Industry Crossroads:

Co-operative or Fragmentation?

Kellogg Rural Leadership Programme 2017 – Brook Yates

EXECUTIVE SUMMARY

The dairy industry in New Zealand today is as important to the future of the dairy farmer as it is to the future of the New Zealand economy.

But as the industry stands, dairy is at a crossroads.

New Zealand was identified early in its colonisation as being blessed with the ideal climate and wide open spaces, ideal for pastoral farming and growing healthy livestock perfect for the production of milk. Chief Dairy Economist to the Government in 1884, William Bowron noted "The untold wealth of New Zealand lies upon the surface and the cow is the first factor in the way of securing it….."

In recent years, dairy in New Zealand has experienced unprecedented growth, driven by the availability of efficient irrigation to areas that traditionally saw other land use. This growth is based on the returns from other sectors not meeting the needs in many cases to make that irrigation viable.

Market signals and the reputation of our milk in emerging markets, notably China has resulted in a change, not only the supply and demand paradigm but also in the interest international corporations and governments have in New Zealand Inc and more importantly New Zealand dairy. This is seen in the purchasing of land for conversion to dairy or established dairy farms, and the building of milk processing plants by these overseas players.

Multinational companies continue to set up in New Zealand thereby increasing competition, but further fragmenting the industry. The increase in optionality for farmers and the attraction of growth through release of share capital has proved to be too tempting for many. Fonterra is still the majority co-operative but it's market share of the New Zealand milk pool has declined in recent times.

The Dairy Industry Restructuring Act (DIRA) introduced at the inception of Fonterra, has played a key role through the past 15 years in the sectors growth and development. It also encouraged greater competition within the industry. Although this act is being reviewed and changes are to go to the select committee, there is a further need for its relevance in the current climate. It needs to be reviewed as to whether parts, if not all of it is necessary at all.

In order to protect the future of the dairy industry, we have to look to the long term. With talk of competition coming at us from less traditional means in the form of synthetic milk we need to work collaboratively in order to ensure our future prosperity as an industry and a country.

TABLE OF CONTENTS

ACKNOWLEDGEMENTS

I would like to firstly acknowledge my wife Olivia for the time she has allowed and her patience and in what has been a very busy time whilst on the programme with the introduction of our second child not long after Phase 2.

I would like to thank my employer Fonterra Co-operative/MyMilk Ltd for the contribution and time they have allowed me to take part in the Kellogg Rural Leadership Programme.

Other people to acknowledge include those who contributed to the outcome of this paper – By way of formal interview or informal conversation each of you has helped me cement what an important topic this is and explore various points of view – Thanks also to those who encouraged me to get involved in the programme for my own personal development.

I would like to acknowledge and thank the Kellogg Rural Leadership Programme for the opportunity but also for the understanding and support exhibited recently with news I received with regards to a family member's health.

The Kellogg Rural Leadership Programme has been invaluable. I have not only learnt a lot about leadership but also about myself and I'm sure the lessons learnt will continue to develop me as an individual, open doors and unlock new networks and opportunities in the years to come.

This course could not happen without the support of the key partners and sponsors and I thank them all for their involvement.

BACKGROUND

I. *Introduction*

The topic is born out of my experience across both the red meat industry and dairy industry. It is an observation of the contrasts in how these industries have operated and also how similar they are becoming in relation to competition at the farm gate. It also looks at how the potential underutilisation of assets and the factors surrounding it can affect the long term price farmers receive and the overall longevity of the industry.

The aim of this paper is to act as a discussion piece that brings to the fore the debate around fragmentation in the dairy industry and whether moving away from a majority owned cooperative in favour of multinational corporations is a good thing for the longevity of the New Zealand Dairy industry and the milk price long term.

This paper explores the importance our heritage plays within the New Zealand Dairy Industry and the evolution that has occurred. It gives context as to where the industry is today and the markets in which NZ milk is distributed.

DIRA has played a big role in the industry and what it has become. This report looks at the formation of the DIRA in 2001, its recent review and the bill that has been put forward to amend parts of the current act.

METHODOLOGY

In doing this paper I wanted to get a balanced point of view. In doing so I engaged in six formal interviews under Chatham House rules with industry experts and people who had a range of views with regards to the formation of Fonterra, as well as those who had differing views on where the industry was today and where it was going with regards to competition. Along with the formal interviews I also had several informal conversations with dairy farmers and industry experts.

I recorded these interviews and throughout the interview took notes on specific points that were of importance and marked down the time stamp when those points were made so to gain context later. I then went back to these recordings and took aspects out of each interview with relation to topic and questions I asked.

I used several forms of literature in which to base my paper including various papers, opinion pieces, reports, books and articles. (Please refer to references page for a list). I then completed a literature review to critically evaluate the points put forward in the material.

II. ***History and Evolution of the NZ Dairy Industry*** [16] [12] [1]

Dairy farming and the Dairy Industry in New Zealand has always been built on the back of hard work and a drive or ambition to provide the best life possible for the families and communities dependant on it.

Since the first immigrants from the UK set foot on New Zealand soil, dairy farming has become a big part of New Zealand's social and political history.

