FONTERRA SHAREHOLDERS' COUNCIL

8 February 2019

Review of the Dairy Industry Restructuring Act 2001 and its impact on the dairy industry

TO: **DIRA Review team**
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Submission on the
Review of the Dairy Industry Restructuring Act 2001 (DIRA)
and its impact on the dairy industry

1. Introduction

1.1. This submission is made by the Fonterra Shareholders' Council (the ***Council***) on behalf of Fonterra Farmers in response to the Ministry for Primary Industries' (***MPI***) 2018 Discussion Document. This submission is separate to and independent of the submission of Fonterra Co-operative Group Ltd (***Fonterra***).

1.2. The Council is a national body of Fonterra Farmers elected by their fellow Fonterra Farmers to represent their interests.

1.3. Council welcomes the opportunity to express the collective views of Fonterra Farmers on the impact of the DIRA on the dairy industry and the extent to which, and how, the DIRA should be amended to achieve the best outcomes for the New Zealand dairy industry and New Zealand as a whole.

1.4. The collective view of Fonterra Farmers has been gathered through the formal meetings arranged by MPI, and many small group and individual farmer engagements arranged by Councillors throughout the country to canvas views.

2. Executive Summary

2.1 DIRA now needs modernising to respond to changes in the global and domestic dairy markets.

2.2 This means:

(a) open entry needs to go;

(b) access to regulated milk for export processors needs to end;

(c) Goodman Fielder should not be entitled to regulated price milk for its export products;

(d) there needs to be standardisation in the calculation of publicised milk prices by all processors; and

(e) there needs to be a clear pathway to de-regulation.

2.3 The focus needs to shift to the future and the highest value creation for New Zealand from our primary sector.

3. Overview

The DIRA's regulatory purpose has been achieved

3.1 DIRA in its current form has achieved its regulatory purpose.

3.2 It enabled New Zealand's dairy industry to evolve by facilitating the merger of Kiwi Co-operative Dairies and New Zealand Dairy Group. That, together with the end of statutory control of export marketing by the Dairy Board, has contributed to a competitive domestic market and has enabled the merged entity (Fonterra) to compete strongly in international markets and as a result make a significant contribution to the economy.

3.3 In 2019 a majority of New Zealand's dairy farmers have choices as to who they supply their milk to and the public has wide choice in terms of the dairy products they buy.

It is imperative to now refresh DIRA's purpose, recognising the current environment but with the future top of mind

3.4 Whilst it's relevant to note the original policy rationale to provide context to the regulatory regime in DIRA, it is now imperative to focus on the future.

3.5 The global environment is changing at a rapid pace and is impacted by a wide range of factors. The domestic environment also is vastly different from 2001. What hasn't changed is that sustainable dairy farming has a critical role to play in New Zealand's future prosperity and economic and social wellbeing.

3.6 As noted in the October 2018 NZIER report to the Dairy Companies Association of New Zealand (***NZIER report***):

(a) the dairy industry remains New Zealand's only industry of global scale, operating in more than 140 countries;

(b) dairy is New Zealand's biggest goods export by far - the dairy sector accounting for 20% of total exports;

(c) dairy provides economic opportunities in many regions where there are few alternative sources of jobs and income; and

(d) dairy is uniquely important to New Zealand amongst developed nations.

3.7 DIRA needs to evolve in response to changes in the domestic market:

(a) milk volumes have plateaued;

(b) there is limited land remaining that is suited for conversion to environmentally sustainable dairying;

(c) there has been significant competitor processor emergence since 2001;

(d) there is strong competition for farmers' milk in the Waikato, Canterbury and Southland – Fonterra is not dominant;

(e) there has been a marked reduction in Fonterra's national market share;

(f) there significant risk of industry over-capacity; and

(g) regions have become increasingly reliant on the dairy industry in terms of economic and social contribution - if over-capacity leads to plant closures there may be significant impacts on some regional communities.

3.8 The Discussion Document notes flattening milk supply growth and anticipates more intense competition for farmers' milk. The dairy industry is now in a new phase. There is an existing footprint of stainless steel processing capacity with limited potential to grow the raw milk pool to flow through it. Further inefficient capacity (through additional new entrants) will lead to heightened risk of stranded assets, to the detriment of the entire industry and entire economy and with significant potential adverse consequences for rural communities with lower milk volumes and / or older, smaller processing facilities.

