Ministry for Primary Industries
Manatū Ahu Matua

Dairy Industry Restructuring (Raw Milk) Regulations – options for amendments to ensure objectives are met

Regulatory Impact Statement

ISBN No: 978-0-478-40492-0 (online)

November 2012

Contents

Page

Regulatory Impact Statement

Dairy Industry Restructuring (Raw Milk) Regulations – options for amendments to ensure objectives are met

Agency disclosure statement

This Regulatory Impact Statement has been prepared by the Ministry for Primary Industries (MPI).

Its purpose is to support a Cabinet paper that proposes amendments to the Dairy Industry Restructuring (Raw Milk) Regulations 2001 (the Regulations) to better meet the objectives of the dairy regulatory regime. The statement is detailed since it deals with a large number of options for potential amendments to the Regulations. The statement provides an analysis of the existing provisions of the Regulations and considers whether alternative options could better meet the objectives of the Regulations.

We believe that the Regulations currently do not fully meet their objectives and propose a series of amendments to improve on the status quo.

There has been extensive consultation with the industry and the wider public over a period of time. A range of Government agencies were also consulted including the Ministry for Business, Innovation and Employment, the Treasury, Te Puni Kokiri, and the Ministry of Foreign Affairs and Trade. The Department of Prime Minister and Cabinet was also informed.

Iain Cossar
Director, Sector Policy
MPI

21 / 08 / 2012

Status quo

BACKGROUND

1. The Dairy Industry Restructuring Act 2001 (DIRA) provided for an authorisation under the Commerce Act 1986 to allow the merger of New Zealand's two largest dairy cooperatives and the New Zealand Dairy Board to form a single cooperative company, Fonterra.

2. Upon its creation, Fonterra collected approximately 96 percent of New Zealand's milk production. Given this dominant market position it was necessary for the government to regulate the behaviour of Fonterra in relation to its farmers and potential competitors in New Zealand dairy markets.

3. The regulatory regime is set out in Part 2, Subpart 5 of the DIRA and the Dairy Industry Restructuring (Raw Milk) Regulations 2001 (the Regulations). It consists of a suite of pro-competition provisions that have the purpose of promoting the efficient operation of New Zealand dairy markets by ensuring:
   - contestability in the market for farmers' milk; and
   - that independent processors are able to obtain raw milk, and other dairy goods and services, necessary for them to compete in dairy markets.

4. The DIRA, through the Regulations, compels Fonterra to make available up to five percent of the raw milk it collects from farmers to independent processors at either an agreed or regulated price. This is because Fonterra's dominant position in the market could enable it to refuse to supply raw milk to other processors, or to supply it at monopoly prices.

5. The regulatory regime is, however, transitionary in nature. It is designed to expire at the point where dairy markets have become workably competitive, i.e. at the point where Fonterra is no longer considered to be dominant.

THE INTENT OF THE REGULATIONS

6. The overall objectives of the Regulations are to:
   - Provide for an entrance pathway for independent processors into the farm gate milk market; and
   - Support competition in the domestic dairy product market.

Entrance pathway

7. Contestability for milk supply at the farm gate encourages Fonterra to set efficient prices for milk and shares. A necessary condition for contestability is low barriers to entry and expansion.
8. Independent processors who are in the business of sourcing milk directly from farmers tend to rely on wholesale milk supply (i.e. milk sourced from another

processor) at the initial stages of their operations as they find themselves in a "catch 22" situation. That is, farmers want to see a processing plant before committing supply and financiers want an assurance of sufficient milk supply before providing the finance for plant construction. Fonterra could create a barrier to entry for independent processors looking to enter the farm gate market by choosing not to supply wholesale milk to these processors.

9. The Regulations provide independent processors with an entrance pathway into the farm gate market by providing them with a critical mass of raw milk on regulated terms.

10. While addressing the "catch 22" situation, the entrance pathway should also encourage independent processors to source milk on standard commercial terms directly from farmers. This ensures that investment in dairy processing capacity is efficient over the longer term.

Competition in the domestic dairy product markets

11. Fonterra's dominant position in the wholesale milk market may also harm competition in downstream domestic dairy product markets.

12. To support downstream competition in domestic consumer product markets, Fonterra was required to divest its NZ Dairy Foods business (now Goodman Fielder) and provide the divested entity with access of up to 250 million litres of regulated milk a season. This allocation was a negotiated outcome between government and the promoters of the dairy merger.

13. The Regulations also support competition in downstream product markets, where independent dairy processors rely on raw milk as an input. Since the Regulations have been in effect, a number of small dairy food and beverage companies have built their business models based on the regulated milk supply rather than having it out-sourced to dairy processors or sourcing it directly from farmers.

FEATURES OF THE REGIME

14. Government has previously reviewed the Regulations to address specific issues that arose with the implementation of the Regulations. Several changes have been made to the Regulations in recent years.

15. These changes include:
    - increasing the total volume of regulated milk available
    - providing for a pro rata rationing rule to be used in the event that demand for regulated milk exceeds the total volume available
    - changing the definition of winter milk
    - clarifying the forecast rules
    - changing the formula for calculating the price of regulated milk.

16. The key provisions of the Regulations currently are:

Access/Eligibility	Each independent processor has access to a maximum of 50 million litres of regulated milk (with the exception of Goodman Fielder who can access up to 250 million litres) in a season for as long as the Regulations are in place.
Total Quantity	Up to 600 million litres of regulated milk can be accessed by all independent processors from Fonterra in a season. Should the total demand from independent processors exceed the total quantity available under the Regulations, a pro rata quantity rationing rule would apply, whereby the amount available to all independent processors would be scaled back.
Regulated Price	The regulated price is Fonterra's farm gate milk price plus 10 cents per kilogram of milksolids. The farm gate milk price reflects the price Fonterra pays its farmers. The additional 10 cents captures the extra cost to Fonterra of providing independent processors with the option of "flattening" the profile of the regulated milk.
"October rule"	The quantity of regulated milk available to an independent processor in each of the months in the dairy season (except for winter months) is set at 110% of the quantity of regulated milk taken by that independent processor during the month of October.
Forecasting rules	The Regulations require independent processors to provide a forecast to Fonterra three months prior to delivery. This forecast is then confirmed seven days prior to delivery, with a plus or minus 40 percent margin. The forecast is confirmed again one day in advance of delivery with a plus or minus 20 percent margin. An independent processor is only required to pay for what it takes (not what it said earlier it would take), within the bounds of the above requirements.
Payment scheduling rules	The regulated price is currently based on Fonterra's farm gate milk price, the price that Fonterra pays its farmers. This price is not set until October after the close of the dairy season in May. This results in a "wash-up" payment the following season.