Dairy factories started to open in the Waikato and Taranaki in the mid 1880's. This is where farmers would take their milk in metal cans on the back of horse drawn carts and where they also would gather to chat with other farmers. Most farmers would supply local privately owned enterprises or corporate businesses.

The first Dairy Co-operative was established on the Otago penninsula in 1881.

Visionary and newly arrived colonist William Bowron put forward the notion in 1881 that the institution of dairy factories for the mass production of cheese and butter would be greatly advantageous to the New Zealand economy. Twenty Factories had been built by 1884 at first using traditional farmhouse methods but through innovation slowly moved to larger steam driven equipment.

William Bowron now Chief Dairy Expert for the Government noted in 1884 that….

"The untold wealth of New Zealand lies upon the surface and the cow is the first factor in the way of securing it….." "We have only to make the prime article in butter and cheese, then no power on earth can stay the flow of white gold in this direction"

Co-operatives would play a pivotal role in the New Zealand dairy industry. By 1890 of 150 factories nationwide 40% were co-operatives. By the 1900's they would outnumber individually or corporately owned factories.

The large number of varied supply options meant the quality of the final product also varied. In 1894 the government introduced the Dairy Industry Act, in which each product was graded for export and payment was made accordingly.

In the years following World War I, there was a large over-supply of butter in the United Kingdom. The wholesale price for butter crashed by about 50%. However the number of factories continued to grow and peaked at around 600 in 1920 of which approximately 85% had a co-operative ownership structure. At the time dairy made up approximately 22% of total exports. As a result of this downward slide on prices saw the government established the Dairy-produce Board of Control and the act of the same name was passed in 1923.

After World War II innovation and improvements in transport, processing and energy availability led to the consolidation and merging of a lot of the co-operatives, to the point where they became larger and fewer in number. On farm, similar innovations in equipment and breeding took place allowing farmers to increase the amount of milk they produced and viably hold larger herds of cows.

Several years and mergers later four large dairy co-operatives remained in the late 1990s. These were New Zealand Dairy Group, Kiwi Co-operative Dairies, Westland Milk Products and Tatua Co-operative Dairy Company.

These companies used a platform of the New Zealand Dairy Board to market their products and sell them into international markets.

In 2001 a major change was brought about after the hard work of a lot of people to action a merger of the New Zealand Dairy Board, New Zealand Dairy Group and Kiwi Cooperative Dairies to create Fonterra. With an 84% vote from the shareholder base of the companies, the motion went through and Fonterra was formed. At the time Westland Milk Products and Tatua Co-operative Dairy Company opted not to be part of the merging companies, preferring to remain smaller and independant. The formation of Fonterra in October 2001 was a significant step for the New Zealand Dairy Industry and boosted the optimisation of manufacturing and marketing due to having one major processing and marketing cooperative. When Fonterra was formed it was owned by its 11000 dairy farmers and had a market share of 96% of the milk supplied, the remaining 4% sitting with Westland Milk Products and Tatua who opted not to be part of the majority co-operative of Fonterra and to establish their own export sales channels.

At the formation of Fonterra, a dominant market player was found. Due to its dominance, the Dairy Industry Restructuring Act (DIRA) was implemented with a number of key features to ensure an efficient and innovative dairy industry and to promote the long term interests of farmers and consumers.

With DIRA came corporate-based competition in the form of Open Country Dairy, Synlait, Danone, and more recently Oceania and Miraka, with the potential of several other competing supply companies on the horizon.

III. ***The Current Situation*** 13 8 6 2

New Zealand Dairy contributes $7.8 billion or 3% to New Zealand's total GDP and despite the recent downturn remains New Zealand's largest goods export sector by a considerable margin. In fact at $13.6 billion in the year to March 2016, means it is twice that of the meat sector, nearly four times the wood sector and almost nine times that of the wine sector.

