create uncertainty if it implies a change in how the Commission has interpreted this provision to date.

19.4 We support transparency and efficiency in the milk price regime. As discussed above, in our view the regime is working well. The milk price regime ensures that our farmers, investors and the market as a whole can have confidence in an efficient base milk price calculation.

19.5 We note that there is no evidence that the base milk price calculation is inefficient or that our milk price is not contestable. Independent processors are able to pay the base milk price. To our knowledge, no independent processor has provided the Commerce Commission evidence of its own costs or sales to refute the practical feasibility of the base milk price.

19.6 We actively engage with the Commerce Commission regarding our milk price calculation. As noted above, we are currently engaging with the Commission regarding the asset beta used in our milk price calculation. This is an example of the milk price monitoring regime working in a robust way, with the Commission openly challenging assumptions and judgements made as a part of our milk price calculation.

19.7 As discussed below in response to Q32, a more useful way to improve transparency regarding milk price in the sector more generally would be to require other processors to provide information regarding their milk price. This would promote greater confidence in the base milk price and support informed decision-making by farmers.

20	*Do you consider that the base milk price should be set by an independent body (e.g. the Commerce Commission?) If so, please provide supporting information.*

20.1 No, there is no compelling reason why the base milk price should be set by an independent body. As discussed above, the current milk price regime is working well and promoting transparency and efficiency in the base milk price calculation (and already involves robust oversight by the Commerce Commission).

20.2 It is not clear what problem this idea is intended to solve. For example, there is no evidence that entry has been deterred by the milk price. Indeed, entry has occurred with full knowledge of the regime.

20.3 Additional price regulation would impose high costs that are not justified. The Commerce Commission has stated that the milk price monitoring regime promotes greater transparency in our milk price setting processes, and greater confidence in the consistency of our base milk price with contestable market outcomes. (See, e.g. the Commission's "2016 Review of the State of Competition in the New Zealand Dairy Industry", at [2.10], and the Commission's most recent milk price manual and base milk price calculation monitoring reports). It also (correctly) did not consider that we would, without the milk price regime, make significant changes to how the milk price is set (at [5.117]).

20.4 Having the price set by an independent body would be an intrusive regulatory intervention, and we agree with MPI that any additional confidence in the base milk price calculation would be unlikely to outweigh the additional costs and risks. Complying with such a regime is likely to be costly for our Co-op as well as materially more costly and resource intensive for the Commerce Commission (by

way of comparison, the levy we currently pay for the Commerce Commission's existing monitoring regime is around $500,000 - $600,000 annually). There is also a risk that it would lead to investment being obstructed, to the long run detriment of farmers and consumers, especially if such investment is necessary to facilitate entry or more competitive conduct in downstream markets. These risks should be given particular consideration given the significance of the base milk price for the New Zealand dairy sector and the economy overall.

20.5 In terms of the perceived benefits, it is not clear to us that a price set by the Commerce Commission would be viewed with more confidence in the market, or become an industry benchmark, as compared with a price set by our Co-op under the milk price regime and scrutinised by the Commission. While the Commission is an expert body, there is still a risk it would not be sufficiently close to the industry to set an appropriate price, or for some other reason its price would be regarded as too high or too low.

21	*Do you agree with our preliminary analysis of the DIRA impact on the domestic consumer dairy markets? Please provide your reasons and information/evidence in support of your views.*

21.1 We agree with MPI that New Zealand consumers are well served by the domestic consumer dairy markets. Domestic consumer dairy markets are highly competitive and support a variety of competing, sustainable business models and strategies. Consumers have access to a variety of dairy products, from basic to premium products, at different price points. This is consistent with Commerce Commission findings, including in its 2011 consideration of whether to initiate a Part 4 inquiry into milk prices (at pp188, 210), and in the 2016 review (at [4.161]-[4.167]).

21.2 We agree that DIRA has supported the development of competition in domestic consumer markets, by enabling the creation and safeguarding the presence of Goodman Fielder and supporting small dairy processors through access to raw milk.

21.3 We support retention of raw milk entitlements for Goodman Fielder, or an equivalent large scale supplier for the domestic market, to ensure a domestic competitor at scale. [redacted] We also support ongoing entitlements for small independent processors, who exert real competitive pressure in the domestic consumer markets.

21.4 However, we do not agree that open entry has been material in enabling competition in domestic consumer markets. Open entry is not the sole, or primary, protection for Goodman Fielder (which relies on raw milk entitlements from our Co-op) or for small, domestically-focused processors (which also tend to access milk under the Raw Milk Regulations, and/or use the 20% rule). Removal of open entry would have no material impact on domestic competition.

22	*Are there any other factors that should be taken into account regarding the domestic consumer dairy markets? Please provide your reasons and information/evidence in support of your views.*

22.1 In 2016, the Commerce Commission found that the competitive dynamics in domestic consumer markets were stable. Despite our Co-op remaining the most significant player, other independent processors were able to and did apply price and quality pressure (at p111). As noted in our previous submission, competition has increased in the downstream domestic market, with the increase of niche players, imports and a new large entrant (Synlait) into the domestic market.

22.2 The Commerce Commission's recent approval of Goodman Fielder's acquisition of Lion's yoghurt business evidences robust and sustainable competition in the domestic consumer market for yoghurt. The Commission approved the acquisition on the basis that:

- Over the past decade the domestic yoghurt industry has been characterised by innovation, particularly in the higher-end (and higher-price) categories as well as Greek yoghurt (at [21]).
- The proposed acquisition would not have, or would not be likely to have, the effect of substantially lessening competition in the market, given (at [155]):
  - strong competition from remaining competitors
  - the threat of entry from new suppliers (in relation to Greek yoghurt), and
  - the role of the supermarkets in exercising countervailing power.

22.3 In our view, similar factors exist in relation to other product categories. For example, there is strong competition for butter (with 7 companies actively competing) and flavoured milk (with 9 competitors). New suppliers, including niche suppliers, are also provide competition in other categories, for example cheese. The number of competitors in fresh milk has even increased recently, with the entry of Synlait. Importantly, supermarkets can and do exercise countervailing power in respect of all consumer product categories.

Chapter 4: Options for change

4.1 Options for the DIRA open entry requirements

23	*Are there any other options for the DIRA open entry requirements that you think should be considered? Please provide sufficient detail when describing any alternative options as well as reasons for considering these.*

23.1 For a summary of our proposals, please refer to the table in Appendix A on p4.

23.2 As discussed below, our preferred option is the full removal of the DIRA open entry requirements (option 4.1.2). This would mean repeal of DIRA sections 73 and 74 as well as section 106 (non-discrimination).

23.3 Repeal of section 73 would include both the obligation to accept supply from new farmers, and the obligation to accept increases in supply from existing farmers. We do not expect this to have a material impact on existing shareholders' ability to increase their supply, in the ordinary course of business. In 2017 and 2018 we received only 5 and 8 such applications, respectively. This is a reflection of the fact that we calculate share requirements based on a rolling three-year average supply.

23.4 As discussed below, in the context of regional expiry, we would also propose a statutory provision requiring our Co-op to continue to accept supply from our existing farmer suppliers in remote locations while open entry remained in place in any region.

