FREQUENTLY ASKED QUESTIONS - Proposals to Amend the Dairy Industry Restructuring Act (DIRA) and Raw Milk Regulations

What is the DIRA?

The Dairy Industry Restructuring Act (DIRA) 2001 is the legislation that allowed for the formation of Fonterra by permitting the merger of Kiwi Co-operative Dairies Limited, the New Zealand Co-operative Dairy Company Limited and the New Zealand Dairy Board.

To allow the merger to take place, the Government granted an exemption to the mergers and acquisition provisions of the Commerce Act 1986.

Upon formation, Fonterra collected 96 percent of the milk supplied by dairy farmers in New Zealand, which meant that it was the largest dairy company in New Zealand and had a dominant position in the market. Given this, it was necessary for the Government to regulate Fonterra to ensure that New Zealand dairy markets remained contestable and efficient.

How does it work?

The contestability and efficiency of New Zealand dairy markets could be compromised if Fonterra was left unregulated. Without regulation, Fonterra could:

- put up barriers to dairy farmers' ability to freely enter and exit Fonterra
- pay farmers inefficient prices for their milk, or
- set inefficient prices for its shares.

The DIRA ensures that dairy farmers can freely enter and exit Fonterra, by requiring Fonterra to:

- remain an open cooperative accepting all milk supply offered by dairy farmers in New Zealand willing to make capital contributions in proportion to their milk supply;
- issue and redeem its cooperative shares at the same price and allow farmer-shareholders to leave the cooperative with minimal transaction costs and in a timely manner;
- ensure that the proceeds of cooperative shares are paid in a timely manner, within 30 working days after the end of the season in which a farmer ceases his/her milk supply; and
- treat new entrants and existing shareholders the same in like circumstances.

The DIRA does not directly intervene in Fonterra's milk and share price setting processes. Instead, through the freedom of entry and exit requirements, the DIRA underpins and strengthens Fonterra's commercial incentives to price its milk and shares efficiently. These incentives come from Fonterra operating in highly competitive global dairy markets.

The DIRA, through the Raw Milk Regulations, also compels Fonterra to make available up to five percent of the raw milk it collects from farmers to independent processors at either an agreed price, or regulated price.

Is this work only relevant to Fonterra and Fonterra farmers?

The DIRA affects New Zealand's entire dairy industry because it regulates Fonterra to allow all dairy farmers the choice to enter and exit Fonterra at any given time. Because dairy farmers have the choice to join/leave Fonterra, it is worthwhile for them to understand how the regulatory regime may affect that choice. In addition, as Fonterra is the dominant firm it is effectively able to set the key input price for the entire milk processing industry in New Zealand. The review should therefore be of interest to independent processors and their suppliers.

Why are changes being proposed?

Ten years from passing into legislation, the DIRA regime including the Raw Milk Regulations require updating to reflect the changing structure of the dairy industry, the need for greater transparency in milk pricing, and to ensure that the regime continues to support growth and innovation in the sector.

The proposed changes seek to:

- improve the transparency of, and confidence in, Fonterra's farm gate milk price setting;
- enable Fonterra to proceed with Trading Among Farmers if it so chooses;
- ensure that Fonterra's share price reflects fair value if Trading Among Farmers does not proceed, or proceeds and is unsuccessful; and
- ensure that the Raw Milk regulations meet their objectives of providing an entrance pathway to the farm gate milk market, and to support competition in the domestic market for factory gate milk.

What changes are being proposed in relation to the farm gate milk price?

Officials' recommendations include:

- embedding Fonterra's current milk price governance arrangements in legislation;
- requiring Fonterra to publicly disclose information in relation to its milk price setting; and
- introducing a milk price monitoring/oversight regime. This would involve the Commerce Commission undertaking, and publishing the results of, an annual qualitative assessment of Fonterra's milk price setting. This assessment would focus on Fonterra's underlying assumptions, inputs and processes, rather than Fonterra's milk price itself, measured against the outcomes that would have arisen in a competitive market for farmers' milk.