Export earnings 2017

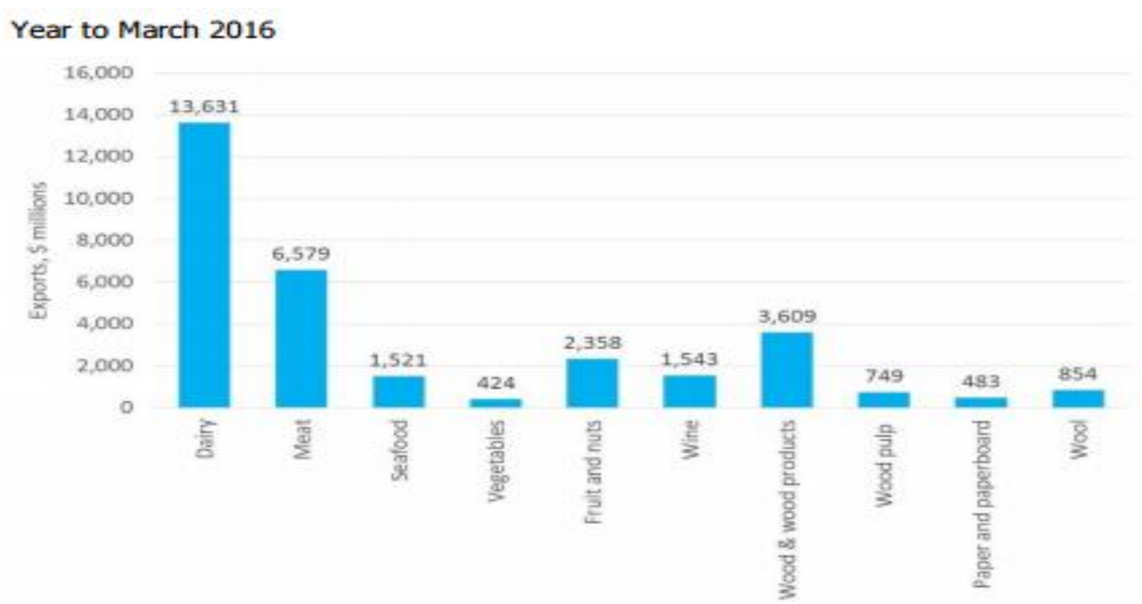

Figure 1. Source – NZIER report to DCANZ February 2017

Since Fonterra was formed in 2001, raw milk production in New Zealand up until 2015 has increased by about 58%

- More cows (up 33%)
- More milk per cow (up 21% on average) –
- More land used for dairying (up 22%) –
- More investment in milk processing plants –
- More water for irrigation –

- More borrowings. (Dairy debt almost trebled over the past decade to reach $32 billion in 2015) –
- More cow genetics and better pasture management

New Zealand Dairy Statistics

Season	Herds	Total cows	Total effective hectares[a]	Average herd size	Average effective hectares[b]	Average cows per hectare[b]
1975/76	18,442	2,091,950	-	113	-	-
1985/86	15,753	2,321,012	1,008,192	147	64	2.30
1995/96	14,736	2,935,759	1,208,352	199	82	2.43
2005/06	11,883	3,832,145	1,398,966	322	118	2.74
2014/15	11,970	5,018,333	1,746,156	419	146	2.87

Figure 2. Source – New Zealand Dairy Statistics 2014/2015

While most milk in New Zealand is processed by farmer-owned cooperatives, the industry has become increasingly diverse. There is a growing number of private local and multinational dairy companies now operating in New Zealand

Tatua's and Westland's combined market share of the New Zealand milk pool has remained at around 4% and several new companies, including Open Country Dairy (OCD), Synlait, Miraka and Oceania are now operating. Together the new processors account for 12% of the market. The six main competing dairy processors, while dwarfed by Fonterra, are sizeable businesses in their own right. Together they have total assets of above $2 billion and annual sales of around $2.3 billion. The estimated shares of the raw milk market in New Zealand of each company are shown below.

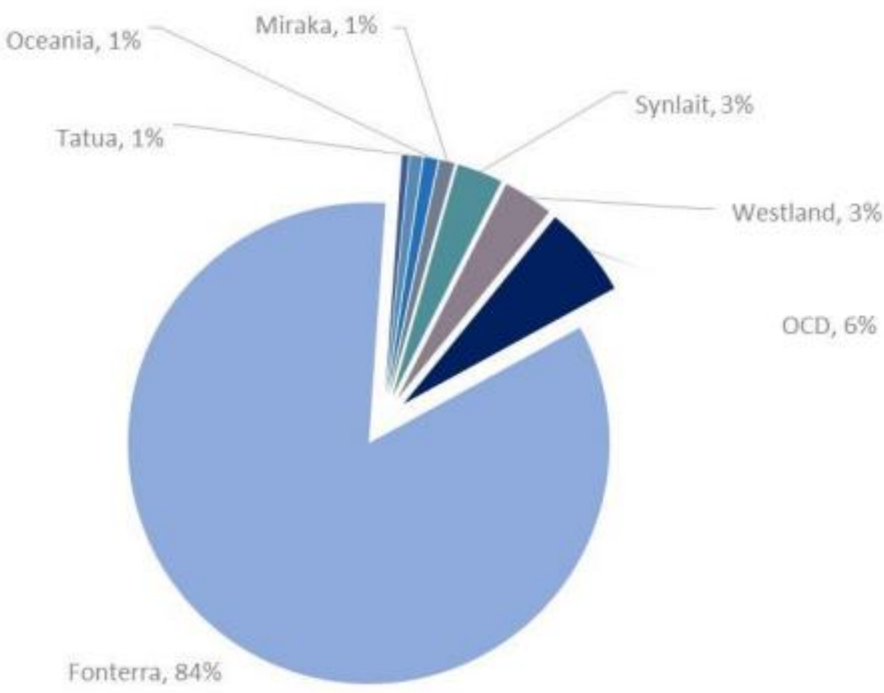

Figure 3. Source – Phil Barry TBD, Fonterra's Competitors

More dairy processing companies means more choice for farmers and greater competition at the farm gate but Fonterra continues to lose market share in what was, at its formation in 2001 a 96% share of all milk supplied, now sits at 84% of all milk and with the introduction of further processing plants across New Zealand this could potentially drop further. This could result in a battle for utilisation of assets means companies can often end up competing against one another both at the farm gate and again in the international market place.

The below table shows the milk price paid by the main competing dairy companies across New Zealand since 2008.

