



# FEDERATED FARMERS

SUBMISSION ON:

The Future of the Pro-competition Regulatory Regime  
in the New Zealand Dairy Industry

# SUBMISSION

**TELEPHONE** 0800 327 646 | **WEBSITE** WWW.FEDFARM.ORG.NZ

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**TO:** Ministry of Agriculture and Forestry  
PO Box 2526  
Wellington 6140

**SUBMISSION ON:** The Future of the Pro-competition Regulatory Regime in the New Zealand Dairy Industry

**FROM:** Federated Farmers of New Zealand

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**CONTACT:** Ann Thompson  
Federated Farmers Dairy Policy Advisor  
  
Federated Farmers of New Zealand  
PO Box 715  
Wellington 6140  
  
P 04 494 9191  
F 04 473 1081  
E [athompson@fedfarm.org.nz](mailto:athompson@fedfarm.org.nz)

# 1. EXECUTIVE SUMMARY

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- 1.1 Federated Farmers welcomes the opportunity to submit on 'The future of the pro-competition regulatory regime in the New Zealand Dairy industry'.
- 1.2 Federated Farmers submits that the Dairy Industry Restructuring Act 2001 (DIRA) be allowed to expire as originally intended.
- 1.3 Federated Farmers submits that the Raw Milk Regulations remain in place as per Option 2(a) as set out in the Ministry of Agriculture and Forestry (MAF) 'Review of

the Dairy Industry Restructuring (Raw Milk) Regulations: Options for addressing industry concerns', May 2008, where an auction will be used to price this milk. The pricing method that will be used for the 2010/11 season, while inferior to an auction system, is also acceptable. The auction system has been signalled by the Minister.

## 2. FEDERATED FARMERS' POSITION ON THE PRO-COMPETITION REGULATORY REGIME IN THE NEW ZEALAND DAIRY INDUSTRY

- 2.1 The position of Federated Farmers in this submission is taken from the perspective of its dairy members, the vast majority of which are Fonterra suppliers. However, from a broader perspective we believe that it is in the interests of the New Zealand economy for Fonterra to be a strong 'national champion'.
- 2.2 Federated Farmers' preference is for markets to be left to work with as little regulation as possible. Regulation should be considered only if there is evidence of market failure, that regulation will address the problem, and if analysis proves that the benefits of the proposed regulation would exceed the costs.
- 2.3 Federated Farmers acknowledges Fonterra would not have been able to be formed without the DIRA, and the presence of the DIRA has allowed the New Zealand dairy industry to expand. The industry in 2010 is far bigger, with many more independent milk processors present than was envisaged in 2001, the date of this legislation, and it is now time for the industry to stand unsupported by regulation.
- 2.4 Agricultural co-operatives have worked well in New Zealand, where the shareholder has control via the ballot box and also the ability to leave the co-operative to supply/use other firms. Farmers have a good understanding of co-operatives, and feel there are enough checks and balances within the way co-operatives work to enable the good of the shareholder to be at the forefront of all business transactions.
- 2.5 This was illustrated recently in Australia where, because shareholders of Murray Goulburn Co-operative were unhappy with the way their milk processing co-operative was operating, they voted out the Chairman and forced the co-operative to change its chief executive. In New Zealand, Fonterra shareholders have used their vote to change directors for the last three years and have also influenced the direction Fonterra is taking on its capital restructure.
- 2.6 The export market for milk is strong, and with the marketing mechanisms New Zealand milk processors have instigated, this should remain a high foreign exchange earner for New Zealand. However, dairy farmers are anxious about any moves that might result in fragmentation of New Zealand dairy exports lest this sees the dairy industry go the same way as the meat industry where fragmented exporters have, in our view, resulted in reduced selling power relative to overseas buyers and under-cutting in markets. It is this competition in the export market that farmers are most concerned about, not the competition for milk that already occurs at the farm gate.
- 2.7 On the whole, agricultural co-operatives set the price for the rest of the industry, where there are many sellers and few buyers. This is seen within New Zealand, where all the milk processors bench mark their milk payout against Fonterra's, never paying more than a few cents above that set by the co-op. This can be masked by complicated formulae for setting the price.
- 2.8 This ability to set the price at the farm gate is also seen in Australia, where Murray Goulburn Co-operative leads the way, despite having only a third of the market last year.
- 2.9 Federated Farmers understands that the Commerce Act contains principles surrounding competition which can be time consuming and expensive to investigate and apply if a dispute occurs. This could go against a farmer, if, for instance, Fonterra refused to pick up milk from his cows. Federated Farmers understands that the DIRA contains special provision, or rules, for the Commerce Commission to act with more ease on behalf of the farmer if it saw any anti-competitive behaviour occurring at the farm gate, and it was for this purpose the DIRA was written. However, there is now sufficient competition at the farm gate for this to not pose such a problem as was envisaged in 2001.

