Review of the State of Competition in the Dairy Industry

Comments on the Commerce Commission's Draft Report

Report to Open Country Dairy

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1 Introduction and Summary

The Commerce Commission (Commission) has released its draft report on the state of competition in the New Zealand Dairy Industry. This follows submissions (and cross-submissions) on its two consultation papers: on its process and approach, and the substantive issues for its review of the state of competition (substantive issues paper).[1]

Open Country has asked Castalia to prepare reports as part of both consultations (our July and August reports).[2] These reports provided our opinion on how the Commission should analyse the state of competition in the dairy industry and potential changes to dairy industry regulation under DIRA.

Open Country has now asked Castalia to assess Fonterra's incentives to exercise its market power in the farm gate market, given that the Commission's draft report dismisses concerns about Fonterra's incentives.

In summary, **without DIRA there are a number of ways Fonterra can exercise its market power to restrict competition** by reducing farmers' confidence to leave Fonterra (such as extending contract lengths or introducing barriers to re-entry), reducing confidence for existing independent processors that they can attract milk supply, tactically pricing them out of the market, or decreasing milk pricing disclosure.

Fonterra does have incentives to exercise its market power at the farm gate to:

- Attract and retain suppliers that drive lower overall collection costs.
- Weaken existing and reduce potential future competition in domestic dairy processing
- Retain or expand the international market Fonterra is able to compete for by reducing the ability (even at the margin) for integrated value-add companies that want to move up the value chain to secure milk directly from farmers
- Capture any New Zealand brand value in international markets.

Fonterra's cooperative structure does not constrain its use of market power. Co-operative structures can constrain behaviour where they are consumer-owned (like in electricity distribution), and can change incentives (from a classic buyer with market power decreasing purchase prices to a co-operative buyer with market power raising them). However, they do not reduce Fonterra's incentive to benefit its shareholders compared with farmers who are outside the co-operative. Any policies Fonterra maintains (such as the single national price) under DIRA cannot be relied upon to negate Fonterra's incentives post-DIRA. This is particularly so when Fonterra has already indicated that it would reduce the uniformity of the national price through transport surcharges.

Fonterra would be unlikely to maintain the same level of transparency under any milk price disclosure regime without the Commission playing a role under DIRA. Fonterra relies on Trading Among Farmers as a reason why Fonterra would maintain the milk price disclosure regime. We agree that Fonterra is likely to retain some form of price disclosure, but Fonterra will no longer have the incentive to provide the same level of

1 Commerce Commission 'Consultation on substantive issues – review of competition in the dairy Industry' 20 July 2015.

2 Our previous reports are accessible at this link.

detail, robustness or transparency that it currently does. Disclosure will simply be to serve its own purposes with no oversight and a far reduced threat of regulatory control.

2 Fonterra Could Exercise Its Market Power Without DIRA

As first highlighted in our July and August reports,[3] Fonterra would have a range of ways to exercise its market power in the farm gate market to the detriment of competitors and consumers without DIRA. These include:

- **Restricting farmers' ability to leave Fonterra and supply an independent processor** (such as long terms contracts, exclusivity arrangements, break fees, or costs or inability to re-enter). For example, we understand that when Fonterra bought NZ Dairies Ltd it was on the condition that all farmers joined Fonterra and farms were locked in for 6 years
- **Reducing confidence for existing and potential independent processors that they can attract supply** and therefore invest in efficient new plant or plant expansions. This could include tactically overpricing milk to drive out existing or potential competitors.
- **Inflating the milk price** to make it difficult for processors who are not co-operatives to compete for milk supply and attract it—even where they are more efficient than Fonterra.
- **Reducing confidence for farmers looking to make long-term investments to convert to dairy farming** that they will be able to sell perishable milk at a fair price to parties other than Fonterra—and to processors with the capacity to accept the large milk quantities necessary at peak season.
- **Price-discriminating** based on the level of competition in a region.
- **Decreasing or removing disclosure** over how its milk price is set.