Key policy problem and objectives of review

PURPOSE OF THIS REVIEW

17. Feedback from the dairy industry indicated that, in spite of previous amendments, the Regulations were still not best achieving their objectives. Given it was over 10 years since their implementation, Government gave an undertaking to review the Regulations in their entirety to ensure they remain fit for purpose

18. The primary issue considered in this review was whether the Regulations are providing an efficient entrance pathway into the farm gate milk market for independent processors, thus providing for competitive pressure on Fonterra in the farm gate milk market. In addition, all provisions of the Regulations were reviewed to ensure they remain workable, practical and appropriate.

HIGH LEVEL DESCRIPTION OF POLICY PROBLEM

19. Currently, all independent processors, regardless of the extent to which they source their own milk supply from farmers, have the ability to access regulated milk on an ongoing basis. In the 2011/12 season, 6 independent processors accessed regulated milk while also sourcing milk directly from farmers. [Withheld under section 9(2)(b)(ii) of the Official Information Act]

20. When independent processors who are no longer new entrants to the farm gate market take regulated milk from Fonterra, by definition, this means they do not have to establish a direct purchasing relationship with farmers for that milk. This then reduces the additional competitive pressure that would have been placed on Fonterra in the farm gate market.

21. Continued access to regulated milk by these independent processors also increases demand pressures on the total volume of regulated milk, potentially triggering the pro rata quantity rationing rule (which means all independent processors, including potential new entrants, then get less regulated milk).

22. In the 2007/08 season the total volume of regulated milk exceeded the 400 million litres cap and the Regulations were amended to increase the total volume to 500 million litres to accommodate the increased demand. From the 2008/09 season, the total volume of regulated milk was increased to 600 million litres. The total amount of regulated milk taken in the 2011/12 season was just less than 540 million litres.

23. A secondary policy issue considered was whether the terms and conditions set by the Regulations are consistent with the objective of supporting competition in domestic dairy product markets.

REGULATORY DESIGN CHARACTERISTICS

24. Two primary objectives have been considered in assessing options for amending the Regulations. These are:

    - To provide an entrance pathway for new independent processors, while encouraging established processors with some of their own supply to further grow the level of their own supply.
    - To ensure access to regulated milk under appropriate terms and conditions for processors without their own supply, thus supporting competition in domestic dairy product markets.

25. To achieve these objectives, MPI considers the following regulatory design characteristics to be desirable:

    - *Entrance pathway*: Independent processors seeking entrance to the farm gate milk market should have access to sufficient quantity of regulated milk necessary for them to overcome the initial “catch 22” entry barrier.
    - *Self-sufficiency*: Independent processors should be encouraged to establish alternative sources of raw milk supply rather than relying on sourcing regulated milk from Fonterra on an ongoing basis. This ensures that access to regulated milk does not reduce competition in the farm gate milk market.
    - *Equivalence*: Access to regulated milk should be on terms that are equivalent to those on which Fonterra purchases its raw milk from farmers; this includes price, quality, product profile, etc. To the extent that regulated milk differs from raw milk Fonterra purchases from farmers (e.g. regulated milk is of a flatter profile and of guaranteed quality) the terms for sourcing regulated milk should fairly reflect these differences. This ensures that the provision of regulated milk supports efficiency.
    - *Economic costs to Fonterra*: The design of the Regulations should be mindful of the economic costs to Fonterra of providing regulated milk and the potential under-utilised capacity which may affect its incentives to invest.
    - *General principles*: The Regulations should be consistent with the general principles of good regulatory practice of promoting regulatory certainty, predictability of regulatory outcomes, as well as transparency, cost-effectiveness and timeliness of regulatory processes.

26. The options considered in this Regulatory Impact Statement are analysed against these design characteristics.

Regulatory impact analysis

27. This section sets out the analysis in relation to the issues which have resulted in recommendations to change the existing policy. A number of other policy issues were consulted on and considered but have not resulted in recommended change. For readability, given the large number of issues considered, the analysis of these “secondary” issues is included in Appendix 1.

ISSUE 1: TIME LIMITED ACCESS TO REGULATED MILK

Status quo

28. Each independent processor has access to regulated milk for as long as the Regulations are in place.

Problem definition

29. The status quo provides regulated milk beyond what is needed as an entrance pathway and therefore provides little incentive for independent processors to replace their take of regulated milk with their own farmer supply.

30. When independent processors, who are no longer new entrants to the farm gate market, take regulated milk this replaces raw milk that would otherwise have been sourced from farmers. This then reduces the additional competitive pressure that would have been placed on Fonterra in the farm gate market, had the milk been sourced from farmers. Appendix 2 details the regulated milk take by independent processors in the 2011/12 dairy season. [Withheld under section 9(2)(b)(ii) of the Official Information Act]

OPTION 1: Retain the status quo

31. Under this option, all independent processors, including those with their own established farmer supply, would continue to have access to regulated milk for as long as the Regulations are in place. [Withheld under section 9(2)(b)(ii) of the Official Information Act]

32. The status quo does not fully meet the key objective of ensuring that regulated milk is targeted to towards meeting the objectives of the Regulations since it provides regulated milk beyond what is needed for an entrance pathway. It thereby increases the risk that processors who require regulated milk in support of the objectives (i.e. as an entrance pathway or to support competition in downstream markets) may be subject to pro rata rationing. The status quo also provides little incentive for independent processors to replace their take of regulated milk with own farmer supply. The main cost of retaining the status quo is the lost opportunity for increased competitive pressure on Fonterra.