3.9 Council believes that the DIRA incentivises inefficient entry by large processors. Whilst establishing a plant requires capital and long-term investment, and businesses seek to generate sufficient returns to recoup that investment, the reality is that the majority of processors are backed by foreign capital and large global businesses.

Move forward with a new Dairy Industry Act – the status quo will not suffice

3.10 The New Zealand dairy industry no longer needs a 'Restructuring' Act - or an Act that focuses on Fonterra alone, if the Government is looking to shape the entire industry for the future.

3.11 It's time to shift the narrative and focus away from today and the past, from Fonterra (alone) and its dominance, to the wider industry, the future and value creation for New Zealand – for our people, communities, land and economy. The status quo will not suffice - DIRA needs to become a Dairy Industry Act.

3.12 When considering the options for change Council encourages MPI and the Government to:

(a) be 'NZ Inc.' focused – ensure New Zealand reaps the rewards of its dairy industry; and

(b) be future focused – don't be constrained by what exists today, anticipate future trends and advancements.

3.13 With that comes the challenge to ensure the heritage, agility and innovation of our dairy industry over the last 150 years is recognised and protected.

3.14 Council notes the following key findings from the NZIER report referred to in paragraph 3.6 above:

(a) the dairy sector is a major contributor to New Zealand's living standards;

(b) dairy plays a crucial role in supporting regional economic development;

(c) dairy plays a significant role in the Māori economy;

(d) dairy helps the New Zealand economy benefit from global economic development;

(e) dairy's impacts flow well beyond the farm gate and processing plant; and

(f) dairy shares its growth inclusively throughout the supply chain.

3.15 The Government has a significant responsibility with this review. It is imperative to ensure the regulatory framework moving forward does not adversely impact the sources of competitive advantage that the New Zealand dairy industry enjoys. The economic performance of the dairy industry is critical to New Zealand – as a nation and regionally. And Fonterra and its 10,000 farmer owners are significant stakeholders in that industry. This review, and the legacy of the current administration, cannot be the first step of a downwards slide of Fonterra or New Zealand's wider dairy industry.

4. What does success look like?

4.1 The New Zealand dairy industry must continue to be able to function sustainably and successfully.

4.2 In an engagement with the MPI DIRA Review team Councillors were asked "What does success look like?":

Success for farmers

- Farmers' long-term interests are protected to ensure farming businesses are sustainable, inter-generationally
- Benefits, risks and responsibilities (including for the environment) are shared equitably with others
- Farmers have the confidence to invest for the future in their farming businesses

Success for Fonterra

- Fonterra is a sustainable co-operatively owned business
- Fonterra is widely recognised as a 'national champion'

Success for New Zealand's dairy industry

- The industry is sustainable for the next 150 years

- Dairy remains a significant contributor to New Zealand's economic and broader wellbeing
- The competitive advantage of New Zealand dairy products is further enhanced
- The industry remains adaptive, agile, innovative and high performing
- New Zealand's reputation for world leading dairy innovation and quality is further enhanced
- The New Zealand public is proud of its dairy industry
- Dairy farming is, and is recognised as being, environmentally responsible
- Future generations of farmers are ensured

Success for consumers
- There is a wide choice of affordable, high quality and responsibly produced goods

For New Zealand
- Export earnings from dairying grow
- The benefits arising from sustainable dairy businesses are shared widely across regional communities
- There is effective and sustainable management of dairying's impact on the environment

5. The DIRA open entry and exit requirements

Farmers' preference is to repeal the open entry requirements

5.1 Council is aware Fonterra Farmers in many regions are advocating for open entry to end.

5.2 Council recognises that not all farmers have a choice of processor, and that some Fonterra Farmers (especially of smaller and / or outlier farms) are concerned they may be 'cut free' by their co-operative.

5.3 Council believes there are existing and adequate protections inherent within Fonterra's co-operative structure to address these concerns. These protections include:

(a) Fonterra's Co-operative Principles;

(b) Fonterra's constitutional provisions - including the requirement for both Council and shareholder support for any changes to the provisions in *Part A - Co-operative Principles of the Company*; and

(c) Fonterra's governance and representation structure - including the composition of the Board (a majority of farmer-elected governors), the processes for appointment of the Board and Council, the separation of governance and representation, and the constitutional functions of Council.

5.4 Council also questions whether it's the Government's role to protect farmer investments – or Fonterra's role to give certainty to its farmers it will continue to take their milk.