23.5 In relation to section 106, the non-discrimination rule is closely linked to open entry and where open entry is no longer considered justified then the non-discrimination rule also does not make sense. 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. But altering terms based on the value of the supply to Fonterra, where the relevant farmers' circumstances are otherwise the same as farmers who are on standard terms, would contravene the non-discrimination rule.

23.6 If MPI is not prepared to recommend removal of open entry (and non-discrimination), we propose an alternative second preference option that removes open entry (and non-discrimination) in any region where our market share drops below 75%, and nationwide exceptions to open entry:

- for new conversions;
- in respect of applications from new and existing farmers if we consider their supply is unlikely to comply with our terms of supply (option 4.1.3 – discussed further below in response to Q24).

23.7 Although removal of open entry (and non-discrimination) is our priority, we also consider it would be appropriate to remove open exit (the right to withdraw and the 160km rule, sections 97 and 107(1)) in any region where our Co-op's market share falls below 75%.

Regional expiry

Our proposal

23.8 As noted above, our co-operative structure means that competition in one region benefits farmers nationally (because we respond on a national basis to regional competition) (NERA, [61]).

23.9 Nevertheless, while robust competition has developed in some regions, we acknowledge that MPI may wish to recommend open entry remains in those regions where limited competition has developed to date. As such, if MPI is not prepared to recommend the repeal of open entry at this stage, we propose expiry of the obligation to accept supply and the non-discrimination requirement in regions where our market share drops below 75%.

23.10 Although expiry of open entry is our priority, in our view regional expiry would justifiably include open exit (the right to withdraw and the 160km rule) as explained below.

23.11 It is important to note that significant DIRA protections would remain, meaning there would be safeguards for competition even in regions where open entry and exit expired. These include the milk price regime, TAF, the Raw Milk Regulations (on the revised basis proposed below), the 20% rule and sale of vats.

Our proposed market share threshold is appropriate

23.12 In our view, market share thresholds are a workable proxy for levels of competition. They were previously used in the legislation as a workable proxy for the competitive landscape. In its Regulatory Impact Statement “Dairy Industry Restructuring (Raw Milk) Regulations – options for amendments to ensure objectives are met” (August 2012), MPI attributed Fonterra’s dominance to its high market share. “Workable competition” was said to occur when this dominance, i.e. market share, has reduced (p3).

23.13 Our proposal for a market share threshold reflects existing dynamics in regional markets. In our view, we are subject to sustainable and robust competition in all regions where our share is around or lower than 85%. In these regions, independent processors exert substantial competitive pressure and farmers have real choice in terms of who they supply to, meaning we are subject to genuine constraint. Our proposed 75% is lower than this and lower than the 80% which previously applied on an island by island basis. Given this and the smaller regional council regions, MPI would have significant assurance that the protections of open entry are no longer required. See further the discussion in response to Q4 above.

23.14 In terms of open exit, MPI emphasises in the Discussion Document the importance of farmers’ ability to switch away from our Co-op – we agree, and we have not proposed the immediate, wholesale removal of open exit. Open exit constrains our ability to present a range of offers to existing and potential suppliers and make more efficient planning decisions. While we have some flexibility in our supply contracts to operate and compete within the existing constraints, as competition develops, the costs outweigh the benefits and the open exit protections should expire. It would be appropriate to repeal open entry once sustainable competition develops to a point that MPI could be comfortable we would be constrained by competition not to “lock in” our suppliers anti-competitively. Also, and importantly, section 36 of the Commerce Act has a large and well-established body of precedent to prevent misuses of market power, and can be relied upon as a powerful backstop. As noted in response to Q5, while section 36 is currently

slated for reform, a purpose of that reform is to tighten rather than loosen the rules for entities with substantial market power.

23.15 The proposed regional market share thresholds provide the comfort that competition has developed to a meaningful and sustainable level in a particular region, and the open exit protections should expire in that region.

Regional council boundaries appropriately define a "region"

23.16 We propose using regional council boundaries as the basis for regional expiry of open entry and exit. Regional council boundaries are well known, and align with environmental regulatory boundaries. Under the previous 80% threshold, DIRA required our Co-op and independent processors to provide market share data in order for the Minister to determine whether the threshold had been met in either the North or South Islands (see DIRA, section 147 (now repealed)). A similar information disclosure requirement could be put in place to support regional expiry of open entry and exit. DairyNZ also collects nationwide market share data and publishes geographical breakdowns, which could assist.

23.17 Regional council boundaries are also a relatively accurate proxy for competition as shown in the maps attached at the end of this Appendix.

23.18 An alternative would be to use a radius from independent processor sites. While this would potentially more accurately reflect areas where farmers have real choice in who they supply, it would be much more difficult to implement and we do not recommend this.

23.19 Our estimates from DairyNZ data suggest we are below the proposed market share threshold in Greater Auckland (%) and Westland (%) regions, and are close to the threshold in Canterbury (%), Horizons (Manawatu-Whanganui) (%) and Southland (%). A regional approach would provide assurance that the Co-op is still bound by open entry and exit in areas where competition is not yet as well developed.

Further details

23.20 To protect outlier farmers, we propose a statutory provision which would require our Co-op to continue to collect milk from our outlier farmer suppliers (including in succession situations where the farm changes hands) while open entry remains in other regions. The new rules would apply only if the farmer ceased supplying our Co-op. For farms that cross regional council boundaries, the location of the farm dairy shed should determine the applicable regional council.

23.21 As this approach would be more complex than straight removal of open entry, we have thought carefully about the potential for unintended consequences. Removal of open entry (potentially, along with open exit) could impact land values in the region, although in our view this is unlikely to be material – particularly with a protection for outlier farms. It also avoids North Island / South Island issues because the determination would be based on competition within a regional council area. For example, Tasman/Marlborough and Northland would likely remain subject to open entry until the provisions were removed entirely. Regional expiry is unlikely to impact viability of independent processors in regions where it occurs (because those are the regions with robust and sustainable competitors). In fact, independent processors may behave differently – for example, they might enter other regions where the open entry protections remain in place, which would be a positive consequence for competition in the industry.

Open entry for new conversions

23.22 In our view open entry in relation to new conversions should be thought of separately from open entry for existing dairy farms:

- Open entry creates an inefficient incentive to enter dairying (due to the guaranteed customer for milk), which is distortionary and potentially environmentally damaging.
- It has no upside for competition; open entry is about free entry to and exit from our Co-op, not about encouraging more dairying for its own sake. NERA “Assessment of Competition in Raw Milk Markets and Costs and Benefits of the DIRA provisions” 17 August 2015 pp 40 – 43.
- The Commerce Commission noted that open entry for new conversions may impose costs on our Co-op without providing significant competition benefits (“2016 Review of the State of Competition in the New Zealand Dairy Industry, p21).
- The Commerce Commission also considered that open entry for new conversions could contribute to the risk of asset stranding (p160). The government accepted these critiques of open entry for new conversions, and proposed section 29 of the Dairy Industry Restructuring Amendment Bill 2017 (which was withdrawn and superseded by the current review), to give Fonterra discretion whether to accept supply from new conversions.

23.23 Accordingly, even if MPI does not consider repeal of open entry (entirely or by region), open entry should be repealed in respect of new conversions at a minimum.