Is the government proposing the milk price monitoring regime because it thinks Fonterra's farm gate milk price is too high?

No. MAF, supported by MED, Treasury and a number of regulatory, legal and commercial advisors, undertook a review of Fonterra's milk price setting methodology and process. The review found that Fonterra's current milk pricing methodology aims to mimic efficient milk pricing outcomes that would arise in a competitive market for farmers' milk. The review also found no evidence that the methodology was being applied by Fonterra in way that leads to a systemic upwards bias of the farm gate milk price.

However, the review did highlight that there is a lack of transparency and monitoring/oversight of what are necessarily subjective judgements by Fonterra in applying its milk price methodology. This makes it very difficult to assess whether or not Fonterra's milk price in any given season is consistent with the outcomes of a competitive market.

Will the retail price of milk be affected by these proposed changes?

MAF's review has been restricted to the price that Fonterra pays its farmers for milk at the farm gate. While the DIRA does not directly intervene in how milk is priced at the retail level, the benefits of increased competition for milk at the farm gate are expected to flow through to retail markets.

What is being proposed in relation to Fonterra's share price?

Fonterra's proposed Trading Among Farmers (TAF) system, supported by the Shareholders Fund and Registered Volume Providers (who act as market makers, standing ready to buy and sell shares on a continuous basis), should result in an effective substitute to Fonterra issuing and redeeming its shares in a timely manner and at efficient prices.

To provide for this, and enable Fonterra to move to TAF, officials recommend the introduction of the following package of legislative requirements:

- a minimum fund size of $500 million as a pre-condition to launch of TAF;
- a further pre-condition that Fonterra shares and fund securities be listed on a registered exchange at all times;
- locking-in key structural features of TAF in legislation to ensure that they are maintained post launch, such as the presence of Registered Volume Providers;
- prohibiting Fonterra from engaging in behaviour with the purpose of hindering liquidity and fungibility (i.e. exchangeability of shares and units) of the TAF share and fund markets; and
- imposing obligations on Fonterra to ensure that fund investors have the ability to appoint/remove a fund manager, and the ability to wind up the fund.

However, should Fonterra decide not to proceed with TAF in the near future, or should TAF be launched but be unsuccessful, it will be important to ensure that Fonterra's share price reflects 'fair value'. Officials therefore recommend introducing legislative guidance in the DIRA in relation to Fonterra's share price.

Why is the government allowing Fonterra to introduce TAF?

Fonterra's performance is important to the New Zealand economy as it forms such a large part of the dairy industry. TAF is designed to improve the permanence of Fonterra's shareholder capital and reduce risk to Fonterra's balance sheet from farmers reducing or ceasing milk supply to Fonterra. This reduced redemption risk will position Fonterra better for future growth.

The government also considers that TAF, if designed and implemented correctly, has the potential to improve the efficiency of New Zealand dairy markets by:

- Strengthening the commercial incentives on Fonterra to ensure efficient farm gate milk price setting. The interests of external investors to maximise Fonterra's profit would provide some counterbalance to the interests of Fonterra's current farmer-shareholders, whose interests are largely around maximising the milk price Fonterra pays them as suppliers.
- Introducing capital market disciplines that would improve transparency around Fonterra's performance and therefore strengthen Fonterra's incentives to operate efficiently.
- Providing a new mechanism by which Fonterra could have the opportunity to raise additional capital from non-farmer investors. This capital could then be used by Fonterra to pursue growth opportunities in New Zealand and other markets.

Why are the Raw Milk Regulation changes being proposed?

The objectives of the Raw Milk Regulations are to:
- provide an entrance pathway into the farm gate milk market; and
- support competition in domestic dairy product markets.

In 2011, officials reviewed the Raw Milk Regulations against these objectives and identified a number of areas where improvements could be made.

What are the key proposals for change to the Raw Milk Regulations?

