

Release of Report

Evaluation of the December 2000 Dairy Industry Merger Package From The Perspective of Competition Policy

**Economics and Law Consulting Limited
11 January 2001**

On 21 December 2000, New Zealand's two dairy companies announced their plan to merge and absorb the Dairy Board. If the merger proceeds it will create the New Zealand's largest company and will have profound effects for the dairy industry.

The dairy sector is New Zealand's largest export earner; it is also a major onshore processor, manufacturer and investor in research and development.

The dairy companies' proposal calls for special legislation to exempt the merger from the anti-monopoly provisions of the Commerce Act, thus avoiding normal Commerce Commission scrutiny and authorisation.

The performance of the dairy sector significantly affects the New Zealand economy as a whole. Before making any decision on the merger proposal the Government wishes to gather further information and to encourage informed debate on the costs, benefits, risks and opportunities presented by the merger plan.

The Ministry of Agriculture and Forestry commissioned *Economics and Law Consulting Limited* to assess the merger from a competition policy perspective. The work was commissioned recognising that the information currently available is very limited.

The Government has decided to release this report in the expectation that it will stimulate and inform further debate. I encourage anyone with an interest in the dairy industry to take the opportunity to read it and discuss its findings.

I emphasise that this is an analysis produced outside government in a very limited time with limited access to supplementary information. It is not government policy.

If and when similar material comes to hand the Government will endeavour to make as much of it available as possible.

Hon Jim Sutton
Minister of Agriculture

***Evaluation of the December 2000
Dairy Industry Merger Package From
The Perspective of Competition Policy***

A Report for the Ministry of Agriculture and Forestry

**Final Report
11 January 2001**

Economics and Law Consulting Limited

*20 Messines Road, Wellington 6005, New Zealand
Phone (64) (025) 409 839 Facsimile (64) (4) 463 5436*

The Author

This Report was prepared for Economics and Law Consulting Limited by Professor Neil Quigley, Executive Dean of the Faculty of Commerce and Administration at Victoria University of Wellington.

Contents

Executive Summary	i
1. Introduction	1
2. A comparison of the Mega-Merger and GDC Proposals	3
3. Public Detriments	6
4. Public Benefits	16
5. Overall Assessment of the Balance Between Benefits and Detriments	19
6. Costs and Benefits of Assessment by the Commerce Commission	20
7. Conclusion	22

Executive Summary

Introduction

On 21 December the Dairy Industry announced a proposal for the merger of the New Zealand Dairy Board, the New Zealand Dairy Group and Kiwi Co-operative Dairies to create Global Dairy Company (hereafter GDC). The Ministry of Agriculture and Forestry has requested that Economics and Law Consulting Limited (ELC) provide an initial report on the following three issues:

- (i) Of the detriments identified by the Commerce Commission in its draft determination on the 1999 dairy industry “mega-merger” proposal, which of those detriments appear to be addressed by the GDC proposal (and to what extent) and which do not appear to be addressed.
- (ii) Of the benefits identified by the Commerce Commission in its draft determination of the 1999 dairy industry “mega-merger” proposal, the extent to which the GDC proposal appears to increase or reduce those benefits.
- (iii) The costs and benefits of allowing the GDC proposal to be implemented without requiring it to be authorised by the Commerce Commission.

ELC accepted this assignment with the caveat that it should be absolutely clear that our Report would not be, and could not be viewed as or used as, a substitute for a full assessment by the Commerce Commission.

The GDC Proposal

The proposal announced by the dairy industry in December 2000 has the following key features:

- (i) The merger of the NZDG and Kiwi, and the integration of the Dairy Board with their operations, to form GDC. Other co-operatives will either merge with NZDG / Kiwi / GDC or sell to GDC their respective interests in the Dairy Board;
- (ii) The single-desk monopoly of the Dairy Board is to be removed within one year, but GDC will own all dairy industry quota rights for foreign markets;

- (iii) The divestiture of Dairy Foods to create competition in the New Zealand domestic market, with GDC licensing Dairy Foods to use certain well-known brands within New Zealand and agreeing contracts for the supply of milk to Dairy Foods;
- (iv) The creation of mechanisms for the establishment of the fair value of the capital invested by suppliers of GDC and the use of capital notes to pay out the capital investment of suppliers who wish to switch from GDC to another manufacturer. There is, however, no proposal to move towards the unbundling of returns on capital invested from returns on milk supplied;
- (v) The creation of a Shareholders' and Suppliers' Council to protect the interests of farmers; and
- (vi) The suggestion that after three years the Commerce Commission will conduct a review of both the domestic wholesale price charged by GDC to Dairy Foods and any other competitors, and the operation of the fair value entry and exit price.

The GDC proposal is supported by a rationale for change in the structure of the dairy industry that is more convincing than the arguments presented in 1999. It argues that the Dairy Board was an effective way to maximise the returns from international marketing when there were 400 dairy co-operatives, but that now, with a large part of the dairy manufacturing industry controlled by two co-operatives, this structure is inefficient. The GDC proposal further suggests that the costs of splitting the operations of the Dairy Board between two competing companies (Kiwi and NZDG) are so high that a merger of the two large co-operatives with the Dairy Board provides the only practical means of achieving vertical integration in the industry. The case put in the GDC proposal appears to be that

- (i) It would be contrary to the national interest to attempt to preserve competing vertically-integrated firms given that [it is claimed that] there are very large benefits from size, full vertical integration and industry-wide co-ordination of manufacturing and marketing strategies,
- (ii) The [“enhancement” of the] co-operative structure of the industry and the sale of Dairy Foods will ensure that neither farmers nor domestic consumers are harmed by the creation of GDC.

Whatever its merits as a solution to structural problems in the dairy industry, the proposal to create a dominant vertically integrated firm is inconsistent with competition policy in New Zealand. The Commerce Commission has taken the view that competition provides efficient outcomes in the dairy industry as in all other industries, and nothing in the GDC proposal provides convincing evidence that this view is inappropriate. For any proposal to satisfy the Commission it must therefore take seriously the need to create markets that are competitive even if effective competition is not immediately present.