5.5 It is also relevant to note that before Fonterra's formation farmers did not have the protections offered by today's open entry. Before Fonterra's formation in 2001 New Zealand dairy co-operatives had well defined and separate collection areas with very little overlap, reflecting the historical geographical development of co-operative processors in New Zealand.

5.6 Open entry should end because:

(a) the key issues that open entry was designed to address are no longer an issue or are now managed in other ways – independent processors can attract supply and the efficient pricing of milk is dealt with through the Milk Price Manual regime and the Trading Among Farmers regime;

(b) open entry creates reputational risk for our co-operative (as noted in the Discussion Document);

(c) there is significant concern that with open entry and the continual building of stainless steel the NZ dairy industry will become fragmented and end up like the meat industry;

(d) there are low barriers for new processors to enter the market;

(e) open entry is encouraging a 'race to the bottom' in intensive dairying regions – new processing capacity chasing plateauing milk volumes will ultimately lead to surplus capacity and industry consolidation;

(f) removal of open entry will protect outlier regions – industry consolidation flowing from over-capacity in processing assets will be more keenly felt in outlier regions with processing facilities at risk of closure;

(g) open entry risks leaving Fonterra as the inefficient processor to pick up milk in those areas / regions which other cherry-picking processors leave behind;

(h) open entry may be artificially holding up the value of some land, thereby influencing best land use and impacting affordability (therefore creating a barrier to entry) for the next generation of dairy farmers looking to enter the industry;

(i) the Commerce Act should manage the risk of anti-competitive behaviour – if that Act is not well equipped to regulate, or is not clear or easy to enforce then its shortcomings should be addressed; and

(j) significant DIRA protections remain – open exit, the 160km rule, the Milk Price regime, Trading Among Farmers, the 20% rule, and sale of vats.

5.7 In 2017 Fonterra advised its shareholding farmers that it would give various undertakings if DIRA open entry was removed as part of the legislative amendments being considered at the time – in terms of continuing to collect milk from farmers supplying Fonterra and the purchasers of their farms for so long as other pro-competition provisions applied (***the 2017 agreement***).

5.8 Whilst Council believes the co-operative features discussed in paragraph 5.3 above address the risk of Fonterra Farmers being 'cut free' by their co-op, the principles of the 2017 agreement could be regulated to provide greater certainty to Fonterra Farmers.

The second preference is:

- ***open entry only applies in regions where there is insufficient competition***
- ***no obligation to accept new supply from conversion land***
- ***no obligation to accept supply from non-compliant farms***
- ***regulate the 2017 agreement to give Fonterra Farmers certainty***

5.9 If the Government remains concerned about competition at a regional level, then DIRA's open entry requirements should be amended to:

(a) Remove open entry in areas where there is competition for farmers' milk. Defining a 'competitive area' could be by reference to Regional Council boundaries, or by competitor supply footprint (adopting a DIRA section 107 160km rule-type approach). The required level of 'competition' could be measured by market share dropping below a specified threshold.

(b) Give Fonterra the discretion as to whether to accept milk from land that is not currently used in dairying.

(c) Enable Fonterra to decline to accept or retain supply from farmers who do not meet its supply terms - Fonterra must be able to protect its brand and reputation.

(d) Regulate the entitlement to continue to supply, and supply growth milk to, Fonterra (subject to compliance with its terms and conditions of supply) from its supplying footprint for as long as open entry applies in any other region as per the 2017 agreement.

5.10 Council sees no issues with different regulatory requirements for different parts of the country. That occurs now at a regional level. In addition, regional application of DIRA was previously envisaged (DIRA expiry provisions previously applied on a North Island and South Island basis).

5.11 Fonterra should not be required to accept supply from land that is not currently used in dairying in any region. Securing a supply entitlement for conversion land should be part of the conversion planning process.

Fonterra Farmers should not have to underwrite risks for farmers supplying other processors

5.12 The cost of maintaining processing capacity for milk from new or returning shareholders is only one cost to consider. As owners Fonterra Farmers are concerned about the free option tied to open entry. Risks associated with moving to a new / smaller processor that should be compensated by a higher milk price from the competing processor are instead carried by remaining Fonterra shareholders, given the exiting farmer's right to supply / return to Fonterra without penalty. Fonterra shareholders are effectively providing a free underwrite of the risk of failure of the alternative processor, and farmers' supply contacts with other processors.