33. Retaining the status quo would avoid the costs and potential uncertainty associated with a regime change.

OPTION 2: Introduce a time bound limit of three seasons for those with own farmer supply **(recommended option)**

34. Under this option, access to regulated milk would be limited to three seasons for those independent processors who have their own farmer supply of milk. A processor would need to collect a minimum of 30 million litres of milk for three consecutive seasons to be considered to have their own farmer supply.

35. All other independent processors who are not considered to have their own farmer supply of milk (i.e. they collect less than 30 million litres of milk from farmers) would be able to continue accessing regulated milk until the Regulations expire.

36. The 30 million litre “own supply” criteria effectively distinguishes between those processors for whom regulated milk is targeted as an entrance pathway and processors who access regulated milk to support competition in downstream product markets. This is illustrated in Appendix 3 which details milk collection for those independent processors who source milk directly from farmers. It illustrates that the large independent processors for whom regulated milk is intended as an entrance pathway take a significant quantity of own supply (well in excess of 30 million litres)[1].

37. In contrast, the 30 million “own supply” criteria would not limit access to those for whom regulated milk is intended to support competition in downstream domestic product markets [Withheld under section 9(2)(b)(ii) of the Official Information Act]. It also allows smaller, niche product processors to source some milk from farmers (thereby providing competition at the farm gate) without being penalised.

38. The key benefit of this option is that it would introduce strong incentives for independent processors to grow the amount of their own farmer supply sooner. It would also ensure that access to regulated milk is targeted to independent processors seeking an entrance pathway into the farm gate market and those with minimal or none of their own farmer supply, rather than established processors with their own supply. That is, it would ensure that regulated milk is targeted at either providing an entrance pathway or supporting competition in downstream domestic markets on an ongoing basis.

39. A cost of this option is that it does not provide any flexibility to allow for the different maturing times of different independent processors. The time necessary for an independent processor to become established will vary, depending on what is happening in the industry at the time, and on the particularities of each processor. However, historical data shows that independent processors could be considered ‘established’ within two to three seasons. Many of the industry submissions received, including advice from some financial institutions, indicated

[1] It would also disincentivise large commodity processors from intentionally sitting under that limit to prolong their access to regulated milk. This is because 80 million litres of milk (30 million litres of milk from farmers, plus an individual maximum of 50 million litres of regulated milk entitlement) is considered insufficient to efficiently run an average sized milk powder processing plant.

that three seasons is considered sufficient time for a processor to establish its own supply of milk.

40. This option would require additional monitoring of ‘own supply’ and independent processors would face administrative costs to provide the government with additional data on the amount of milk they source directly from farmers while they access regulated milk. However, the additional information requirement is not expected to be onerous for processors, as they will already be collecting this data for their own business purposes.

OPTION 3: Introduce ‘established own farmer supply’ rule

41. Under this option access to regulated milk by those with their own farmer supply would cease once a certain level of own supply of milk is established (e.g. 100 million litres).

42. This option has the flexibility to allow independent processors to grow their own supply of milk at the rate they choose. Careful consideration would need to be given, however, to determining the right access threshold. In particular, the access threshold would need to be set at a relatively high level to ensure it didn’t capture processors too early (i.e. when they still require regulated milk as an entrance pathway). However, given it would need to be at a relatively high level, it could create a perverse incentive for independent processors to establish and maintain their own supply just below the access threshold (e.g. 99 million litres) therefore disincentivising independent processors from seeking their own supply.

43. As with option 2, increased monitoring of the levels of ‘own supply’ would be required.

PREFERED OPTION Option 2: Introduce a time bound limit of three seasons for those with own farmer supply

Summary for Issue 1: time limited access to regulated milk

	Entrance pathway	*Self-sufficiency*	*Equivalence*	*Economic costs to Fonterra*	*General principles*	*Overall assessment*
Option 1: Retain status quo	Provides regulated milk beyond what is needed for an entrance pathway	No incentive for processors to seek alternative sources of supply	Not applicable	Greatest cost to Fonterra since regulated milk is provided for the longest time period	• Low administration cost, simple design • Regulatory uncertainty about how long access to regulated milk would remain in place	Not recommended as it does not ensure access to regulated milk is targeted at meeting the objectives of the Regulations
Option 2: Introduce a time bound limit of three seasons for those with own farmer supply	3 seasons is considered a sufficient time period for an entrance pathway	Strong incentive for processors to seek own supply	Not applicable	Lowest cost to Fonterra since regulated milk is potentially available for the shortest time period	• Simple design • Administrative costs less than option 3	**Recommended**, improves on status quo
Option 3: Introduce 'established own farmer supply' rule	Sufficient time for an entrance pathway	Some incentive for processors to seek own supply	Not applicable	Less cost to Fonterra than under the status quo	• More complex to design and administer • Most scope for perverse incentives	Not recommended, improves on the status quo but more complex to design and most scope for perverse incentives

ISSUE 2: TOTAL VOLUME OF REGULATED MILK AVAILABLE TO ALL PROCESSORS

Status quo

44. The DIRA allows the total volume of regulated milk to be set at up to 5 percent of Fonterra's milk supply. Within this 5 percent limit, the actual volume available is set in the Regulations. The 5 percent limit set in the DIRA was considered to be an appropriate proportion of Fonterra's milk supply that can be diverted to independent processors under the Regulations without causing significant economic harm to Fonterra.

45. In 2001, when the Regulations were originally drafted, the total volume of regulated milk was set at 400 million litres. Since then, the Regulations were amended to increase the limit to 500 million litres for the 2007/08 season and lifted again to 600 million litres for the 2008/09 season. The limit has remained at 600 million litres, which accounted for approximately 3.5 percent of Fonterra's milk supply for the 2011/12 season.

Problem definition

46. As the number of new independent processors accessing regulated milk continues to grow there is an increasing likelihood that demand for regulated milk will exceed the total cap.

