

Cabinet Business Committee

## THE RAW MILK REGULATIONS: CABINET REPORT BACK ON OPTIONS FOR 2009/10 AND BEYOND

### Proposal

1. This paper reports back to Cabinet on the findings of the *Review of Dairy Industry Restructuring (Raw Milk) Regulations* ('the Review'). It presents five options for consideration and recommends that Cabinet agree to Option Two (a).

### Executive Summary

2. In August 2007, in the face of a risk of severe industry disruption, the Government imposed a two year interim solution for the supply of regulated milk pending the outcome of the Review.
3. The Review identified three issues:
  - a. The current default pricing formula is under-pricing regulated milk;
  - b. The Regulations do not manage situations of excess demand for regulated milk by independent processors; and
  - c. There is an unmanaged transition risk associated with the prospective ending of the statutory obligation on Fonterra Cooperative Group Limited ('Fonterra') to supply regulated milk.
4. I have also directed the Ministry of Agriculture and Forestry (MAF) to develop options that seek to minimise any negative impact on the prices paid by domestic consumers.
5. Five options are outlined:
  - a. **Option One:** *Extend the current interim solution.* This requires the Regulations to be amended to retain the supply of 600 million (M) litres at current default pricing for the next dairy season only. In 2009 the Government would have to consider what to do in subsequent years;
  - b. **Option Two (a) [Recommended Option]:** *Retain the default price in 2009/10 and signal an auction process for 2010/11.* This requires the Regulations to be amended to retain the supply of 600M litres. It also requires a Bill to be drafted to make the necessary amendments to the Dairy Industry Restructuring Act (2001) ('the DIRA') to implement an

auction. This Bill would need to be introduced in the next parliamentary term;

- c. **Option Two (b):** *Amend the Regulations to adopt the farm gate price from 1 June 2009 and signal an auction process for 2010/11.* This option is the same as option Two (a) except that it involves amendment to the regulations to replace the default milk price with the higher farm gate milk price in 2009/10, before moving to an auction in 2010/11;
  - d. **Option Three:** *Impose time limits on large scale processors with own (non-Fonterra) milk supplies.* This requires the Regulations to be amended to retain the supply of 600M litres at the current default price. It also requires the Regulations to be amended to define classes of processor to be excluded from the supply of regulated milk over time (this change does not require legislative amendment); and
  - e. **Option Four:** *Establish a two-tier pricing system.* This requires a Bill to be passed during this parliamentary term to implement the two-tier pricing of raw milk. Large processors (those classed as large-scale independent processors with their own milk supply) would pay a higher 'exporter' price (a fairer reflection of cost) than small-scale processors or those processors (such as Goodman Fielder Limited and Cadbury Confectionary Limited ['Cadbury']) without their own supply who would continue to pay the current default price.
6. The only difference between Options Two (a) and Two (b) is that Option Two (b) moves to the higher farm gate milk price in 2009/10 before moving to the auction price in 2010/11. Option Two (b) smoothes the transition to higher milk prices by raising the wholesale price in 2009/10 some of the way before the auction price is implemented in 2010/11.
7. Options Two (a), Two (b) and Four will over time replace the current default pricing formula leading to moderate increases in domestic milk and dairy prices over the current default price for regulated milk. While accurate predications are very difficult, a reasonable estimate is that:
- a. **Option Two (a):** domestic wholesale prices might increase by 3-5 cents a litre from 1 June 2010 relative to the default price; and
  - b. **Option Two (b):** domestic wholesale prices might increase by 2-3 cents a litre from 1 June 2009 before the total increase of 3-5 cents a litre from 1 June 2010, relative to the default price.
  - c. **Option Four:** domestic wholesale prices might increase by 3-4 cents a litre from 1 June 2011 relative to the default price.
8. It is not possible to estimate what the retail impact will be of the price increases associated with options Two (a), Two (b) and Four. However, it is reasonable to expect at least the wholesale price increases will be passed on to consumers.
9. It is also important to note that MAF is forecasting that the Fonterra payout (and hence the default price) will be lower in the 2009/10 and 2010/11 seasons than

the 2007/08 season. This view is shared by Fonterra and independent dairy analysts. This implies that domestic wholesale milk prices will fall relative to the 2007/08 default price. While this fall could be of a similar or greater magnitude to the increases associated with options Two (a), Two (b) and Four, it is very difficult to predict with a high degree of certainty given the volatility in exchange rates and international commodity prices plus the need to account for lags in domestic prices.

10. While no increase in domestic prices is desirable from a consumer perspective, it is important to note that the price increase resulting from options Two (a), Two (b) and Four resolves a long standing under-pricing issue and is comparatively modest compared to drivers such as exchange rates, international commodity prices, and increasing production and distribution costs.
11. While Option Three does not envisage any change to the default formula, given the under-pricing that is present in the existing default formula it is highly questionable whether such a policy is durable even with the imposition of time limits on 'exporter' processors. This implies that all options, excluding Option Two (b) only postpone a relative increase in domestic prices due to the current under-pricing of regulated milk. Option Two (b) starts and smoothes the transition to higher wholesale prices from 2009/10.
12. All options require an amendment to the Regulations in terms of quantity to ensure demand does not exceed supply. The time available for such an amendment is very tight.
13. Options Three and Four were developed late in the process on very short notice. Neither of these options has been through a consultation process with stakeholders. This raises the risk of judicial review based on the Government not having consulted with affected parties. While the likelihood of a challenge is considered to be high and the probability of success is assessed to be low.
14. Options Two (a), Two (b) and Four require legislative change. However, Options Two (a) and Two (b) do not require a Bill to be passed this Parliamentary term whereas Option Four does.
15. Two rounds of consultation with industry participants and interested stakeholders have been undertaken, with the second consultation document signalling the auction process as the preferred option.
16. Consultation revealed that there is, at best, mixed support for Options Two (a) and Two (b) (the auction process): While Federated Farmers and Synlait Dairies Limited strongly supported the proposal (albeit with some caveats), most independent processors favoured retaining the default pricing formula whilst substantially increasing the quantity of raw milk made available.
17. In comparison, Fonterra (and Fonterra suppliers) wanted the opposite: a smaller quantity of regulated milk at a substantially higher price.

18. The Commerce Commission also expressed concerns regarding any move from the default pricing formula and the introduction of an auction from a competition policy perspective.
19. A 'sleeper' issue has emerged regarding the sunset clauses contained in the DIRA. These clauses could expire as soon as 2013 (and possibly earlier) and once expired, the statutory obligation on Fonterra to provide regulated milk ceases. This has resulted in serious concerns from industry stakeholders (e.g. Cadbury and small scale processors) and the Commerce Commission about the ability of independent processors to secure raw milk on competitive terms in a post-DIRA environment.
20. Given the Commission's concerns, and in the absence of a method to manage transition issues, it is likely that a future government will be under significant pressure to undertake a comprehensive review of the DIRA with particular reference to the DIRA sunset clauses.
21. MAF estimates that such a Review would take two years (including a legislative process). Given that such a review would revisit the agreement that led to the creation of Fonterra it is highly likely that Fonterra would need to review the timeframe for making a decision regarding its future capital structure.
22. While the issue of the DIRA sunset clauses are outside of the scope of this Review, it is my view that a well functioning auction provides a future government with a high degree of choice to manage a smooth transition to a post-DIRA environment.
23. Options One, Three and Four focused on addressing domestic pricing concerns so were not specifically designed to address the transition issue.
24. The Review also sought stakeholder views on a minor technical change to the definition of winter milk, which is defined in the Regulations.<sup>1</sup> The majority of stakeholders were supportive of the change. It is recommended that this change be incorporated when the Regulations are amended.
25. In August 2007 the Regulations Review Committee (the Committee) published its report regarding a complaint associated with the DIRA, and recommended that the Government amends regulation 8(6) of the Regulations to take into account the Committee's views.
26. As the recommended option is based on replacing the default pricing formula with the Fonterra farm gate milk price as the auction reserve, this issue no longer requires attention.

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<sup>1</sup> Winter milk is defined as raw milk supplied by Fonterra in May, June and July. As it is produced 'out of season' it attracts a premium to allow for increased production costs.

## Background

### *The Raw Milk Regulations*

27. The Regulations are part of a suite of pro-competitive measures that were implemented at the time of Fonterra's formation. The Regulations require Fonterra to supply a specified quality of raw milk at a regulated price to independent processors (this term is defined in the DIRA). Under the DIRA the Minister of Agriculture can compel Fonterra to divest up to 5% of its milk.
28. The Regulations aimed to:
  - a. protect the position of companies that bought raw milk from either the Kiwi Cooperative Dairy Company or NZ Dairy Group Limited from monopoly pricing (e.g. Cadbury);
  - b. protect domestic consumers from monopoly pricing (this is achieved through ensuring Fonterra has a national competitor in the form of Goodman Fielder); and
  - c. provide an entry path for new processors into the milk processing industry.
29. The quantity of milk made available under the Regulations was set at 400M litres from 2002 until the 2006/07 season; with temporary increases to 500M litres and 600M litres in 2007/8 and 2008/9 only. Unless action is taken, the Regulations will revert to 400M litres from the 2009/10 season. This outcome is undesirable as it would lead to ongoing uncertainty and disruption as demand is expected to exceed the 400M litre threshold.
30. The price of regulated milk is currently derived from a formula that is specified in the Regulations. A formula was required due to historical industry practice of bundling milk and capital payments into a single 'milk payout cheque', with the formula splitting out the 'dividend' part of the payout – thereby leaving the 'milk price'. These are referred to as the 'default formula' and 'default milk price'.
31. Regulated milk was never intended to be:
  - a. '**Cheap**': either in the sense of creating a domestic 'cheap food' policy or to subsidise entrance by new processors. Instead, the intent was to approximate – as close as possible – a commodity or 'farm gate milk price'; or
  - b. '**Permanent**': once a sufficient level of competition was re-created then the competition mechanisms contained within the DIRA (including the provisions for the Regulations) will expire. These are referred to as the 'DIRA sunset clauses'.
32. Since the 2006/07 dairy season Fonterra has unbundled its payout into distinct milk and dividend components. This paper refers to the milk component of the Fonterra payout as the 'farm gate milk price'.

### *Need for a Review*

33. The Regulations came under significant pressure in June 2007, as Fonterra did not adequately manage the transition to a situation of excess demand for regulated milk from independent processors. The uncertainty that resulted had the potential to cause significant industry disruption including company failures.
34. On 8 August 2007, the Cabinet Economic Development Committee, having been authorised with Power to Act [CAB Min (07) 28/7 refers]:
  - a. **agreed** to an interim solution that the Raw Milk Regulations be amended to require Fonterra to increase the supply of regulated milk from up to 400M litres to up to 500M litres for the 2007/08 season and up to 600M litres for 2008/09 season only; and
  - b. **directed** officials, led by the Ministry of Agriculture and Forestry, to undertake a review of the Raw Milk Regulations [EDC Min (07) 16/1 refers].
35. Cabinet invited the Minister of Agriculture to report back to Cabinet on this Review by 31 July 2008. In doing so, Cabinet noted that this timing would allow independent processors to prepare for any changes to the regulatory regime, including securing additional suppliers, in time for the 2009/10 season.
36. Cabinet also agreed that the following principles would apply to the Review:
  - a. the 'open entry and exit' regime in the DIRA is the primary means for promoting a competitive market for raw milk. The Regulations need to be considered in this context;
  - b. milk that is required to be made available under the Regulations should be made available at a fair and efficient price; and
  - c. the Regulations should promote competition at the farm gate for raw milk by not discouraging independent processors from sourcing milk on standard commercial terms directly from farmers [POL (07) 25/7 refers].

### **Review Findings**

37. The Review identified three issues:
  - a. The current default pricing formula is under-pricing regulated milk;
  - b. The Regulations do not manage situations of excess demand for regulated milk by independent processors; and
  - c. There is an unmanaged transition risk associated with the prospective ending of the statutory obligation on Fonterra to supply regulated milk due to the expiry of the sunset clauses contained in the DIRA.
38. In addition to these three issues, the issue of domestic pricing impacts have also been considered.
39. These issues are examined in turn.