Public Benefits and Detriments

In its August 1999 draft determination the Commerce Commission found that the merger proposal had moderate to large detriments and small public benefits. The vast majority of the detriments were associated with the loss of productive and dynamic efficiency as a result of the loss of effective competition for the merged entity and not from the impact of the merger on prices paid by domestic consumers.

The GDC proposal contains the following substantive changes from the 1999 proposal. In each case, the impact on the case as it is likely to be viewed by the Commerce Commission is indicated in brackets.

- Specifies, for inclusion in legislation, a method for fair valuation of capital on entry and exit to remove barriers to switching [positive]
- Clearer and more credible specification of the gains from the merger [positive]
- Shareholders' and Suppliers' Council [weak positive]
- Proposal for three-year review by the Commerce Commission [neutral]
- Allocation of all quota rights to GDC [negative]
- No proposal for tradable shares and payment unbundling [negative].

This summary highlights the fact that the GDC proposal has introduced a number of positive and negative changes: on balance we doubt that the changes would have a strong positive or negative impact on the views of the Commission. We reach this conclusion primarily because the changes that are positive are not likely to have a material impact on the Commission's assessment of the detriments associated with the merger. In particular, the proposal does little to improve the environment for

competition: it does little to enhance the likelihood that over a two-year time frame a viable competitor for GDC can emerge. Of particular concern is the allocation of all quota rights to GDC and the establishment of Dairy Foods on a basis that precludes use of its major brands in international markets. While the GDC proposal is based on the proposition that vertical integration is essential for efficiency in the dairy industry, both these factors limit the ability of potential competitors of GDC to expand into export markets. Equally important from the perspective of potential competition is the absence of a commitment to unbundling returns to farmers, the absence of a mechanism to provide for tradable shares, and a fair value mechanism that is likely to set values for equity stakes in co-ops that are biased against switching. We therefore conclude that the Commerce Commission is likely to find that the detriments of the GDC proposal substantially outweigh the benefits.

Role of the Commerce Commission

The primary role of the Commerce Commission is to ensure that market structures and market practices are consistent with competition. We consider that the GDC proposal should be considered by the Commerce Commission for the following reasons:

1. It would be inappropriate to deny the Commission the opportunity to assess the proposed merger but then to require it to undertake ongoing monitoring of the operation of the relevant markets.
2. The Commerce Commission plays a vital role in collecting information, making assessments of net benefits to the public, and in considering any structural (but not behavioural) remedies for concerns that it might have. The larger are the firms proposing to merge, and the greater the contribution of the industry to national income, the more important it is that any merger proposal be authorised by the Commission.
3. Only in very unusual cases (of which the GDC proposal does not appear to be one) is it possible that the analysis of the Commission will not be consistent with an analysis of the national interest.
4. With a Commerce Commission decision, it will be clearer if there is a “benefit to the nation” justification for any behavioural undertakings that may be

offered the Government and included in the legislation that will be required to facilitate change in the industry.

5. Failure to require the proposal to be authorised by the Commission would create a precedent that proponents of future mergers of large firms would invoke to avoid authorisation by the Commission.

Conclusion

By comparison with the merger proposal put forward by the industry in 1999, the GDC proposal provides a more plausible statement of the benefits to be derived from the merger than did the 1999 proposal. However, it still does not meet the key concern of competition policy: the need to create a structure within which viable competition for GDC will be present within two years. In its current form, our assessment is that the GDC proposal has detriments well in excess of the benefits, and that this is synonymous with the view that the proposal does not represent the best deal for New Zealand. It appears to us to be important, however, that the industry seek an authorisation from the Commission and consider structural means of reducing the detriments as a prerequisite for any legislative action by Government.

1. Introduction

On 21 December the Dairy Industry announced a proposal for the merger of the New Zealand Dairy Board, the New Zealand Dairy Group and Kiwi Co-operative Dairies to create Global Dairy Company (hereafter GDC). The Ministry of Agriculture and Forestry has requested that Economics and Law Consulting Limited (ELC) provide an initial report on the following three issues:

- (iv) Of the detriments identified by the Commerce Commission in its draft determination of the 1999 dairy industry “mega-merger” proposal, which of those detriments appear to be addressed by the GDC proposal (and to what extent) and which do not appear to be addressed.
- (v) Of the benefits identified by the Commerce Commission in its draft determination of the 1999 dairy industry “mega-merger” proposal, the extent to which the GDC proposal appears to increase or reduce those benefits.
- (vi) The costs and benefits of allowing the GDC proposal to be implemented without requiring it to be authorised by the Commerce Commission.

ELC accepted this assignment with the caveat that it should be absolutely clear that our Report would not be, and could not be viewed as or used as, a substitute for a full assessment by the Commerce Commission. This caveat is important because:

- (i) Our assessment at this time must be based on the small amount of information that has been made available to the public. This information is in every respect inadequate as a basis for any full assessment of the public benefits and detriments of the merger proposal.
- (ii) The assessment of benefits and detriments to the competitive process relies on both the availability of detailed (and often commercially sensitive) information about the industry and the judgements made by the investigation staff and members of the Commerce Commission. In respect of these issues, we note that
 - The information provided by the Dairy Industry is not in the form or at the level of detail and specificity on competition matters that would be included in any formal application to the Commerce Commission, and

- The Commission might legitimately make different judgements from those of ELC about the weighting of different factors.

The approach to the analysis of a merger that is taken by the Commerce Commission is to first consider whether a dominant position is likely to be created in the relevant markets. If it finds that dominance is likely, then the merger can only be authorised if the public benefits from the merger outweigh the public detriments. Consistent with the terms of reference provided for this report, we have not attempted to consider each aspect of the Commission's 1999 analysis of dominance. Rather, the main factors relevant to the creation of a dominant position are considered directly in explaining our views about the likely impact of the GDC proposal on the balance of public benefits and detriments.