47. This means that independent processors who are in their early development or those with no farmer supply, and who therefore rely on regulated milk, may not be able to access the amount of regulated milk that they need. This could result in potential new entrants delaying or deciding against entry which carries with it an associated cost due to missing out on potential innovations and opportunities realised by new entrants.

OPTION 1: Retain the status quo

48. Under this option, the current 600 million litre cap would be maintained.

49. This level of total quantity has, up until recently, been sufficient to provide all independent processors with access to regulated milk at their full entitlement. If the recommended option for Issue 1 is implemented, demand for regulated milk is likely to reduce in the future, as established processors cease accessing regulated milk.

50. However, with the growing number of independent processors, and with all independent processors likely to access regulated milk for at least the next three years, this level of total quantity might not be sufficient to meet demand. The final forecast was 595 million litres in the 2011/12 season, which indicates that the cap being reached is a real possibility[2].

---

[2] The pro rata rationing takes effect if the final forecast, made in accordance with the forecasting rules in the Regulations, is greater than 600 million litres.

51. A potential benefit of the status quo is that, depending on how excess demand is managed (which is discussed further below) it could incentivise independent processors to seek alternative sources of milk supply rather than relying on regulated milk.

52. The main cost of the status quo is the risk that independent processors who are in their early development or those with no farmer supply, cannot access the amount they need. In this event, the Regulations would not be meeting their objectives.

OPTION 2: Increase the "total quantity" to 5 percent of Fonterra's total milk supply and review every 3 years **(recommended option)**

53. Under this option, the total quantity of regulated milk would be set at approximately 5 percent of Fonterra's milk supply, as currently allowed by DIRA. The 5 percent cap would be based on the average quantity of milk Fonterra received over the previous three seasons and would be reviewed at a minimum every three seasons to ensure that it continues to represent approximately 5 percent of Fonterra's total milk supply.

54. This option provides greater flexibility, allowing the total regulated milk quantity to move in line with the total quantity of milk Fonterra collects. A greater number of independent processors would be able to access regulated milk if they need it, thus providing the entry pathway. If combined with limiting access to three seasons for those with their own farmer milk supply, independent processors would still be incentivised to seek alternative sources of milk supply and the availability of regulated milk would be better targeted to meeting the objectives of the Regulations.

55. The legislation already provides for the total quantity to be set at 5 percent of Fonterra's total milk supply; mimicking this in regulation provides consistency and certainty for stakeholders.

56. If a number of existing processors were to cease accessing regulated milk in three years' time, changing the total quantity could be perceived as an unnecessary regulatory change. At that point demand would be unlikely to exceed supply. Increasing the limit, however, ensures there is sufficient quantity for the next three years, as well as providing a safeguard for the future, as it is difficult to predict how much new entry there may be in future years.

57. Reviewing the total volume every three years would increase the administrative costs associated with the regime but would be necessary to ensure the quantity remains at 5 percent of Fonterra's milk supply as it changes over time.

ISSUE 2: TOTAL VOLUME OF REGULATED MILK AVAILABLE TO ALL PROCESSORS

Status quo

58. The DIRA allows the total volume of regulated milk to be set at up to 5 percent of Fonterra's milk supply. Within this 5 percent limit, the actual volume available is

set in the Regulations. The 5 percent limit set in the DIRA was considered to be an appropriate proportion of Fonterra's milk supply that can be diverted to independent processors under the Regulations without causing significant economic harm to Fonterra.

59. In 2001, when the Regulations were originally drafted, the total volume of regulated milk was set at 400 million litres. Since then, the Regulations were amended to increase the limit to 500 million litres for the 2007/08 season and lifted again to 600 million litres for the 2008/09 season. The limit has remained at 600 million litres, which accounted for approximately 3.5 percent of Fonterra's milk supply for the 2011/12 season.

Problem definition

60. As the number of new independent processors accessing regulated milk continues to grow there is an increasing likelihood that demand for regulated milk will exceed the total cap.

61. This means that independent processors who are in their early development or those with no farmer supply, and who therefore rely on regulated milk, may not be able to access the amount of regulated milk that they need. This could result in potential new entrants delaying or deciding against entry which carries with it an associated cost due to missing out on potential innovations and opportunities realised by new entrants.

OPTION 1: Retain the status quo

62. Under this option, the current 600 million litre cap would be maintained.

63. This level of total quantity has, up until recently, been sufficient to provide all independent processors with access to regulated milk at their full entitlement. If the recommended option for Issue 1 is implemented, demand for regulated milk is likely to reduce in the future, as established processors cease accessing regulated milk.

64. However, with the growing number of independent processors, and with all independent processors likely to access regulated milk for at least the next three years, this level of total quantity might not be sufficient to meet demand. The final forecast was 595 million litres in the 2011/12 season, which indicates that the cap being reached is a real possibility[3].

65. A potential benefit of the status quo is that, depending on how excess demand is managed (which is discussed further below) it could incentivise independent processors to seek alternative sources of milk supply rather than relying on regulated milk.

66. The main cost of the status quo is the risk that independent processors who are in their early development or those with no farmer supply, cannot access the amount they need. In this event, the Regulations would not be meeting their objectives.

[3] The pro rata rationing takes effect if the final forecast, made in accordance with the forecasting rules in the Regulations, is greater than 600 million litres.

OPTION 2: Increase the "total quantity" to 5 percent of Fonterra's total milk supply and review every 3 years **(recommended option)**

67. Under this option, the total quantity of regulated milk would be set at approximately 5 percent of Fonterra's milk supply, as currently allowed by DIRA. The 5 percent cap would be based on the average quantity of milk Fonterra received over the previous three seasons and would be reviewed at a minimum every three seasons to ensure that it continues to represent approximately 5 percent of Fonterra's total milk supply.

68. This option provides greater flexibility, allowing the total regulated milk quantity to move in line with the total quantity of milk Fonterra collects. A greater number of independent processors would be able to access regulated milk if they need it, thus providing the entry pathway. If combined with limiting access to three seasons for those with their own farmer milk supply, independent processors would still be incentivised to seek alternative sources of milk supply and the availability of regulated milk would be better targeted to meeting the objectives of the Regulations.