Table 1 – Dairy industry pay out history – Interest.co.nz

	Fonterra	Tatua		Westland		Synlait	Open Country	Miraka	Oceania Dairy*
$/kgMS	Total	Retention	Milk	Retention	Milk	Milk	Milk	Milk	Milk
	$	$	$	$	$	$	$	$	$
2008-09	5.2	-0.01	5.38		4.58	5.03			
2009-10	6.37	-0.33	6.32		6.15	6.31	6.07		
2010-11	7.9	-0.25	8.1	-0.58	7.7	7.76	7.56		
2011-12	6.4	-0.1	7.5	-0.54	6.04	6.22		6.18	

2012-13	6.16	-0.14	7.4	-1.17	6.34	5.89		5.94	
2013-14	8.5	0	9	-1.32	7.57	8.31	8.5	8.5	8.75
2014-15	4.65	-0.04	7.1	-0.63	4.95	4.54	4.61	4.5	4.5
2015-16	4.3	-0.11	6.41	-0.11	3.62	4.02	3.85-4.00	4	4.5
2016-17	6.55		6.00-6.50		5.30-5.70	6.29	5.60-5.90	5.80-6.00	5.60*

Fonterra, using its milk price model, generally sets the precedent for milk price. The Milk Price Model is governed by the Milk Price Group which is an independent group run by Ernst & Young and is audited by PWC. The Commerce Commission also has oversight of its workings. The model works out the maximum amount that an efficiently managed and sustainable producer of commodity milk products (with the same milk volume as Fonterra but turned only into a powder product portfolio), could afford to pay for milk. The key points being that it pays the **"maximum amount" for the milk** and that it is for an **"efficiently run" hypothetical company**.

IV. NZ – Our Markets [15]

New Zealand exports its products to more than 150 countries worldwide and produces a wide range of dairy products. Milk powders are a large part of the product mix, reflecting the sharp seasonality of New Zealand milk production. Our distance from market, market access and demand dynamics, as well as New Zealand's skill in milk powder manufacturing also contribute to this. We export about 95% of our dairy production into several markets the world over but our top five markets for exports are China, United States, United Arab Emirates, Australia and Japan with emerging markets in Africa.

New Zealand dairy companies are trusted suppliers of a full range of dairy products, including high value or value add dairy nutritional products, specialised dairy ingredients for food service, and infant formulas. In 2015 Whole milk powder accounted for 37% of what we export, cheese 12%, skim milk powder 10%, and butter 9%, then Protein products, UHT milk, and infant formula accounted for 21%. We do have quite a diverse range of products but with the majority being processed into powders based on the factors I mentioned above.

On a world scale NZ is unique when it comes to the export of our primary products and in particular dairy. New Zealand only accounts for two percent of world dairy production but we export over 95 percent of our national production. This is in sharp contract with the global trend where around 95 percent of total dairy production is usually consumed within the country of origin. As a country we sit at around the 8th largest producer of all nations around the world when it comes to Milk Supply

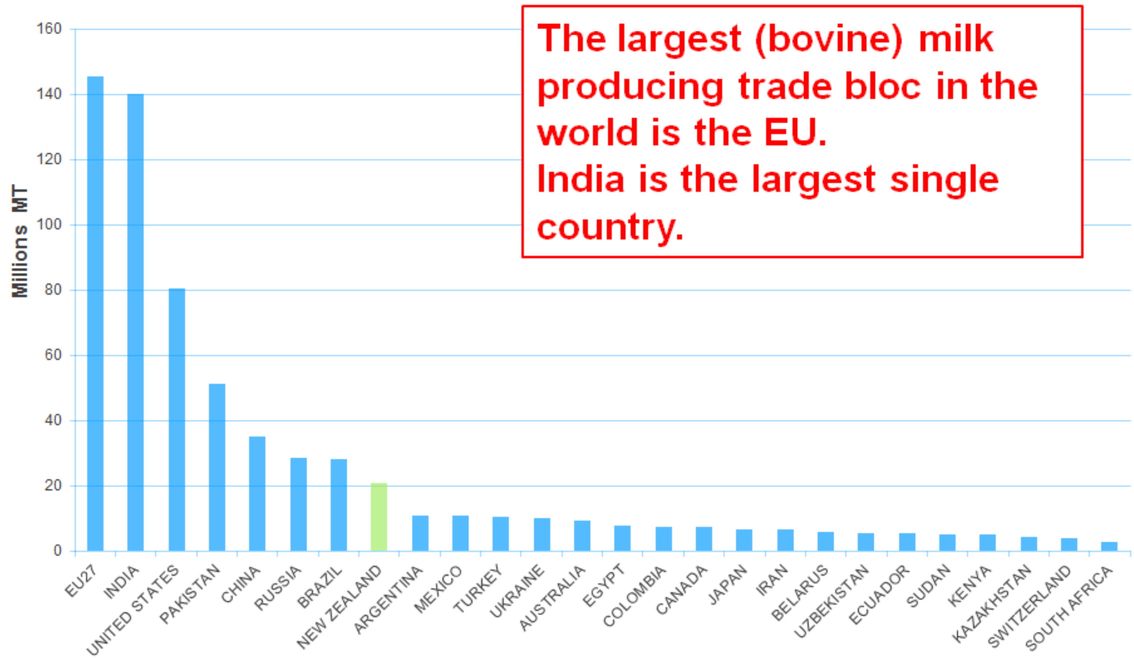

Figure 4. Total Milk Production by Country, Source – Fonterra Internal

New Zealand dairy products account for around one third of the international dairy trade, and New Zealand remains the largest exporter of dairy products.