Public benefits and detriments are normally assessed against benchmarks provided by one or more counterfactuals. The Commission based its August 1999 draft determination on two counterfactuals:

1. The status quo in the dairy industry, with industry-driven structural change, and
2. Deregulation of the single desk export monopoly and the emergence of two large vertically-integrated dairy processors/exporters.

Our analysis is based on the use of these two scenarios as the counterfactuals against which the benefits and detriments of the GDC merger proposal would be assessed.

The structure of our report is as follows. In Section 2 we review the proposal for considered by the Commerce Commission in August 1999 and compare it with the GDC proposal announced on 21 December 2000. In Section 3 we consider the principal detriments identified by the Commerce Commission in 1999, and consider whether and to what extent they have been addressed by the GDC proposal. In Section 4 we consider the principal benefits identified by the Commission. In Section 5 we consider the costs and benefits of requiring the GDC proposal be assessed by the Commerce Commission. In Section 6 we offer an overall assessment of the balance of benefits and detriments in the GDC proposal. In Section 7 we provide some concluding remarks.

2. A Comparison of the Mega-Merger and GDC Proposals

The current structure of the dairy industry is directed by legislation. Consequently, both the “mega-co-op” proposal put forward in 1999 and the December 2000 proposal require changes to the regulatory environment for the dairy industry. In each case, the competitive impact of the proposals will be determined to a significant extent by the changes to industry regulation that accompany the proposal.

The proposal put forward by the dairy industry in 1999, and approved by the Government subject to Commerce Commission approval, had the following key features:

- (i) The merger of all of the dairy co-operatives in New Zealand and the integration of the Dairy Board into a single vertically integrated entity (a “mega-co-op”);
- (ii) The divestiture of Dairy Foods to create competition in the New Zealand domestic market, with Dairy Foods being licensed to use certain well-known brands within New Zealand and having contracts for the purchase of milk;
- (iii) Removal of the single desk monopoly of the Dairy Board and the creation of a company to allocated quota rights but with retention of exclusive rights for the mega-co-op to export into certain quota markets for up to 6.5 years;
- (iv) The creation of a structure for the establishment of the fair value of supplier capital stakes in co-operatives, and for the payment of fair value on entry or exit. This involved the creation of tradable shares (with suppliers able to trade in a range from 80% - 120% of the shares associated with their supply) and the unbundling of returns on capital invested and returns on milk supply.

The proposal announced by the dairy industry in December 2000 has the following key features:

- (i) The merger of the NZDG and Kiwi, and the integration of the Dairy Board with their operations, to form GDC. Other co-operatives will either merge with NZDG / Kiwi / GDC or sell to GDC their respective interests in the Dairy Board;

- (ii) The single-desk monopoly of the Dairy Board is to be removed within one year, but GDC will own all dairy industry quota rights for foreign markets;
- (iii) The divestiture of Dairy Foods to create competition in the New Zealand domestic market, with GDC licensing Dairy Foods to use certain well-known brands within New Zealand and agreeing contracts for the supply of milk to Dairy Foods;
- (iv) The creation of mechanisms for the establishment of the fair value of the capital invested by suppliers of GDC and the use of capital notes to pay out the capital investment of suppliers who wish to switch from GDC to another manufacturer. There is, however, no proposal to move towards the unbundling of returns on capital invested from returns from milk supplied;
- (v) The creation of a Shareholders' and Suppliers' Council to protect the interests of farmers; and
- (vi) The suggestion that after three years the Commerce Commission will conduct a review of both the domestic wholesale price charged by GDC to Dairy Foods and any other competitors, and the operation of the fair value entry and exit price.

The GDC proposal is supported by a rationale for change in the structure of the dairy industry that is more convincing than the arguments presented in 1999. It argues that the Dairy Board was an effective way to maximise the returns from international marketing when there were 400 dairy co-operatives, but that now, with a large part of the dairy manufacturing industry controlled by two co-operatives this structure is inefficient. The costs of vertical separation of marketing and manufacturing are represented as follows:

These costs arise primarily from the interface between Dairy Board and dairy companies. In pursuing the interests of their shareholders (as they should) parties are sometimes encouraged to make decisions that merely shift costs to other parts of the industry or to pass up opportunities that would add to the wealth of all dairy farmers. Further, the parties' often conflicting interests result in lengthy and costly decision-making processes. [Business Case for Global Dairy Co Ltd: Executive Summary at 2]

Current arrangements create delays in the ability of the New Zealand industry to respond to opportunities in the marketplace. It takes time to decide which company will manufacture product to meet orders, creating risk they will be lost. It takes time for decisions to be made on international acquisitions or joint venture opportunities when these arise, creating the risk they will be missed. Shareholder value is eroded while the industry debates the ownership of intellectual property rather than immediately applying that intellectual property to new products for overseas markets. [The Merger Package at 8]

The GDC proposal further suggests that the costs of splitting the operations of the Dairy Board between two competing companies (Kiwi and NZDG) are so high that a merger of the two large co-operatives with the Dairy Board provides the only practical means of achieving vertical integration in the industry.

While these arguments are not presented in the detail that would be required by the Commerce Commission, we consider that they are intuitively plausible. As a result, they provide important insights into the benefits that we should expect to flow from legislation that makes it possible for vertically integrated companies to emerge in the industry.

In respect of its approach to competition in the dairy industry, the GDC proposal shares with the proposals put forward in 1999 the view that competition is costly and that the maximisation of benefits to farmers requires that the industry as a whole be planned by a single company. For example, it is claimed that

When new plant is required, an industry-wide perspective can be taken rather than two competing companies duplicating that investment. This will lead to greater specialisation across the industry's infrastructure and more efficient use of capital. [The Merger Package at 8]

And

If the merger doesn't happen there will either be industry stagnation with the current structure or chaos as competing companies go their separate ways and fight over the bones of the board. [Key Questions and Answers at 1]

The case put in the GDC proposal appears to be that

- (iii) It would be contrary to the national interest to attempt to preserve competing vertically-integrated firms given that [it is claimed that] there are very large benefits from size, full vertical integration and industry-wide co-ordination of manufacturing and marketing strategies,
- (iv) The [“enhancement” of the] co-operative structure of the industry and the sale of Dairy Foods will ensure that neither farmers nor domestic consumers are harmed by the creation of GDC.