All these ways in which Fonterra could exercise its market power have the potential to reduce productive and dynamic efficiency in the New Zealand dairy industry. Unless independent processors can compete on a level playing field, then more efficient processors will be unable to attract milk supply, and they will have reduced incentives to invest in ways to add value to New Zealand's milk.

3 Fonterra Would Have Incentives to Exercise its Market Power Without DIRA

The Commission's view in its draft report was that Fonterra would not have the incentive to exercise market power at the farm gate. Even in a competitive global market, Fonterra would have the incentive to exercise its market power at the farm gate to:

- **Attract and retain the suppliers that drive lower overall collection costs.** Fonterra buys milk from the largest network of suppliers in New Zealand. The cost of obtaining this milk varies by location of farmer supply. If independent processors pose the threat of entering and capturing market share in a way

[3] Our previous reports are accessible at this link.

that increases average collection costs, Fonterra would have a strong incentive to defend those areas to keep average collection costs low. This may be so even if it involves paying a premium to individuals or groups to tactically price-out competitors. Even if it is unsuccessful in ultimately driving out its key competitors altogether, Fonterra would still benefit if such an approach reduces average collection costs.

- **Weaken existing and reduce potential future competition in domestic dairy processing.** Although Fonterra may not be able to prevent access by its largest existing rivals, it may be able to forestall early stage-competitors through tactical pricing to retain market share in future. This is consistent with Fonterra's conduct in practice. We note the Commission has previously investigated Fonterra undertaking tactical pricing, and accepted that it had taken place—though it did not breach section 36 of the Commerce Act.[4] In addition, in its submission on the substantive issues paper, Tatua Co-operative Dairy Company Limited (Tatua) identifies instances of tactical or differentiated pricing by Fonterra. Tatua notes pricing varied by region (based on level of competition) in one case and commitment or certainty on the other (Guaranteed Milk Price).
- **Expand the international market Fonterra is able to compete for.** A number of processors in New Zealand are connected to international firms that produce value-added dairy products downstream. Those international firms are also current (or potential) Fonterra customers. If these firms move up the supply chain to raw milk processing, Fonterra has the potential to lose business or reduce the market it is able to compete for. Restricting the ability (even at the margin) of such firms to access supply in New Zealand potentially benefits Fonterra even if it is not able to influence international prices.
- **Capture any New Zealand brand value on international dairy markets.** It is unclear whether there are any dairy products for which New Zealand obtains a premium for its milk on international markets. However, to the extent that the international market does differentiate milk products from New Zealand, Fonterra would have the incentive to maximise its position relative to other New Zealand producers. This is to enable Fonterra to extract as much of any New Zealand brand premium as possible.

4 Being a Co-Operative Does Not Constrain Fonterra's Behaviour

Both Fonterra and the Commission place emphasis on Fonterra's co-operative structure playing a role in restricting Fonterra's incentives to exercise its market power. It is hard to see how Fonterra being a co-operative reduces the nature of the risks identified in Section 3. Fonterra is still incentivised to weaken domestic processing competition at the farm gate in the ways identified.

There is only one circumstance when being a co-operative can constrain a firm's behaviour when it has market power—if that co-operative is owned by those that it supplies. In this case, any market power would be exercised against the very group that

[4] Commerce Commission 'Fonterra Did Not Breach Commerce Act' Media Release, 24 December 2008 accessible here.

benefit from it. This is analogous to the rationale for consumer-owned electricity distribution businesses not being subject to price regulation under the Default Price-Quality Path in Part 4 of the Commerce Act.

Fonterra being a co-operative changes its incentives to exercise market power relative to other ownership structures, but its incentives do not disappear. If Fonterra was a normal company rather than a co-operative, it would be expected to act like a classic single buyer. That is, it would reduce the price it pays for milk in order to earn additional profits. Since suppliers cannot supply anyone else, they are forced to accept this lower price. That is unlikely to happen in Fonterra's case because the farmers who would be paid less for their milk are the ones that would receive the dividend from that behaviour. This situation is not analogous to consumer-owned electricity distributors because not all farmers are shareholders in Fonterra.