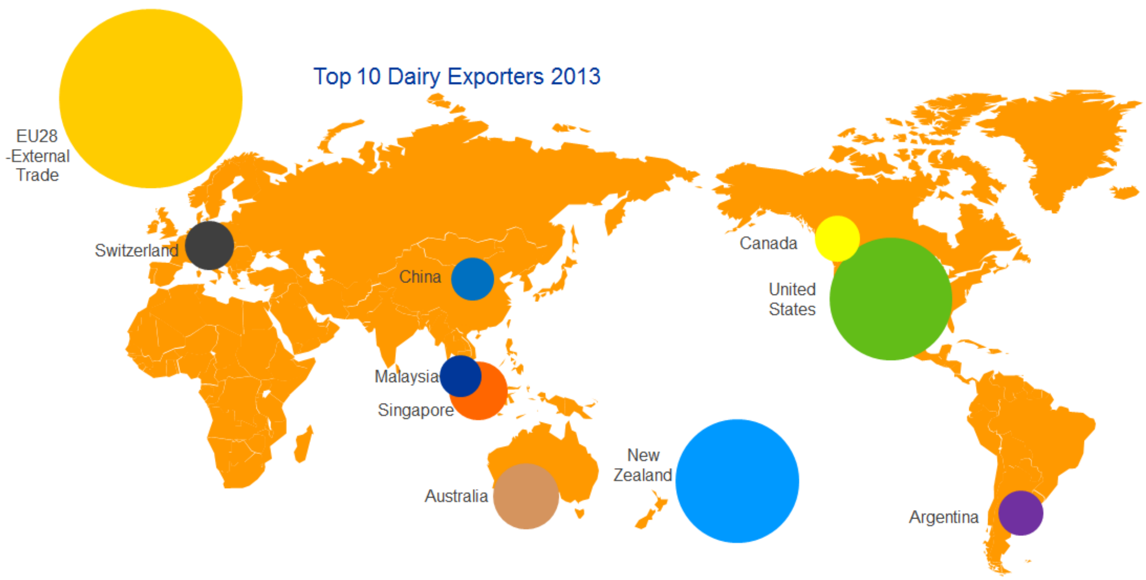

Figure 5. Source – Global Trade Atlas

Establishing, maintaining and growing these markets is essential to the future of dairy in New Zealand. Processing companies all to often operate individually, allowing them to develop their own relationships within overseas markets. However, it also means they often behave in an uncoordinated manner and companies can often end up competing against one another both at the farm gate and again in the international market place. Fonterra is the majority player but with increasing competition within the New Zealand Milk Supply space the risk of this becoming a much larger issue is imminent. There needs to be continued collaboration to coordinate activities in the manner necessary to take advantage of opportunities, and maximise returns to the farmer and the sector.

V. *Value add and Commodities*

COMMODITIES

Commodities are products which can be bought and sold and for which the attributes of the same product don't differ between competitors. Commodity markets are throughput driven so achieving economies of scale is important. Because commodities are not differentiated a competitive market approach is required, which is often better suited to larger businesses.

VALUE ADDED

Products delivered to a value added market are differentiated, meaning that one or more of the products attributes are different from those of their competitors. These products have been part of a value chain where at each stage the product is developed in order to deliver a product which is tailored to the needs of the end consumer. These markets require a market driven and collaborative marketing approach. This can better suit smaller businesses, as it requires continual innovation, flexibility and strong relationships with both niche customers and suppliers of the raw product

The growth in milk production across New Zealand has had a major influence on the product mix. It has seen a higher proportion of milk at peak production put into commodity products. In recent years several more specialised plants have been built to focus on Value add products. The flexibility these new plants have provided at peak milk production is invaluable for processors and allows them to now process what they want almost when they want.

"It was noted that the primary focus of the dairy industry over the last 10 years has been production growth. So even with the value add investments that have been made, this means the proportion of product being converted into specific value add product is now lower than it was 10 years ago. It is wrong to assume, however, that the remainder of our dairy production is being turned into basic commodity products. We have some of the most sophisticated dairy ingredient processing capability in the world, and our ingredient and foodservice solutions are globally sought-after. Over the last decade, the dairy sector has made a huge investment in processing assets to handle the growth in milk production, with most of this going into drying technologies. The challenge now is to ensure the industry is sufficiently nimble to respond to changes in customer requirements, as their lifestyles and diet evolves." The KPMG Agenda 2015

BUSINESS STRUCTURES

I. *Business structures within the NZ Dairy Industry*

All the business structures within the New Zealand dairy industry play a role in either international and domestic markets, or both.

All milk companies who collect milk from the farm gate pay a milk price to their farmers. Some of the co-operatives also pay a dividend. The key difference between is where the profits go. Cooperative business structures distribute a dividend to its farmer shareolders, where a multinational companies dividend is generally distributed to its owners. If those owners live outside New Zealand the assumption can be made that monies received will be spent outside New Zealand. But in the case of a cooperative the monies received in most cases are passed back to their farmers and then these farmers spend that money in their local communities, boosting rural New Zealand.