69. The legislation already provides for the total quantity to be set at 5 percent of Fonterra's total milk supply; mimicking this in regulation provides consistency and certainty for stakeholders.

70. If a number of existing processors were to cease accessing regulated milk in three years' time, changing the total quantity could be perceived as an unnecessary regulatory change. At that point demand would be unlikely to exceed supply. Increasing the limit, however, ensures there is sufficient quantity for the next three years, as well as providing a safeguard for the future, as it is difficult to predict how much new entry there may be in future years.

71. Reviewing the total volume every three years would increase the administrative costs associated with the regime but would be necessary to ensure the quantity remains at 5 percent of Fonterra's milk supply as it changes over time.

PREFERRED OPTION
Option 2: Increase the total volume to 5 percent of Fonterra's total milk supply and review every 3 years.

Summary of Issue 2: total volume of regulated milk available to all processors

	Entrance pathway	*Self-sufficiency*	*Equivalence*	*Economic costs to Fonterra*	*General principles*	*Overall assessment*
Option 1: Retain status quo	Risk that the current 600m litre limit could be breached, thereby leading to pro rata rationing for processors who require regulated milk as an entrance pathway	Not applicable	Not applicable	No additional cost to Fonterra	• Uncertainty to independent processors due to risk that pro rata rationing will be imposed under current cap • Regulations themselves predictable and transparent since the fixed quantity is specified	Not recommended, may not provide sufficient regulated milk to provide for an entrance pathway for new processors.
Option 2: Increase the "total quantity" to 5 percent of Fonterra's total milk supply	Increasing the total quantity of regulated milk available would increase the number of new entrants that will be able to access regulated milk	Not applicable	Not applicable	Cost to Fonterra would be higher than under the status quo. The cost to Fonterra increases as more regulated milk is accessed.	• A change in the total volume available may create regulatory uncertainty, but improves certainty that pro rata rationing will not need to be applied • Additional administrative costs in reviewing the total volume cap every 3 years • Makes the Regulations consistent with the volume specified in the DIRA	Recommended, makes the Regulations consistent with the DIRA and improves likelihood that new entrants will have full entitlement to regulated milk required as an entrance pathway.

ISSUE 3: ALLOCATION OF REGULATED MILK THROUGHOUT THE MILK SUPPLY SEASON

Status quo

72. Currently the Regulations contain a rule known as the “October Rule” that controls the quantity of regulated milk a processor can take in each month. The quantity of regulated milk taken in October determines the quantity of regulated milk that can be taken in the other months of the season. A processor can only take up to 110 percent of what they took in October.

73. In order to compensate Fonterra for providing independent processors with the opportunity to take regulated milk on a curve which is flatter than the seasonal curve, a margin of $0.10 was added to the regulated milk price. The additional 10 cents captures the extra cost to Fonterra of providing independent processors with the option of “flattening” the profile of the regulated milk.

Problem definition

74. Under the current “October rule”, the Regulations provide independent processors with the ability to access regulated milk on a flatter supply profile than would be possible if they were sourcing that milk from farmers. The October rule also gives independent processors access to greater quantities of regulated milk in the shoulder months, when it is most valuable. This imposes costs on Fonterra and does not help transition independent processors to the conditions they will face when having to source all their milk from farmers.

75. The 10 cent margin is applied as an average across the season and may not be the appropriate margin to fully reflect the economic cost to Fonterra when independent processors take significant quantities of regulated milk in a single month in a particular geographic region.

76. To promote efficiency, access to regulated milk should, to the extent practicable, be provided on terms comparable with what an independent processor would face in a competitive farm gate milk market. The current ability for an independent processor to both flatten the supply curve and pay an average price across the season does not achieve this.

OPTION 1: Retain the status quo

77. The purpose of the “October rule” is to prevent independent processors from taking their regulated milk only in the shoulder months when the milk is most valuable. The design of the October rule, however, allows independent processors to “flatten” their regulated milk take over the season and not be subject to the typical New Zealand milk production curve. This doesn’t prepare processors for when they will be sourcing all their milk from farmers. Moreover, the ability to flatten the supply curve combined with an average price across the season does not promote efficiency. .

78. It also means that processors are compelled to take regulated milk in October, when it may not be efficient for them to do so.

79. A benefit of the status quo is that it provides a simple approach to compensating Fonterra and charging independent processors for the ability to flatten the seasonal supply curve. This option may not however be compensating Fonterra fairly for providing access to regulated milk at average prices during the off-peak supply when raw milk is most valuable. Fonterra has advised that it has had to shut some of its own processing plants during the shoulder months, due to not having sufficient milk to process, because of the quantity of milk that has been taken under the Regulations.

OPTION 2: Introduce a price schedule for different points of the season

80. This option would see different price margins set for different times of the season, e.g. lower margins during peak milk supply and higher margins during non-peak milk supply.

81. This option could allow for a more efficient allocation of regulated milk as the independent processors would be able to take regulated milk when they need it (rather than having to take it in October). The margin that they would pay to compensate Fonterra would reflect the scarcity of milk supply at the time the milk is taken. For example, there could be a relatively low/no margin attached to the peak milk supply, with a slightly higher margin being set for the mid-season supply, and a significantly higher margin set for the regulated milk that independent processors took during the shoulder months of the dairy season.

82. While this option may provide a more efficient mechanism for distributing milk across the season, it would add a considerable degree of complexity to the pricing and scheduling provisions of the Regulations. Setting the appropriate margins throughout the season would be a very difficult exercise and setting the margins at inappropriate levels would exacerbate the current problem.

OPTION 3: Introduce monthly maximum volume limits to reflect the seasonal supply curve

83. Under this option, regulated milk will be available in monthly quantities which reflect a typical seasonal supply curve. The 50 million litres of regulated milk available to an individual processor in a season, would be split into the following monthly maximums:

- August: 3 million litres
- September: 6 million litres
- October: 7 million litres
- November: 7 million litres
- December: 6 million litres
- January: 6 million litres
- February: 5 million litres
- March: 4 million litres
- April: 4 million litres
- May: 2 million litres.