## Issues Regarding the Default Pricing Formula

40. The default pricing formula has not been without controversy. Fonterra has long argued that the default formula systematically under-prices regulated milk whereas independent processors have taken issue with aspects of the pricing formula through the Commerce Commission, the Supreme Court, and the Regulations Review Committee.
41. To retain objectivity, officials have until now specifically refused to be drawn into the debate as to whether the default milk price is under-priced (or not). Instead, officials have noted that since Fonterra is now unbundling its payout into distinct milk and capital components the need to have a separate formula to perform the same function is largely redundant.
42. There is however an increasing amount of evidence that suggests that the default pricing formula is under-pricing regulated milk. This implies that in most seasons, independent processors have been able to access Fonterra milk at a lower price than Fonterra pays its own farmers.
43. 2007/08 prices illustrate this under-pricing issue (see table 1). For completeness, prices are listed in kilograms of milk solids (kgMS) and litres.

Table 1: Milk prices 2007/08

	<b>KgMS</b>	<b>Litre</b>
<b>Default price paid by independent processors</b>	\$7.24	\$0.603
<b>Price paid by Fonterra to its farmer-suppliers ('farm gate price')</b>	\$7.55	\$0.629
<b>Estimated price range paid by independent processors for non-Fonterra milk</b> (Source: MAF contacts with independent processors)	\$7.65 – \$7.95	\$0.637 - \$0.662

44. The key points from table 1 are:
  - a. In 2007/08 Fonterra was obliged to sell milk at 31 cents per kgMS (or 2.6 cents per litre) less than it paid its farmers; and
  - b. Independent processors that source their own milk supplies from farmers are paying between 41 to 71 cents kgMS (or 3.4 to 5.9 cents per litre) more for milk compared to the default price.
45. On the basis of the 2007/08 season, Fonterra claims that the Regulations cost the company \$29 million, which is split:

- a. \$14 million as the direct cost of selling milk to independent processors for less than it pays its own farmer-suppliers; and
- b. \$15 million in terms of lost revenues from Fonterra Brand's sales into the domestic market.<sup>2</sup>

46. The 2007/08 season is not unique. Fonterra reports that with the exception of the 2006/07 season, the default pricing formula has under-priced regulated milk. The annual amounts are outlined in table 2.

Table 2: Difference between the default and Fonterra milk price

Year	2002/03	2003/04	2004/05	2005/06	2006/07
<b>Cents kgMS</b>	<b>Withheld under s9(2)(ba)(i) of the Official Information Act</b>				
<b>Cents per litre</b>					

47. Fonterra is deeply concerned about what it perceives as a serious financial risk to the cooperative through regulated milk. In addition to revenue Fonterra claims it is losing, Fonterra also argues that under-priced regulated milk significantly reduces the entry barriers for new processors to enter the industry and this exacerbates its redemption risk.<sup>3</sup>
48. Both the Regulations and the open entry and exit provisions in the DIRA are intended to provide an entrance pathway for new independent processors and place competitive pressure on Fonterra by imposing a redemption risk. However, it is important that entry decisions of new processors are not based on access to under-priced milk as this can lead to distorted investment decisions and the potential for excess investment in processing facilities.

*Managing excess demand*

49. The Regulations are silent on what happens should excess demand for regulated milk by independent processors develop (indeed, this is the very issue that led to the need for the Review in the first place). While the Regulations envisaged the need for an entrance pathway for new processors, given that regulated milk tends to be under-priced there is no incentive for independent processors to ever cease accessing regulated milk.
50. There are three approaches to addressing the excess demand issue:
- a. allow the price of regulated milk to increase until supply matches demand;
- or

<sup>2</sup> This is because Fonterra Brands gets milk at the same price as Goodman Fielder Limited, who access regulated milk at the default price.

<sup>3</sup> Redemption risk occurs when farmers chose to leave Fonterra and supply other milk processors. Fonterra's shares are fully redeemable/refundable when a farmer exits the co-operative, which can result in capital flight as Fonterra pays exiting farmers while at the same time faces a diminishing supply of raw milk.

- b. introduce a quantity rationing rule such as a pro-rata allocation (this means that all independent processors are equally scaled); or
- c. impose time limits on the supply of regulated milk to some or all independent processors.

### *Transition issues*

- 51. Whilst clearly signalled in the second Raw Milk Consultation Document, a 'sleeper' issue has emerged regarding the DIRA sunset clauses. The clauses could expire as soon as 2013 (and possibly earlier). Once expired, the statutory obligation on Fonterra to provide regulated milk ceases. This has resulted in serious concerns from industry stakeholders (e.g. Cadbury and small scale processors) about the ability of independent processors to secure raw milk on competitive terms in a post-DIRA environment.
- 52. The Commerce Commission also expressed considerable concerns regarding the sunset clauses, stating that:
  - a. the level that the sunset clauses were set at were too generous to Fonterra (and as a consequence, should be substantially increased); and
  - b. the process for expiration of the raw milk regulations was considered too abrupt and would benefit from having a five year phase out period.
- 53. While an examination of the DIRA sunset clauses were outside the scope of the Review, the need for a smooth transition into a post-DIRA environment was recognised and incorporated into Options Two (a) and Two (b).

### *Domestic pricing implications*

- 54. Officials' estimate of the possible domestic wholesale price impacts of:
  - a. Option Two (a): between 3-5 cents per litre from 1 June 2010;
  - b. Option Two (b): between 2-3 cents a litre from 1 June 2009, and a total of 3-5 cents a litre from 1 June 2010, and
  - c. Option Four: between 3-4 cents per litre from 2011/12.

It is not possible to estimate the impact at the retail level but it is reasonable to assume at least a 100% pass through of any increase.

- 55. There are many other factors that affect likely price movements, notably exchange rates and international commodity prices. These are likely to have a much greater bearing on domestic prices than changing the price of regulated milk.
- 56. It is also important to note that MAF is forecasting that the Fonterra payout in the 2009/10 and 2010/11 seasons will be lower than the 2007/08 payout. This view is shared by Fonterra and independent dairy analysts. This implies that domestic wholesale milk prices will fall relative to the 2007/08 default price. While this fall could be of a similar magnitude or greater to the increases

associated with Options Two (a), Two (b) and Four, it is very difficult to predict with a high degree of certainty given the volatility in exchange rates and international commodity prices plus the need to account for lags in domestic prices.

57. Table 3 summarises the timing of the domestic wholesale price impacts of the different options.

**Table 3: Timing of Domestic Wholesale Price Impacts**

	<b>08/09</b>	<b>09/10</b>	<b>10/11</b>	<b>11/12</b>
Option 1 – Extension	No change	No change	?	?
Option 2(a) – Auction	No change	No change	<b>New price</b>	<b>New price</b>
Option 2(b) – Auction	No change	<b>New price</b>	<b>New price</b>	<b>New price</b>
Option 3 – Time limits	No change	No change	No change	No change
Option 4 – Differential pricing	No change	No change	No change	<b>New price</b>

### **Option outline and analysis**

#### *Option One: Extend the current interim solution*

58. Option One involves amending the regulations so that Fonterra must supply up to 600M litres of raw milk at the default price for the 2009/10 season only.
59. Option One extends the interim solution from 2008/09 for another season. In 2009 the Government would have to consider what to do in subsequent years. This option defers action on the review issues and leaves uncertainty regarding domestic prices beyond 2009/10.

#### *Option Two (a): Retain the default price in 2009/10 and signal an auction process for 2010/11 [Recommended Option]*

60. Option Two (a) involves:
- a. Amending the Regulations so that Fonterra must supply up to 600M litres of raw milk at the default price for the 2009/10 season (and until an auction is enacted);
  - b. Amending the regulations so that Fonterra is able to manage situations of excess demand through an equal scaling back of all processor demand (that is, until an auction is enacted); and
  - c. Amending the DIRA and Regulations in order to permit an auction with independent processors bidding for the right and – potentially - the obligation to buy raw milk at the farm gate price (this includes the ability to set an auction reserve price).
61. The current default pricing formula is retained for 2009/10 and replaced by the auction in 2010/11.

62. The auction would involve an online platform where independent processors could bid for a 'portfolio' of milk up to its respective processor limit. Processors would then schedule and forecast the delivery of raw milk as per the status quo.
63. Consultation revealed that small processors were concerned about being out-bid or left without milk supplies as a result of the auction process. They were also concerned about scheduling rules, security of supply, and lot sizes. The auction can be designed to address these concerns.
64. Option Two (a) addresses all three Review concerns as follows:
  - a. it removes the under-pricing issue by replacing the default pricing regime with an auction to purchase the right and - potentially - the obligation to buy milk at the Fonterra farm gate milk price from 2010/11;
  - b. the auction process manages excess demand by using price to match the demand for with the supply of regulated milk; and
  - c. it provides a future government (and Fonterra) with a high degree of optionality on managing the transition to a post-DIRA environment in a smooth fashion.
65. Optionality is provided in the following ways:
  - a. Fonterra could voluntarily agree to continue to supply milk as:
    - I. It is commercially attractive to do so; and/or
    - II. It is substantially reduces the need for a comprehensive DIRA review.
  - b. A future government could:
    - I. Legislate Fonterra to continue to supply raw milk for a period of time whilst still allowing the DIRA sunset clauses to expire (thereby avoiding the need for a comprehensive review); or
    - II. Impose a universal service obligation on all processors beyond a certain size to divest a quantity of raw milk to be sold on the auction platform.
66. The key point is that no decision needs to be made now but the ability to make decisions is preserved.
67. The auction process has been well socialised with stakeholders through the consultation process.

*Option Two (b): Replace the default formula with the farm gate price in 2009/10 and signal an auction process for 2010/11*

68. Option Two (b) is the same as option Two (a) except that it involves amending the regulations to replace the default milk price with the farm gate milk price in 2009/10.
69. The auction process has been well socialised with stakeholders through the consultation process.

70. Option Two (b) addresses the Review's concerns and provides optionality in the same way as Option Two (a).

*Option Three: Impose time limits on large scale processors with own milk supplies*

71. Option Three involves amending the Regulations so that:
- a. Fonterra must supply up to 600M litres of raw milk at the default price for the 2009/10 season (and beyond);
  - b. Fonterra is able to manage situations of excess demand through an equal scaling back of all processor demands;
  - c. Fonterra's obligation to supply regulated milk to 'existing processors' (as defined in the DIRA – e.g. the Tatura Cooperative Dairy Company ['Tatura']) expires on 31 May 2010;
  - d. A new class of large scale export oriented independent processor with own supply is created ('exporter processors'), which is defined as firms that have 100M litres (or more) of non-Fonterra supply.
  - e. Exporter processors are only entitled to access regulated milk for three years in total, from 1 June 2008.
72. The current default pricing formula is retained.
73. The affect of the time limits would be to end the ability of affected firms to access milk according to the following timeline:
- a. Tatura – 31 May 2010 (one more season);
  - b. Dairy Trust/Open Country Cheese, New Zealand Dairies, Synlait – 31 May 2011 (two more seasons); and
  - c. Matura Valley Milk – 31 May 2012 (three seasons commencing 1 June 2009).
74. In terms of the three issues identified by the Review Option Three does not address the under-pricing issue at all, may not address the excess demand issue in the short run (hence the rationing rule) and leaves the issue of a transition unmanaged. This is likely to be of particular concern to Cadbury, Goodman Fielder and the small processors.
75. Option Three has not been subjected to consultation with stakeholders. This raises a risk that affected parties may complain as a result of the lack of consultation. This could potentially expand into a legal challenge on this ground. Officials have assessed the probability of a successful challenge as being low.

*Option Four: Establish a two-tier pricing system*

76. Note that the timing for this option to be implemented is extremely tight as it requires legislative amendment this calendar year.