Officials' recommended amendments to the Raw Milk Regulations include:

- independent processors, who source some of their raw milk directly from farmers, only being able to access raw milk under the Raw Milk Regulations for three seasons;
- the total quantity of raw milk available under the Raw Milk Regulations to be increased to approximately five percent of Fonterra's milk supply. The Act sets the maximum quantity at five percent but the Regulations currently limit the total volume to 600 million litres (approximately 4 percent of Fonterra's total milk supply);
- the October Rule will be removed and replaced with a series of maximum quantity limits set, restricting how much milk independent processors can take under the Raw Milk Regulations in different months of the season, based on the seasonal supply curve; and
- the price for regulated milk to be changed by removing the $0.10 margin, which is currently added to the farm gate milk price to compensate Fonterra for providing independent processors with the opportunity to take regulated milk on a flatter curve than that which Fonterra receives from its farmers.

Why is it proposed that independent processors who collect milk from farmers be able to access regulated milk for a maximum of three years?

Regulated milk is targeted at independent processors seeking an entrance pathway into the farm gate market. Those independent processors who continue to access regulated milk, beyond what is needed for an entrance pathway, are using raw milk that would have otherwise been sourced from farmers. This in turn reduces the competitive pressures that would have occurred in the farm gate market, had the milk been sourced from farmers.

Why is it proposed that the maximum quantity be increased to 5 percent of Fonterra's milk collection?

The DIRA allows the total volume of regulated milk to be set at 5 percent of Fonterra's milk supply. Currently the Raw Milk Regulations specify the total volume at 600 million litres which makes up approximately 4 percent of Fonterra's milk supply.

One of the objectives of the Raw Milk Regulations is to provide an entrance pathway for independent processors and without sufficient regulated milk available, this objective cannot be achieved. This proposal is in line with what the legislation already provides for.

Note that even though the total volume of regulated milk will increase, the government believes it is unlikely that demand will reach this level. Under the proposal of limiting access to regulated milk for 3 seasons, demand pressures on regulated milk should ease once existing processors can no longer access regulated milk.

Why is it proposed to have maximum quantity limits per month instead of the old "October Rule"?

The "October Rule" controls the quantity of regulated milk an independent processor can take in each month, based on the quantity of regulated milk the processor took in October. The purpose of the October rule is to prevent independent processors from taking most of their regulated milk in the shoulder months. The October rule in effect allows independent processors to access regulated milk on a flat supply curve over the season in stead of a typical New Zealand seasonal supply curve.

It is proposed to remove the October rule and replace it with maximum quantity limits per month. This would limit the quantity of milk an independent processor can access each month. These monthly limits would closely reflect the typical New Zealand seasonal supply curve.

Wouldn't large processors just take milk on the shoulder months only?

The Raw Milk Regulations is a regime designed for new independent processors entering the market. Therefore it is unlikely that they would take regulated milk only in the shoulder months because they would likely not have enough of their own milk supply to be able to fill their processing plant and would need additional regulated milk in all months throughout the season. After three years they should have sufficient quantities of their own milk supply and they will no longer be able to access regulated milk.

How can farmers and the public have input?

The above proposals are yet to be agreed by the Government. Instead, they represent officials' recommendations, and would benefit from industry consideration, feedback and input, before any decisions are made. For the purposes of consultation, officials have developed:

- a draft Dairy Industry Restructuring (Fonterra's Milk Price, Capital Restructure, and Share Valuation) Bill, and
- draft Dairy Industry Restructuring (Raw Milk) Amendment Regulations

Given previous rounds of public consultation about the Raw Milk Regulations and the regulatory amendments to enable Fonterra to move to TAF, feedback on the technical detail of, and any practical implementation issues with, these policy matters will be most valuable at this stage of the policy development process.

There has been limited public input into officials' work around Fonterra's farm gate milk price setting to date so comments on the wider policy options (as discussed in the draft Regulatory Impact Statement that accompanies the exposure draft Bill), as well as the technical detail, will be highly valuable.

What is the timeframe for this consultation process?

MAF's consultation will be open for one month. The closing date for submissions is Friday 24 February, 5pm.