The below table summarises all dairy processors operating within New Zealand. It gives an overview of the ownership structure and the sales channels that each dairy processor within New Zealand operates. It is worthwhile noting some of the similarities in the products they produce and the sales channels in which they operate.

Cooperative Business Structures 2017

Company	Year Established	2016 Revenue	Product Positioning	Sales channels	Ownership
Westland	1938	$588m	Base commodities through to branded consumer products, powders, UHT milk, butter, and yoghurt.	Export to 60+ countries.	Co-op owned by 429 farmer suppliers
Tatua	1914	$293m	High value speciality ingredients, caseinate, whey protein and anhydrous milk.	Progressively established offshore offices once separated from NZDB/Fonterra.	Co-op owned by 113 farmer suppliers.
Fonterra	2001	$17.2b	Base commodities through to branded consumer products, powders, UHT milk, butter, cheese	Export to 140+ countries.	Co-op owned by 10500 farmer shareholders

Corporate Business Structures 2017

Company	Year Established	2016 Revenue	Product Positioning	Sales channels	Ownership
Open Country Dairy	2002	$833m	Commodity powders and cheese, with some movement recently into higher value ingredients (mozzarella curd, mature cheddar, whey protein concentrate).	100% exports to over 64 countries Sells direct to trade customers. 20% of sales though OLAM (a 15% shareholder).	NZ public unlisted company, Talley's 76%, OLAM 15%, sixty others 9%.
Synlait	2007	$547m	Ingredient powders, infant formulas, cream, UHT and specialty ingredients	Sells direct to business partners and trade buyers. 2% of sales to Bright Dairy (a 39% shareholder).	Publicly owned and listed on NZX and ASX. Bright Dairy 39%, A2 Milk 8%, Mitsui 5%.
Miraka	2011	$125m + (estimate based on plant capacity).	Whole milk powder, UHT milk.	100% exports to over 23 countries. Sells through broker, Vinamilk, and Shanghai Pengxin	Owned by 29 mainly Maori incorporations. The two largest shareholders are Wairarapa Moana and Tuaropaki each with 29%. Vinamilk is a dairy products enterprise in Vietnam and

					has a 21% stake.
Oceania	2013	$200m + (estimate based on plant capacity	Whole milk powder, infant powders, UHT milk	Exported through Yili (100% owner) sales channels.	100% Yili Industrial Group.
Yashili	2013	$200m + (estimate based on plant capacity).	Yashili does not collect any milk directly from farmers, it purchases ingredients from other processors and then manufactures infant powders.	Exported though Yashili and Danone sales channels.	100%Yashili Group (25% owned by Danone).

II. The difference in Ethos between Corporates and Cooperatives[14]

Although there are many similarities in the way in which a lot of corporates and co-operatives operate, there are some key differences.

The key factors that make a good cooperative are similar in theory to what make a good society.

Cooperatives have a clear set principles called the Rochdale principles that are a set of ideals for the operation of Co-operatives. These principles are:

- Voluntary and open membership
- Democratic member control
- Member economic participation

- Autonomy and independence
- Education, training and information
- Cooperation among other cooperatives
- Concern for community

The idea of a co-operative is that the business is owned by its suppliers and everyone works together for a common goal.

Corporate companies generally have a set of values or principles according to which they operate. They will relate to a vision the company has set and are often used to guide the behaviour of their employees. A company's core values can guide its decision making process.

It is worthwhile noting that this exercise of setting these values or principles is totally at the discretion of the corporate and its executive. In most cases and if we use the New Zealand dairy industry as an example, the profits generated by these corporate companies goes back to the shareholders by way of dividend or back into infrastructure to help the continual growth.

You have to ask yourself, if multinational companies are setting up in New Zealand and profits generated are going back to their shareholders, where are there shareholders and how does this effect our local and national economy.

III. The Co-operative Life Cycle [5]

The concept of a Co-operative Life Cycle was quoted to me by one of my interviewee's as "a bit of a myth". Even so I thought it was worthwhile to share the work of Economist Michael Cook who proposed that co-operative's failures may be due to systemic problems universally inherent to all co-operative organizational structures. His work on an agricultural co-operative theory provided a systematic, logical method for deciding when to selectively apply a relevant theory to issues of patron owned co-operatives such as combating organizational degeneration is very interesting. It has some relevance to what we are seeing or have seen in Cooperatives both here in NZ and what we have seen overseas and more in particular in the United Kingdom.