77. Option Four involves:
- a. Amending the DIRA in order to allow differential pricing;
  - b. Passing the amendment Bill this Parliamentary term;
  - c. Amending the Regulations so that:
    - I. Fonterra must supply up to 600M litres of raw milk at the default price for the 2009/10 season (and beyond);
    - II. a new class of large scale export oriented independent processor with own supply is created ('exporter processors'), which is defined as firms that have 100M litres (or more) of non-Fonterra supply.

**NB:** By default, all other independent processors are classed as 'domestic processors'.

    - III. a second formula to derive the 'exporter' price for 'exporter processors' is specified;
    - IV. the allocation for 'exporter processors' is limited to 200M litres per annum (the 'exporter' pot);
    - V. a 'domestic pot' of 400M litres is created; and
    - VI. to establish the following rationing rules;
  - d. If excess demand occurs in the 'domestic pot', domestic processors have first call on milk in the 'exporter pot', with this milk being available at the default price;
  - e. If the domestic pot is under subscribed, the excess milk is available to 'exporter processors' at the 'exporter price';
  - f. If excess demand arises in the 'exporter pot', the excess demand is equally scaled back across exporter processors; and
  - g. Equalising prices in 2011/12.
78. Under Option Four, Tatura, Dairy Trust/Open Country Cheese, New Zealand Dairies, Synlait, and Mataura Valley Milk will be classed as 'exporter processors' so will pay the exporter price from 2009/10. All other processors (e.g. Goodman Fielder, Cadbury, the small processors) would access regulated milk at the default price until 2010/11 and pay the exporter price from 2011/12.
79. Option Four partially addresses the under-pricing and excess demand issues but does not address the transition issue.
80. Option Four has not been subjected to consultation with stakeholders, which raises the risk of:
- a. A challenge based on an expectation of consultation; and
  - b. Affected processors seek a Commerce Commission determination regarding the pricing methodology used to achieve the higher price.

## Stakeholder Consultation

### *The Consultation Process and stakeholder feedback*

81. On 2 April 2008, the Cabinet Policy Committee, having been authorised with Power to Act, agreed to publicly release a second Raw Milk Consultation document [CAB Min (08) 5/3 refers].
82. The resulting document, Review of the Dairy Industry Restructuring (Raw Milk) Regulations: Options for Addressing Industry Concerns outlined an auction process as the Review's preferred option as it is the option most likely to ensure regulated milk is fairly and efficiently priced.
83. 52 submissions were received on the second discussion document. A summary of submissions is attached as **Annex A**. Officials met with a wide range of stakeholders during both consultation stages (sometimes on multiple occasions). A full list of the stakeholders that made written submissions to both consultation rounds can be found in **Annex B**.
84. Consultation revealed that there is, at best, mixed support for the auction process. While Federated Farmers and Synlait Dairies Limited strongly supported the proposal (albeit with some caveats), most independent processors favoured retaining the default pricing formula whilst substantially increasing the quantity of raw milk made available.
85. As outlined in annex A, independent processors also expressed a range of concerns regarding auction design issues (e.g. scheduling rules, security of supply, and lot sizes). These concerns have been noted and can be addressed through the auction design process.
86. In comparison, Fonterra (and Fonterra suppliers) wanted the exact opposite to the independent processors: a smaller quantity of regulated milk at a substantially higher price.

### *Commerce Commission Submission*

87. The Commerce Commission expressed concerns regarding the auction process and Fonterra's ability to manipulate prices. MAF has commissioned a peer review of the Commission's submission from Professor Lewis Evans of Victoria University and NERA Economic Consultants. Neither MAF, Professor Evans nor NERA Economic Consultants share the Commission's concerns on these matters.
88. Whilst signalled by the Review in the second consultation document, a 'sleepers' issue has emerged regarding the sunset clauses contained in the DIRA; which could expire as soon as 2013 (and possibly earlier). Once expired, the statutory obligation on Fonterra to provide a quantity of raw milk at a regulated price ceases. This has resulted in serious concerns from industry stakeholders (e.g. Cadbury) and the Commerce Commission about the ability of independent

processors to secure raw milk on competitive terms in a post-DIRA environment.

89. The Commerce Commission also expressed considerable concerns regarding the sunset clauses, stating that:
  - a. the level that the sunset clauses were set were considered to be too generous to Fonterra (and as a consequence, should be substantially increased); and
  - b. the process for expiration of the raw milk regulations was considered too abrupt and would benefit from having a five year phase out period.
90. Both MAF and Professor Evans share the Commission's concerns about the abrupt ending of the supply of regulated milk. As outlined in paragraphs 61-63 (above), adopting an auction process is considered to give a future government a high level of optionality to deal with the transition issues.
91. Given the Commission's concerns, and in the absence of a method to manage transition issues, it is likely that a future government will be under significant pressure to undertake a comprehensive review of the DIRA with particular reference to the DIRA sunset clauses.
92. MAF estimates that such a review would take two years (including a legislative process). Given that such a review would revisit the agreement that led to the creation of Fonterra it is highly likely the Fonterra would need to review the timeframe for making a decision regarding its future capital structure.

### **Winter Milk Issues**

93. The consultation process also sought stakeholder views as to whether the current definition of winter milk (defined as raw milk supplied in May, June, and July) should be changed to being defined as milk supplied in June and July only. The reason for this change is that Fonterra has sufficient milk supplies in May but is required to average winter milk premiums over three months, which results in a degree of under-recovery of winter milk costs. Averaging the price over two months eliminates this issue.
94. Most stakeholders favoured the change. Changing the definition of winter milk requires a minor technical amendment to the Regulations. It is recommended that these changes be incorporated when the Regulations are amended.

### **The Regulations Review Committee Report**

95. In August 2007 the Regulations Review Committee (the Committee) published its report regarding a complaint associated with the DIRA, and recommended that the Government amends regulation 8(6) of the Regulations to take into account the Committee's views.
96. As the recommended option is based on replacing the default pricing formula with the Fonterra farm gate milk price, this issue no longer requires attention.

## **Legislative Implications**

97. The Crown Law Office confirms that legislative change will be required to the Dairy Industry Restructuring Act 2001 if option Two (a), Two (b), or Four are proceeded with.

## **Legislative Programme**

### *Options Two (a) and Two (b)*

98. To implement the auction under Options Two (a) or Two (b), legislative change to the DIRA will be required to allow regulated raw milk to be sold at multiple prices and to permit a reserve price.
99. Proposed title: Dairy Industry Restructuring Act (Raw Milk Auction) Bill, Category 5, estimated number of clauses: 2.
100. There are likely to be contentious issues regarding multiple pricing.
101. The proposed DIRA (Raw Milk Auction) Bill is binding on the Crown.
102. As part of the Raw Milk Review, a discussion document covering a suite of options including the preferred option of an auction was released to industry stakeholders and the Commerce Commission seeking feedback on the proposed options. The Ministry of Economic Development and the Treasury have also been consulted on the auction.
103. Regulations will be required subsequent to the DIRA (Raw Milk Auction) Bill to give effect to the policy decision. These will cover:
- a. the auction platform;
  - b. the reserve price;
  - c. auction management; and
  - d. other auction design features.
104. To allow sufficient time for independent processors to secure milk supply for the 2010/11 season, the Bill would need to be enacted by November 2009. This would require a Select Committee report back by October 2009, introduction of the Bill by May 2009, LEG and Cabinet approval by April 2009, the Bill to be provided to the Ministry of Justice by March 2009, and for drafting instructions to be issued to the Parliamentary Council Office by September 2008.

### *Option Four*

105. To implement a two-tier pricing regime, legislative change to the DIRA is required to allow regulated raw milk to be sold at two prices.

106. Proposed title: Dairy Industry Restructuring Act (Two-tier Pricing) Bill, Category: 5, estimated number of clauses: 10.
107. There are likely to be contentious issues regarding two-tier pricing.
108. The proposed Bill is binding on the Crown.
109. Private sector stakeholders have not been consulted on the two-tier pricing option. The Ministry of Economic Development and the Treasury have been informed.
110. Regulations will be required subsequent to the Bill to give effect to the policy decision. These will be around amendment to the quantity of raw milk supplied and to identify separate classes of independent processors.
111. Timeline: Enacted under urgency by November 2008.

### **Consultation**

112. The Ministry of Agriculture and Forestry has consulted the Ministry of Economic Development and the Treasury during the development of this paper and the respective departmental views are represented.
113. The Department of Prime Minister and Cabinet was informed of this paper.

### **Fiscal Implications**

114. There are no fiscal implications associated with the recommendations contained in this paper.

### **Human rights**

115. Officials consider that this paper is not in any way inconsistent with the New Zealand Bill of Rights Act 1990 and the Human Rights Act 1993.

### **Regulatory impact analysis**

116. MAF confirms that the regulatory impact analysis requirements, apart from the consultation Regulatory Impact Assessment requirements, have been complied with. A Regulatory Impact Statement was prepared and the Regulatory Impact Analysis Unit considers the analysis and the Regulatory Impact Statement to be adequate. However, the Regulatory Impact Assessment Unit notes that there has been no consultation with stakeholders on options One, Three and Four, and therefore considers that the consultation on those options is inadequate. The final Regulatory Impact Statement was circulated with the Cabinet paper for departmental consultation.

## **Publicity**

117. I intend to issue a press release announcing the Cabinet decisions on these matters. Due to the high level of stakeholder interest in this issue, I consider it advisable to release this paper, the Commerce Commission submission to the Review, and Annex A (Summary of Stakeholder submissions) and Annex B (List of submitters that made submissions to the second consultation round).
118. I also consider it advisable that Fonterra, Federated Farmers and the Commerce Commission be provided with an embargoed copy of the press release and be provided with an oral briefing prior to any public announcement.

## Recommendations

The Minister of Agriculture recommends that Cabinet:

1. **Note** that the Raw Milk Regulations Review sought to respond to the issues raised by the Regulations Review Committee in August 2007 regarding how retentions are calculated as part of the default pricing formula for regulated milk;
2. **Note** that given the recommended option arranges to end the default pricing formula, the issue with the formula components no longer needs to be addressed;
3. **Note** that on 8 August 2007, the Cabinet Economic Development Committee, having been authorised with Power to Act [CAB Min (07) 28/7]:
  - 3.1. **agreed** to an interim solution that the Dairy Industry Restructuring (Raw Milk) Regulations 2001 be amended to require Fonterra to increase the supply of regulated raw milk from up to 400M litres to up to 500M litres for the 2007-08 season and up to 600M litres for 2008-09 season only; and
  - 3.2. **directed** officials, led by the Ministry of Agriculture and Forestry, to undertake a review of the Raw Milk Regulations [EDC Min (07) 16/1 refers];
4. **Note** that the Review found that the three main issues regarding the Dairy Industry Restructuring (Raw Milk) Regulations 2001 are:
  - 4.1. The current default pricing formula is under-pricing regulated milk;
  - 4.2. They do not manage situations of excess demand for regulated milk; and
  - 4.3. There is an unmanaged transition risk associated with the prospective ending of the statutory obligation on Fonterra to supply regulated milk;
5. **Note** that in addition to addressing these issues, officials were subsequently instructed to consider limiting the impact of regulatory change on New Zealand domestic retail dairy prices;
6. **Note** that new options have been developed since the Review consultation process, and officials advise that decisions to undertake these options (Options Three and Four) could face legal challenge on the grounds of lack of consultation;
7. **Note** that Option Two (b) is the only option that will have any impact on domestic consumer dairy prices in the 2009/10 season;
8. **Note** that Options Two (a) and Two (b) are the only options which have been consulted on and the only options that addresses all the issues raised in the review (see Recommendation 4 above);
9. **Note** that the timing for Option Four to be implemented is extremely tight as it requires legislative amendment this calendar year;

10. **Agree** that Annex A (Summary of Stakeholder submissions) and Annex B (List of submitters that made submissions to the second consultation round) be publicly released;
11. **Agree** that this paper and the Commerce Commission submission be publicly released;
12. **Agree** to change the definition of winter milk to milk supplied in June and July only; and
13. **Invite** the Minister of Agriculture to issue drafting instructions to PCO to amend the Dairy Industry Restructuring (Raw Milk) Regulations 2001 to enable the change to the definition of winter milk.
14. **EITHER**

*Option One: Extend the current interim solution*

- 14.1. **Agree** to Option One which extends the 600M litre interim solution from the 2008/09 season into the 2009/10 season only, so that Fonterra must supply up to 600M litres of raw milk at the default price;
- 14.2. **Invite** the Minister of Agriculture to issue drafting instructions to PCO to amend the Dairy Industry Restructuring (Raw Milk) Regulations 2001 to ensure supply of 600 million litres of raw milk for 2009/10 season only.