Fonterra still has the incentive to act in the best interests of its farmer-shareholders, even if that means acting to the detriment of farmers that are outside of Fonterra. A key example relates to the acceptance of farmers who want to re-enter Fonterra. Fonterra states it would always accept farmers entering the co-operative so long as incremental revenues exceed incremental costs. NERA supports this on the basis that this is profit maximising behaviour. However, this ignores the potential value in tactical pricing or imposing terms on suppliers that create barriers to entry for new processors. Even if there is a risk of not accepting the re-entry of a profitable farmer, to the extent that the threat stops farmers leaving in the first place, this approach could conceivably benefit Fonterra (and existing shareholders).

Fonterra's submissions on the current review confirm that Fonterra seeks to differentiate between farmers in ways that may conflict with the Commission's view of Fonterra's incentives as a co-operative. In its submissions, Fonterra notes that it wants to have the power to impose transport surcharges for farmers that are expensive to serve. We have no concern with transport surcharges that efficiently recover additional collection costs. However, imposing transport surcharges on a new farmer that is costly to serve is a strong example of protecting the interests of existing farmer shareholders that suggests Fonterra still has the incentives we highlight in Section 3.

We also highlight that NERA appear to agree that there is nothing inherent in the nature of a co-operative that negates its incentives to exploit market power. The academic literature NERA cited in the 2010 review of the state of competition confirmed that co-operatives with market shares in excess of sixty to seventy-five percent possess and use monopoly power.[5]

5 Milk Price Disclosure is Likely to Weaken Without Commission Oversight

Fonterra's submission on the substantive issues paper states both that the existence of the Fonterra Shareholders' Fund (FSF) acts as a discipline on Fonterra's pricing incentives and also that in the absence of DIRA it would continue to disclose the milk price calculation. The Commission appears to accept that the disclosure of the milk price is likely to continue post-DIRA, and that this might play a sufficient role in retaining

5 See for example Baumer, D., Masson, R., & Masson, R. (1986). 'Curdling the Competition: An Economic and Legal Analysis of the Antitrust Exemption in Agriculture' *Villanova Law Review*, 31, 183-252.

transparency. Our view is that there is a significant risk of the disclosure becoming progressively less transparent, detailed, robust and reliable.

We disagree that the FSF significantly influences Fonterra's pricing decisions compared with the benefits of reducing competition. The FSF only makes up approximately 6 percent of Fonterra's equity, and FSF unitholders do not have any voting rights. This is likely to give FSF unitholders limited impact compared with Fonterra's farmer shareholders.

We also consider that there is a material difference between DIRA and deregulation regarding the disclosure of the milk price. We agree that, in principle, Fonterra is likely to retain some form of milk price disclosure regime because it benefits FSF unitholders. However, the absence of the Commission's role would remove the independent oversight that is a key part of the regime. For example, data and assumptions that have been independently verified by the Commission or its advisors may no longer be applicable, and the model could progressively become less transparent, detailed, robust and reliable. If Fonterra reduces the information disclosed in the model, two potential inefficiencies might arise:

- It could raise barriers to entry for potential processors by increasing uncertainty in the price they will have to pay for raw milk (without the substantial time and cost necessary to fully understand the complexities of Fonterra's milk pricing)
- It removes the Commission's main option for ongoing review of the operation of the dairy industry, and neither the Commission nor the industry will have a ready way of knowing if Fonterra is paying inefficiently high milk prices.

6 Conclusion

We agree with the Commission's finding that there is not yet workable competition in the dairy industry and that the DIRA regulations should continue. However, we are concerned with the Commission's views on the competitive dynamics of the dairy industry that form part of the basis of this conclusion.

Fonterra has the ability and incentive to exercise market power in the farm gate market, and Fonterra's co-operative structure does not change this conclusion. Further, Fonterra's continued disclosure of the milk price cannot be relied on by the wider industry in the absence of the Commission's oversight, which is mandated by regulation.

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