In contrast, the Commerce Commission has taken the view that competition provides efficient outcomes in the dairy industry as in all other industries. In its August 1999 draft determination the Commission took the view that the merger would create the potential for the exercise of monopoly power and that the market structure proposed created very limited scope for the entry of new competition. The Commission found that neither the need for the dairy industry to compete in international markets nor the co-operative ownership structure of the industry mitigated the costs that the absence of competitive pressure would likely create for domestic consumers, dairy farmers, and the industry as a whole. For any proposal to satisfy the Commission it must take seriously the need to create markets that are competitive even if effective competition is not immediately present

3. Public Detriments

3.1 Findings of the Commerce Commission

The Commerce Commission’s analysis of public detriments provided in its draft determination of August 1999 may be summarised as follows:

- A reduction in allocative efficiency in the range from \$1.4 million to \$6.0 million resulting from the exercise of monopsony power by the merged entity to reduce the raw milk price by 5 – 10 percent.

- A reduction in allocative efficiency in the range from \$1.0 million to \$4.0 million resulting from the exercise of monopoly power by the merged entity to increase consumer prices in the domestic market by 10 – 20 percent.
- A reduction in productive efficiency in the range from \$75.5 million - \$151 million against the status quo counterfactual and \$96.0 million - \$192.0 million against the deregulation counterfactual as a result of less efficient operation of the merged entity in those aspects of its operations where competition is absent.
- A reduction in dynamic efficiency, resulting from less efficient decision-making about product innovations and new investments in the future, in the range from \$60 million to \$300 million for the status quo counterfactual, and \$65 million to \$325 million against the deregulation counterfactual.

Overall, the Commission suggested the detriments resulting from the merger would be likely to fall in the range from \$138 - \$461 million for the status quo counterfactual, and \$163 - \$527 million for the deregulation counterfactual. While the Commission devoted some attention to the potential costs of the merger for domestic consumers, the magnitude of these costs was little influenced by the impact on domestic consumers. Productive and dynamic efficiency losses in the dairy industry resulting from the absence of competitive pressure on those aspects of the merged entity that would not be subject to direct competition in international markets made up by far the largest part of the total detriments.

3.2 The Price of Dairy Products in the New Zealand Market

At paragraph 513 the Commission expressed concerns about the impact on the domestic market that are directly relevant to the current merger proposal.

The Applicant argues that competition between [Dairy Foods as an independent competitor to NewCo's domestic operation (i.e. Mainland)], combined with both [Dairy Foods and Mainland] accessing raw milk, butter and cheese from NewCo on equal terms, will ensure that competition would prevail....[T]he Commission has reached the preliminary view that Dairy Foods will not be a constraint on NewCo. Even if it were, however, the Applicant's argument overlooks the point that NewCo would remain dominant in the supply of those inputs. NewCo would thus be in a position to extract any monopoly profits available in the downstream markets for final goods through the prices it charges both Dairy Foods and Mainland for the inputs.

In effect, it was the Commission's view that NewCo would have the power to set the monopoly price in the domestic market through its power to set the wholesale price faced by Mainland and Dairy Foods.

The effectiveness of the competition that GDC faces from Dairy Foods will depend on whether its new owners have the ability develop the technology, marketing and distribution needed for long-term viability, and whether the market structure is permissive of the development of a competitor. In respect of the proposal for the divestment of Dairy Foods, there is little in the GDC proposal that is different from the proposal considered by the Commission. Under the GDC proposal Dairy Foods would not have the opportunity to export to quota markets since the proposal is that the quota market rights should stay with GDC. The proposed structure severely limits the potential for Dairy Foods to become a viable independent competitor of GDC for two reasons. First, the fact that key brands will be licensed to Dairy Foods for use only in New Zealand will restrict the ability of Dairy Foods to develop a viable export business within the two-year time frame considered by the Commission. Second, and given that the GDC proposal is based on the claimed efficiency of fully vertically integrated firms in the dairy industry, it is difficult to see how Dairy Foods will be able to pay competitive returns to build its own group of direct suppliers unless it can establish a viable export business.

Proponents of the proposal to create GDC might argue that the suggested 3 Year Review by the Commerce Commission and the potential for the Commission to recommend that the Government "implement a procedure for establishing and administering an independent milk price" will deal with this concern. But the potential to invoke price control is one that is always available to the government as a response to the exercise of market power. There is nothing in the explicit recognition of this power in the GDC proposal that would change the view of the Commerce Commission about the likely efficiency losses that would result from the exercise of market power that might provoke the introduction of price controls.

3.3 Ability to Exit and Calculation of the Fair Value of the Farmer's Interest

Suppliers to dairy co-operatives have a share in the capital of the co-operative that is based upon the amount of milk solids that they supply to the co-operative. The value of the capital invested in the co-operative is part of the value that is purchased when dairy farms change owners, and there is no reason not to assume that in these transactions the true market value of the capital invested in the co-operative is received by the vendor.

The Commerce Commission identified two factors that provide barriers to competition and efficiency when farmers switch co-operatives. It took the view that these barriers increased both the monopsony power of the merged entity and reduced the ability of suppliers to vote with their feet to sanction inefficient management. First, farmers who switch co-operatives currently do not receive the fair market value of their equity and are not charged the true value of the equity stake they acquire when they enter a new co-operative. Capital shares in dairy co-operatives are not traded independently, and the return on the capital invested in the co-operative is bundled into the price that farmers receive for the milk that they supply. This means that new members of co-operatives may receive a much higher return on their capital investment than those farmers who have been members (and made a substantial contribution to retained earnings) over a long period of time. Equally, farmers who increase or decrease supply are required to increase or decrease their share of the capital at the nominal rate set by the co-operative. Second, under the Co-operative Companies Act, a co-operative may withhold the capital of a farmer who leaves the co-op for up to five years, even though that farmer will be required to make an immediate capital contribution to any new co-operative that they join.