**OR**

*Option Two (a): Retain the default price in 2009/10 and signal an auction process for 2010/11 [Recommended Option].*

- 14.3. **Agree** to Option Two (a) to amend the quantity of raw milk to up to 600M litres from 2009/10, retain the default price for 2009/10 only, and introduce an auction in 2010/11;
- 14.4. **Invite** the Minister of Agriculture to issue drafting instructions to PCO to amend the Dairy Industry Restructuring (Raw Milk) Regulations 2001 to:
  - 14.4.1. ensure supply of 600 million litres for 2009/10 season and beyond; and
  - 14.4.2. enable Fonterra to manage excess demand for raw milk by scaling back all processor demands equally;
- 14.5. **Note** that the above changes to the DIRA Regulations need to be in place by November 2008 to provide sufficient time for independent processors to secure their milk supply for the 2009/10 season;

- 14.6. **Approve** the inclusion of the DIRA (Raw Milk Auction) Bill in the 2008 legislation programme, category 5, to be introduced by May 2009 and enacted by November 2009;
- 14.7. **Invite** the Minister to issue drafting instructions to PCO to amend the Dairy Industry Restructuring Act 2001 to implement an auction of raw milk (including a reserve);
- 14.8. **Invite** the Minister to issue drafting instructions to PCO to amend the Dairy Industry Restructuring (Raw Milk) Regulations 2001 to implement an auction of raw milk;
- 14.9. **Note** that the DIRA (Raw Milk Auction) Bill will be binding on the Crown;
- 14.10. **Note** that the drafting instructions for the DIRA (Raw Milk Auction) Bill will be issued to Parliamentary Counsel Office by September 2008;
- 14.11. **Note** that the DIRA (Raw Milk Auction) Bill should be introduced no later than May 2009;
- 14.12. **Note** that the DIRA (Raw Milk Auction) Bill should be passed no later than November 2009.

**OR**

*Option Two (b): Amend the Regulations to adopt the farm gate price from 1 June 2009 and signal an auction process for 2010/11.*

- 14.13. **Agree** to Option Two (b) to amend the quantity of raw milk to up to 600M litres from 2009/10, replace the default price with the farm gate price for 2009/10 only, and introduce an auction in 2010/11;
- 14.14. **Invite** the Minister of Agriculture to issue drafting instructions to PCO to amend the Dairy Industry Restructuring (Raw Milk) Regulations 2001 to:
  - 14.14.1. ensure supply of 600 million litres for 2009/10 season and beyond;
  - 14.14.2. replace the default pricing formula with the Fonterra farm gate milk price; and
  - 14.14.3. enable Fonterra to manage excess demand for raw milk by scaling back all processor demands equally;
- 14.15. **Note** that the Fonterra farm gate milk price is defined as the milk component of the Fonterra payout as reported in Fonterra's annual report for the associated season;
- 14.16. **Note** that the above changes to the DIRA Regulations need to be in place by November 2008 to provide sufficient time for independent processors to secure supply for the 2009/10 season;

- 14.17. **Approve** the inclusion of the DIRA (Raw Milk Auction) Bill in the 2008 legislation programme, category 5, to be introduced by May 2009 and enacted by November 2009;
- 14.18. **Invite** the Minister to issue drafting instructions to PCO to amend the Dairy Industry Restructuring Act 2001 (DIRA) to implement an auction of raw milk (including a reserve);
- 14.19. **Invite** the Minister to issue drafting instructions to PCO to amend the Dairy Industry Restructuring (Raw Milk) Regulations 2001 to implement an auction of raw milk;
- 14.20. **Note** that the DIRA (Raw Milk Auction) Bill will be binding on the Crown;
- 14.21. **Note** that the drafting instructions for the DIRA (Raw Milk Auction) Bill will be issued to Parliamentary Counsel Office by September 2008;
- 14.22. **Note** that the DIRA (Raw Milk Auction) Bill should be introduced no later than May 2009;
- 14.23. **Note** that the DIRA (Raw Milk Auction) Bill should be passed no later than November 2009.

**OR**

*Option Three: Impose time limits on large scale processors with own (non-Fonterra) milk supplies.*

- 14.24. **Agree** to Option Three to retain the default pricing regime but time limits the entitlement of large scale independent processors with their own (non-Fonterra) supply to an entrance pathway only.
- 14.25. **Invite** the Minister to issue drafting instructions to PCO to amend the Regulations to:
- 14.25.1. ensure the supply of 600 million litres for 2009/10 season and beyond;
  - 14.25.2. enable Fonterra to manage excess demand for raw milk by scaling back all processor demands equally; and
  - 14.25.3. define classes of independent processor to be excluded from supply of regulated milk over time.

**OR**

*Option Four: Establish a two-tier pricing system.*

- 14.26. **Note** that the timing for Option Four to be implemented is extremely tight as it requires legislative amendment this calendar year;
- 14.27. **Agree** to Option Four to establish a two-tiered pricing regime with processors that supply the domestic market paying the default price for

regulated milk and export processors paying an 'exporter' price from 2009/10;

- 14.28. **Approve** the inclusion of the DIRA (Two-tier Pricing) Bill in the 2008 legislation programme, with category 1;
- 14.29. **Invite** the Minister to issue drafting instructions to PCO to amend the Dairy Industry Restructuring Act to enable differential pricing, to be passed in this Parliamentary term;
- 14.30. **Invite** the Minister to issue drafting instructions to PCO to amend the Regulations to:
- 14.30.1. ensure supply of 600 million litres for 2009/10 season and beyond;
  - 14.30.2. establish different classes of independent processors to pay different prices; and
  - 14.30.3. establish rationing rules;
- 14.31. **Note** that the DIRA (Two-tier Pricing) Bill will be binding on the Crown;
- 14.32. **Note** that the drafting instructions for the DIRA (Two-tier Pricing) Bill will be issued to Parliamentary Counsel Office by September 2008;
- 14.33. **Note** that the DIRA (Two-tiered Pricing) Bill needs to be introduced and passed under urgency;

Jim Anderton  
Minister of Agriculture

/ / 2008

# Regulatory Impact Analysis: Cabinet Report Back on Options for 2009/10 and Beyond

## Executive Summary

The Dairy Industry Restructuring (Raw Milk) Regulations 2001 (“the Raw Milk Regulations”) came under significant pressure in June 2007 due to a transition to a situation of excess demand for raw milk.

On 8 August 2007, the Cabinet Economic Development Committee imposed a two year solution pending the outcome of the Review. The two year solution required Fonterra to increase the supply of regulated milk from 400 million (M) litres to 500M litres for the 2007/08 season and 600M litres for 2008/09 season only. Unless regulatory and/or legislative changes are made, the volume of regulated milk will return to 400M litres for the 2009/10 season (and beyond).

Two rounds of consultation with industry participants and interested stakeholders have been undertaken.

The Review identified the following three issues:

1. The current default pricing formula is under-pricing regulated milk;
2. The Regulations do not manage situations of excess demand for regulated milk by independent processors; and
3. There is an unmanaged transition risk associated with the prospective ending of the statutory obligation on Fonterra to supply regulated milk.

In addition, officials were asked to examine the possible impact on domestic consumer prices from a change in the price of regulated milk, in light of price rises from other causes.

Officials were instructed to design new options following the end of the consultation period. These new options were not consulted on and have been developed on short notice.

Five options have been developed to address these issues:

1. **Option One:** Extend the 600M litre interim solution so that Fonterra must supply up to 600M litres of raw milk at the default price for the 2009/10 season only; or
2. **Option Two (a):** Retain the default pricing formula in 2009/10 and signal the move to an auction process for 2010/11; or
3. **Option Two (b):** Adopt the farm gate milk price in 2009/10 and signal the move to an auction process for 2010/11; or
4. **Option Three:** Amend the Regulations to impose time limits on the supply of regulated milk to large scale independent processors with their own (e.g. non-Fonterra) milk supplies; or

5. **Option Four:** Establish a two-tier pricing system that provides regulated milk at a [higher] 'exporter' price to large scale independent processors with their own milk supplies whereas all other independent processors can continue to access regulated milk at the default price for the 2009/10 and 2010/11 seasons (after which point all regulated milk would be sold at the 'exporter' price).

The auction process was consulted on during the Review process and is proposed under recommended Option Two (a) and alternative Option Two (b).

The Review also sought stakeholder views on a minor technical change to the definition of winter milk, which is defined in the Regulations.<sup>4</sup> The majority of stakeholders were supportive of the change. Changing the definition of winter milk requires a minor technical amendment to the Regulations. It is recommended that these changes are incorporated at the same time the regulations are amended.

### **Regulations Review Committee**

In August 2007 the Regulations Review Committee (the Committee) published its report regarding a complaint associated with the DIRA, and recommended that the Government amends regulation 8(6) of the Regulations to take into account the Committee's views.

As the recommended option is based on replacing the default pricing formula with the auction price by 2010/11, this issue no longer requires attention.

### **Adequacy Statement**

The Regulatory Impact Analysis Unit has reviewed the RIS and considers the RIS is adequate according to the adequacy criteria. However, the RIAU notes that there has been no consultation with stakeholders on Options One, Three and Four, and therefore considers that consultation on those options is inadequate.

### **Status Quo and Problem**

Between 2002 and the 2006/7 dairy season, the Raw Milk Regulations required Fonterra to supply up to 400 M litres per annum to independent processors at a regulated price.

The Dairy Industry Restructuring Act (DIRA) 2001 provides for the Government to regulate up to 5% of Fonterra Co-operative's milk supply. Based on the 2006/07 season, this represents almost 750M litres.

The Regulations came under significant pressure in June 2007, as Fonterra did not adequately manage the transition to a situation of excess demand for regulated milk

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<sup>4</sup> Winter milk is defined as raw milk supplied by Fonterra in May, June and July. As it is produced 'out of season' it attracts a premium to allow for increased production costs.

from independent processors. The uncertainty that resulted had the potential to cause significant industry disruption including company failures

On 8 August 2007, the Cabinet Economic Development Committee, with Power to Act [CAB Min (07) 28/7 refers] agreed to:

1. an interim solution, amending the Raw Milk Regulations to require Fonterra to supply (at the regulated price) up to 500M litres in 2007/08 and up to 600M litres in 2008/09; and
2. a comprehensive review of the Raw Milk Regulations, with the view to having a new durable regime in place for the 2009/10 season [EDC (07) 16/1 refers].

The Cabinet also agreed the following principals would be applied to the review:

1. the “open entry and exit” regime in the DIRA is the primary means for promoting a competitive market for the raw milk. The Regulations need to be considered in this context;
2. milk that is required to be made available under the regulations should be made available at a fair and efficient price; and
3. the Regulations should promote competition at the farm gate for raw milk by not discouraging independent processors from sourcing milk on standard commercial terms directly from farmers [POL (07) 25/7 refers].

The interim solution is for two years only and expires at the end of the 2008/09 dairy season. After this time, if a new regime is not put in place, the Raw Milk Regulations would revert back to their original form for the 2009/10 season and beyond. This outcome is undesirable as it would lead to ongoing uncertainty and disruption as demand is expected to exceed the 400M litre threshold, as well as leaving other industry concerns unresolved.

The price of regulated milk is currently derived from a formula that is specified in the Regulations and is referred to as the default price. The formula was required due to historical industry practise of bundling the milk and capital returns into a single payout, with the formula stripping out the dividend component and leaving the milk price. Fonterra is now unbundling the payout into distinct milk and capital components meaning the need to have a separate formula to perform the same function is largely redundant.

