

9 October 2019

**Submission on the
Dairy Industry Restructuring Bill (No. 3)**

TO: Committee Secretariat
Primary Production Committee
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Wellington

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Submission on the Dairy Industry Restructuring Bill (No. 3)

1. Introduction

- 1.1. This submission is made by the Fonterra Shareholders' Council (the **Council**) on behalf of Fonterra Farmers. 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. The collective view of Fonterra Farmers expressed here is informed by farmer meetings that took place during the 2018/19 DIRA consultation.

2. Executive Summary

- 2.1. The open entry rule should be removed completely.
- 2.2. Access to regulated milk for large dairy processors (except Goodman Fielder for domestic milk) should end.
- 2.3. All milk processors should be required to disclose the milk price they pay to their suppliers so that farmers are able to make valid price comparisons.
- 2.4. The Government should not nominate an appointee to the Milk Price Panel as there is already adequate independent oversight including via the Commerce Commission and no strong reasons have been given for the appointment.
- 2.5. The DIRA regime should have an expiry provision reinstated.

3. The DIRA open entry requirements

- 3.1. While Council acknowledges the Bill adds two new exceptions to the open entry rule, Council submits that these do not go far enough and that the open entry rule should be completely removed or at very least removed in regions which have adequate competition for milk supply and removed for farmers who have previously elected to leave the Co-op.
- 3.1 Major changes have occurred in the domestic dairy processing market in the 18 years since Fonterra was formed meaning the issues that open entry was designed to address are no longer relevant. Fonterra's share of the domestic milk supply market has dropped from 96% to around 80% in that time. Significant competitor processing has emerged which has led to strong competition for farmers' milk particularly in the major dairying regions of Waikato, Canterbury and Southland.
- 3.2 Recognising the emergence of the alternative processor options, it is no longer reasonable to require Fonterra Farmers who have remained loyal to the Co-operative through good times and bad to accommodate the milk supply of farmers who have previously left Fonterra and wish to return. Why should Fonterra Farmers be required to indefinitely ensure processing capacity for those who have chosen to walk away?
- 3.3 A continuation of the open entry rule risks frustrating Fonterra's stated aim of focussing on increasing the *value* of New Zealand milk. The obligation to ensure processing capacity ties up precious capital which could be better deployed in enhancing the value of our milk. Open entry forces Fonterra to maintain a focus on the ability to process *volume* which is no longer desirable for the Nation or Fonterra.
- 3.4 Open entry means a farmer's decision to switch their milk supply from Fonterra to another processor is a risk free decision. The ability to return to Fonterra at any time on standard

terms means the risks of leaving are underwritten by the farmers who remain with Fonterra. This leads to distortions in the dairy processing market:

- Alternative processors are generally smaller, younger, not co-operatives, operate fewer manufacturing sites and produce a narrower range of product ranges. Farmers might expect a premium for supplying milk to them. The open entry rule has limited any 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.
- Open entry also distorts the allocation of capital. Land values have been inflated by the open entry rule because there has been no necessity to price any risk regarding the ability to supply milk from that land.

3.5 Open entry has created a significant risk of over-capacity in the industry. New Zealand is widely regarded to have reached peak milk. Indeed, recent Government proposals concerning freshwater management and agricultural greenhouse gas emissions have significantly increased the likelihood that New Zealand will experience falling milk volumes. This will only increase the risk of stranded processing assets. The examples of over-capacity evident in the New Zealand meat processing industry over the past decades and the Australian dairy industry more recently, demonstrate the issues this can cause.

3.6 Council recognises that not all farmers have a choice of processor, and that some Fonterra Farmers are concerned they may be 'cut free' by their co-operative if the open entry rule was removed. Council believes there are existing and adequate protections inherent in Fonterra's co-operative structure to address these concerns. These protections include:

- Fonterra's Co-operative Principles;
- 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
- 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.

3.7 It is also relevant to note that before Fonterra's formation in 2001, farmers did not have the protections offered by today's open entry. Prior to Fonterra, 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.

3.8 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**). Whilst Council believes the co-operative features discussed 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.