In its draft determination of August 1999, the Commission took the view that the terms on which capital could be withdrawn by farmers who wished to switch co-operatives was a barrier to competition. In particular, it noted (at page 56) that:

1. The merger proposal before it contained no mechanism that would ensure that fair value entry and exit were established, or that the new dairy conglomerate would implement the proposal to introduce some form of share tradability.

2. Fair value entry and exit terms would also require that the fair value of the capital in the Dairy Board should be included in the value paid out to a farmer who switched to supply a dairy company that was not part of the Dairy Board structure.
3. The proposal to limit share trading to members of the dairy co-operative might not be effective in creating a true market value for the shares.

Section 3 of the GDC proposal addresses these issues. Because of its significance it is set out in full below.

- 3.1 *GDC will be established as a co-operative and its capital structure will address both the dilution effect of new shareholding and the cost of new capacity. GDC will have fair value shares to be issued and surrendered through GDC. Capital will be held both in proportion to a supplying shareholder's total supply over a season and that shareholder's peak supply.*
- 3.2 *For the purposes of issue and surrender of such shares, GDC's shares will be valued, at least annually, by an independently qualified person or firm. The valuer will be appointed on an annual basis by GDC's Shareholders' and Suppliers' Council.*
- 3.3 *The valuer shall determine a fair value per share. GDC's constitution will provide that the valuer must determine which is the best method, or combination of methods, for determining the fair value per share, having regard to GDC's business at the time the valuation is undertaken and valuation best practices. For example, the valuer at its discretion may take into account such factors as sustainable projected cash flow to the supplying shareholders of GDC and sustainable earnings of GDC before interest, tax, depreciation and amortisation. The valuer must take into account the impact on GDC of the end of season re-adjustment for surrenders and issues of shares. In every case, the valuer must apply consistent methodology from year to year except where:*
 - (a) *exceptional circumstances require a different methodology in any year;*

or

 - (b) *a different methodology is required on an ongoing basis,*

in which case the valuer must advise the Board of the change in methodology and its impact.
- 3.4 *The valuer will be required to recommend a value per share range to the GDC Board. The value range can not exceed plus or minus 7.5% of the mid point of the value range. The Board will be required to determine a value within that range and disclose its reasons for selecting the value but need not disclose confidential information if that disclosure may adversely affect GDC's business. In determining that value the Board must seek to avoid:*
 - (a) *disadvantage being suffered by a shareholder who wishes to cease holding shares in, and supplying milk to, GDC, and to re-invest the surrender value and sell milk at a competitive price to a competitor of GDC; and*

(b) disadvantage being suffered by a prospective shareholder who wishes to commence supplying milk to GDC and cease selling milk at a competitive price to a competitor of GDC.

In doing so, the Board of GDC may take into account the sustainable terms and conditions on which milk is bought by its competitors at different times and different locations in New Zealand.

- 3.5 *Public notice of the valuer's preliminary value will be given at, or just before, the commencement of each season. A final valuation will be given towards the end of the season. Issues and surrenders of shares will generally occur at the end of the season and will be on the basis of the final valuation.*
- 3.6 *When shares are surrendered, the surrender price will be satisfied by the issue of variable interest rate notes issued by GDC, with a total market value equal to the fair value amount of the shares being surrendered. GDC will seek quotation of those notes on the New Zealand Stock Exchange (or any successor to that exchange).*
- 3.7 *If a shareholder, or a person whose application for supply has been accepted by GDC, wishes to acquire shares as a result of new or increasing milk supply, that shareholder may convert any notes held to shares in GDC at a rate of conversion which reflects the face value of these notes and the then current amount determined by the Board of GDC to be the fair value of GDC shares.*

This proposal does provide credibility to the claim that GDC will provide a mechanism for fair value entry and exit. In this sense the GDC proposal does reduce the magnitude of the public detriments associated with the merger. We do, however, have some concerns about specific aspects of the proposal.

This proposal represents an administrative rather than a market mechanism for the establishment of fair value, and there is no mechanism by which a market check on the valuations is established. Such a market check can only be provided by tradable shares. Even if shares are tradable only among suppliers, the price established by this trading activity will provide some check on prices established by administrative means. From the perspective of efficiency and the potential effectiveness of future competition in the industry, we consider the absence of any commitment to unbundling returns from shareholding and returns from milk supply and to the creation of tradable shares as a serious weakness of the GDC proposal.

The proposed mechanism for the establishment of fair value does provide the potential for continued bias against switching. This is because the interests of the members of the Shareholders' and Suppliers' Council will be to choose valuers

who will set conservative valuations of the shares. Conservative valuations will ensure that

- (i) farmers who leave GDC will be taxed for the benefit of those farmers who remain in GDC (and who only realise their capital interest in GDC through the sale of their farm) and new entrants, and
- (ii) there is a subsidy available to new farmers joining GDC.

It is likely that the Shareholder's and Suppliers' Council will see their personal interests as being strongly aligned with this position. This conclusion is reinforced by the proposal to assess equity participation on the basis of both total and peak milk suppliers. The use of peak milk supply creates the opportunity for GDC to design two-part pricing strategies that maximise the penalty for switching and the benefits of staying with or joining GDC.

The proposal to pay out equity stakes with variable rate capital notes rather than cash requires further elaboration before we can comment on it in detail, but it appears to us to have a number of features that are at least unusual.