The current default pricing regime for regulated milk is seriously flawed for the following reasons:

1. The current default pricing formula is under-pricing regulated milk;
2. The Regulations do not manage situations of excess demand for regulated milk by independent processors; and
3. There is an unmanaged transition risk associated with the prospective ending of the statutory obligation on Fonterra to supply regulated milk due to the expiry of the sunset clauses contained in the DIRA.

## Objectives

The relevant purposes and objectives of the DIRA are, among other things, to:

1. provide the efficient operation of dairy markets in New Zealand by regulating the activities of [Fonterra] to ensure New Zealand markets for dairy goods and services are contestable [section 4(f)]; and
2. promote the principle that independent processors must be able to obtain raw milk, and other dairy goods and services necessary for them to compete in dairy markets [section 71(a)].

When the Raw Milk Regulations were enacted in 2001, they aimed to:

1. protect the position of companies that bought milk from either the Kiwi Cooperative Dairy Company or NZ Dairy Group Limited from monopoly pricing;
2. protect domestic consumers from monopoly pricing; and
3. provide an entry path for new processors into the milk processing industry.

The Raw Milk Regulations are therefore an important part of the regulatory measures put in place at the time Fonterra was formed. However, the pro-competitive measures, including the Raw Milk Regulations, are intended to remain only until a sufficient level of competition has been re-created in both the North and South Islands.

Given current and planned investments in the dairy processing industry, these thresholds could be met as soon as 2013 (and potentially sooner).

The Raw Milk Regulations, therefore, should not only be durable in the short-medium term, but should also provide for a smooth transition once the Regulations expire.

## Options

Five options have been developed:

1. **Option One:** Extend the 600M litre interim solution so that Fonterra must supply up to 600M litres of raw milk at the default price for the 2009/10 season only; or
2. **Option Two (a):** Retain the default pricing formula in 2009/10 and signal the move to an auction process for 2010/11; or
3. **Option Two (b):** Adopt the farm gate milk price in 2009/10 and signal the move to an auction process for 2010/11; or
4. **Option Three:** Amend the Regulations to impose time limits on the supply of regulated milk to large scale independent processors with their own milk supplies; or
5. **Option Four:** Establish a two-tier pricing system that provides regulated milk at a [higher] 'exporter' price to large scale independent processors with their own milk supplies whereas all other independent processors can continue to access regulated milk at the default price for the 2009/10 and 2010/11

seasons (after which point all regulated milk would be sold at the 'exporter' price).

**Option One:** *Extend the current interim solution*

This option extends the 600M litre interim solution from the 2008/09 season into the 2009/10 season only, so that Fonterra must supply up to 600M litres of raw milk at the default price. This option requires an amendment to the regulations only. This means that there will be no impact of this regulation on domestic consumer prices through the 2009/10 season.

Option One defers addressing any of the issues identified by the Review and leaves the issue of a transition unmanaged.

This option would necessitate further consideration of the Raw Milk Regulations and a decision to be made in 2009 in time for the 2010/11 season.

Option One has not been socialised with stakeholders through a consultation process.

**Option Two (a):** *Retain the default milk price in 2009/10 and signal an auction process for 2010/11.*

This option retains the default price formula for 2009/10 season and signals the move to an auction process for 2010/11 season.

This option involves:

1. Amending the regulations by November 2008 to:
  - a. set the quantity at a minimum 600M litres per annum to be supplied by Fonterra from 2009/10 and beyond; and
  - b. to allow a rule to equally scale all independent processors, if the situation of excess demand occurs before the auction is running;
2. Maintaining the default price for the 2009/10 season;
3. Amending the DIRA to facilitate an auction platform; and
4. Passing the amendment Bill next parliamentary term.

Option Two (a) addresses all three concerns raised in the Review as follows:

1. it removes the under-pricing issue by replacing the default pricing regime with an auction to purchase the right and potentially the obligation to buy milk at the Fonterra milk price;
2. the auction process manages excess demand by using price to match demand for milk with the supply of regulated milk; and
3. provides a future government with a high degree of choice to manage the transition to a post-DIRA environment in a smooth fashion.

Option Two (a) requires legislative change but, unlike Option Four, a Bill would not need to be passed until the next parliamentary term.

If the Government signals its intention to move to an auction process to allocate regulated milk for the 2010/11 season, MAF considers there is less pressure to move from the default pricing formula in the 2009/10 season.

### *Equal Scaling of all Independent Processors*

In the situation of excess demand occurring before the auction is in place, independent processors' demands will be equally scaled back. For example, a scaling back by 20% would allow independent processors to purchase up to 40M litres of raw milk and for Goodman Fielder to purchase up to 200M litres.

It is difficult to quantify what effect this may have on independent processors. Those with their own supply could look to increase their supply base and thus reduce their reliance and demand for regulated milk. For processors without their own suppliers this could be more problematic.

Under this option, for Goodman Fielder to purchase from Fonterra 250M litres of raw milk in a combination of regulated milk (200M litres) and unregulated milk (50M litres) could cost an additional \$8.3 million – \$12.5 million (assuming the 'market price' for unregulated milk is between \$2 – \$3 per kg MS higher than the regulated price).

Equal scaling has the following advantages:

1. Simplicity and transparency;
2. Equity – as all processors are being treated the same;
3. Fairness – as smaller processors can upwardly estimate their requirements they therefore face something of a 'natural hedge', whereas larger processors can simply increase own supply; and
4. Equal scaling was outlined in the second discussion document so has had a level of public exposure and consultation.

The auction process has been socialised with stakeholders through the consultation process and the second consultation document signalled the auction process as the preferred option.

***Option Two (b): Adopt the farm gate milk price in 2009/10 and signal an auction process for 2010/11.***

Option Two (b) is similar to Option Two (a) except that the default price is replaced with the farm gate milk price for 2009/10 season before the move to an auction process for 2010/11 season. The farm gate price is defined as the milk component of the Fonterra payout as reported in Fonterra's annual report for the associated season.

This option involves:

5. Amending the regulations by November 2008 to:

- a. set the quantity at a minimum 600M litres per annum to be supplied by Fonterra from 2009/10 and beyond;
  - b. to allow a rule to equally scale all independent processors, if the situation of excess demand occurs before the auction is running; and
  - c. replace the default price with the farm gate milk price from 2009/10.
6. Amending the DIRA to facilitate an auction platform; and
  7. Passing the amendment Bill next parliamentary term.

Option Two (b) addresses all three concerns raised in the Review and provides optionality in the same way as option Two (a). In addition, option Two (b) provides a smoother transition to higher raw milk prices by significantly reducing the under-pricing issue from 1 June 2009.

The auction process has been socialised with stakeholders through the consultation process and the second consultation document signalled the auction process as the preferred option.

***Option Three: Impose time limits on large scale processors with own milk supplies.***

This option retains the default pricing regime but systematically limits the entitlement of large scale processors with their own milk supply to continue to access regulated milk. This progressively forces these processors off regulated milk and to seek alternative sources of supply.

This option requires amending the Regulations so that:

1. Fonterra must supply up to 600M litres of raw milk at the default price for the 2009/10 season (and beyond);
2. Fonterra is able to manage situations of excess demand through an equal scaling back of all processor demands;
3. Fonterra's obligation to supply regulated milk to 'existing processors' (as defined in the DIRA) (e.g. Tatura) expires on 31 May 2010;
4. A new class of large scale export orientated independent processors with own supply is created 'export processors', which is defined as firms that have 100M litres (or more) of own (e.g. non-Fonterra) supply; and
5. 'Export processors' are only entitled to access regulated milk for three years in total, from 1 June 2008.

The major focus of Option Three is to address concerns regarding regulatory induced increases to domestic milk and dairy prices. While Option Three does not envisage a change to the default pricing regime, this is unlikely to be a durable policy option even with time limits on large scale processors. This implies that Option Three still merely postpones the increase in domestic prices due to the under-pricing of regulated milk. Moreover, the prospective expiry of the DIRA sunset implies that the default pricing formula becomes unenforceable anyway.

Option Three was developed on short notice and has not been socialised with stakeholders through a consultation process. This raises the risk of legal challenge on the basis of the Government's obligation to consult with affected parties.

In terms of the purpose of the review, Option Three does not address the underpricing issue at all, does not address the excess demand issue in the short run (although a rationing rule could be added to the regulations) and leaves the issue of a transition unmanaged.

***Option Four: Establish a two-tier pricing system***

This option establishes a two-tiered pricing regime with processors that supply the domestic market or do not have their own milk supply (excluding regulated supply) paying the default price for regulated milk and 'exporter processors' with significant levels of non-Fonterra supply paying a higher 'export' price from 2009/10.

This option involves:

1. Amending the DIRA in order to allow differential pricing;
2. Passing the amendment Bill this parliamentary term;
3. Amending the regulations:
  - a. So that Fonterra must supply up to 600M litres of raw milk at the default price for the 2009/10 season (and beyond);
  - b. To create a new class of large scale export orientated independent processor with own supply ['export processor'], which is defined as firms that have 100M litres (or more) of own supply per annum (**NB:** by default all other processors are classed as 'domestic processors').
  - c. A second formula to derive the 'exporter' price for 'export processors' is specified e.g. the farm gate price);
  - d. So that the allocation for 'export processors' is limited to 200M litres per annum (the 'exporter pot');
  - e. So that a 'domestic pot' of 400M litres per annum is created (the 'domestic pot'); and
  - f. To establish the following rationing rules:
    - i. If excess demand occurs in the 'domestic pot' domestic processors have first call on the milk in the 'export pot', with this milk being available at the default price;
    - ii. If the 'domestic pot' is under subscribed, the excess milk is available for 'export processors' at the 'export price'; and
    - iii. If excess demand arises in the 'export pot' the excess demand is equally scaled back across export processors.

The major focus of Option Four is to address concerns regarding regulatory-induced increases to domestic milk and dairy prices. This option postpones regulatory-induced price increases until 2011. Option Four is not designed to address the issue of transition to a post-DIRA environment.

Option Four would lead to a [moderate] increase in domestic milk and dairy prices as wholesale prices would increase by approximately 3-4 cents a litre from 1 June 2011. It is not possible to estimate what the retail impact would be of the price increases associated with Option Four. However, it is reasonable to expect the wholesale price increases would at least be passed on to consumers.

Option Four requires legislative change. However, unlike options Two (a) and Two (b), a Bill would need to be introduced and passed this parliamentary term in order to implement the two-tiered pricing regime in time for the 2009/10 season. Such a Bill is likely to be controversial and would be bitterly opposed by large scale independent processors.

Option Four was developed on short notice and has not been socialised with stakeholders through a consultation process. This raises the risk of legal challenge on the basis of the Government's obligation to consult with affected parties.

Option Four also opens the possibility that large scale processors seek a Commerce Commission determination regarding the pricing methodology used to achieve the higher price.

In terms of the purpose of the review, Option Four partially addresses the underpricing and excess demand issues but fails to address the transition issue.

### *Domestic Milk Prices*

None of the options, except Option Two (b), will change the domestic wholesale price of regulated milk for 2009/10, thereby delaying any Government imposed increases in domestic retail milk prices for at least two years.

Option Two (b) is likely lead to a moderate increase of 3cents per litre in domestic wholesale milk and dairy prices associated with the switch to the farm gate price in 2009/10. In 2010/11 the introduction of an auction is expected to increase wholesale prices by a further 1-2 cents a litre. In total, both moves are expected to increase wholesale milk prices by 3-5c per litre.

Option Two (a) is likely to lead to an increase in domestic wholesale milk prices of 3-5 cents per litre from the introduction of the auction in 2010/11. Option Four is expected to increase the domestic wholesale price by 3-4 cents per litre from 2011/12. Options One and Three are expected to have no impact on domestic wholesale milk prices.

Table 3 summarises the timing impacts on domestic wholesale milk prices of the different options.

