New Zealand Productivity Commission
PO Box 8036
Wellington 6143

Attention: Geoff Lewis, Inquiry Director
(geoff.lewis@productivity.govt.nz)

5 February 2021

Dear Geoff,

Open Country Dairy Limited—Submission on Frontier Firms Report

Open Country Dairy Limited (Open Country) is pleased to make this submission on the Productivity Commission's draft report "*New Zealand firms: Reaching for the frontier*" (the Report). The Report is a valuable examination of the contribution of the most productive firms in New Zealand to economic performance and dissemination of innovation.

Open Country makes this submission in response to findings 9.2 and 9.3 and recommendation 9.2 of the Report and the comments on Open Country's role in the processing industry.

Open Country has improved productivity and generates high returns for farmer-suppliers

Open Country has a long-term perspective on how the regulatory framework in DIRA impacts the performance of dairy processors and New Zealand's productivity performance. We were the first independent processor founded after the Dairy Industry Restructuring Act 2001 (DIRA) permitted the merger that gave rise to Fonterra. We have a history of growth and innovation. We work in partnership with 1,000 independent dairy farmers. We operate four plants in regional New Zealand in addition to our head office in Auckland. We are constantly innovating to improve productivity and our environmental impact through technology and building the skills of our team.

As the TDB report appended to the Report shows, Open Country has generated high average returns. Open Country farmer-suppliers have also earned higher total economic returns than Fonterra suppliers over the same period. Appendix A sets out analysis by Castalia comparing the returns. Open Country achieved these returns for suppliers by focusing on a productivity improvement strategy. We operate at a scale and across multiple regions, which is not available to some of some our highly specialised niche processor peers that operate in different parts of the value chain.

The milk price monitoring regime under DIRA requires strengthening

Finding 9.2, and the commentary in the Report are mostly correct. However, the milk price monitoring regime has not led to optimal outcomes. It requires strengthening.

Open Country Dairy Ltd
8 Business Parade South,
East Tamaki, Auckland 2013,
New Zealand

PO Box 11 159, Ellerslie,
Auckland 1542, New Zealand

T +64 9 589 1372
F +64 9 525 0347

We agree that DIRA has led to some of the positive outcomes mentioned. The regime has facilitated some success with the entry of innovative new processors. We further agree that the industry is moving towards a more environmentally sustainable ethos.

DIRA regulation was originally intended to regulate the then-new dominant cooperative Fonterra in a way that would provide for efficient operation of dairy markets and ensure the market is contestable. This was intended to encourage the innovation and investment needed to create higher long term returns on investment, by both Fonterra and independent processors.

However, the dominance of Fonterra and deficiencies in the regulatory regime has constrained the possible level of new entry and innovation. The regulatory regime has proven ineffective to constrain some excesses of Fonterra's behaviour. Until the recent Dairy Industry Restructuring Amendment Act 2020 (2020 Amendment), Fonterra used a low asset beta contrary to Commerce Commission findings over many years, enjoying a significant pricing benefit. Fonterra has also persisted in using opaque off-market trades to benchmark its basket of commodity product sales, when publicly disclosed trade prices were lower.

The Productivity Commission could consider how DIRA provisions can be strengthened and enforced more consistently, for example through a more robust independent monitoring and enforcement regime.

2020 DIRA Amendment is a serious threat to competition and innovation in the dairy sector

We fully agree with your finding 9.3 that removing open entry via the Dairy Industry Restructuring Amendment Act 2020 (2020 Amendment) will increase Fonterra's power to deter farmer-suppliers from leaving Fonterra to supply another processor. We support recommendation 9.2. The 2020 Amendment harms competition, new entry and innovation in dairy processing and is simply not needed to advance the public policy aims.

Repeal of open entry permits Fonterra to boycott farmers for potentially anti-competitive reasons

Repeal of open entry essentially permits Fonterra to boycott farmer-suppliers for perceived disloyalty. Farmers can be refused re-entry or have penalty-like conditions imposed if they seek to return to Fonterra. This greatly increases the perceived risk for farmers considering supplying another processor (for example, a new start-up). It locks in farmers with Fonterra and reduces incentives on Fonterra to improve its efficiency and returns for its farmer-shareholders.

Fonterra has been proven (in the Supreme Court) to have penalised farmers that have left the co-op and are "disloyal". Fonterra penalised farmers who had supplied New Zealand Dairies at Studholme. That processor went into receivership, and its assets were purchased by Fonterra in 2012. Fonterra imposed lower milk price payments on the "disloyal" returning farmers. That attempt was rightly prevented by a ruling of the Supreme Court in 2017.

With the repeal of open entry, it will be very hard to demonstrate that Fonterra is boycotting farmers or imposing tactical pricing for anti-competitive reasons. The legislative change in DIRA specifically grants Fonterra discretion to reject supply or impose conditions, notwithstanding its dominant market position (in many, if not all dairy production regions). Affected parties will need to undertake costly litigation to avoid tactical pricing or boycott, with uncertainty about whether the Commerce Act prohibition on such conduct would be overridden by the 2020 Amendment.

Repeal of open entry will create significant barriers for new processors entering a region or the industry

The repeal of open entry will likely make market entry by a dairy processor impossible. Independent processors might seek to enter the industry or an existing processor might seek to enter a region where Fonterra is the only processor (Northland and Wairarapa, for example). New processors are inherently a riskier option for farmers. Farmers need some assurance that they can return to an established processor if the new processor underperforms or fails.

By shutting the door on new start-up processors, the policy reduces the potential for innovative and more efficient market entrants or new business models in the processing market.