1. Farmers switching to another co-op receive payment from GDC only via the issue of capital notes, but farmers wishing to join GDC may purchase a capital stake either through converting capital notes or with cash.
2. The value of these notes will be determined by the relationship between the variable interest rate and the market rate of interest on similar corporate debt. The market value will reflect the performance of GDC in so far as this performance impacts on the risk premium required by investors purchasing the notes. This impact may be quite large given that the notes are perpetual (do not have any fixed date of maturity) so the holders of these notes will be required to closely monitor the performance of GDC.
3. The issue of notes rather than cash requires that the farmer bear the transactions cost of selling the capital notes into the market to obtain cash.
4. The ability of shareholders to convert capital notes owned to shares in GDC at the market rate is without value, since cash can also be used to purchase shares in GDC at market value.

It has been suggested to us that the issue of capital notes is designed to substitute for a market for shares in respect of those farmers who switch to a manufacturer

other than GDC, and is designed to allow GDC to manage the any “runs” (large scale switching). In the former case, the capital notes appear to us to be a poor substitute for tradable shares in GDC. Only a small number of capital notes will be issued while switching remains limited, and since they confer no rights other than the right to receive interest they will be traded as a pure commercial debt instrument. In the latter case, we think that it is at least arguable that GDC should issue capital notes directly to the market, using the funds to pay cash to any switching farmers and (potentially) using the funds raised to finance new investment. This would allow GDC the advantages of the creation and management of a much larger and more orderly market for its debt.

3.4 Competition Between Co-operatives

In its draft determination of August 1999 the Commission identified three important elements of the existing competition between co-operatives:

1. Switching – the threat that farmers will transfer from low-performing to high-performing co-operatives,
2. Benchmarking – the ability of farmers to assess the performance of co-operative management by comparing returns with those achieved by other co-operatives, and
3. The threat of take-over – the ability of higher performing co-operatives to take over those with poorer performance, thus removing weaker management from the industry.

To these factors we would add the positive impact of diverse strategies. There is clear evidence that the dairy industry has in the past benefited from the diversity of strategies pursued by different co-operatives and the competitive tension that these different strategies have created. The creation of GDC will mean, in effect, that the entire New Zealand dairy industry has only one strategy, and that will be the strategy of GDC.

All of these benefits of competition, and in particular the benefits arising from the strong competition between Kiwi and NZDG will be lost through the creation of GDC, as they were with the 1999 proposal.

3.5 Potential for Competitive Entry

In its draft determination of August 1999 the Commission noted that

Development of significant competition from a consumer operation would be possible, especially if Dairy Foods is sold to a company with access to the product technology, marketing and distribution needed. At this stage, however, the Commission cannot assume that this will occur. Dairy Foods has not been sold, and the likely purchaser will not be evident until after the completion of this authorisation process.

In considering remedies for mergers to monopoly such as that set out in the GDC proposal, competition authorities normally look for divestment of an entity that either is from the outset, or can become over a two-year time frame, a viable competitor. We have already indicated that the terms proposed for the divestment of Dairy Foods do not make it possible to consider Dairy Foods as a viable competitor for GDC over any short time frame.

The question then is whether any other competitive entry into any of the relevant markets in New Zealand is likely to emerge in response to the more rapid removal of the single desk export monopoly. Niche entry will occur, but this is not likely to have a significant impact on competition in the market as a whole. As the Commission concluded in 1999, the barrier to large-scale entry by an international company looking to acquire milk and export dairy products from New Zealand is in their ability to acquire any large number of suppliers. Even with fair value exit, we consider that it is unlikely that over the two-year time frame considered by the Commission any viable new competitor could acquire sufficient suppliers in New Zealand to provide viable competition for GDC.

3.6 Farmer Scrutiny of GDC activities

In its draft determination of August 1999 at paragraph 524 the Commerce Commission expressed concerns that in the light of limitations on farmers' ability to vote with their feet by switching co-operatives, productive efficiency might be reduced because:

NewCo will become so large, and cover such a diversity of geographic regions and farmer interests, that the voice of the individual suppliers or groups of suppliers is unlikely to be heard or heeded. Moreover, the organisation would be so large and complex that it would be even more impossible than it is now for suppliers to monitor and assess performance.

It is not clear exactly how much weight the Commission gave to this factor in reaching its overall assessment of the range of likely losses in productive efficiency that would result from the proposed merger. It may in addition be significant in determining the extent of farmer support for the proposal.

The GDC proposal provides a comprehensive attempt to address the problems raised by the Commission in this respect. In particular, the merger agreement states:

- 5.1 *GDC's constitution will contain the following provisions, which may be changed only with the consent of the Minister of Agriculture:*
- (a) *GDC will have a Shareholders' and Suppliers' Council which will have the following functions:*
 - (i) *working with the Board to develop GDC's co-operative philosophy;*
 - (ii) *receiving quarterly reports from the Board reporting on performance measured against key performance indicators;*
 - (iii) *ensuring the voice of supplying shareholders is heard by ascertaining the views and concerns of shareholders and suppliers and reflecting these to the Board and monitoring GDC's actions in resolving those concerns;*
 - (iv) *calling a special meeting of shareholders if the Council has serious concerns about the Board's compliance with the co-operative philosophy or achievement of GDC's performance goals;*
 - (v) *appointing a Milk Industry Ombudsman;*
 - (vi) *appointing the fair value valuer;*
 - (vii) *acting in accordance with any regulations governing the Shareholders' and Suppliers' Council.*
 - (b) *GDC may not discriminate between suppliers of raw milk. This would require that, when exercising discretions under the constitution and any milk supply agreement, GDC would be required to act on commercial principles, and not arbitrarily favour one supplier or purchaser of milk over another; and*
 - (c) *the Shareholders' and Suppliers' Council shall be required to appoint a Milk Industry Ombudsman who shall consider any concerns or complaints by shareholders or suppliers of GDC about the manner in which GDC is operated or exercises its powers and discretions in its constitution or milk supply agreement. The Milk Industry Ombudsman will be entitled to enquire into those complaints and make non-binding recommendations to the GDC Board. If the Board decides not to implement those recommendations, it will report to the shareholders on its reasons.*

In its draft determination of August 1999 the Commission expressed skepticism about the potential for internal mechanisms such as those proposed above to provide effective substitutes for choice and competition between co-operatives. It is likely that they would take a similar view of these arrangements. In addition, it is not clear to us that the benefits associated with the Shareholders' and Suppliers' Council will outweigh the complications that are created by introducing it into the governance structure of GDC. We therefore do not expect that these arrangements will reduce the estimate of productive efficiency losses.