84. A processor would not be compelled to take regulated milk in every month, and could choose to take zero in certain months. However, no processor would be able to take any more than the maximum amount permitted in any given month.

85. The key benefit of this option is that it promotes efficiency relative to the status quo in that, for processors taking the full 50 million litres, conditions will be more closely reflective of those in a competitive farm gate milk market. In particular, those processors wishing to take the full 50 million litres of regulated milk will have to take it according to the seasonal supply curve. This also prepares them for when they will be sourcing all of their milk from farmers.

86. This option does not disadvantage processors who do not wish to source milk from farmers and who need to be able to flatten the curve (such as town milk suppliers). This is because the quantities these processors take generally fall below the proposed monthly maximums. This therefore continues to achieve the objective of supporting down stream competition.

87. This option would remove the perverse incentives for independent processors to take more regulated milk than they either want or need in October in order to maximise the regulated milk available to them in the shoulder months. Processors will no longer be able to take greater quantities of milk in the shoulder months, which should reduce the associated costs to Fonterra.

88. A cost of this option is that processors would, in principle, have the ability to take regulated milk in the shoulder months only, when the milk is most valuable, but they would not be paying a margin for that milk (i.e. inefficient allocation of milk). However, new entrant processors would be likely to require additional milk in all months of the season while they are in the process of building up their own milk supply. It is therefore unlikely that new entrant processors would take milk only in the shoulder months. Under the current October rule, independent processors still take regulated milk in November, which is also considered a peak month, even though there is no obligation on them to do so.

89. However, the uncertainty could impose additional costs on Fonterra. For example, Fonterra would have to ensure it retained the capacity to process milk in the peak months. This could create uncertainty, particularly if processors indicate they will be taking a certain amount of regulated milk in those peak months, but then take less. This uncertainty and the need to retain the extra processing capacity could impose extra costs on Fonterra.

90. This option would be simple and easy to administer, however as it removes the need for the "October rule", it has implications for the mechanics of the pro rata rationing rule.

OPTION 4: Introduce monthly maximum volume limits to reflect the seasonal supply curve and retain the "October Rule" **(recommended option)**

91. Under this option, the seasonal limits set out in option three would apply as well as the existing "October rule". In addition to the monthly limits, an independent processor could not take more than 110% of the amount of regulated milk that processor took in the month of October.

92. As well as the benefits set out under option three, this option has the benefit of mitigating against the risk that a processor would use the Raw Milk Regulations purely to access valuable milk in the shoulder months and not any other month. If a processor were to do this they would be getting milk that has a higher value relative to milk taken at other times of the season, but they would be paying a lower, average price. Such a scenario would not prepare a processor to rely solely on their own supply of milk from farmers and could impose additional costs on Fonterra, as detailed under Option 3.

93. The option is more effective than option 3 in ensuring the conditions will be more closely reflective of those in a competitive farm gate milk market. It is therefore more effective in promoting efficiency relative to the status quo.

94. The cost of this option (additional to the costs set out in option three) is that processors will be compelled to take regulated milk in October even if it is not efficient for them to do so. However, it is considered that this cost is outweighed by the benefits of preventing processors from only taking regulated milk in the shoulder months as which places additional costs on Fonterra.

PREFERRED OPTION Option 4: Introduce monthly maximum volume limits to reflect the seasonal supply curve and retain the October Rule.

Summary of issue 3: allocation of regulated milk throughout the milk supply season

	Entrance pathway	*Self-sufficiency*	*Equivalence*	*Economic costs to Fonterra*	*General principles*	*Overall assessment*
Option 1: Retain status quo	Not applicable	Processors can flatten their milk supply and maximise efficiency in shoulder months, disincentivising processors to seek own supply	• Processors have the ability to flatten their supply curve, maximising plant efficiency • These terms are more beneficial than what Fonterra faces	• Potentially significant cost to Fonterra where shoulder milk is more valuable in some regions • The 10 cent margin may not be sufficient to compensate Fonterra fairly	• Design of this regime is fairly complicated • Processors have certainty of the margin they pay for regulated milk (on top of the farm gate milk price)	Not recommended, potentially gives processors an unfair advantage of being able to flatten supply curve if the margin is set too low. It is difficult to assess what would be a fair margin.
Option 2: Introduce a price schedule for different points of the season	Not applicable	Provides regulated milk on terms and conditions closer to commercial terms	Processors would still have the ability to flatten their supply curve but at an additional cost, compensating Fonterra for this benefit	Cost to Fonterra would reduce since the margin or price schedule would compensate Fonterra fairly	• Design of this regime is complicated • Apart from the farm gate milk price, processors have certainty on the margin they pay for regulated milk in each month	Not recommended, setting monthly price schedule would be difficult. Risk of setting “wrong” margins could exacerbate current issues.

Option 3: Introduce monthly maximum volume limits to reflect the seasonal supply curve	Not applicable	Processors face the same supply curve as the milk they collect from their own suppliers, thereby improving efficiency relative to the status quo.	• Processors wanting to take their full entitlement of regulated milk, would have to access it on the same seasonal supply curve as what Fonterra does, but could choose to take milk only in the shoulder months • This option removes the ability to flatten the supply curve	On the one hand, cost to Fonterra should reduce since the volume of regulated milk available in the shoulder months is significantly reduced. On the other hand, costs could increase due to risk processors could choose to take milk only in the shoulder months.	Design is more complicated, stipulating different quantities for each month but it would remove the need for the complicated "October rule"	Not recommended, as processors could opt to purchase only on the shoulder months when milk is more valuable
Option 4: Introduce monthly maximum volume limits to reflect the seasonal supply curve; retain the "October Rule"	Not applicable	Processors face the same supply curve as the milk they collect from their own suppliers, thereby improving efficiency relative to the status quo (and relative to option 3)	• Processors wanting to take their full entitlement of regulated milk, would have to access it on the same seasonal supply curve as what Fonterra does • This option removes the ability to flatten the supply curve	Cost to Fonterra should reduce since the volume of regulated milk available in the shoulder months are significantly reduced	Design is more complicated, stipulating different quantities for each month	Recommended, removes the need to establish price points for different months, improves on the status quo as it removes the ability to flatten supply curve. Improves on option 3 as it prevents processors from only taking on the shoulder months.