**2.10 Recommendation: Federated Farmers submits that the DIRA should be allowed to expire as originally intended.**

2.11 The remainder of this section comments on key specific aspects of the DIRA.

**Open entry and exit**

2.12 The ability to leave Fonterra, through the provision of the open entry/exit clauses of the DIRA, has been seen by some as detrimental to the good of the co-operative, and those shareholders with little understanding of the co-operative ethos have been able to take this easy option. There has also been anecdotal evidence of trading banks forcing the sale of shares where too much debt has accrued; this, too, is to the detriment of Fonterra.

**Payment in a timely manner**

2.13 Federated Farmers acknowledges that delays in payout can be a slight deterrent for quick decision making, but the practice of some agricultural co-operatives of not paying out within the same season should be seen in a positive light, especially when New Zealand law requires shareholders to be paid out within three years.

**Other DIRA pro-competitive measures**

2.14 The other main provisions within the DIRA (the contract supply expiration, the 20% rule and the sale of milk vat rule) are seen as being of little consequence to farmers and are not an impediment to changing business practice.

**Raw Milk Regulations**

2.15 If the Raw Milk Regulations are to continue, then a fair price for this milk must be attained and conditions placed on this milk, so that good business decisions can be made. Option 2(a) as set out in MAF's 'Review of the Dairy Industry Restructuring (Raw Milk) Regulations: Options for addressing industry concerns', May 2008, where an auction was proposed to price this milk and with conditions being placed on those taking this milk, is acceptable. The pricing method that will be used for the 2010/11 season, while inferior to an auction system, is also acceptable.

2.16 Federated Farmers realises that raw milk must still be made available. It allows start-up companies, companies with no wish to get into the farmgate milk market and others who find a constant supply of milk to their advantage, an avenue to buy milk at a fair and efficient price. The provision in place for the 2010/11 season, where the Fonterra farmgate price plus a margin is paid, is seen as being inferior to an auction, but is more acceptable than the previous default price based on an inefficient formula.

**2.17 Recommendation: Federated Farmers submits that if the Raw Milk Regulations remain in place the proposed changes to the price must be implemented.**

### 3. SPECIFIC QUESTIONS FROM THE CONSULTATION DOCUMENT

**Q 1** *In your opinion, has the DIRA pro-competition regime been effective in promoting efficient operation of dairy markets in New Zealand? Please explain your answer.*

**Yes** The DIRA allowed new start-up companies into the market through the provision of Regulated Raw Milk, which in turn has led to independent processors taking on own-supply. It is now time, however, for the industry to stand away from the DIRA.

The ability for dairy farmers to switch processors has always been limited and difficult, even before the formation of Fonterra when there were many co-operatives in New Zealand.

Dairy farmers are, however, anxious about any moves that might result in fragmentation of New Zealand dairy exports lest this sees the dairy industry go the same way as the meat industry where fragmented exporters has in our view, resulted in reduced selling power relative to overseas buyers and under-cutting in markets.

**Q 2** *Do you consider that Fonterra's high market share could lead to inefficient operation of the farm gate milk market? Please explain your answer and provide evidence, if available.*

**It could**, but in reality, co-operatives within the agricultural industry set the price at the farm gate in many countries of the world. Murray Goulburn Co-operative, in Australia, collected and processed only a third of all milk produced in 2009, but all the other processors benchmarked their milk price against that.