24	*What costs and benefits would each of the options for the DIRA open entry requirements create for your business? Please provide quantitative information if possible.*

4.1.1 Status quo: retain the existing open entry and exit requirements

24.1 We do not support this option. We agree with MPI that it would not minimise the unintended consequences of DIRA in preventing our Co-op from effectively managing reputational risk. It is no longer required and creates unnecessary costs for our Co-op and the industry at large that far outweigh any benefits now that sustainable competition exists in the farm gate market.

24.2 The costs of open entry to our Co-op are material, and outweigh any residual benefit:

- We discuss the costs to our Co-op, in terms of our commercial and investment strategy, in response to Q5.
- The potential costs associated with over-capacity in the market and lower returns for farmers are discussed in response to Q8.
- We discuss environmental costs associated with open entry in response to Q14.

24.3 In addition, in our view, open entry unnecessarily perpetuates long-term dependence on regulation, which imposes cost on our industry and the New Zealand economy. Removal of open entry is necessary if we want a sustainable dairy industry for the future. Removing open entry would remove cost by deterring inefficient investment decisions and promoting sustainable competition.

24.4 Our view is that the benefits of open entry have significantly decreased:

- As NERA outlines, the key problems that open entry was designed to solve (ensuring independent processors could attract supply and ensuring efficient pricing) are no longer an issue or are otherwise managed (see in particular sections 2 and 4). There are now 10 dairy companies operating and competing in the New Zealand dairy market. Independent processors are able to attract their own supply, or access supply on the factory gate market on commercial terms. Furthermore, under our proposals smaller domestic processors will retain the "leg up" of the Raw Milk Regulations.
- As described in Q1 above, the milk price regime and TAF ensure an efficient base milk price.

24.5 Without open entry, we would be in a position to make a greater contribution to New Zealand. The ability to manage our volume in response to demand and our commercial strategy will allow us to invest in value added production and achieve higher returns for our stakeholders.

24.6 It is important to note that as competition develops the costs of the protections of open exit will also supersede the benefits. Open exit constrains our Co-op's ability to present a range of offers to existing and potential suppliers and make more efficient planning decisions. And where we face vigorous and sustainable competition that constraint, as well as the Commerce Act, can be relied on to ensure we offer competitive terms to our suppliers (including in relation to rights to exit); the costs of open exit at that point would outweigh the benefits and consideration should be given to its repeal.

4.1.2 Repeal the open entry requirements

24.7 We support repeal of the open entry requirements for the reasons given above. This is our preferred option. As noted above, several other stakeholders also support removal of the open entry requirements, at least in part, including other dairy processors (Synlait p4 "Initial Comments on the Terms of Reference for the DIRA review" July 2018), and Westland (p26 "Initial Submission on DIRA Review", June 2018) and Environment Canterbury ("Environment Canterbury Interest in the DIRA Review" July 2018). We summarise the costs and benefits of open entry immediately above.

Regional expiry and expiry for new conversions

24.8 Regional expiry of open entry and non-discrimination would not result in the benefits of open entry in other regions outweighing the costs, but it would at least address the costs in certain geographic areas. The same applies for open exit.

24.9 In respect of new conversions, the proposed exception would remove the costs of open entry and non-discrimination for a type of potential supplier in respect of which there is no competition benefit (see the response to Q23 above).

4.1.3 Amend the DIRA open entry requirements to allow Fonterra to decline to accept applications from new and existing farmers if Fonterra considers their supply is unlikely to comply with Fonterra's terms of supply.

24.10 We agree that open entry creates reputational risk for our Co-op. As noted above, our preferred option is to repeal open entry. Our second preference is to remove open entry for new conversions and in regions where our Co-op's market share is below 75%, along with this option 4.1.3.

24.11 Option 4.1.3 alone would not materially reduce the costs of open entry, and for the reasons set out above in our view the benefits are no longer material. While it would be an improvement on the status quo, and would give rise to net benefits, it will increase administrative burden (cost).

24.12 In terms of costs, exceptions that involve material discretion (unlike the simplicity of an exception regarding conversions, or a regional market share threshold) can be difficult and costly to manage and monitor. Exceptions can also be confusing and difficult to implement and lead to disputes – in this case by farmers who may be declined entry under the exception. This in turn would lead to costly review processes and slow, administratively burdensome decision making. These costs would need to be added to those identified above.

24.13 At present, we are able to decline to *collect* milk if a farmer is in breach of our supply terms. As a co-operative, we prefer to work closely with our farmer suppliers to ensure compliance, and non-collection notices are only issued as a last resort. This is because the implications of a non-collect notice are significant for farmers and can have animal welfare implications and environmental issues (including the potential dumping of milk), and can lead to disputes over whether we have properly exercised our discretion to decline collection. While we back ourselves to make good decisions and exercise our discretion reasonably, there is little downside for a farmer in challenging that decision, and we know from experience that disputes will arise and resolution can be costly and time consuming.

24.14 Removing open entry entirely is the best way to achieve the objectives of this option – without the cost or confusion. If MPI is not prepared to recommend this, then as outlined earlier, we would propose a combination of this option, along with an exception where we consider a farmer would be unable to comply with our terms of supply, and where our market share in a region drops below 75% – see further the table in Appendix A on p4.

25	*How well do you think each of the options for the DIRA open entry requirements would perform against the principles of good regulatory practice of promoting certainty and predictability of regulatory outcomes, transparency, cost-effectiveness and timeliness of regulatory processes?*

4.1.1 Status quo: retain the existing open entry and exit requirements

25.1 The status quo (option 4.1.1) is no longer required.

25.2 While open entry and exit has provided for certain and predictable outcomes, it is no longer cost effective. It creates unnecessary costs for our Co-op and the industry at large that far outweigh any benefits now that sustainable competition exists in the farm gate market.

4.1.2 Repeal the DIRA open entry requirements

25.3 Repeal of open entry (option 4.1.2) would remove unnecessary regulation, and allow our Co-op to better manage our volumes. It would provide certainty and predictability in regulatory outcomes. It would also improve cost-effectiveness for our Co-op and the industry as a whole.

25.4 If MPI is not prepared to recommend the repeal of open entry, then removal of open entry by region would have a similar impact, albeit incrementally. We consider removal of open entry by region would be capable of being implemented in a way that preserves certainty and predictability of regulatory outcomes,

transparency, cost-effectiveness and timeliness of regulatory processes, in particular by using regional council boundaries. Regional council boundaries are well known and established, providing certainty, and avoiding the cost and uncertainty that would arise out of having to establish new boundaries.

25.5 For the reasons given in response to Q24 above we also consider regional council boundaries are a sufficiently accurate proxy for the boundaries of regional competition, data collection on a regional council basis is administratively easy, and regional council boundaries align with environmental regulation. All of these elements contribute to the compliance of this proposal with principles of good regulatory practice.

4.1.3 Amend the DIRA open entry requirements to allow Fonterra to decline to accept applications from new and existing farmers if Fonterra considers their supply is unlikely to comply with Fonterra's terms of supply.

25.6 Option 4.1.3 would go a small way to removing unnecessary regulatory constraints on our Co-op. However, it would create an additional administrative cost burden. It would also provide less certainty and predictability than full repeal of open entry, as it would inherently involve the exercise of discretion. Would-be suppliers would not automatically or immediately know whether they would qualify for entry, which means this option would be less attractive in terms of the principles of good regulatory practice than the full removal of open entry, or removal on a regional council basis.