3.9 If the Government remains concerned about competition at a regional level, then DIRA's open entry requirements should be amended to 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. Council sees no issues with different regulatory

requirements for different parts of the country. Regional application of DIRA was envisaged in the original DIRA.

4 Access to regulated milk

- 4.1** Council acknowledges that the Bill tightens the eligibility conditions for access to regulated milk for large processors. However, Council submits that these amendments do not go far enough.
- 4.2** The DIRA has already achieved its purpose. An appropriate level of competition has been established in the dairy processing market. Why should Fonterra farmers be required to subsidise foreign-backed dairy processors? Why would the New Zealand Government persist with legislation which promotes the continued transfer of dairy processing capacity from domestic to foreign-backed ownership?
- 4.3** Access for export-focused processors has failed to add value to the domestic milk market in New Zealand.
- 4.4** Investment in additional processing capacity should no longer be encouraged in an environment of plateauing, or potentially falling, milk supply.
- 4.5** Access to regulated milk for large, export focussed processors provides a very poor business case for NZ Inc. New Zealand is giving away to foreign-backed companies the provenance of its milk for free. Council believes that it is better for all New Zealanders to keep dairy generated profits in New Zealand.
- 4.6** Council submits that access to regulated milk should be removed for all 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.
- 4.7** Goodman Fielder's entitlement should be for the domestic market.

5 Milk price transparency and the Government nominated appointee on the Milk Price Panel.

- 5.1** Council supports the Government's desire to have a transparent milk price so farmers can assess Fonterra's and other dairy processors' milk price offers. However, in order for this to occur, other processors must be required to disclose the milk price they actually pay to their suppliers.
- 5.2** Council opposes the requirement for Fonterra to appoint a member to the Milk Price Panel on the nomination of the Minister of Agriculture. This proposal did not form part of the consultation discussions which preceded the Bill and there has been very little comment on the reasons for it. There is already independent oversight of milk pricing, including via the involvement of the Commerce Commission. Council believes this oversight has proven an adequate safeguard for all parties involved in the raw milk market. In the absence of strong reasons for a Government appointee, Council questions what will be achieved from the appointment. Council also notes the potential for appointee change arising from changing Governments.

6 DIRA review and expiry provisions

- 6.1** Council submits that the requirement in the Bill for the Minister of Agriculture to carry out periodic time bound reviews of the DIRA does not go far enough.

- 6.2** The Bill needs to include a clear sunset provision for subparts 5 and 5A of Part 2 of the Dairy Industry Restructuring Act. Clear, immutable sunset triggers will provide welcome certainty and encourage the development of a sustainable industry with sustainable competition.
- 6.3** 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.
- 6.4** There is deep frustration within the Fonterra Farmer base around the continual shifting of the goal posts around the sunset provisions. The DIRA was effectively a bargain between dairy farmers and the Government: The vast majority of New Zealand dairy farmers were allowed to aggregate into one Co-operative, and in return; they accepted certain restrictions designed to curtail Fonterra's ability to undesirably exploit its market dominance until a more competitive market emerged. Farmers have kept their end of the bargain. Successive Governments have not.
- 6.5** Fonterra farmers have watched while corporates have cherry picked the most profitable parts of the dairy industry. They understand that the DIRA meant that a certain amount of this was inevitable. However, the original thresholds for the cessation of restrictions have been exceeded. The time has come to remove those restrictions. Our farmers are tired of seeing milk collected from their farms being delivered to competitors' factories. They are tired of subsidising foreign owned competitors and farmers who choose to leave their Co-operative. They want an end to the distractions and distortions caused by the DIRA restrictions. Our farmers want their Co-operative to be freed from those shackles so it can bring an uncompromised focus to maximizing its performance. Our farmers firmly believe that repealing the DIRA restrictions would benefit their farms and families, Fonterra, the wider dairy industry, and New Zealand as a whole.

7 Select Committee Appearance

- 7.1** Council requests the opportunity to present its submission to the Select Committee in person. This request is separate to and independent of any similar request made by Fonterra Co-operative Group Limited.