**Table 3: Timing of Domestic Wholesale Price Impacts**

	<b>08/09</b>	<b>09/10</b>	<b>10/11</b>	<b>11/12</b>
Option 1 – Extension	No change	No change	?	?
Option 2(a) – Auction	No change	No change	<b>New price</b>	<b>New price</b>
Option 2(b) – Auction	No change	<b>New price</b>	<b>New price</b>	<b>New price</b>
Option 3 – Time limits	No change	No change	No change	No change
Option 4 – Differential pricing	No change	No change	No change	<b>New price</b>

However, it is important to note that MAF is forecasting that the Fonterra payout will fall over the next three seasons compared to the 2007/08 season. Whilst precise predictions are impossible, it is possible that the decreases in the farm gate price will be greater – or equal to – the increase due to the introduction of the auction.

It is very difficult to predict what the implication would be for retail prices, but it is reasonable to assume at least a 100% pass through. The impacts on domestic prices due to world dairy commodity prices and exchange rates are likely to be substantially greater.

The auction provides a more fair and efficient price by allocating raw milk to the most efficient users. The auction also provides the incentive for independent processors to source own supply, and helps facilitate a smooth transition to when the DIRA triggers are reached and Fonterra is no longer required to provide regulated milk.

A reserve will be set as part of the bidding process.

## **Consultation**

### *Stakeholder Engagement*

As part of the first stage of the review, MAF released a discussion document that sought industry feedback on the Raw Milk Regulations' intent and to clarify concerns in relation to the current operation of the Regulations. 39 written submissions were received in response to the discussion document.

The second stage of the review determined three preferred options and incorporated these into a second discussion document for industry consultation. One of these options included an auction process, which is now being considered in both Options Two (a) and Two (b). Submissions were requested seeking feedback on the impacts of the options and asking for any other industry concerns. 52 submissions were received in response to the second discussion document.

In addition, officials conducted a series of consultation meetings with dairy processing companies to discuss their concerns in further depth, during both consultation rounds.

### *Review Findings*

Consultation revealed three main issues with the Raw Milk Regulations:

1. The current default pricing formula is under-pricing regulated milk;
2. The Regulations do not manage situations of excess demand for regulated milk by independent processors; and
3. There is an unmanaged transition risk associated with the prospective ending of the statutory obligation on Fonterra to supply regulated milk.

These concerns have been comprehensively addressed by Options Two (a) and Two (b).

Options One, Three and Four were not consulted on as they were developed late in the process.

### *Key Stakeholder Concerns*

#### Quantity of Milk

Additionally, stakeholders were concerned what the total amount of regulated milk should be. 600M litres of raw milk is considered adequate in the context of moving to an auction process. The rationale for this is:

1. Total demand for the 2007/08 season was only 410M litres, so 600M litres still allows significant 'head room' for the entrance of new processors; and
2. 600M litres also permits the smooth introduction of an auction in 2010/11 as it is possible that there still may be an excess supply of milk (this implies no independent processor would 'miss out' at the auction).

If, however, it was not possible to move to an auction process to allocate regulated milk than an alternative method would need to be found to manage potential excess demand for regulated milk or the total quantity of milk made available would have to increase.

The two alternative 'end points' of 750M litres and 400M litres have been considered:

1. 750M litres of milk would result in a permanent excess supply of milk unless the independent processor eligibility criteria were substantially amended. Amending these criteria ran the risk that independent processors could become more dependent on regulated milk at the precise time that processors needed to consider the implications of a post-DIRA environment; and
2. 400M litres was considered too small a quantity of milk, especially in the context of an auction, given that:
  - a. Demand is already greater than 400M litres; and
  - b. Under the Regulations Goodman Fielder can take up to 250M litres, which leaves little milk for other independent processors.

#### Security of Supply and Transition Issues

Stakeholders that did not have their own supply or have a business model that allowed for own supply options were extremely worried about short term certainty of supply in addition to the ability to procure milk on a commercially terms in a post DIRA environment.

#### Auction Design Issues

Stakeholders that did not have their own supply or a business model that allowed for own supply options expressed concern regarding the auction processes that underpins Options Two (a) and Two (b). Key concerns were:

1. Being out bid for milk;

2. Being unable to secure milk;
3. Inability to handle the proposed lot sizes; and
4. Scheduling requirements and in particular, the 'take and pay' provisions in the contracts.

It is proposed to address these concerns in three ways:

1. Much of the existing system will be retained (e.g. definition of independent processor, scheduling rules, transport rules, etc) thereby minimising disruption;
2. The auction will held at a time when firms can still access own supply or enter into other contractual arrangements if firms are unable to procure all the supply desired through the auction platform; and
3. Aspects of product and auction design can substantially mitigate specific stakeholder concerns such as security of supply and scheduling requirements/take or pay conditions.

### **Winter Milk Issues**

The consultation process also sought stakeholder views as to whether the current definition of winter milk (defined as raw milk supplied in May, June, and July) should be changed to being defined as milk supplied in June and July only. The reason for this change is that Fonterra has sufficient milk supplies in May but is required to average winter milk premiums over three months, which results in a degree of under-recovery of winter milk costs. Averaging the price over two months eliminates this issue.

The majority of stakeholders were supportive of the change. Changing the definition of winter milk requires a minor technical amendment to the Regulations. It is recommended that these changes are incorporated at the same time the regulations are amended.

### **Regulations Review Committee**

In August 2007 the Regulations Review Committee (the Committee) published its report regarding a complaint associated with the DIRA, and recommended that the Government amends regulation 8(6) of the Regulations to take into account the Committee's views.

As the recommend option is based on replacing the default pricing formula with the auction price by 2010/11, this issue no longer requires attention.

### **Implementation and Review**

The Minister of Agriculture will issue a media statement as soon as practicable after a Cabinet decision on policy, to provide immediate certainty to all affected parties for the 2009/10 season and out-years.

The Commerce Commission is responsible for making determinations if a person has a dispute with Fonterra about the application of the Raw Milk Regulations. MAF will track the Commission's activities in this area to ensure the Raw Milk Regulations are not creating excessive dispute activity.

MAF officials will also continue to monitor the dairy industry to ensure that the Raw Milk Regulations are helping to provide for the efficient operation of dairy markets in New Zealand. This includes monitoring the quantities of raw milk collected and forecasting when competition will likely meet the thresholds required for the Regulations to expire.

### **Departmental Consultation**

The Ministry of Agriculture and Forestry consulted the Ministry of Economic Development and the Treasury during the development of this paper and their departmental views are incorporated.

## ANNEX A: SUMMARY OF STAKEHOLDER SUBMISSIONS

### ANALYSIS OF SUBMISSIONS ON REVIEW OF THE DAIRY INDUSTRY RAW MILK REGULATIONS: OPTIONS FOR ADDRESSING INDUSTRY CONCERNS

The second discussion document on the Review of the Raw Milk Regulations sought feedback on the following broad areas:

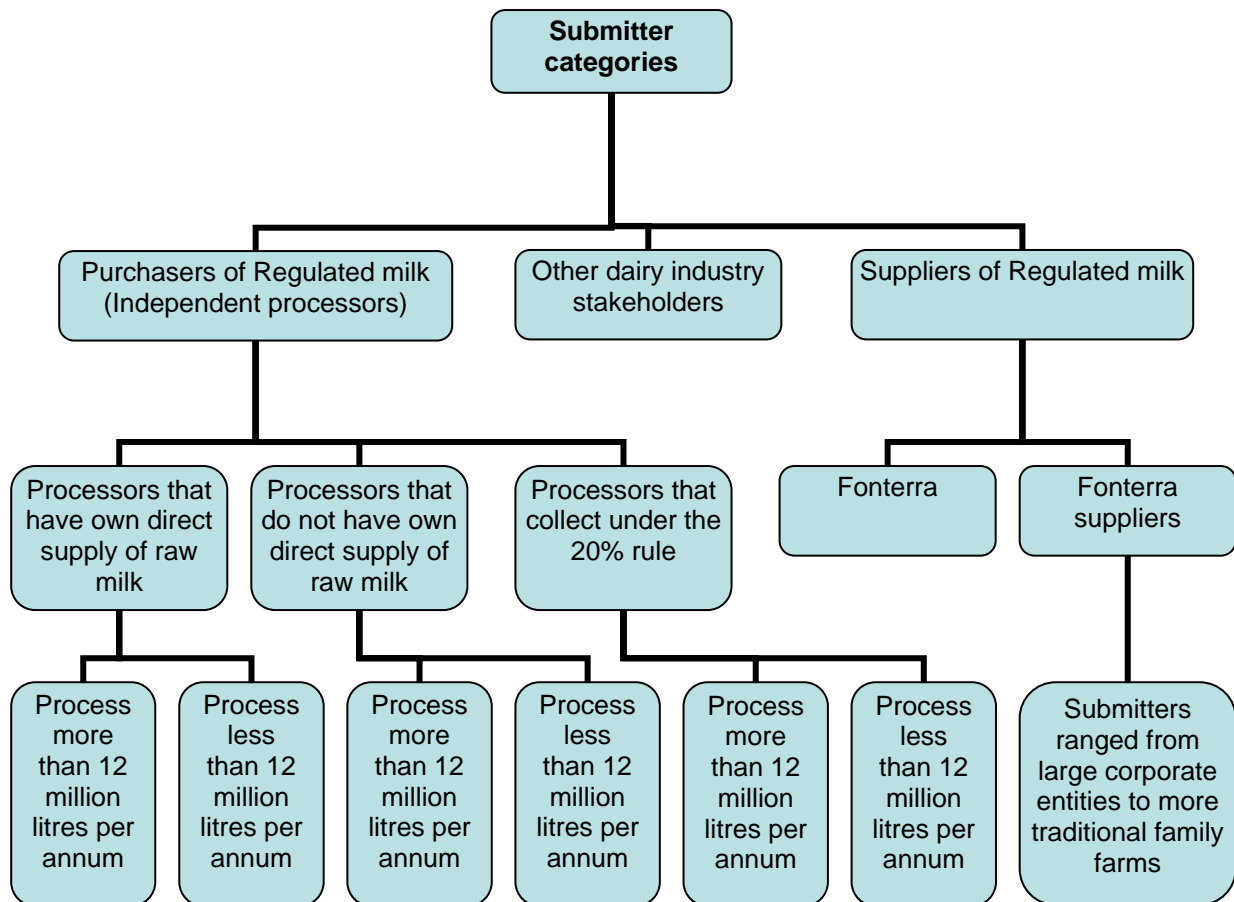
1. consultation options;
2. winter milk;
3. the 20% rule;
4. finding a fair and efficient milk price;
5. setting the volume cap;
6. managing excess demand; and
7. contractual issues.

Additionally, submitters were asked to provide feedback on any other concerns in relation to the Regulations.

A total of 52 written submissions were received. Figure 1 outlines the broad categories of industry stakeholders that made submissions.

A full list of the parties that made submissions during the second consultation round of the Raw Milk Review is located in **annex B**.

**Figure 1: Broad categories of industry stakeholder submitters**



## Summary of Submissions

### Suppliers of Regulated Milk

A myriad of concerns were expressed by farmers, with the key concerns being the:

1. obligation to supply regulated milk at all (alternative is that all independent processors should source raw milk directly from farmers or enter into a commercial contract with Fonterra);
2. price of regulated milk is too low and results in a subsidy from Fonterra suppliers to purchasers of regulated milk; and
3. ability for independent processors to access regulated milk is undermining the cooperative and leading to a redemption problem.

Farmer submissions argued that:

1. regulated milk should be primarily for the NZ domestic market;
2. firms with significant levels of own supply should not be allowed to access regulated milk;

3. existing processors, such as Tatua, should not be allowed to access regulated milk at all;
4. replacing the default pricing formula with the Fonterra farm gate price is a [belated] step in the right direction; and
5. the idea of an X is strongly supported, but if an auction in proceeded with then X needs to be incorporated into the reserve price.