26	*What is your preferred option for the DIRA open entry requirements? Please provide your reasons and information/evidence in support of your views?*

26.1 See our proposals in the table in Appendix A on p4.

26.2 Our preference is for open entry and non-discrimination to be repealed immediately (option 4.1.2).

26.3 However, if MPI is not willing to recommend this proposal, our second preference is repeal of open entry, and the non-discrimination rule in any region where our Co-op's market share drops below 75%, along with exceptions to open entry and the non-discrimination rule elsewhere:

- for new conversions; and
- in respect of applications from new and existing farmers if we consider their supply is unlikely to comply with our terms of supply (option 4.1.3).

26.4 If this were not considered acceptable, then we would advocate exceptions to open entry and non-discrimination:

- for new conversions; and
- in respect of applications from new and existing farmers if we consider their supply is unlikely to comply with our terms of supply (option 4.1.3).

26.5 As noted above, our view is that open exit (the right to withdraw and 160km rule)) should not be repealed wholesale, but should expire in any regional council region where our-Co-op's market share falls below (75%).

4.2 Options for access to regulated milk for large dairy processors (except Goodman Fielder)

27	*Are there any other options for access to regulated milk for large dairy processors that you think should be considered? Please provide sufficient detail when describing any alternative options as well as reasons for considering these.*

27.1 No – we agree with MPI's preliminary analysis.

28	*Do you consider that the proposed 30 million litres threshold is too high or too low? If so, what would you consider the right threshold to be, and why?*

28.1 The 30m litre threshold is a workable proxy for large processors; it is a level that has worked well under the current own-supply limits. The 30m litre threshold sits between what known small processors, and what known large processors, take or have taken under the Raw Milk Regulations as reported annually to MPI.

28.2 However, the threshold (including for Goodman Fielder) should be 30m litres of own supply *or*, where the processor exports 20% or more of its production volume, 30m litres of processing capacity. This is because:

- As noted above, the definition should capture large processors who have the capacity to process large volumes for export, and who do export in significant quantities. This is necessary to ensure that the Raw Milk Regulations do not incentivise a deliberate business strategy involving long term regulatory dependence (i.e. avoiding sourcing own supply in order to take advantage of the regulatory protection). It could also help to facilitate development of the factory gate market, by reducing dependence on regulatory support (see NERA, section 5, discussed further below).
- In a situation where a processor holds a large amount of processing capacity, but that capacity is used for domestic supply, then we propose that processor continue to be eligible to receive regulated raw milk. This would allow a domestic processor to enter, at scale, without first establishing its own supply, and is consistent with the Raw Milk Regulations' objective of safeguarding competition in domestic markets.

29	*What costs and benefits would each of the options for access to regulated milk for large dairy processors create for your business? Please provide quantitative information if possible.*

4.2.1 Status quo: retain the existing eligibility provisions for regulated milk in the Raw Milk Regulations

29.1 We agree with MPI that this option would not be effective in meeting the objective of ensuring that access to regulated milk from our Co-op is targeted to dairy processors who need it to be able to enter and compete in New Zealand consumer dairy markets. Current regulations mean that large export-focused processors can obtain DIRA milk for at least three years (and longer if they do not establish 30m litres of own supply). In addition, we discuss the role of export-focused processors in the dairy sector, in response to Q18.

29.2 This is a cost to our Co-op (and to New Zealand farmers) as our Co-op does not make any return on raw milk supplied under the Raw Milk Regulations. Large independent processors are able to access raw milk below its true cost (as they

generally benefit from a flatter supply curve and do not incur the additional costs of running a milk sourcing operation) and with flexibility and security around volume. Our Co-op bears the risks of, for example, weather implications and biosecurity threats on production (both increases and decreases) which can be material in terms of our ability to use raw milk for our own purposes or meet other contractual obligations.

29.3 As noted above, eligibility for raw milk under the Raw Milk Regulations also carries a cost in terms of encouraging long-term regulatory dependence. Furthermore, it impacts on capacity requirements, crowding out value added investment, as well as development of the factory gate market. As NERA notes, independent processors could compete with our Co-op in the factory gate market if they were incentivised to do so and were not crowded out by regulated milk (at [82]). NERA goes on to explain (at [86]) that, to the degree the price of regulated milk is less than our opportunity cost, then:

a. our Co-op investors are subsidising independent processor entry – which, as well as being allocatively inefficient, could also reduce our ability to invest in profitable opportunities;

b. this could lead to inefficient independent processor entry; and

c. there could be crowding out of development of the factory gate market.

29.4 In our view, there are no material countervailing benefits of large export-focused processors' eligibility under the Raw Milk Regulations. As set out above, competition is well-established and sustainable. Removal of eligibility under the Raw Milk Regulations would not compromise that. Any new processors looking to enter New Zealand should not be relying on access to regulated milk in order to do so. Those processors ought to be incentivised to be sustainable regardless of access to regulated milk.

4.2.2 Amend the eligibility provisions in the raw milk regulations to exclude large dairy processors

29.5 We support this option. There are now sufficient numbers of established large processors who are able to access and sustain their own supply that this element of the Raw Milk Regulations does not bring any material benefit. It is open to large processors to contract with our Co-op (or others) on commercial terms for raw milk. The costs and benefits of this option are as outlined in our response to option 4.2.1 above.

30	*How well do you think each of the options for access to regulated milk for large dairy processors would perform against the principles of good regulatory practice of promoting certainty and predictability of regulatory outcomes, transparency, cost-effectiveness and timeliness of regulatory processes?*

30.1 Excluding large processors from eligibility under the Raw Milk Regulations would reduce regulatory dependency and remove a material regulatory cost for our Co-op and for New Zealand. It would also promote certainty and predictability in the regulatory regime, because it would signal a clearly-defined and unambiguous pathway out of the regime for growing processors.

31	*Do you have a preferred option for access to regulated milk for large dairy processors? Please provide your reasons and information/evidence in support of your views.*

31.1 See our proposals in the table in Appendix A on p4. Our preferred option is 4.2.2: amend the eligibility provisions in the Raw Milk Regulations to exclude large dairy processors. As above, our proposed definition of large dairy processor is a processor with 30m litres per year of its own supply, *or*, where the processor exports 20% or more of its production volume, 30m litres per year of processing capacity.

4.3 Options for the base milk price calculation

32	*Are there any other options for the base milk price calculation that you think should be considered? Please provide sufficient detail when describing any alternative options as well as reasons for considering these.*

32.1 We support an efficient and transparent milk price, for our Co-op, our farmers and the wider industry. But at this stage, we consider that the milk price regime is working well and should be maintained.

32.2 In addition, we propose a requirement on other processors to provide information regarding their milk price, to improve transparency throughout the industry (rather than only by our Co-op). Specifically, we support all processors being required to publish the average price they pay to farmers, the key parameters of their milk price and examples showing the payout for different parameters. This would ensure that all farmers are able to make more informed choices about what they are likely to receive for their milk and who to supply. In our experience, some farmers have not received the amount they thought they would receive from some independent processors.

32.3 We have noted above the comparison with the Australian market and the difficulties associated with information asymmetry (in our response to Q2 and in particular paragraph 2.37 and following); in our view, greater transparency would enhance competition in the market.