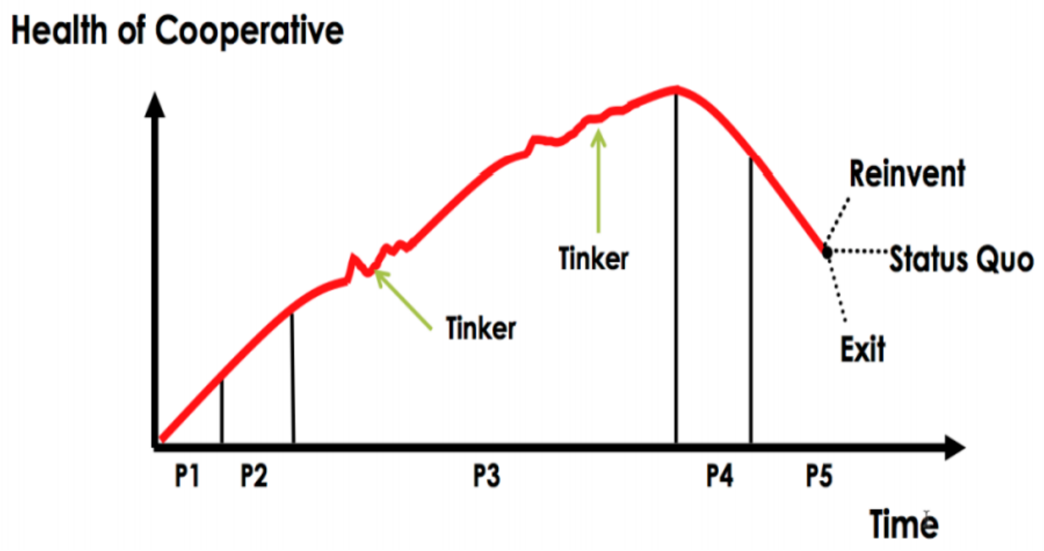

Figure 6. Source – Michael L. Cook, A Cooperative Life Cycle Framework – Health of cooperative

This framework was applied to the Berkeley Co-operative, that at its height was the largest and most influential consumers cooperative in North America but collapsed in what was believed to be a classic example of organizational failure. The Phases they were seen to go through were:

- Phase 1 – Economic Justification
- Phase 2 – Organizational Design
- Phase 3 – Growth, Glory and Heterogeneity
- Phase 4 – Recognition and Introspection, and
- Phase 5 - Choice

I think it is worthwhile to take note of this example and the potential implications NZ could run into when it comes to the longevity for Agricultural and Rural Cooperatives.

DAIRY INDUSTRY RESTRUCTURING ACT [3] [4]

I. *Overview*

Through creation of Fonterra, the industry sought to realise efficiencies of scale and scope in the collection and processing of farmers' milk and to compete in international dairy markets for the overall benefit of New Zealand.

At Fonterra's creation, it collected approximately 96 percent of New Zealand's raw milk production. Allowing the creation of such a dominant company had competition policy implications.

In particular, a dominant firm could have:

- the incentives and ability to create barriers for farmer-suppliers to prevent them switching to potential competitors;
- the incentives and ability to impede entry into the farmgate market by new dairy processors;
- the incentives and ability to set wholesale prices in downstream domestic dairy markets; and
- fewer incentives to drive cost efficiencies and invest in innovation, as it could use its market position to retain farmer- suppliers even if they were dissatisfied with the company's performance. **Source - Commerce Commission NZ - http://www.comcom.govt.nz/regulated-industries/dairy-industry/**

The Dairy Industry Restructuring Act 2001 (DIRA) authorised the amalgamation after the Commerce Commission's draft determined that the merger would result in a strengthening of a dominant position in each of the relevant markets.

As the amalgamation resulted in an entity with a substantial degree of market power in a number of key domestic New Zealand dairy markets, DIRA was designed and implemented to mitigate the risks of Fonterra's market power.

DIRA allows for contestability in the New Zealand raw milk market and provides for access to other dairy goods or services supplied by Fonterra to be regulated if necessary. Regulations made under the Dairy Industry Restructuring (Raw Milk) Regulations 2001 contain further provisions to facilitate the entrance of independent processors to New Zealand dairy markets and enable them to obtain the raw milk necessary to compete in dairy markets. Those original regulations required Fonterra to supply, at a regulated price, up to 50 million litres of raw milk per season to any independent processor and up to 250 million litres per season to Goodman Fielder. The price of regulated raw milk was the farmgate milk price (FGMP) for that season plus reasonable transport costs.

The DIRA provisions work in parallel with and are supplementary to the general competition provisions of the Commerce Act 1986.

II. ***Dairy Industry Restructuring Amendment Bill 2017*** [11]

The Dairy Industry Restructuring Bill 2017 makes changes to the Dairy Industry Restructuring Act 2001 or DIRA.

In the Commerce Commission report last year, it found that despite market share having fallen considerably, competition was not yet sufficient to be able to pursue deregulation at this time.

The DIRA Amendment Bill has been introduced after the Government had reviewed proposals to amend DIRA.

The DIRA amendment bill will introduce a number of changes to DIRA:

- Retain the DIRA regime for the time being, by preventing it from expiring
- Require a review of the need for DIRA legislation again during 2020/21 season
- Allow Fonterra discretion to accept applications to become shareholders from new dairy conversions from 2018/19
- Make other technical changes unrelated to the review of the state of competition

As a result of Cabinet decisions announced in October last year, the DIRA regulatory regime will be retained but some changes will be made to it to make the pathway to future deregulation easier.