Fragmentation, due to too much competition at the farm gate, could initially result in temporarily higher prices at the farmgate, but ultimately it will lead to lower prices as competition falls away, especially where non-cooperatives are involved. Again, dairy farmers are anxious that this could lead to the downfall of the dairy industry, as has happened with the meat industry.

**Q 3** *Do you consider some of the DIRA pro-competition regulatory measures to be more critical than others in promoting competition in dairy markets in New Zealand?*

**No** Federated Farmers submits there is no need to further promote competition at the farm gate. There is now sufficient choice, with more coming, enabling farmers to sell their milk wherever they think best.

However, Federated Farmers submits that the provision of an efficiently priced Regulated Raw Milk Regime could help the New Zealand dairy industry.

**Q 4** *In your opinion, what costs are imposed by the DIRA pro-competition regulatory measures and are these costs unduly burdensome on Fonterra and other parties? If so, what changes do you consider desirable?*

The pro-competition regulatory measures have the potential to shift the costs from the factory gate back to the farm gate. The Raw Milk Regulations has forced Fonterra to supply a set volume of milk all through the year, regardless of the season and the volume produced by its farmers. In some years of low production, Fonterra has been forced to bring milk in from other areas, in order to satisfy the demand for Regulated Raw Milk. During the winter, Fonterra pays its farmers a premium in order to satisfy the demand for this milk, which includes the liquid milk market, the powder market and the Regulated Raw Milk takers. However, in places the cost of this milk is not enough to cover the on-farm costs associated with the production of this milk. Therefore this pro-competition regulatory measure passes the cost back to the farmgate.

Fonterra is a fully integrated business, where shareholders (the farmers) pay all the costs, regardless of whether they are at the farm gate or the factory gate.

Independent milk processors have also used this regime very cleverly. Some have maximized the intake of Regulated Raw Milk by selling their own supply in the peak of the season to other factories (for example Synlait has sold milk to Westland), in order to use the total amount of Regulated Raw Milk for the season. This is because the amount taken is related to the peak month intake. This maximizes the throughput of the independent milk processor's factory.

Federated Farmers understands that many independent milk processors have used this Regulated Raw Milk to add a substantial margin per kilogram milk solids to their suppliers' payout. This is because, as was discovered during the review of the Raw Milk Regulations carried out by MAF in 2008, this milk has been underpriced. It has been cheaper for them to purchase this milk than to buy more milk from their own suppliers.

Independent processors have also used the provision of Regulated Raw Milk to mitigate the risks within its own factory. The milk it buys off Fonterra is of high quality and therefore does not have to deal with downgraded milk, which it would have to do if it used own-supply.

Federated Farmers submits that the only way to stop this type of behaviour is to efficiently price Regulated Raw Milk and to add conditions surrounding the taking of this milk. Federated Farmers supports the findings by MAF in its 'Review of the Dairy Industry Restructuring (Raw Milk) Regulations: Options for addressing industry concerns', May 2008, and in particular, Option 2(a) as a way of dealing with this issue.

**Q 5** *Do you consider that a workably competitive farm gate milk market is likely to be in place at the time the DIRA pro-competition regime is currently legislated to expire?*

**Yes** There is currently a workably competitive milk market at the farm gate, and Federated Farmers cannot see this being improved upon.

**Q 6** *If not, what level of market share threshold do you consider to be an optimal proxy for workable competition in the farm gate milk market?*

Federated Farmers submits that the current thresholds provide sufficient competition at the farm gate and that when these thresholds are reached, competition at the farm gate will continue.

**Q 7** *Is there any other measure of workable competition than a market share threshold that you consider to be a better proxy for workable competition in the farm gate milk market?*

**No**

**Q 8** *For your firm, are there close substitutes for raw milk supplied by other dairy processors as an input to your product? If so, what are these substitutes, and are they readily available and acceptable to you? If not, why not?*

**N/A**

**Q 9** *At the time of the currently legislated expiry of the Raw Milk Regulations, do you believe there will be alternative raw milk supply options for dairy food companies seeking a flat, rather than seasonal, raw milk supply? If so, what is the likely impact on the business models of dairy food companies? If not, why not?*

Federated Farmers believes that there will always be a market for milk at any time, given that firms have always had the ability to negotiate a price with a willingly seller. However, there may be times when there is no willing seller. Federated Farmers submits there remains a place for efficiently priced Regulated Raw Milk to allow those processors not wishing to buy this milk directly from farmers

**Q 10** *In your opinion, is acquiring own supply directly from farmers likely a close substitute for acquiring raw milk from a dairy processor?*

**Yes** Some processors already do this, and an example of a gain for dairy farmers can be found in Tasmania. The Ashgrove Cheese Factory processes its own milk and is looking to take on extra supply as it expands its business. It is willing to pay higher than the local milk processors for this milk in order to secure supply.