5.13 The ability for all dairy farmers to supply Fonterra on standard terms, if and when they choose to, has essentially eliminated the price of risk that should be associated with supplying an alternative processor. Alternative processors are smaller, younger and / or not co-operatives, with fewer manufacturing sites and narrower product ranges. Maintaining a regulatory environment that does not allow that risk to be valued by the market (by essentially removing it) has limited the premium that corporate processors have had to pay to attract their suppliers and therefore limited the value that has been delivered to New Zealand farmers by these processors.

5.14 At the same time as profitability has been affected, so too has the allocation of capital. Land values have been driven higher than they otherwise would have, as there has been no need to add a risk premium (or discount) relating to the supply rights of that land. Therefore, the regulatory framework is distorting market values for farmland.

5.15 The right to return, once a decision has been made to exit, needs to be split from other aspects of open entry – being a Fonterra Farmer's right to continue to supply milk (existing and growth milk) to Fonterra.

5.16 And Fonterra should have the same discretion to accept new milk from a new entrant like other processors do – by assessing if the milk is of value to Fonterra and whether it has capacity to process it.

The capacity constraint notice regime is ineffectual

5.17 The capacity constraint notice regime theoretically gives Fonterra time to build new plant – 15 months. In reality, that window is inadequate and impractical. And at the end of the 15 months the milk must be collected. The cost of additional capacity is not avoided – just deferred for a short time.

Price does not influence milk supply volumes

5.18 Fonterra pays its Farmers a market price for their milk, not an artificially inflated or deflated price to encourage / discourage production.

5.19 The Constitution, milk price regime and Fonterra's co-operative structure require it to pay the maximum sustainable price for its Farmers' milk.

5.20 Since 2009 that price has been calculated using an independently approved methodology that enables total returns to be allocated between payments for milk and returns on capital invested by Fonterra Farmers and unit holders in the Fonterra Shareholders' Fund.

5.21 Deviations from the Milk Price Manual determined base milk price require exceptional circumstances and are closely monitored by Council, as well as the Commerce Commission.

5.22 There have only been two occasions when the final milk price set by the Board for a season has deviated from that determined under the Milk Price Manual. As required by the Milk Price Manual regime, the Board had to publicly explain why it had deviated from the base milk price calculated under the Manual. Basically, on both occasions (2013/14 and 2017/18) due to wider financial circumstances Fonterra could not afford to pay the Manual determined base milk price.

5.23 MPI's preliminary analysis is that New Zealand dairy farmers' milk production decisions are sensitive to price, albeit the price-volume relationship is not linear, can be subject to time lags and is impacted by multiple other factors. The Discussion Document states '...when the price paid to farmers for milk is high, production volumes tend to increase. Similarly, when prices fall, production tends to decrease."

5.24 The key factor influencing a farmer's production and production decisions is climate. Farmers are very wary about basing farming decisions on Fonterra pricing signals.

5.25 The 4 - 5% increase in milk volumes this season, when the milk price has been declining, is evidence of the major impact that climate has – rather than price. Further, the implications of a good climate this season will continue to be felt next season with more feed available, better in calf rates and cow condition etc. Farmers do not know what next season's price will be but are likely to see good production next season even in an average climate year due to these positive factors. Equally, a bad season can depress the next season's volume regardless of price for the same reasons.

5.26 It is also relevant to note that milk price movements are announced after milk has been supplied, and well after any decisions affecting production levels have been made.

5.27 In seasons when milk price is low or reduces, farmers will control costs – feed, stocking rates, defer maintenance etc.

6. Access to regulated milk for large dairy processors (except Goodman Fielder)

Access to regulated milk for export processors needs to end

6.1 Council strongly supports the proposal to remove access to regulated milk for large, export-focused processors because:

(a) access for export-focused processors has failed to add value to the domestic milk market in New Zealand;

(b) the original rationale - to reduce risk for dairy processors seeking entry into the market - is no longer valid;

(c) investment in additional processing capacity should not be encouraged in an environment of plateauing milk supply; and

(d) access provides a very poor business case for NZ Inc where there is foreign ownership of the processor – keep profits in New Zealand.

6.2 Council submits that access to regulated milk should be removed for <u>all</u> export focused processors, irrespective of the level of own supply or the size of the processor. The focus should be on whether the processor is primarily servicing the domestic or export market. Processors primarily servicing export markets could still purchase raw milk on commercial terms. What other industry is regulated in order to subsidise competitors focusing on offshore markets?