As a matter of good process, the policy process that resulted in the 2020 amendment to DIRA did not investigate the competition and market health implications of repealing open entry in this way.

Repeal of open entry is not necessary to achieve improved environmental and efficient land-use outcomes

Fonterra does not need the removal of open entry to deal with other important policy issues. Some commentators and submitters on the 2020 Amendment cited cross-subsidy issues or negative environmental impacts.

Fonterra can already prevent cross subsidy for new conversions, including charging for additional transport costs. Fonterra can also suspend milk collection if environmental regulations are not met. Environmental impact of dairying is an important issue that needs addressing. Other policy tools are available to the government to address specific environmental harms. For example, both the Climate Change Response (Zero Carbon) Amendment Act 2019 and the National Policy Statement for Freshwater Management 2020 addressed the environmental harms of agriculture.

Thank you for considering our submission. We would welcome the opportunity to discuss it in more detail.

Regards,

Malikah Mitha
Chief Financial Officer

APPENDIX A

February 2021

This analysis calculates the total economic returns per kilogram of milk solids (kgMS) production of a typical Fonterra farmer-supplier versus a typical Open Country Dairy farmer-supplier for each season from 2008-09 to 2019-2020 (12 years). On average, Open Country Dairy suppliers have earned higher returns compared to Fonterra suppliers.

The typical Fonterra farmer-supplier's economic returns are made up of a (1) milk price, (2) dividend, (3) change in the share price from season to season, less (4) the cost of capital to fund the purchase of shares. The Open Country farmer-supplier simply receives a payment for milk:

Fonterra supplier	Open Country supplier
1) Receives milk price payment for the season	Receives milk price payment for the season
2) Receives dividend from Fonterra share	Does not need to source additional capital
3) Makes economic gain or loss depending on movement in Fonterra share price	
4) Must source additional capital at a cost and invest it in Fonterra shares	

Fonterra suppliers are required to purchase one share for each kgMS supplied to the cooperative, subject to some exceptions[1], while an Open Country supplier does not. We therefore include the cost of financing this at a farm's cost of capital, which we estimate with the Reserve Bank's floating residential mortgage rate[2].

The value of the shares is 'marked to market' at June 1, and the gain or loss for the year added to the return.

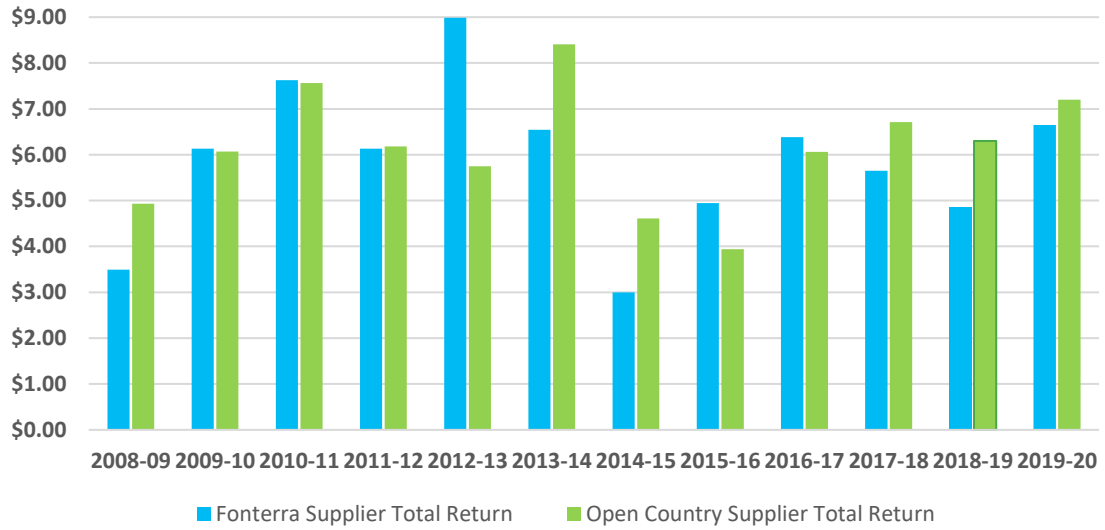
[1] These include: Mymilk: Contract-only suppliers paid a milk price $0.05 below the FGMP; A Fonterra strike price contract: The farmer must initially acquire 20 percent of the shares, and increase shareholding over subsequent seasons when a strike milk price is reached; and a Share-up over time contract: 3 or 6 years.

[2] This is typically lower than the small business lending rate, or what the money would have otherwise earned in the stock market

We do not include the benefit to the Open Country supplier of earlier milk price payments within each season[3], or ancillary benefits for Fonterra suppliers such as cheaper supply purchasing through Fonterra's Farm Source or access to support loans.

Figure A.1 below shows how these returns have changed season by season. Fonterra suppliers have received an average $5.87 per kgMS, while Open Country suppliers have received an average $6.14.

Figure A.1: Farmer-Supplier Total Economic Returns by Season Comparison



Sources: Milk payments for year from interest.co.nz, Open Country Dairy, Dividends from Fonterra's Annual Results, Floating mortgage rate from https://www.rbnz.govt.nz/statistics/key-graphs/key-graph-mortgage-rates, Share prices from: https://www.nzx.com/instruments/fcg

The Fonterra farmer's economic returns are disaggregated into four components below (Figure A.2). The capital value of Fonterra shares has declined most years since Fonterra Shareholder Fund units were listed on the NZX (part of Trading Amongst Farmers), in the 2012/13 season.

[3] We estimate this benefit at 1 - 3 cents per kg of milk solids

Figure A.2: Fonterra Farmer-Supplier Total Economic Returns Disaggregated