ISSUE 4: PRICE UNCERTAINTY

Status quo

95. The price for regulated milk is based on Fonterra's farm gate milk price. Fonterra uses an ex-post pricing system, where the final farm gate milk price (which is the key component of the regulated milk price) is not set until the October following the end of the dairy season in May. This results in a "wash-up" payment whereby Fonterra pays farmers and independent processors pay Fonterra if the final milk price is higher than the forecasts through out the season.

Problem definition

96. A number of independent processors, across the spectrum, complained about the uncertainty of the final price for regulated milk. The status quo presents a number of challenges for independent processors, as they have limited means of knowing what the final price for their key input is (although guided by Fonterra's quarterly forecasts) until well after the marketing and product mix decisions have been made. Under the current pricing system, independent processors do not know the final regulated milk price until 18 months after the first purchase of milk was made. For example, in the 2010/11 dairy season, forecasts ranged between $6.60 per kilogram of milk solids (kgMS) at the start of the season and $7.50 towards the end of the season, whereas the ex post farm gate milk price was $7.60.

97. Price volatility is an inherent feature of the market (as the farm gate milk price is highly correlated with international prices). Therefore, the price would likely be volatile, and hence uncertain, even in a competitive wholesale market. However, the 18 month delay in knowing the final price is a feature of how Fonterra determines its farm gate milk price rather than a feature of the market.

98. Although independent processors are guided by Fonterra's forecast milk price, many smaller domestic processors do not have the knowledge or experience to assess to what degree this forecast price might change over the season. [Withheld under section 9(2)(g)(i) of the Official Information Act].

99. All processors are affected to some degree by this price uncertainty; however large independent processors with their own milk supply from farmers are likely better placed to manage this uncertainty. Small independent processors without their own significant milk supply base are more vulnerable to this price uncertainty. This is due in part to smaller processors generally relying completely on regulated milk, and partly due to the majority of these processors tending to supply the domestic market, rather than exporting their products. Therefore, in addition to not having other milk supply options, small processors may also have limited knowledge of the international market trends that drive milk price changes.

OPTION 1: Retain the status quo

100. This option does not mitigate the current concerns but would remain consistent with how Fonterra and other processors with their own supply pay their own farmers. It also allows for innovative commercial solutions to be developed to address this issue.

101. For processors with their own supply, only a portion of their total milk processed would be subject to these “wash-ups”. The remaining portion of own supply milk could potentially still face these problems and would not be affected by any changes made to the Regulations.

102. MPI is aware of some independent processors who have developed their own commercial solutions to overcome this issue. Retaining the status quo could encourage processors to seek their own commercial solutions. However, it is difficult to know if Fonterra would treat all processors the same. There is also the risk of Fonterra taking advantage of its dominant position.

OPTION 2: Introduce set quarterly pricing **(recommended option)**

103. Under this option, Fonterra would be required to offer to sell regulated milk at Fonterra’s most recent quarterly farm gate milk price forecast. This option would only be available to those processors without their own significant milk supply as they are most exposed to the price uncertainty. In line with the recommended option for issue one above (time limited access to regulated milk), a processor would need to collect a minimum of 30 million litres of milk for three consecutive seasons to be considered to have their own farmer supply (refer to the discussion under Issue 1, Option 2 for an explanation of why 30 million litres is an appropriate limit; the same rationale applies here).

104. This mechanism would be included in the Regulations as an option, alongside the current ex-post pricing mechanism, and independent processors without their own supply (less than 30 million litres) could choose which pricing method they prefer. The key benefit of this option is providing more price certainty to those independent processors who need it most. For example, for even a very small independent processor taking around 30,000 kgMS of regulated milk in a season (equivalent to around 350,000 litres), the price difference of $1/kgMS in the example above equates to a difference in cost of regulated milk – the key input product – of $30,000 between the time they would be making investment decisions and the time at which the final price is known. Given that such processors rely largely on regulated milk, and given their limited exposure to international market trends, the potential change in cost represents a significant risk and impacts their ability to make investment decisions at the start of a season.

105. The quarterly pricing does not include a requirement for independent processors to pay an additional margin compensating Fonterra for bearing the risk of price changes during the quarter. However, although the change in price impacts the viability of small independent processors, it represents only a very small proportion of Fonterra’s milk supply. Even if all independent processors with less than 30 million litres own supply opted in to the fixed quarterly pricing scheme,

the milk subject to the scheme would represent only 0.3% of Fonterra's milk supply (based on 2011/12 season).

106. Depending on the rigour associated with Fonterra's forecasting process, forecasts should over time decrease as often as they increase. Therefore, any impact on Fonterra's bottom line should, over time, be neutral, while providing independent processors with greater certainty. Historically Fonterra would be more likely to bear the risk of price increases because their farm gate milk price forecast tend to be conservative. However given Fonterra's desire to move to Trading Among Farmers and the increased scrutiny that will be applied to its milk price, Fonterra will be incentivised to apply a more rigorous forecasting process than has historically been the case. As a result both Fonterra and independent processors will bear the risk of price changes during the quarter.

PREFERRED OPTION Option 2: Introduce fixed quarterly pricing for processors without significant 'own supply'.