6.3 This would also encourage the development of a factory gate market, one of the outcomes sought by the last Commerce Commission review.

7. Access to regulated milk for Goodman Fielder and smaller processors

Amend the existing provisions in the Raw Milk Regulations as they apply to Goodman Fielder to remove access to regulated price milk for export volumes

7.1 Council supports the regulated supply of milk for the domestic market. Farmers support competition in New Zealand markets for dairy products.

7.2 Council notes the view of some Fonterra Farmers that Goodman Fielder's entitlement should end. However, Council is wary that those farmers may not understand the full context of all the commercial supply arrangements between Fonterra and Goodman Fielder. The volume supplied as a percentage of total milk collected is also relevant.

7.3 Council submits that Goodman Fielder should not, however, be entitled to regulated milk for product it exports.

7.4 This should also apply to any other processor entering New Zealand to primarily supply the domestic market which does not establish its own supply and also exports.

Develop a transition pathway to de-regulation

7.5 In its last review the Commerce Commission sought to develop the factory gate market. Is that still considered to be imperative for a competitive dairy industry? It won't develop while Fonterra is required to supply all needs of domestic raw milk users.

7.6 Some farmers have suggested other processors with their own supply should be regulated to sell raw milk. However, a better option may be to reduce the volume limits to reflect the reduction in Fonterra's market share – possibly on a regional basis. This could also help encourage the development of the factory gate market.

7.7 At some point the regulatory requirement to supply milk should end - there should be a clear transition pathway for the end of regulatory dependency.

Ensure there is a fair price at the factory gate and for consumers

7.8 Council submits that the price that Goodman Fielder and smaller processors pay should reflect the full cost to Fonterra of purchasing that milk from its suppliers, including in the 'shoulder' months.

7.9 Council notes and agrees with comments made by farmers during the MPI consultation process about the need for a review of the impact of the supermarket duopoly on retail pricing of dairy goods.

8. The base Milk Price calculation

8.1 Fonterra Farmers highly value the transparent milk price delivered by the current milk price regime. It ensures fairness, certainty and clarity.

8.2 Non-Fonterra farmers also value that regime as it effectively ensures they receive a market price for their milk. It is notable that Fonterra's competitors generally do not offer a milk price regime independent of the Fonterra milk price.

Retain the existing provisions for Fonterra's base milk price calculation and Commerce Commission monitoring

8.3 The existing regime for Fonterra's base milk price calculation and Commerce Commission monitoring should be retained without change. It provides a transparent calculation of the market value of New Zealand milk in global dairy markets.

8.4 The historical gap between the milk price achieved in New Zealand compared to the milk price received by farmers in the European and US markets has now closed. This can be attributed to:

(a) the Milk Price Manual providing a greater level of transparency of the cost of goods for Fonterra's business; and

(b) the introduction of Global Dairy Trade which has provided a true market signal, both internally and externally, of the market value for milk off farm.

8.5 A strong co-op milk price means all processors pay a strong milk price, which means greater investment by all farmers in the environment and their communities. It also ensures more of the total value of milk produced in New Zealand is retained in New Zealand and not exported as profit, potentially through transfer pricing to other countries.

8.6 Alternative non-cooperative processors will assert the Fonterra milk price is too high, but their farmers won't, as they know it sets the base for the price they will be paid.

Fonterra should set its base Milk Price

8.7 An independent body should not set the Fonterra milk price. The Manual's clear methodology and the Commerce Commission's oversight address the regulatory concerns. There should be a focus on finding pathways to less regulation – not more regulation.

Greater transparency should be required from other processors

8.8 It is currently very difficult for non-Fonterra Farmers to understand the actual milk price they will be paid by the processor they supply, adversely impacting farmers' ability to make informed decisions on who to supply.

8.9 There is strong farmer support for better transparency from other processors.

8.10 During the consultation meetings the MPI Review Team commented that greater price transparency by competitor processors is considered to be an information disclosure issue and not relevant to DIRA or Fonterra. Council does not agree with this view for the following reasons:

(a) It is imperative, in the interests of fair competition, and an informed and efficient industry, for some standardisation in the calculation of publicised milk prices so that comparisons can be fairly made and therefore better-informed decisions by farmers about the highest alternative use of their milk.