32.4 The Raw Milk Regulations already require independent processors to provide information regarding milk solids collected (Raw Milk Regulations, regulation 23A ; DIRA, section 115(1)(f)). Previously, independent processors were required to provide market share data under s 147 (now repealed). Section 116 of DIRA also contains a general power to make regulations requiring our Co-op to disclose information. To facilitate greater transparency in the sector, DIRA could be amended to include a power to make regulations requiring other milk processors to provide information regarding their milk price. This would be consistent with the purpose of DIRA to promote contestability in New Zealand dairy markets, by reducing the asymmetry of information between farmers and independent processors. Similar regulation making powers are contained in the Gas Act 1992 (section 43G). The Electricity Authority has similar information disclosure powers under the Electricity Industry Act 2010 (section 46).

33	*What costs and benefits would each of the options for the base milk price calculation create for your business? Please provide quantitative information if possible.*

4.3.1 Status quo: retain the existing DIRA provisions for our base milk price calculation and Commerce Commission monitoring

33.1 This is our preferred option. The milk price regime is working well and should be retained in its current form. Given the level of competition in the market and independent processors' demonstrated ability to compete effectively and sustainably, there does not appear to be any basis for a lack of confidence in the current milk price regime.

33.2 The milk price regime is enshrined in DIRA and is a form of statutory price regulation. We describe the statutory regime in detail in response to Q12 above. The milk price regime means that we cannot manipulate the base milk price for strategic or commercial reasons.

33.3 We also consider that, in the absence of DIRA regulation, we would not make material changes to the way we set our base milk price (and this is consistent with Commerce Commission findings in its "2016 Review of the State of Competition in the New Zealand Dairy Industry" at [X35]). This suggests that the costs of the regulation outweigh any benefits.

33.4 However, the milk price regime supports transparency and efficiency in the farm gate milk market. It ensures that farmers and other processors have access to our pricing information and can make informed decisions. Through the statutory monitoring regime, the Commerce Commission has full access to our Co-op's underlying data and pricing information. That data is assessed by experts engaged by both us and the Commission.

33.5 Given other aspects of the regime are consistent with the practice our Co-op would adopt regardless of the regime, the key costs of the regime arise out of the administrative burden of complying with the Commerce Commission's oversight processes. The levy we pay for the Commerce Commission's statutory monitoring is around $500,000 – $600,000 annually. In our view, these costs are outweighed by the benefits in terms of providing additional transparency, and comfort regarding the efficiency of the milk price (as well as an effective regulatory backstop should we attempt to game the regime).

4.3.2 Amend the DIRA to provide additional statutory guidance on the meaning of the term "practically feasible"

33.6 We do not support this option. Implementing this option would result in the increased cost of regulation but no corresponding benefit.

33.7 In our view, there is sufficient certainty in how the Commerce Commission interprets the term "practically feasible". The Commission's August 2017 guidance note, discussed in response to Q19 above, explains in detail the Commission's approach to interpreting this term. It is unlikely that legislation would provide further clarity. It may also have the perverse effect of creating additional uncertainty (cost), to the extent it implies a change in how the Commerce Commission has interpreted the term to date.

33.8 Since this option would not be likely to enhance the clarity of the "practically feasible" it would not result in any material benefit. Further, as noted above, if the option is implemented then the Commerce Commission and our Co-op may be

required to make additional effort (i.e. incur cost) to re-settle the interpretation of the term.

4.3.3 Amend the DIRA to give the Commerce Commission statutory power to set the base milk price for the dairy industry

33.9 We do not support this option.

33.10 There is no evidence to suggest that the existing milk price regime is broken. For the reasons given above, the current regime supports transparency and efficiency. Commerce Commission oversight provides an effective check on our compliance with the milk price regime.

33.11 Implementing this option would result in the increased cost of regulation but no corresponding benefit. Accordingly, on a cost-benefit basis it is not justified.

33.12 The market is becoming more competitive, not less competitive. In this context, a more highly regulated model of price control would be costly, time consuming and inefficient. We note that a more highly regulated model was also rejected at the time DIRA was implemented. It would be counter-productive to move to more regulation now, when the aim of DIRA has always been to facilitate a move to a less regulated environment.

34	*How well do you think each of these options for the base milk price calculation would perform against the principles of good regulatory practice of promoting certainty and predictability of regulatory outcomes, transparency, cost-effectiveness and timeliness of regulatory processes?*

4.3.1 Status quo: retain the existing DIRA provisions for our base milk price calculation and Commerce Commission monitoring

34.1 Given the level of competition in the market and independent processors' demonstrated ability to compete effectively and sustainably, there does not appear to be any basis for a lack of confidence in the current milk price regime. The milk price regime is working well, and meeting the objective of ensuring the base milk price provides an incentive to our Co-op to operate efficiently and provide for contestability in the farm gate market. The milk price is well understood by the Commerce Commission, Fonterra and stakeholders and its outcomes are predictable.

34.2 As noted above, the regime also promotes transparency. The statutory framework for setting the base milk price, and in particular the Commerce Commission's monitoring role, ensure transparency in the way we set the base milk price. The Commerce Commission has noted, in its 2016 "Review of the State of Competition in the New Zealand Dairy Industry", the increased transparency their monitoring has delivered (at [4.74]):

> We consider that the increased transparency of information and the additional independent assurance provided by our reviews under the milk price regime may help reduce barriers to entry by IPs, by providing some disincentive for Fonterra to set the farm gate price of milk too high, and providing IPs and other stakeholders with a better understanding of and confidence in how Fonterra sets its milk price.

34.3 The Commerce Commission runs an open and transparent process, although it is not required by the legislation to do so - DIRA only requires the Commission to consult with us. An open and transparent process results in a trade-off for the cost-effectiveness and timeliness of the regulatory processes, but on balance we

would expect most stakeholders to agree this is worthwhile due to the importance of allowing submissions and debate in the process. The Commerce Commission is experienced at managing such input.

34.4 As noted above, we propose that independent processors also be required to publish the average price they pay to farmers, the key parameters of their milk price and examples showing the payout that would be received for different parameters, to improve transparency throughout the industry. We believe this would enhance competition in the market via increased transparency and be good for farmers who would be able to make more informed choices about who to supply. This proposal is detailed in response to Q32 above.

34.5 For completeness, we note that two independent processors have raised concerns regarding the process for setting the base milk price. OCD submits that the process for the setting the farm gate milk price is flawed, and the monitoring regime overseeing that process is ineffective. It submits that, as a result, the farm gate milk price does not represent the most accurate approximation of a market-derived price. Synlait submits that the farm gate milk price is too high, due in part to the fact that there are shortcomings in the method for calculation, which largely come from lack of transparency and oversight in how we set the milk price. OCD also supports establishing a new Dairy Authority to either approve the Milk Price Manual and other inputs used by our Co-op, or determine the price-setting methodology itself.

34.6 We believe these concerns are unfounded. While we agree that an efficient and transparent milk price is important for our Co-op, our farmers and the wider industry, we consider that the current regime is working well and is sufficiently transparent. We note that for the majority of independent processors (that are not co-operatives), any reduction in milk price is a direct benefit to their non-farmer shareholders.

34.7 It is worth nothing that independent processors have made similar arguments during the Commerce Commission's milk price monitoring processes for some time, which, for good and sound reasons, the Commission does not accept. In its Review of Fonterra's 2017/18 Base Milk Price Calculation, the Commission noted (at [B180]):

> We acknowledge the continued investment and growing share of milk production which is now processed by independent processors. We agree that this suggests that the overall milk price is set at a level which provides for contestability.