4. Public Benefits

4.1 Introduction

We have been provided with a copy of a document titled "Business Case for Global Dairy Co Ltd: Executive Summary", in which is an outline of the sources of the \$310 million dollars in benefits that are claimed to be associated with the merger. The claimed costs savings and revenue enhancements are summarised as follows:

Annual cost savings in the order of \$120 million. These savings arise from elimination of duplicated facilities and activities and are achievable from the first year of GDC. But the immediate impact of the savings is offset by one-off costs of around \$100 million.

Annual revenue enhancements and productivity improvements in the order of \$70 million. These benefits are expected to arise from the second year of GDC and represent enhanced economies of scale and scope if manufacturing activities are integrated with marketing and distribution functions.

Further benefits arise because the merger will enable the harnessing of synergies between different parts of the industry, provide fresh strategic impetus and broaden options to exploit new market, technology and biotech opportunities. The estimated impact on GDC's net earnings is an additional \$120 million per year from the third year of the merger.

While this outline is couched in the most general terms, it is possible to offer some high level comparisons based on the views expressed by the Commission in 1999.

4.2 Promotion of Industry Change

In a paper presented to the Commission in support of the merger the NZIER suggested that the 1999 proposal would promote industry change by providing for a cessation of the bundling of payouts to farmer/shareholders and by facilitating the integration of manufacturing and export marketing. The Commission was not convinced that the merger was necessary to obtain these benefits, and in respect of industry change it assessed the benefits of the merger as being in the order of \$5 million - \$15 million.

4.3 Promotion of Processing and Structural Efficiencies

The annual cost saving claimed in the NZIER paper supporting the merger proposed in 1999 claimed benefits of \$136.6 million as a result of the potential to reduce duplication in ancillary facilities, plant production flexibility and rationalisation. Of these claims, the Commission accepted benefits in the range from \$21 million to \$41 million against the status quo, and \$46.5 million to \$71.5 million against the deregulation counterfactual.

We note that annual savings of \$120 million per year are claimed in the statement cited above, and thus that the industry claim for public benefits under this category has not changed materially. In the absence of further information, we must therefore conclude that the benefits accepted by the Commission under this heading are unlikely to increase.

4.4 Preservation of a Single Seller Market

In addition to the claimed benefits of the GDC proposal noted at the beginning of this section, the “Business Case ... Executive Summary” at page 2 claims that if the single-seller framework was replaced by two major competing New Zealand companies, then “The experience of NZDG, NZDB and Kiwi suggests that market premiums of around \$110 million annually would be lost ...”.

The premium associated with single desk selling was considered by the Commerce Commission. It noted that the Dairy Board claimed that outside of the quota markets it is able to wield market power in some product and geographical markets by virtue of its market share and the premium associated with New Zealand dairy products. It is argued that these market premiums would be eroded as two competing New Zealand companies attempted to increase their share of the markets in which those premiums above the world price are extracted.

The evidence that such premiums exist is contentious. In a study commissioned by the Dairy Board, the NZIER (1998) estimated that the premiums totaled \$40 million per annum. In a critique of the NZIER study commissioned by the Producer Board Project Team, Economics and Law Consulting Limited (1998) demonstrated that the conceptual basis of the NZIER study was implausible and both the methodology and conclusions were flawed. There is nothing in the material provided as part of the GDC proposal to indicate the basis of the claim of single desk premiums of \$110 million.

In considering the evidence in 1999, the Commission was reluctant to endorse the claim the market premiums are obtained through single desk selling, and it did not agree these premiums would be lost completely if there were two or more competing New Zealand exporters. The Commission assigned a range from \$0 - \$20 million for the public benefits associated with the retention of single desk premiums. Despite the higher amount claimed by the proponents of the GDC merger, in the absence of quality empirical evidence in support of the amount claimed, we consider it unlikely that the Commission would recognise public benefits larger than the \$0 - \$20 million range.

4.5 Industry Development

In its August 1999 decision the Commission considered a range of claims about intangible benefits associated with a consolidated dairy industry. These included the benefits of the adoption by the industry as a whole of best practice from each co-op, the structure for funding industry good research (from Dairy Board revenues), the benefits to New Zealand of having a large multinational firm based in this country,

and the claim that the industry could grow its revenues from US\$4 billion to US\$30 billion in a relatively short time frame. As the Commission noted, there was no evidence that this growth in revenues of the merged company would produce tangible benefits for farmers or consumers in New Zealand. The Commission declined to include any tangible benefits associated with these factors in its analysis.

The GDC proposal contains little detail on any of these factors. The supporting material provides a high profile to the fact that GDC would be the 14th largest dairy company in the world, and that it would retain New Zealand ownership of the organisation. It is not, however, clear, that there are any tangible public benefits associated with these factors. In respect of these factors we therefore see no reason to expect that the Commission would find tangible benefits in the GDC proposal.

5. Overall Assessment of the Balance Between Benefits and Detriments

In its August 1999 draft determination the Commerce Commission found that the merger proposal had moderate to large detriments and small public benefits. The vast majority of the detriments were associated with the loss of productive and dynamic efficiency as a result of the loss of effective competition for the merged entity and not from the impact of the merger on prices paid by domestic consumers.

The GDC proposal contains the following substantive changes from the 1999 proposal. In each case, the impact as it is likely to be viewed by the Commerce Commission is indicated in brackets.