(b) There's an imbalance of information available to farmers compared to the processor. It is currently very difficult for non-Fonterra Farmers to understand the actual milk price they will be paid by the processor they supply. Fonterra publicises the average milk price paid to its suppliers whereas other processors publicise the maximum price achievable if a supplier meets all the incentives offered by the processor. Transport costs, milk composition, demerit payments and other deductions, and incentive pricing mean that the milk price each competitor processor publicises is not usually the milk price paid to the majority of their suppliers.

(c) Corporate processors (that are not co-operatives) will not pay any more than they have to in order to secure milk. It is common knowledge that other non-cooperative processors set their milk price based on what Fonterra pays, not on a maximum sustainable price.

8.11 In its recent inquiry into the Australian dairy industry the Australian Competition and Consumer Commission (***ACCC***) determined:

(a) most Australian dairy farmers have little bargaining power when negotiating with a processor;

(b) given the number of farmers compared to processors, effective contract negotiations are unlikely to occur;

(c) there's an imbalance of information available to farmers compared to the processor; and

(d) a processor (recognising there are no co-operatives in Australia) will not pay any more than it has to in order to secure milk.

8.12 The ACCC recommended:

Contracts between farmers and processors must set out either:

- *a clear price or schedule of prices that will apply to that farmer (based on elements such as volume, quality and composition), and/or a clear pricing mechanism (such as a formula); and/or*
- *a price notification process (the process by which the processor notifies the farmer of the price.*

Such that at any given point in time, a farmer can be certain of the base milk price that will be paid for the milk produced.

8.13 All processors should be required to publish:

(a) total milksolids collected;

(b) the farm gate milk price for the season – being the average amount paid for milk from farmer suppliers excluding any premium for winter or organic milk; and

(c) average premiums paid for winter and organic milk

Figures should exclude milk purchased / sold at the factory gate (that is, milk transferred between processors).

9. DIRA review and expiry provisions

There must be clear review and expiry provisions

9.1 The Government needs to send a clear sunset signal and transition pathway to farmers and the wider industry, and then stick with it. The industry is operating under ambiguity. Certainty will encourage the development of a sustainable industry with sustainable competition.

9.2 There is deep frustration within the Fonterra Farmer base around the continual shifting of the goal posts around the sunset provisions.

There should be regional thresholds and periodic review

9.3 There should be a combination of regional thresholds (with automatic expiry of pro-competition provisions when a set market share threshold is reached) and periodic review of competition in the dairy industry to determine whether what remains at the time of the DIRA regulatory regime should be retained, repealed or amended. That periodic review should commence no more than three years since the last review was completed, with a set expiry date to ensure the review is completed and changes are enacted on a timely basis.

9.4 Thresholds should not be set on a national basis, but rather should recognise the reality of regional competitor activity, and ensure competing processors don't eat away at New Zealand's dairy heartland to the detriment of the environment and other regions.

10. Fonterra's performance

10.1 Council notes the observations on Fonterra's performance in Appendix 1 of the Discussion Document.

10.2 In 2017 Council engaged independent advisors to assess Fonterra's financial performance since its inception. A copy of the resulting report accompanies this submission. This report provides an independent and reliable view of actual performance over the last 17 years based on sound methodology and, importantly, having access to relevant financial information. Council asks MPI and Government to draw conclusions and observations about Fonterra's performance from this report, and not from sources that are not independent and do not have access to all relevant information.

10.3 In particular, Council draws attention to the commentary (page 9 of the report) comparing Fonterra to other processors operating in New Zealand. This includes:

(a) Fonterra is very different to the other entities operating in the New Zealand dairy sector due to a range of factors, and a direct comparison of each company's performance is potentially misleading. Key differences include:

- Fonterra's historical obligation to supply competitors which has meant it has effectively internalised some production and volume risks on behalf of its competitors
- The limited catchments that some competitors purchase milk from, and the ability for some competitors to change their catchment over time to suit their needs – compared to the obligation in DIRA on Fonterra to collect milk from an extensive catchment.
- Scale – Fonterra collects approximately 12 times as much milk as OCD, 25 times as much as Synlait and 102 times as much as Tatua. Given its scale Fonterra is more exposed to international commodity prices and market fluctuations.
- There is a mix of higher and lower proportion of commodity products produced by each entity.