34.8 As advised to MPI, OCD has recently commenced a claim for judicial review of certain decisions made by the Commerce Commission in its review of our milk price calculation for the 2017/2018 season under the DIRA milk price regime. The claims are generally focused on issues on which OCD has submitted in the course of the 2017/2018 milk price review and earlier milk price reviews by the Commission. The Commission is actively defending these claims. We consider that OCD claims have little merit and are joining the proceedings to defend the decisions of the Commission that are being challenged. OCD's ability to do this is another element of the checks and transparency in the regime.

4.3.2 Amend the DIRA to provide additional statutory guidance on the meaning of the term "practically feasible"

34.9 In our view there is already a satisfactory degree of regulatory certainty on this point, and in fact adopting new statutory language would likely lead to increased uncertainty. Furthermore, the current statutory language and its interpretation

results in predictable and sound outcomes – as noted above, there is no evidence the milk price regime has led to detrimental processes or outcomes.

34.10 Additional statutory language would also not improve the transparency, cost-effectiveness or timeliness of the regulatory processes that are a part of the milk price regime; and these do not appear to be goals of this option.

4.3.3 Amend the DIRA to give the Commerce Commission statutory power to set the base milk price for the dairy industry

34.11 This option would materially reduce the timeliness and cost-effectiveness of the regulatory process, given the existing process is satisfactory and this option would be much more costly and time consuming.

34.12 The Commerce Commission is an independent body with pricing expertise - but there does not appear to be any suggestion the current regime fails to achieve certainty and predictability in terms of the milk price it produces. It is also not clear that having the Commission set the milk price would improve certainty and predictability.

35	*Do you have a preferred option for the base milk price calculation? Please provide your reasons and information/evidence in support of your views.*

35.1 See our proposals in the table in Appendix A on p4.

35.2 Our preferred option is 4.3.1: status quo: retain the existing DIRA provisions for our base milk price calculation and Commerce Commission monitoring. In addition, we support all processors being required to publish the average price they pay to farmers, the key parameters of their milk price and examples showing the payout that would be received for different parameters.

4.4 Options for access to regulated milk for Goodman Fielder and smaller processors

36	*Are there any options for access to regulated milk for Goodman Fielder and smaller processors that you think should be considered? Please provide sufficient detail when describing any alternative options as well as reasons for considering these.*

36.1 See our proposals in the table in Appendix A on p4.

37.1 We are happy to support ongoing access to regulated milk for Goodman Fielder and smaller processors (as it is important that we protect and retain robust competition in domestic consumer markets). We consider the current limits to be working effectively.

36.2 There are, in our view, some minor improvements that could be made, first, to prevent independent processors from “milk component harvesting” i.e. taking their entitlement to raw milk to obtain certain components and then on-selling the rest (e.g. taking the cream for ice-cream to be exported, and on-selling skim milk, or taking the skim for infant formula and selling the cream). This should also apply to Goodman Fielder. The intent of the Raw Milk Regulations is to support domestic consumer markets, not to enable processors to broker milk components – if they do that, they are profiting from a cost to Fonterra, and this is not what was intended. It should be the case that raw milk supplied under the Raw Milk Regulations must be processed into finished consumer or foodservice products.

36.3 Secondly, we propose improvements to the Raw Milk Regulations in relation to forecasting (currently independent processors forecast on a Thursday for delivery the following Sunday-Saturday) and certain other matters.

36.4 In particular:

- The tolerances in Regulations 10(3), 21(1) and 21(2) 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. We are generally able to cope with these during "shoulder" months but face significant costs and challenges dealing with the potential variability of demand during "peak" months. We agreed with MPI's proposals to address this in the previous DIRA review by limiting the variation of: (a) processors' one week supply estimates to 20% more or less than the earlier three-month estimate; and (b) contracted volume to between 90% and 110% of the one week supply estimates.
- Currently in Regulation 11(2)(a), independent processors must give 18 months' notice of requiring winter milk supply above 20,000 litres per day. A period of 18 months can be insufficient for our Co-op to source new winter milk 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), although the amount of any winter milk premium can impact this. We recommend the notice period is extended to 24 months.
- Regulation 11(3) provides a large (40%) tolerance for winter milk supply quantity estimates. We need to separately contract winter milk from our suppliers and pay them a winter milk premium. If independent processors do not purchase the winter milk they have forecast to purchase we still have to pay the premium to our suppliers. Although we are able to process the milk we do not recover the winter milk premium. Accordingly, the tolerance for winter milk supply quantity estimates should be reduced to 10%.
- Regulation 21(5) – for the same reasons, we should be able to impose a take or pay obligation in respect of the winter milk premium component of the regulated price. While we can process the winter milk not purchased into other products, we would not be able to recover the winter milk premium when an independent process does not take what they forecast to take on short notice.

36.5 We also note 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. While we can obtain a winter milk premium, which reflects the cost to Fonterra of sourcing that milk, the premium does not justify independent processors purchasing unlimited volumes of winter milk under Regulation 6.

36.6 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. 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 us 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 30m litres of its own supply in the three preceding seasons. However this would no longer be a

concern if the changes to the eligibility criteria set out in response to Q28 and Q31 are implemented.

37	*What costs and benefits would each of the options for access to regulated milk for Goodman Fielder and smaller processors create for your business? Please provide quantitative information if possible.*

4.4.1 Status quo: retain the existing provisions in the raw milk regulations as they apply to Goodman Fielder and smaller processors.

37.2 It is important that we protect and retain robust competition in domestic consumer markets. New Zealanders place value on access to high quality and affordable dairy products. We support a conservative approach to policy change and risk in relation to those markets.

37.3 We acknowledge the importance of Goodman Fielder as a viable large-scale competitor. We have consistently supported retaining Goodman Fielder's regulated supply.

37.4

37.5 MPI notes some uncertainty around the arrangements between our Co-op and Goodman Fielder post-2021, when the current contract expires. Negotiations

37.6

37.7

37.8 There is a cost to this regulation regulatory protection of Goodman Fielder's supply does provide an important benefit in terms of safeguarding confidence in the competitiveness of domestic dairy supply and on that basis is justified.

4.4.2 Amend the raw milk regulations to update the terms on which Goodman Fielder can access regulated milk from Fonterra.

37.9 Overall, we do not support this option because, in our view, the current regulations are working well in relation to Goodman Fielder's regulated supply. Unnecessary additional regulation would add to the cost burden and in our view would not provide corresponding benefits.

37.10 In particular, we do not consider that the regulations should be updated to:

- allow Goodman Fielder to purchase raw milk at fixed quarterly prices. The intent of the fixed quarterly price is to avoid complexity for small players. Goodman Fielder is large and sophisticated enough to manage the final price; or
- increase the total amount Goodman Fielder could buy. We do not consider Goodman Fielder requires more than its current entitlement to service its domestic market. If it did, there is sufficient competition in the market for it to obtain that product without regulatory support. If Goodman Fielder requires additional supply, it can seek it on commercial terms from our Co-op, another processor at the factory gate or by sourcing its own supply. As above, we support Goodman Fielder's presence as a large-scale domestic competitor, but we do not consider regulatory dependence should be encouraged beyond what is required to guarantee that position.