- Specifies, for inclusion in legislation, a method for fair valuation of capital on entry and exit to remove barriers to switching [positive]
- Clearer and more credible specification of the gains from the merger [positive]
- Shareholders' and Suppliers' Council [weak positive]
- Proposal for three-year review by the Commerce Commission [neutral]
- Allocation of all quota rights to GDC [negative]
- No proposal for tradable shares and payment unbundling [negative].

This summary highlights the fact that the GDC proposal has introduced a number of positive and negative changes: on balance we doubt that the changes would have a strong positive or negative impact on the views of the Commission. We reach this conclusion primarily because the changes that are positive are not likely to have a material impact on the Commission's assessment of the detriments associated with the merger. In particular, the proposal does little to improve the environment for competition: it does little to enhance the likelihood that over a two-year time frame a viable competitor for GDC can emerge. We therefore conclude that the Commerce Commission is likely to find that the detriments of the GDC proposal substantially outweigh the benefits.

6. Costs and Benefits Of Assessment By the Commerce Commission

The GDC proposal suggests a role for the Commerce Commission in monitoring the actions of GDC in the domestic market, but that the Government rather than the Commerce Commission should make the decision to implement the proposal (or not). This appears to us to undermine the basic principles of competition policy, and to reverse the primary and secondary roles of the Commission. The primary role of the Commission is to ensure that market structures and market practices are consistent with competition. If there is a competitive process at work in a market, ongoing monitoring is not necessary. Only where the Commission has not had the opportunity to impose structural remedies to achieve a competitive process is it appropriate to consider other actions by the Commission such as price control. In our view it would be inappropriate to both deny the Commission the opportunity to assess the impact of the GDC proposal and then require the Commission to make an assessment of the outcome.

The GDC proposal emphasises that time is a crucial issue. The timing of events in the proposal is built around the suggestion that the merger should be implemented for the 2001 – 2002 milk season, which means in practice by June 2001. While there is some

logic to the proposal that the merger be implemented for the 2001 – 2002 milk season, the short time frame is one that has been created by the dairy industry. Further, we can not rule out the possibility that the timing of the announcement was the result of a strategic choice to attempt to create the perception that the Government must act in an extremely tight time frame.

In our view, the time frame need not and should not be used to justify the avoidance of a Commerce Commission decision on the proposal. The proponents of the merger would be imprudent if they had not spent the period since 21 December 2000 preparing an application for the Commerce Commission. In any event, it should be possible to submit such an application to the Commission within two weeks of an indication from Government that this is required. Having considered the “mega-merger” proposal in 1999, the Commission should not require more than the normal 60 days to make a decision on a new proposal that clearly addresses the issues that were raised in their 1999 Draft Determination. This means that a Commerce Commission decision could be available at or soon after the end of March. Provided that the Commission approves the proposal, the timeline set out in the GDC proposal would still be feasible.

The Commerce Commission plays two crucial roles in the assessment of any merger. First it has statutory responsibilities and powers to collect information and consult market participants, and a track record for maintaining the confidentiality of commercially sensitive information that it acquires. The Draft Determination of the Commission dated 29 August 1999 built on past decisions relating to the dairy industry, provided new data about the industry and identified significant issues associated with the competitive impact of the proposed merger that could only be addressed on the basis of such a detailed study. Second, the Commission may broker and accept structural undertakings which resolve concerns that it might have. The Commission is the optimal agent to consider such “deals”. Both roles are crucial for the achievement of the best outcome for the industry and for New Zealand consumers.

It may be claimed that the Commerce Commission’s mandate is not sufficiently broad to consider all of the issues raised by the GDC proposal, but in our view there is only one special case in which this might be true. If deregulation of the dairy industry

created the optimal structure of the market from the perspective of dynamic efficiency but this market structure was unlikely to produce effective competition inside the two-year horizon used by the Commission, it is possible that the Commission's approach could be improved by implementing the proposal with the Government finding some mechanism to accept some behavioural undertakings for the period in which effective competition is absent. In our view, for this approach to be considered by the Government, it must be true that

- (i) the structure of the industry and the market that is created is optimal from the perspective of facilitating competition in the future, and
- (ii) there is a mechanism by which the Government can accept and monitor compliance with short-term behavioural undertakings.

The GDC proposal appears to be far from optimal in terms of its creation of a market structure that will facilitate future competition, and its failure to include price unbundling will increase the difficulties of monitoring any behavioural undertakings.

Without an assessment by the Commission it will not be clear where the major concerns with the GDC proposal actually lie, and it will be more difficult to identify those concerns that can be addressed by undertakings given to the Government. Thus with a Commerce Commission decision, it will be clearer if there is a "benefit to the nation" justification for undertakings that are accepted by the Government and included in the legislation that will be required to facilitate change in the industry.

6. Conclusion

By comparison with the merger proposal put forward by the industry in 1999, the GDC proposal provides a more plausible statement of the benefits to be derived from the merger than did the 1999 proposal. However, it still does not meet the key concern of competition policy: the need to create a structure within which viable competition for GDC will be present within two years. It is hard to reconcile the claim that the GDC proposal will allow retention of single-desk seller advantages in export markets with the claim that a market structure is being established that will allow the emergence of viable competition in the supply of the purchase and processing of raw milk, the supply of milk products to the domestic consumer market and the export of

dairy products from New Zealand. The failure to establish Dairy Foods on a basis that would allow it to emerge as a viable competitor of GDC, the failure to provide for price unbundling and tradable shares, and the allocation of all quota rights to GDC represent major impediments to the development of competition. In addition, the proposal could be improved if it was developed or clarified in respect to the proposal to issue capital notes and the proposal for dealing with the Dairy Board stakes of the small independent co-operatives.

In its current form, our assessment is that the GDC proposal has detriments well in excess of the benefits, and that this is synonymous with the view that the proposal does not represent the best deal for New Zealand. It appears to us to be important, however, that the industry seek an authorisation from the Commission and consider structural means of reducing the detriments as a prerequisite for any legislative action by Government.