(b) Of the local processors, OCD is arguably the most comparable to Fonterra. Over the last 10 years OCD has derived an average pre-tax return on capital employed of 7% p.a. Over the same period Fonterra's was 8.3% p.a.

11. Fonterra's co-operative structure

11.1 The new legislation should continue to recognise, but better reflect, Fonterra's co-operative structure, the value to New Zealand of that structure and the fact that co-operatives act differently to corporates.

11.2 A strong co-operative is imperative to ensure the economic and social benefits of New Zealand's dairy industry are shared widely throughout New Zealand. Being a co-operative is a source of strength for the co-operative's farmer owners and for the New Zealand dairy industry as a whole.

11.3 A co-operative acts differently to a corporate and a co-operative's shareholders have greater influence and control than shareholders of, and suppliers to, a corporate. In Fonterra's case, this difference is evident through the Co-operative Principles, its Constitution framework, and Council's representation function.

11.4 Farmers get a say within a co-operative. Major Constitution changes need to be voted in by shareholders, and in Fonterra's case also by Council. Council acts as a gateway to changes to Fonterra's terms and conditions of supply – all changes are reviewed and reasons for those changes are validated to Council before the changes are put for approval by the Board.

11.5 Competition in one region benefits farmers nationally as co-operative principles (milk pricing, capital contribution, averaging of transport costs etc) are applied on a nationwide basis.

11.6 Members of a co-operative police its performance and behaviours. The 2018 Director Election, and shareholder disquiet about the 90-day creditor payment terms, are great examples of Fonterra shareholders exercising their ownership voice.

11.7 A co-op is equipped as a collective to protect its suppliers – farmers will unite to protect their common best interests.

12. Environmental considerations

12.1 Environmental issues are relevant to all processors and all their suppliers' farms – not just Fonterra and its suppliers' farms.

12.2 Environmental management should be determined by local and regional authorities through regional and district plans, and by Government through a well-functioning RMA.

12.3 DIRA's open entry has created an incentive over alternative land uses as it has given a guaranteed buyer of milk from land converted to dairy.

13. Overseas ownership of processing assets

13.1 Given the dairy sector remains New Zealand's largest goods exporter by some margin and accounts for nearly 20% of New Zealand's goods and services trade. In the same way that there are now restrictions on foreign investment in sensitive land, and recent measures implemented to address overseas ownership of housing, Council invites the Government to consider restrictions on overseas ownership of dairy processing capacity.

14. Putting value-add in context

14.1 There is a lot of commentary about Fonterra's investment in value-add production. Commodity milk products have been good for New Zealand and have their place.

14.2 Commodity products also reflect the reality of New Zealand's seasonal supply curve. There would be significant environmental consequences from square curving milk production.

14.3 Value add products only use a proportion of the components in raw milk – the remaining components also need to be processed. And all components need to be optimally processed.

15. Reasons farmers leave Fonterra

15.1 The Discussion Document discusses farmers switching milk production to the highest value user.

15.2 Recognising other processors generally base their milk pricing off Fonterra's milk price, key reasons farmers will supply an alternative processor are:

(a) as a general 'protest' to Fonterra's performance (not its milk price);

(b) to avoid compliance with Fonterra's supply terms;

(c) because they are capital constrained they can sell shares and supply another processor from the same farm;

(d) to fund additional investment; or

(e) they have a higher value alternative land or capital use.

16. In conclusion – in Farmers' own words

'Leaving DIRA the same encourages nothing new or better'

'Should this be the Fonterra regulatory Act or the Dairy Industry regulatory Act?'

'If we're not careful, we will end up like the meat industry or the Australian dairy industry'

'The co-op will continue to pick up my milk if open entry goes. We own it'

'We know what we are getting paid is fair - the other companies want Fonterra to pay as little for their milk as possible'

'The way we produce our milk is New Zealand's competitive advantage. It should be New Zealanders who benefit from this'

'We are supposed to be a subsidy free industry yet Fonterra Farmers are subsidising other processors'

'Goalposts keep shifting and I have no confidence that the Government will implement deregulation'

'You cannot talk about Fonterra and its farmers separately – those farmers own Fonterra. Fonterra is its Fonterra dairy farmers'

'Good regulation is minimal regulation'

Council would be happy to discuss any aspect of this submission and requests the opportunity to provide further input as the process progresses.

Sincerely,

Duncan Coull
Chairman, Fonterra Shareholders' Council