Fonterra argued that:

1. existing processors, such as Tatua, should not be allowed to access regulated milk at all;
2. established processors (for example Open Country Cheese) and processors with substantial levels of own supply (for example Synlait) should be rapidly weaned off regulated milk;
3. replacing the default pricing formula with the Fonterra farm gate price is a [belated] step in the right direction;
4. the idea of an X is strongly supported, but if an auction in proceeded with then X needs to be incorporated into the reserve price;
5. if an auction is proceeded with, Fonterra does not want to have any responsibility regarding its operation or funding its operating and development costs; and
6. Fonterra's preference is simply to price regulated milk at 105% of the farm gate price.

### Purchasers of Regulated Milk

Common arguments across dairy and food companies were:

1. A profound mistrust of Fonterra, which manifested itself as:
  - a. entrenched opposition to the concept of Fonterra having anything to do with organising an auction due to concerns around manipulation;
  - b. serious reservations about using the Fonterra farm gate price due to the potential for manipulation by Fonterra (this is due to the milk price and dividend being fully fungible, permitting systematic over pricing of regulated milk); and
  - c. The move from a cost price to a cost *plus* regime will result in higher priced milk.

The reservations around price manipulation and a cost plus pricing regime are shared by the Commerce Commission.

Independent processors also expressed concerns relating to auction design features, namely the:

1. need to forecast up to 18 months in advance;
2. minimum lot size of 1 million (M) litres (considered too large by small processors);

3. take or pay nature of the contracts; and
4. risk that firms could 'miss out' completely.

Representatives of the smaller processors were also unimpressed with the proposals outlined in the discussion document to reserve 15 ML of regulated milk for niche processors that processed less than 2.5M litres per annum, considering it inadequate.

## Issues and Questions Raised by Stakeholders

Key issues raised in each broad area of the discussion document are outlined below.

### *Consultation options*

#### Suppliers of regulated milk

On balance, suppliers of regulated milk appear to prefer an auction system. This preference, however, includes the following caveats:

1. **The reserve price is the farm gate price plus a premium (X):** There were a mixture of reasons submitters considered there should be an X, including:
  - a. regulated milk is currently under priced;
  - b. there are costs associated with attracting suppliers, installing vats and managing the supply curve;
  - c. purchasers of regulated milk are able to square their supply curves and thereby achieve greater processing efficiencies; and
  - d. there is a risk premium in having own supply rather than being able to purchase regulated milk.

If the auction proposal with a 600 M litre total cap was used, suppliers of regulated milk consider that this would not produce an X as there is unlikely to be excess demand. It is for this reason that any auction reserve price should include an X. It has been recommended that the X premium should be 5 percent of the farm gate price.

2. **The total cap is 400 million litres and eligibility rules apply:** Independent processors that have their own supply of more than 20M litres per annum should not qualify for regulated milk and should be required to compete in the open market.
3. **Definition of independent processor is clarified:** This should be made explicit that one physical site can only process a maximum of 50M litres of regulated milk per season.
4. **Auction is satisfactorily designed:** Submissions vary on who should pay for and run an auction and include:
  - a. the auction costs being met by independent processors;

- b. the auction being government run and funded; and
- c. another stakeholder suggested that Fonterra own the platform and charge a service fee to purchasers who use the service.

### Purchasers of Regulated Milk

Independent processors' views on the auction option differ. Some supported the auction proposal, provided it is fair, transparent and has controls in place to avoid manipulation.

There is, however, a concern that an auction is a 'quantum leap' from the current Regulations and that it is not what was intended by the DIRA. There are particular concerns over the design of any auction, potential to game for high/low price, auction liquidity and who would bear the costs. Independent processors are concerned that any auction would need to find a balance between being:

1. **close enough to the start of the season:** Commercially unrealistic to commit to demand in November through an auction. Independent processors will not have enough certainty of the amount of regulated milk they will require in the following season.
2. **long enough out from the new season:** Independent processors need to be able to acquire their own direct supply, or alternative source of raw milk, if the required amount of milk is not obtained in the auction.

A general theme from the submissions is that this balance may be difficult achieve.

Producers of fresh consumer milk have particular concerns with an auction and some consider that the auction is designed for milk powder dryers as they have longer shelf lives, known sales and consistent quantities of relatively low value product. An auction is seen as being particularly problematic for fresh milk manufacturers because:

1. it is hard to predict requirements in 18 months time;
2. an auction would leave no room for supply responsiveness;
3. short shelf life for products; and
4. individual auction amounts are too restrictive.

These processors regard the current forecasting rules as performing well and that these should be continued.

If an auction option is to be used, the following alternative provisions have been suggested:

1. the auction should be for a total of 750M litres;
2. the 2007/08 season's 500M litres be grandfathered between current purchases and that the remaining 250M litres be auctioned; and
3. X is set at the lowest accepted auction bid (capped at 5 percent) and is applied to the other 500M litres.

The discussion document introduced a possible benefit of the auction in that it may continue to be supplied after such a time as Fonterra are no longer required to do so. There is, however, little confidence amongst independent processors that Fonterra would supply any domestic auction once the Regulations have expired.

Certainty of supply is often viewed by independent processors as the most important aspect in any of the three proposed options, particularly for new entrants. There is a concern that if an auction is used, large established players could potentially buy all regulated milk available, potentially defeating the three initial objectives of the Regulations. Others are concerned that a foreign entrant could potentially purchase all regulated milk and that there would be no supply for domestic/ existing independent processors.

In relation to the discussion documents proposal that a premium should be added to the farm gate price, there were mixed views from independent processors. Some independent processors supported the inclusion of X as long as it is fair and not anti-competitive. Others submit there should be an X but only once there is excess supply.

The main theme, however, from independent processors was that they need to be able to obtain milk in a manner that allows them to compete and not at a premium which can be gamed by Fonterra. Concerns have been expressed over Fonterra's influence and ability to manipulate the farm gate price. Fonterra would have control over the 'make fee' and it is suggested that this would require independent scrutiny. The estimated annualised share value is significantly higher than Fonterra's self calculated 'added value' dividend, suggesting Fonterra significantly overstates the farm gate milk price. To this end, many independent processors are concerned that the proposals do not sufficiently promote the efficient operation of dairy markets to ensure markets for dairy goods and services are contestable.

Submissions from independent processors also included an assertion that X should not be added as a premium for managing the supply chain as Fonterra's supply chain is inefficient. The risks and costs of managing the supply chain are already captured in the pricing formula and current transport charge.

### Other Stakeholders

Other stakeholders were mixed in their submissions and on their preferences for an auction or for an alternative proposal. In relation to price, there were those who considered the price for regulated milk should be:

1. the farm gate price plus X; or
2. similar to the price derived by the current formula, as the current formula is satisfactory. The price should remain prescriptive and not be determined by entity the Regulations aim to control.

Additionally, it was submitted that contestability in the New Zealand dairy industry would be promoted by the exclusion of X from the price calculation.

### *Winter Milk Issues*

Fonterra is neutral between the proposed winter milk options B and C. Fonterra shareholders, however, generally prefer Option A. They have submitted that there is a need to keep winter milk mechanism aligned with Fonterra suppliers' winter contracts. Opinions are split on whether winter milk should be included in an auction or not. However, whatever the option chosen, it needs to ensure that full premium is passed through to purchasers.

It is preferred by suppliers of regulated milk that if winter milk was included in an auction the 18 month notice rule would still need to be maintained.

The majority of independent processors also prefer Option B, although some would like to keep status quo as this would require less change. Opinions also differ on whether winter milk should be included in an auction or not. The difference in opinion here usually depends on the submitters generally position regarding the auction.

It is not apparent from submissions that any of the proposals would have a major impact on independent processors operations in general, except for some having to review their production schedules to ensure that efficiencies are maximised.

### *The 20 Percent Rule*

While suppliers of regulated milk do not generally see any particular barriers to the use of the 20 percent rule, some have submitted that it is impractical to work for a farmer, too costly to transport and therefore not worth it for independent processors. Farmers are also more likely to shift 100 percent of milk supply rather than 20 percent. In some regional areas there is no demand for the 20 percent rule.

A more common comment was that independent processors do not use the 20 percent rule as they are not prepared to commit the resources and to organise themselves to do it. Regulated milk is seen as too cheap and therefore a more viable option.

Other stakeholders had various opinions, including:

1. the 20 percent rule is unworkable and should be discontinued;
2. there is a lack of competition which limits use; and
3. the 20 percent rule and guaranteed supply of milk should be kept after the triggers are reached to allow for competition to develop.

Most independent processors do not use the 20 percent rule. For those that do it is often crucial to their business model. Suggestions contained within these submissions include:

1. a simple and properly operating 20 percent rule could provide for a more competitive market;
2. the 20 percent rule should remain after the triggers have been hit; and

3. a concern that the 20 percent rule should continue once the South Island triggers are reached.

### *Finding a Fair and Efficient Milk Price*

Some suppliers and purchasers of regulated milk have submitted that the price should be subject to regular reviews. However, most submitters from both the supply and purchasing side have generally preferred that if there was an X that it should be set in the Regulations. It is suggested that X should be set as a percentage of farm gate prices in Regulations to avoid disputes. One suggestion has been that X should be set at 5 percent of the farm gate price.

Purchasers of regulated milk generally dispute the need for an X. It is considered by most that the present formula derives a fair price and that most issues with price formula have been resolved. Any changes to formula would require Legislative process and this should not be rushed.

Some purchasers of regulated milk have submitted that reviews are inefficient and could lead to extreme variability in the price of regulated milk. Setting X as a percentage would provide a sensible margin and help processors consider life beyond regulated milk. Independent processors also added that even if the price is fair and efficient, small processors may still choose to purchase regulated milk for practicality reasons.

Purchasers of regulated milk have also outlined additional concerns, including the lack of price certainty. One submitter suggested that the regulated milk price should be priced at Fonterra's quarterly payout forecast (with a maximum of its final annualised payout). There was also a concern from suppliers of regulated milk that the price should stay as an ex post price.

One specific suggestion that was received was that Regulation 9 (2) should be amended to read:

“If new co-op does not use a cost of equity capital rate in calculating the price of a co-operative share, the Commission must set a discount rate for calculating annualised share value and new co-op must use that rate.”

It is noted here that, whether or not submitters supported the inclusion of an X, some suggested that an independent body be set up to review the price of regulated milk. Moreover, an independent arbiter could assess whether process and principles of Regulations have been followed.

Similarly, others have recommended the appointment of a Milk Ombudsmen to:

1. provide independent view to Government;
2. provide a forum for complaints to be heard; and
3. ensure a competitive environment is in place, including post Regulation.

The lack of certainty and the time taken with disputes is seen to be problematic. A suggestion is that this independent body would be made capable of determining disputes in no more than 6 weeks.

### *Setting the Volume Cap*

The preferred options for setting the total volume cap differs greatly between purchases and suppliers of regulated milk. A main theme to come through is that the appropriate volume cap will be dependent on various other components of the Regulations, for example the eligibility rules and price, as well as other external factors such as Fonterra's total milk supply and the size and requirements of New Zealand's domestic dairy industry.

### Suppliers of Regulated Milk

Suppliers of regulated milk generally considered that the volume cap for regulated milk should be set somewhere in the range of 400 M litres to 600 M litres.

Submissions included:

1. reducing the cap to 400M litres;
2. a smoother transition back to 400M litres, namely:
  - a. 600M litres for 2008/09;
  - b. 500M litres in 2009/10; and
  - c. 400M litres in 2010/2011 and onwards.
3. setting the volume cap at 500M litres and indexing it to Fonterra's supply;
4. setting the volume cap at 600M litres and indexing it to Fonterra's supply; and
5. 600 M litres and no indexing.

The majority of supplier submissions did not want the volume cap indexed to Fonterra's supply. They viewed indexing as potentially contributing to a decrease in competition at the farm gate. Many also submitted that the cap should be reduced each year and eventually phased out. Independent processors should be encouraged to source their own supply.