- Parts of DIRA will be prevented from expiring in the South Island and require the next review of the state of competition to begin during 2020/21 dairy season
- Eligibility for milk from Fonterra will be altered as well as the terms that it is available on – more specifically
    - Fonterra will no longer be required to sell milk to large, export focused processors from the start of the 2019/20 season
    - There will be reduced flexibility on all processors purchasing regulated milk and the forecasting of the volume of regulated milk they intend to purchase from Fonterra from the start of the 2018/19 season

The next review will take place in the 2020/21 season, 20 years since the formation of Fonterra and when DIRA was created. This reviews scope will spread further than just competition policy and will take into account any impacts from the work on downstream milk markets.

DISCUSSION

Our distance from market and the nature of a volatile world is the environment we operate in.

As a nation that export the majority of what it produces from it's primary industries we have always had to adapt it's products for an ever changing world. We have had to grow and explore the opportunities new markets have had to offer and innovate to meet the demand of these markets.

However, the seasonal nature in how New Zealand produce our raw products and the importance and necessity of statistically significant players who have the ability to process at peak supply, means some of the largest infrastructure for dairy in the world is required here in New Zealand. The first round of aggregation was driven by improved roading and the development of tankers.

As we look back at our heritage in dairy there was a need and understanding to consolidate the many small processors and take a more collective view in how we operate to get economies of scale. This culminated in the formation of Fonterra as the two major processors left made the choice to collaborate rather than have a head to head fight for dominance.

Due to the formation of such a dominant industry player at 96%, the Diary Industry Restructing Act 2001 was created. Several parts of this act were put in place to protect the farmer and domestic consumer by aiding competition. The DIRA has had a huge bearing on the increase in the growth we have seen in dairying in recent years. One of the key parts of the act, which is also a Rochdale principle, is the right of entry and exit. So effectively within the parameters of its most distant farm from a given plant Fonterra has to give that supplier the right to supply. However on the flip side of that, they also are not obliged year on year to stay with Fonterra.

Also, the act encouraged competition but the introduction of this competition as we see it today has come mostly from multinational companies. Was this a loop hole in the act that allowed these companies to not only set up in New Zealand but also as part of DIRA, to receive the 50million kgMS per annum during the set up phase of these companies processing facilities? These companies were then able to use that milk to compete in some of the same international markets. Recent work was undertaken to review the state of the competition and DIRA itself by the Commerce Commission. In the opinion of one of my interviewee's the scope in which the Commerce Commission carried out its analysis was limited to the markets within the New Zealand border and did not extend downstream to our overseas markets and the effect that competition has there.

The DIRA has encouraged this competition and with each new processor into New Zealand comes their own approach to how they market their products to the international market place resulting in a fragmented approach.

NZ is unique in the sense that there is a need for the ownership of infrastructure to handle the milk flow during the peak of supply and the need to then shift that product into markets quickly due to its perishable nature. Fonterra is the company that has the economies of scale to achieve this .

The introduction and duplication of capacity to produce commodities or more particularly milk powder by alternative processors to then compete against each other in market seems counterproductive in driving the best price back to our farmers.

Fonterra being the dominant processor, its milk price is seen as a benchmark across the New Zealand Milk pool. This is partly based on its size but also on how the milk price is calculated and regulated. Fonterra's current milk pricing methodology aims to mimic the most efficient milk pricing outcomes of a commodities based processor that would arise in a competitive market for farmers' milk. Thus drives the highest milk price possible back to its farmer shareholders.

During the interview process an idea from an interviewee was that we should allow as many companies as possible in New Zealand to add value to our milk rather than further duplicating the current commodities model in place and competing at the farm gate. This duplication could potentially result in an under utilisation of the assets we have as an industry and these companies instead should be establishing further processing facilities. We see this in the current model of Yashili which does not collect any milk directly from farmers. It purchases ingredients from other processors and then manufactures infant powders.

Dairy has to learn from other sectors within the primary production industries. Looking and comparing to the current state of the sheep meat industry. They have looked in recent times to try and achieve a similar model to that of the dairy industry but due to the degree of fragmentation in their approach throughout the whole supply chain have failed to find any or much collaboration. With this in mind the dairy industry has to ask ourselves with further fragmentation are we going back or forward?

From a fragmentation point of view competition can hinder or affect our approach to market but the major benefit of competition is seen in the improvement of products and services to its suppliers and its markets.

RECOMMENDATIONS

- New Zealand has seen an increase in competition. Although this can drive some value back to farmers in the short term, long term we may be selling ourselves short. In my opinion the multinational corporations should not be competing at the farm gate and should solely be further processors of the commodity products produced by a central co-operative like Fonterra meaning the farmer sees a higher total milk price. This would still enable value add of the primary product and I believe would bring stronger sustained returns to the farmer base.

- New Zealand has an innovative primary industry but in order to ensure the future of the industry we need to meet the consumer's needs and add value where possible. There is technology coming at dairy from all sorts of angles with the introduction of synthetic milk at a price point that in time could sit well under the New Zealand Dairy farmers current cost of production. In light of this dairy needs to get good at adding value, positioning itself in the right markets and then passing that value back to the farmer to future proof the industry. In my opinion and in a perfect world the idea of adding value and having complete collaboration should return the highest cost of goods sold. In order to effectively collaborate, as many dairy companies as possible within New Zealand need to start talking and working together for the future of the industry. This should return the highest price possible for our farmers, our industry and our country.

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