37.11 However, we do support MPI's proposed option to amend the regulated price to include a margin to contribute to the additional costs of flat supply and running a milk sourcing operation. We recommend a margin of $0.12 per litre. We also recommend that it applies to all independent processors entitled to raw milk supply (not just Goodman Fielder) as they all take a flat supply and benefit from our additional costs of running a milk sourcing operation. From our perspective $0.12 per litre is conservative: we estimate the cost of flat supply is more than $0.10 per litre, with the remainder being a small contribution towards the costs of running a milk sourcing operation.

37.12 It is worth bearing in mind the goal of these provisions, which is to safeguard domestic competition. They are not designed to support Goodman Fielder's international exports and there would be no benefit in doing so that would outweigh the cost of the regulatory burden.

4.4.3 Amend the raw milk regulations to gradually reduce Goodman Fielder's eligibility to access regulated milk over time.

37.13 As noted above, Goodman Fielder can obtain competitive terms and/or choose to reduce its reliance on our Co-op and on that basis the cost inherent in the regulations could be said to be unnecessary. However, we acknowledge that the existence of the regulations underpins public confidence in the security of Goodman Fielder's position as a viable and large-scale domestic competitor. In our view, there would not be a net benefit in reducing Goodman Fielder's entitlement to regulated raw milk at this stage.

4.4.4 Amend the raw milk regulations to remove limits on the amount of regulated milk available to dairy processors supplying New Zealand consumer markets.

37.14 As noted above (at [6.3]), and as NERA discusses in section 5 of its report, there are costs to our Co-op in complying with the existing requirements. Nevertheless, we have always supported, and continue to support, measures to safeguard domestic competition. This includes the supply of raw milk to smaller processors supplying the domestic market that might not otherwise be able to do so.

37.15 While this option would increase the cost burden on our Co-op, we have no objection in principle to removing the individual limits, but further careful consideration would be needed, including safeguards to ensure:

- an overall cap of 650m litres – we estimate the total New Zealand domestic market to be around 650m litres (including Goodman Fielder's and our own domestic division sales), so this total cap combined with the 20% rule and supply from other independent processors should be sufficient to meet domestic demand;
- a margin of $0.12 per litre to reflect the costs of the flat supply curve and the additional costs of running a milk sourcing operation that benefits all independent processors.
- regulated raw milk is used primarily for supplying the domestic market, rather than for exports.

37.16 These measures would mitigate the increased costs. The knowledge that regulated raw milk is available in volumes sufficient to satisfy domestic demand would also allow Goodman Fielder and other processors to bid for contracts without concerns about adequacy of supply.

37.17 Lifting the individual limit (but retaining the overall cap) would make it easier for a new large processor supplying the domestic market to enter and remove the protection Goodman Fielder currently has over other independent processors seeking to enter the domestic market. (To date, Synlait is the only independent processor that has managed to enter the New Zealand liquid milk market without DIRA supply.)

37.18 However, given the costs of this option, it is not in our view a priority. In any event, there are no limits on independent processors negotiating additional supply on commercial terms. We do provide additional volumes at a negotiated price to processors and there is no evidence the price of those volumes is hindering competition.

37.19 Finally, while we support safeguards on domestic competition, it is important to balance this against the risk of increasing the potential for long-term regulatory dependence, which can in itself result in material costs in terms of both the regulatory burden and inefficiencies in the market.

4.4.5 Amend the raw milk regulations so that the terms on which dairy processors supplying New Zealand consumer markets can access regulated milk mirror the terms on which Fonterra supplies its own New Zealand consumer business.

37.20 There does not appear to be any compelling reason that would warrant further regulatory intervention of this nature. The Raw Milk Regulations, and domestic consumer markets, are operating well. The Commerce Act also provides additional and effective protection (as noted above). Goodman Fielder and our own domestic division, the two largest processors supplying the domestic market, actively compete in the domestic consumer markets. Small independent players also compete effectively and apply real competitive pressure to larger processors. Domestic consumer markets are functioning well, and we do not believe that our domestic division has a competitive advantage that would justify a higher level of regulatory intervention. Given the lack of clear benefit, and that a higher level of regulatory intervention is likely to result in high costs, this option would be difficult to justify.

37.21 Regulatory intervention of this nature would impose in our view a disproportionate and costly administrative burden on our Co-op.

38	*How well do you think each of these options for access to raw milk for Goodman Fielder and smaller processors would perform against the principles of good regulatory practice of promoting certainty and predictability of regulatory outcomes, transparency, cost-effectiveness and timeliness of regulatory processes?*

38.1 Access to raw milk for processors supplying the domestic consumer market is important to maintaining confidence in the competitiveness of domestic consumer markets. In relation to Goodman Fielder specifically, the ongoing entitlement promotes certainty and predictability in the viability of a competitor at scale.

38.2 It is important to note that the status quo with the amendments we summarise in the table in Appendix A on p4 provides these benefits in a manner that does not conflict with the principles of good regulatory practice. In our view, increasing the level of regulatory intervention would not enhance the regime's performance against those principles.

39	*Do you have a preferred option, or a combination of options, for access to regulated milk for Goodman Fielder and smaller processors? Please provide your reasons and information/evidence in support of your views.*

39.1 See our proposals in the table in Appendix A on p4.

39.2 We consider the domestic market is generally working well, and no material problems have been identified with the current regime. As such, we favour option 4.4.1 – status quo – for Goodman Fielder and smaller processors, except for the addition of a fee of around $0.12 per litre to contribute to the costs of flat supply and the costs of running a milk sourcing operation. Even with monthly volume limits, independent processors are still taking a flat profile – which they can do because the quantities they take are generally well below the volume limits.

39.3 We also consider raw milk supplied under the Raw Milk Regulations should have to be processed into finished consumer or foodservice products (to limit the Raw Milk Regulations to safeguarding domestic competition as intended).

39.4 We also propose some amendments to the detail of the Raw Milk Regulations, as set out in our response to Q36.

39.5 Finally, it is not our preference, but we would not object in principle to the removal of limits on regulated raw milk supply to small independent processors. This would need careful consideration and safeguards as discussed above in response to Q37.

4.5 Options for the DIRA review and expiry provisions

40	*How best do you consider "market dominance" could be measured? For example, are there certain criteria (other than a market share threshold) that could be provided for in legislation as a trigger for review and/or expiry of the DIRA?*

40.1 In our view, and as noted above in our response to Q23, market share thresholds are a workable proxy for levels of competition. We consider a market share

threshold would be suitable for triggering automatic expiry of open entry (and potentially exit) by region, as discussed above.

40.2 Another option would be some form of qualitative competition assessment, which could be used as a trigger for review provisions. A qualitative competition assessment could take account of complex factors but would be harder to administer than a market share threshold.

40.3 Other than for regional expiry of open entry and potentially exit, as outlined above in response to Q23, our view is that the legislative trigger should result in a review rather than the automatic expiry of DIRA; given that, we consider a simple time period to be appropriate. That is, the trigger itself does not need to do any “work” in terms of equating to a measure of market power; it needs only to provide an appropriate amount of time for market conditions to potentially alter.

41	*Are there any other options for the DIRA review and expiry provisions that you think should be considered? Please provide sufficient detail when describing any alternative options as well as reasons for considering these.*

41.1 See our proposals in the table in Appendix A on p4. If open entry and non-discrimination are not removed entirely, then we would support regional expiry of those provisions (and potentially open exit, being the right to withdraw and the 160km rule) subject to a market share trigger. Our reasons are given in response to Q23 above.