However, there will be some processors for whom having own supply will never be part of their business strategy and so access to raw milk at the factory gate will always be a reality. In order to address the issue of an unwilling seller, Federated Farmers submits that an efficiently priced Regulated Raw Milk market remains.

**Q 11** *Do you consider that workable competition in the factory gate milk market is likely to be in place at the time the Raw Milk Regulations are currently legislated to expire? If not, what threshold/criteria do you consider to be an optimal proxy for workable competition in the factory gate milk market to develop?*

**Yes** Firms have always had the option of buying milk off other firms at the factory gate. However, to address the issue of an unwilling seller of raw milk at the factory gate, efficiently priced Regulated Raw Milk should be made available.

Federated Farmers submits that it cannot see any advantage to economic growth from having legislative control of the factory gate milk market, but has little objection as long as it is efficiently priced.

**Q 12** *At what point, is it no longer justifiable from a competition policy perspective for there to remain a statutory obligation on Fonterra to supply the factory gate milk product?*

Federated Farmers submits that when the current triggers expire there will be sufficient competition at the factory gate for independent firms to continue in business, and for new ones to form.

However, if a raw milk auction (under the guise of Regulated Raw Milk) were to take

place as proposed by MAF, a price threshold would be discovered and competition would occur naturally at the factory gate. The current provision for the 2010/11 season will also allow good business decisions at the factory gate.

**Q 13** *If the Raw Milk Regulations are extended, are there viable alternatives to an auction platform that would derive an efficient price for regulated milk?*

**No** The 2010/11 allocation method for Regulated Raw Milk will give a standard price, while an auction would allow a larger profit margin to be made, albeit small. This profit, however, will be entirely dependent on the ratio of buyers and the volume of milk available. Federated Farmers submits that this volume should be capped at 500ML since the number of buyers is limited, due to New Zealand's small size.

Having Regulated Raw Milk priced via an auction platform is an efficient way of encouraging all firms to make good business decisions.

**Q 14** *Do you agree with MAF's tentative conclusion that there may be a prima facie case for extending the DIRA pro-competition regulatory regime in its entirety? Please state your reasons, along with any supporting arguments and/or evidence.*

**No** Once the current thresholds have been reached, the DIRA should fall away. Those firms in the market place need to be able to welcome the chance to be independent.

Federated Farmers has no objection to the Raw Milk Regulations remaining in place, provided it is priced efficiently.

Federated Farmers submits that the DIRA be allowed to fall away.

Federated Farmers submits that Approach 3 (Extend only the Raw Milk Regulations) be adopted. However, Federated Farmers is against lowering legislative thresholds. While we do not know what would be lowered, Federated Farmers would be completely against raising the

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volume of milk available in the regime, and ask that the volume be decreased, from 600ML to 500ML. This would allow an efficient price to be gained, allowing firms to make good business decisions.

Federated Farmers submits that, if an efficient price for regulated milk can be attained, the Raw Milk Regulations remain, giving independent firms the ability to either take this milk or not. This could remain indefinitely.

## 4. ABOUT FEDERATED FARMERS

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- 4.1. Federated Farmers of New Zealand is a primary sector organisation that represents farming and other rural businesses. Federated Farmers has a long and proud history of representing the needs and interests of New Zealand farmers.
- 4.2. The Federation aims to add value to its members' farming business. Our key strategic outcomes include the need for New Zealand to provide an economic and social environment within which:
- Our members may operate their business in a fair and flexible commercial environment;
  - Our members' families and their staff have access to services essential to the needs of the rural community; and
  - Our members adopt responsible management and environmental practices