Others contend that the original Regulations were made for 400M litres based on the size of the domestic dairy market and that this volume cap should remain as the domestic market has not grown significantly. Indexing the cap to Fonterra's milk supply is rewarding other processors for Fonterra's 'hard work'.

A common theme was that processors who have their own supply (except the very small processors) should not be able to access raw milk. This would reduce overall demand and therefore a lower cap could be set. Small independent processors should be able to access raw milk, but need to pay the right price for it.

Some submitters also contended that the Regulations should be discarded immediately as there is already sufficient competition in the New Zealand dairy industry.

## Purchasers of Regulated Milk

The majority of purchasers of regulated milk considered that the total volume cap should be set at 750M litres (approximately 5 percent of Fonterra's supply) and indexed regularly to keep it at the 5 percent mark. The rationale for this is that 400M litres were appropriate when the original Regulations were set, but this is not appropriate now. A higher volume cap would promote greater competition in the New Zealand dairy industry.

Others agreed that 60 M litres were an appropriate cap in the short-term. Some of these submitters considered that this could be indexed to Fonterra's supply, while others considered that the 600M litre cap should be based on requirements of the domestic industry rather than Fonterra's total supply

Many of the smaller independent processors believe that there should be a two-tier system; with separate pools of regulated milk for smaller and larger processors. It has been submitted that the separate pool for smaller processors could be for those who process under 10M litres per year. Another suggestion is that the limit for small producers should be set at a maximum of 10,000 litres per day. It is suggested that this separate pool could be 100M litres per season.

It has been submitted that if an auction is used, in the long-term there would be no need for a volume cap as processors would bid at the market price.

## Other Stakeholders

Specific proposals included the total volume cap being set at 5 percent of Fonterra's milk supply with new entrants getting 7M litres for 3 years and 50M litres for a second period of three years and that this provision continues after the triggers have been hit. Alternatively, new entrants' allocations could decline gradually each year beyond the third season.

Another stakeholder suggested that the volume cap should be set at a mid-point compromise of 500M litres.

## *Managing Excess Demand*

### Suppliers of Regulated Milk

The majority of suppliers of regulated milk preferred price rationing, although some would like quantity rationing. The main theme coming through, however, was that a stricter set of allocation rules could be used to manage demand and those that were eligible could have their quantity rationed via the auction.

Specifically, there were numerous submissions that considered independent processors with their own supply should not be able to access regulated milk. Some believed these processors should be cut off from regulated milk immediately, while others preferred a phase out period over 2-3 seasons. Allocation rules to manage excess demand should be set out in the Regulations. It has also been suggested that an expert regulator should be given discretion to adjust these rules in response

to any unforeseen circumstances, which would best achieve the purpose of the DIRA.

### Purchasers of Regulated Milk

Of those who submitted on this question, there is a fairly even split between those who favour price rationing and those who favour some type of quantity rationing.

Some concerns have been expressed that price rationing would mean that Fonterra gets a too high price and that the milk supply could become unfairly spread.

A number of quantity rationing rules and entitlement criteria were suggested that could help manage excess demand, including:

1. processors with own supply should have reduced entitlement, which would lessen the likelihood that excess demand would occur;
2. those who supply the domestic liquid milk market should not be rationed; and
3. any 'new entrant rule' should only be introduced once there is a need for rationing.

Generally the smaller processors would like their own separate pool of regulated milk and, therefore, have their demand rationed within this pool (if at all). If an auction was to be used, small processors could buy at the average auction price.

### Other Stakeholders

A significant point made here was that the review needs to recognise the time required for independent processors to build the scale necessary to source unregulated milk economically. Ideally, the Regulations should reduce the dependency on regulated milk over the long run. To do this the Regulations could provide each independent processor with an allocation of regulated milk that gradually declines to zero over time.

### *Contractual Issues*

Suppliers of regulated milk agreed with take and pay provisions being inserted into the Regulations. It is considered that the current regulations place too much of the risk and cost on Fonterra if independent processors do not accurately forecast their regulated milk requirements.

While some independent processors also agreed with take and pay provisions, the majority did not. Take and pay provisions were seen as not being commercially viable. There is a belief that the forecasting rules in place are already doing an adequate job. Forecasts should remain as forecasts and not be legally binding.

Take or pay provisions are seen as favouring the vendor, not new entrant, and therefore do not promote competition. It has been submitted that in combination with the auction the take and pay provisions are particularly unfair. Processors would

have to take regulated milk up to 18 months later, irrespective of the economics of taking that milk at the time.

### *Other Concerns*

There were a range of other concerns submitted from various parties. Some of these touched on the above topics, while others were additional concerns or questions. The main other concerns and suggestions raised by submitters are summarised below.

### Suppliers of Regulated Milk

A particular theme coming through is that the price should be fair to all parties and there should be no subsidies or under-pricing. The price of regulated milk is considered to be too low and that this leads to an inefficient outcome. It is also claimed that Fonterra is being commercially disadvantaged by having their capacity reduced, while competitors can run at full capacity through the use of regulated milk to square their supply profile.

Suggested eligibility rules included:

1. independent processors under 10M litres should be able to access a separate 75M litre pool (also suggested that any amount reserved for small players should include a higher transport cost for inefficient amounts);
2. large independent processors without own supply should get supply while Regulations are in place;
3. large independent processors with established own supply should not be eligible for regulated milk;
4. new entrants should have limited to access for three years; and
5. regulated milk should be for the domestic consumer market, not for processors who export.

*Definition of Independent Processor:* Independent processors should only get regulated milk if they intend to process the milk themselves and only one physical site should be able to process a maximum of 50M litres of regulated milk per season. This will prevent secondary trading of regulated milk, which is not what was intended by the Regulations.

*Timing of changes:* Changes should take place in time for 2008/09 season; otherwise it is an additional year of Fonterra being required to sell subsidised milk.

*North and South Island trigger rules:* The North and South Island triggers should be independent and expire on an island by island basis. There are also incentives for independent processors in the South Island to game the system by purposely staying under the trigger limit of 25M kilograms of milk solids.

## Other Stakeholders

A main concern is that the review needs to recognise Fonterra's position of dominance. It is essential that competition is encouraged to ensure the highest returns for dairy farmers. The review should first and foremost keep in mind the goals of the DIRA and the Regulations: the enhancement of the contestability of domestic dairy markets.

A specific suggestion has been made regarding the definition of retentions in the Regulations. Clause 3(1) should be amended to read:

“new co-op retention:

- (a) means the after-tax profit or loss generated from the milk processing activities of new co-op for a season that is retained by new co-op and not paid to shareholding farmers; but
- (b) does not include retentions for extraordinary items.”

There is also a concern over the level of competition that is required trigger end of the Regulations. It is suggested that Section 147 to 150 of the DIRA should be reviewed, and the competition triggers be revised upwards. Once the triggers set out in sections 147 and 148 of the DIRA are reached, a further review of the Regulations could be signalled to ensure that the market is indeed competitive. Access to regulated milk could also be phased out gradually, over a period of five years, say, rather than being abruptly withdrawn.

## Purchasers of Regulated Milk

There is a principle concern that the review is considering major changes when the current system is by and large working fine. The review also needs to consider the Regulations as part of a wider package, with Fonterra benefiting substantially from other parts of this package. The Regulations need to actively 'promote' competition, rather than just 'allowing' competition.

The Regulations need to genuinely manage Fonterra's behaviour so that competition is on a level playing field basis. The optimum way to do this is to ensure that the definitions in the Regulations are clear and unambiguous, including ensuring that Fonterra complies with forecasting provisions.

A real concern is what happens after the Regulations expire. There is nothing currently in the proposals to assure independent processors that they will have an ongoing milk supply once the Regulations expire. It is considered that 87.5 percent of the New Zealand supply of raw milk does not represent a competitive market. Other potential suppliers of raw milk do not appear to be feasible alternative options. Similar to a suggestion from another industry stakeholder, independent processors have suggested that an independent review should take place once triggers are hit to determine whether a competitive market is in place.

A main concern for some small processors is that the 20 percent rule stays in place after the triggers are reached. Sourcing milk from other sources is often not possible for geographic, farmer incentive and quality reasons. In addition, taking a whole farms supply may be too much milk. Small start-up specialist manufacturers often

add a lot of value and innovation. Removing the 20 percent rule would adversely affect the wider industry. There needs to be some security of supply and flexibility from Fonterra given its monopoly situation.

The definition of independent processor: This should be amended to make it clear that the contracting out of part of the processing of milk does not disqualify a processor as an independent processor.

Price certainty: It is considered that a way around ex post pricing needs to be found as the current pricing regime is too volatile.

Equity and fairness: Seen as very important by smaller processors due to:

1. economies of scale;
2. efficiency in collection of raw milk;
3. innovation from smaller niche players;
4. company closures;
5. potential for lost jobs; and
6. regional losses.

Another concern is that the prices of some processed components of raw milk have risen higher and faster than the milk payout (and therefore the price of regulated raw milk). The Regulations do not adequately address the interest of companies that use processed components of milk instead of raw milk. This needs to be addressed through the new Regulations either via adjusting prices relative to Fonterra's value add component or independent processors being able to access ingredients at the price of the raw milk required plus a make fee.

Others consider that consultation was inadequate and that MAF policy had already made up mind on the auction option. There is a concern that industry opinions will not be listened to and genuine concerns not addressed.

Finally, it has been suggested that after the review has been completed, MAF should further investigate ways to enhance a competitive structure of dairy industry.

**ANNEX B: LIST OF STAKEHOLDERS THAT MADE SUBMISSIONS ON THE  
SECOND CONSULTATION ROUND**

A P Reilly	Fonterra supplier
Abe de Wolde	Fonterra supplier
Andre Hickson	Fonterra supplier
Bill and Helen Thomas	Fonterra supplier
Stephen and Rhonda Lowry	Fonterra supplier
DR and PA Pamment	Fonterra supplier
G M Larmers	Fonterra supplier
Garry Voogt	Fonterra supplier
Ged Donald	Fonterra supplier
George Moss	Fonterra supplier
Dennis and Anita Orchard	Fonterra supplier
Gordon and Pam Blake	Fonterra supplier
Hugh Earwaker	Fonterra supplier
Ian Brown	Fonterra supplier
Peter West	Fonterra supplier
Phil Winter	Fonterra supplier
Jim Hedley	Fonterra supplier
John, Jill and Nathan Bluett	Fonterra supplier
Jos van Loon	Fonterra supplier
Margaret Westlake	Fonterra supplier
Mark Croucher	Fonterra supplier
Ian Hopkins	Fonterra supplier
Murray Linton	Fonterra supplier
Tracey Brown	Fonterra supplier
Vaughan Templeton	Fonterra supplier
Neville Skilling, Rushbrook Farms, Brebt and Sharon Trufford, Barry and Kim Walls	Fonterra suppliers
Paul Christensen	Fonterra supplier
Pauline Stewart	Fonterra supplier
Bruce MacDonald	On behalf of a group of Fonterra suppliers
David Matthews	Fonterra Co-operative Group
Mark Callaghan	Cadbury Confectionary
David Glik	Goodman Fielder New Zealand Limited
Aidan Johnstone	New Zealand Dairies Limited
Wyatt Creech	Open Country Cheese Company Limited
Andrew Talley	Talley's Group
John Penno	Synlait
S Allan and P van Booheemen	Tatua
Neil McGarva	Mymilk Ltd.

Stewart Alexander	Emerald Foods Ltd
Sue Arthur	Over the Moon Dairy / New Zealand Cheese School
Graham Kitson	Hi Tech Foods Ltd
Ian Hercus	Blue River Dairy Products Ltd
Jill and Chris Whalley	Mount Eliza Cheese Ltd
Di Hawkins	Karikaas
Bruce Pulman	Green Valley Dairies Ltd
Wyatt Creech	Kaimai Cheese
Brent Thornton	Independent Dairy Product User Group
Colin Glass	Dairy Holding Limited
Phillip Jones	Punui Farms
Ritchie Hutton	Commerce Commission
Michael Leonard Allan	Beker Findlay Allan Limited
Ann Thompson	Federated Farmers