41.2 Regional expiry can in our view be justified given the significant presence of competitors in some regions, where our market share is relatively low. Although as set out above we would argue competitive regions “protect” regions where we have a higher market share, if MPI remains concerned about the regions where we have a high market share, then we would support expiry by region.

42	*What costs and benefits would each of the options for the DIRA review and expiry provisions create for your business?*

4.5.1 Status quo: no statutory provision for review and/or expiry of the DIRA regulatory regime in legislation

42.1 We do not support this option. It is a priority to ensure a pathway to deregulation, particularly given the challenges facing the dairy industry including flattening milk supply, the increasing impact of climate change and other pressures.

42.2 Retaining the status quo would result in unnecessary costs. As noted above in our view the costs of certain aspects of DIRA already materially outweigh the benefits, and this will only become more pronounced as competition develops in a low or flat milk growth environment.

42.3 Furthermore, this option goes against DIRA’s original incentive structure and long-term policy signals, including providing long-term regulatory certainty around the pathway to deregulation, to support industry strategy and investment decisions. DIRA was always intended to set the dairy industry up to be deregulated. Failing to provide a pathway to deregulation increases the costs of the regime by encouraging inefficient investment decisions that are based on a reliance on the regime rather than a truly viable business case. There is no benefit to providing for continued regulatory protection regardless of the need for it.

4.5.2 Amend the DIRA to require periodic reviews of competition in the dairy industry to determine whether the DIRA regulatory regime should be retained, repealed or amended.

42.4 A periodic review mechanism has the benefit of simplicity. The disadvantage, however, is that – depending on the review trigger – it may not be possible to respond in a timely way to changes in market conditions, for example, material changes in our Co-op's market share. As such, it may result in costs arising out of regulation remaining in place longer than is justified. Automatic expiry of provisions would be less costly (avoiding a review) but the trigger point must be carefully judged.

42.5 We have proposed a hierarchy of preferences regarding the removal of open entry (and potentially open exit) as set out in the table in Appendix A on p4. We propose that the remaining DIRA regulation, including the milk price regime, TAF, the Raw Milk Regulations, the 20% rule and the sale of vats, remains in place subject to a periodic review commencing three years after any change is effective. In our view, a 5 yearly review period would be too long (if we assume that implementation of each review could take between 12 and 24 months). Specifically, it would fail to keep pace with the industry's development, and consequently risk regulation remaining in place longer than is justified.

42.6 In our view, our proposals would provide an appropriate balance of costs and benefits: at a high level, simple triggers, but no wholesale expiry of DIRA without a review. The proposed automatic expiry by region should not be considered risky and potentially costly given the level of competition that would be indicated by the market share threshold being reached (our reasoning is set out above in our response to Q23).

4.5.3 Amend the DIRA to require a review of competition in the dairy industry to determine whether the DIRA regulatory regime should be retained, repealed or amended, to be undertaken when a set market share threshold has been reached?

42.7 As noted above, market shares are a simple and useful initial proxy for market power – this approach would allow real market conditions to be taken into account in triggering a review of DIRA. However, we consider our proposed combination of regular reviews and regional expiry of certain provisions based on market share expiry triggers to strike a more appropriate balance of costs and benefits.

4.5.4 Amend the DIRA to provide for its automatic expiry from a nominated date or when a set market share threshold has been reached

42.8 We accept it would be difficult to identify an appropriate date trigger for expiry, unless it is in the near term (e.g. three years). In our view, wholesale automatic expiry without any review would be concerning to a number of stakeholders. Additionally, it could risk incurring costs associated with removing the DIRA regulation, or certain of its elements, too soon.

43	*How well do you think each of the options for the DIRA review and expiry provisions would perform against the principles of good regulatory practice of promoting certainty and predictability of regulatory outcomes, transparency, cost-effectiveness and timeliness of regulatory processes?*

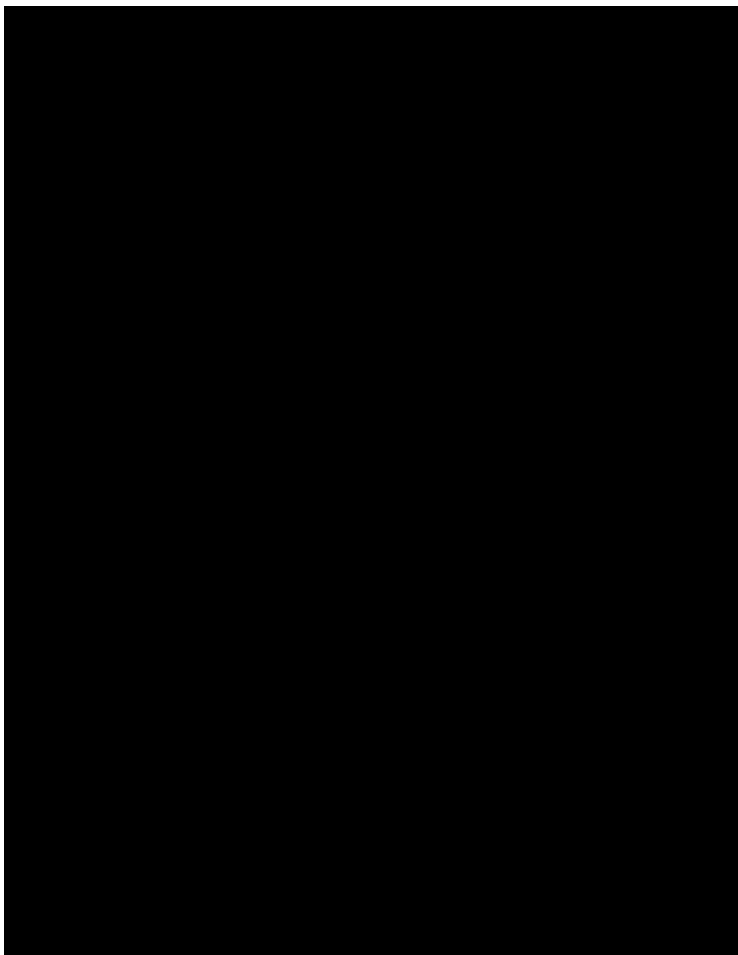
43.1 In our view, the status quo – which is the latest shifting of the goalposts for deregulation – is generating uncertainty and is likely to result in unnecessary cost.

Over the past 17 years, the DIRA sunset provisions have been subject to a number of alterations, generating uncertainty for farmers and processors. A clear pathway to deregulation is in the long-term interests of the New Zealand dairy sector – for certainty and to avoid unnecessary (and potentially costly) dependence on regulation. The status quo is also likely to undermine cost-effectiveness because regulation would remain in place after costs outweigh benefits.

44	*Do you have a preferred option, or a combination of options, for the DIRA review and expiry provisions? Please provide your reasons and information/evidence in support of your views.*

44.1 Our preferred option is a periodic review (to the extent provisions are not repealed earlier in accordance with our proposals – see the table in Appendix A on p4) every three years after legislative change is effective.

Map 1: Regional Council boundaries with our estimate of competitor collection zones



Map 2: Regional Council boundaries and competitor collection zones, overlaid with our Co-op supplier farms