Summary of issue 4: price uncertainty

	Entrance pathway	*Self-sufficiency*	*Equivalence*	*Economic costs to Fonterra*	*General principles*	*Overall assessment*
Option 1: Retain status quo	Not applicable	Not applicable	Processors are subject to an end of season 'wash up' in the same way that Fonterra is	No additional cost to Fonterra	Does not promote regulatory certainty for small processors with limited ability to manage uncertainty	Not recommended as it does not mitigate the problem of small processors facing price uncertainty
Option 2: Introduce set quarterly pricing	Not applicable	Not applicable	• Small processors will be at a slight advantage over Fonterra as there will be no wash up at the end of the season. • However, processors may end up paying more for regulated milk than under the status quo if Fonterra's forecasts over-estimate the actual farm gate milk price	If Fonterra's quarterly forecasts are below the final farm gate milk price this will impose an economic cost (though it relates to a very small proportion of Fonterra's milk supply). .	Promotes regulatory certainty for small processors	Recommended, improves the status quo as provides more price certainty to the smaller processors who require this the most

Consultation

107. In March 2011, targeted consultation was undertaken with key stakeholders about the objectives of the Regulations. This stage of consultation also asked stakeholders their views about which elements of the Regulations worked well, and which did not.

108. This targeted consultation was followed by the release of a public consultation document in July 2011, to which approximately 1500 submissions were received. Further discussions were held with individual processors on particular aspects of the Regulations.

109. Subsequent to the consultation process in July 2011, submissions were analysed and preferred policy options were presented to Ministers. Ministers agreed to another round of public consultation in January 2012 to test the preferred options. Exposure draft amended Regulations were released at the same time for comment. MPI received more than 800 submissions in response to the consultation process which resulted in further refinements to existing proposals and additional amendments to the Regulations.

CONCLUSIONS AND RECOMMENDATIONS

110. To ensure that the Regulations better meet the objectives of the dairy regulatory regime, the amendments set out in the table below are recommended.

Recommendation	**Comment**
Access to regulated milk limited to three seasons for independent processors who source a significant quantity of ‘own supply’ from farmers (Issue 1, Option 2).	Improves targeting of regulated milk to those who require it as either an entrance pathway or to support competition in downstream domestic product markets. Promotes competition in the farm gate market since processors who no longer require an ‘entrance pathway’ will replace regulated milk with farm gate milk.
Total volume of milk available under the Regulations increased to five percent of Fonterra’s total milk supply (Issue 2, Option 2).	Increase brings Regulations in line with DIRA. Reduces possibility that the 50 million litre limit may not be available to all processors who require it to meet the objectives of the Regulations.
In addition to the existing October rule, there will be a series of maximum quantity limits set, restricting how much milk an independent processor can take under the Raw Milk Regulations in different months of the season, to reflect Fonterra’s seasonal supply curve. The $0.10 margin removed from the regulated milk price, as processors will no longer have the ability to flatten the supply curve	Ensures access to regulated milk more closely represents conditions in a competitive farm gate milk market, which improves efficiency relative to the status quo. Removes potential costs to Fonterra that arise under the status quo as a result of independent processors being able to flatten the supply curve.

(Issue 3, Option 4).	
For independent processors without their own milk supply base, Fonterra will be compelled to offer to sell regulated milk at the most recent forecast farm gate milk price (Issue 4; Option 2).	Improves certainty to small independent processors (those who take limited own supply and compete in downstream domestic product markets) who have limited ability to manage that uncertainty.

111. Although all these options individually would provide for improvements over the status quo, they would be particularly effective if implemented jointly. In particular, the package of amendments will:

- Ensure regulated milk is available to those independent processors who either need it as an entrance pathway into the dairy processing industry or who need it as an input to domestic competition in dairy products (access to regulated milk better **targeted**);
- For large independent processors – i.e. those who do or will source a significant quantity of "own supply" from farmers – ensure access is provided on terms comparable with those they would face in a competitive farmgate market (provision of regulated milk promotes **efficiency**);
- Ensure large independent processors have incentives to source milk from farmers once they are established (access to regulated milk doesn't reduce **competition** in the farm gate milk market);
- For small independent processors – i.e. those who do not source much or any "own supply" from farmers – uncertainty and risks are minimised (improved **certainty** for those with limited ability to manage uncertainty).

IMPLEMENTATION ISSUES, INCLUDING RISKS

112. It is intended that the amended Regulations will take effect by 1 June 2013, when the 2013/14 dairy season commences.

113. The recommendation to increase the total volume of regulated milk available to 5 percent of Fonterra's total milk supply is based on the assumption that Fonterra's total milk supply will continue to increase as it has done for the last few years. There is a small risk that Fonterra's total milk supply may decrease and therefore the amount of milk specified in the Regulations represents more than 5 percent of Fonterra's total milk supply. The DIRA specifies that the Regulations must not require Fonterra to supply more than 5 percent of its total milk supply.

114. The recommendation to make regulated milk available according to the seasonal supply curve will present transition issues. These monthly limits will apply from 1 August 2013. However, the Regulations require processors to provide a forecast in May for the August delivery date, ahead of the Regulations coming into force.

115. MPI will manage this transition by communicating this change to all affected processors as soon as Cabinet approvals are obtained. This should give processors sufficient time to adjust their forecasts to reflect the new monthly

limits. Only those processors who take their full entitlement of regulated milk, or close to their full entitlement, may be affected.

116. A further risk was highlighted through the submission process about the timing of the three year limited access rule coinciding with Fonterra's proposed Trading Among Farmers' (TAF) regime. Independent processors considered that TAF would present additional challenges to secure farmer suppliers to replace the regulated milk they can no longer access. Farmers may be hesitant to leave Fonterra during this period of uncertainty. MPI considers this to be a relatively low risk since independent processors should have 3 years to secure extra supply after TAF is launched (assuming this is in November 2012).

ARRANGEMENTS FOR MONITORING, EVALUATION AND REVIEW

117. A number of the recommended options for amendment will require further monitoring.

118. The Regulations will be amended to include a new requirement for independent processor to supply MPI with information about their own supply collected from farmers. This will enable MPI to monitor processors' level of own milk supply that would indicate for how long they are able to access regulated milk.

119. The monthly maximum quantity limits would need to be monitored to ensure processors do not exceed their monthly entitlements. Fonterra is best placed to monitor this and this will be a similar monitoring regime that took place under the "October rule".

120. Fonterra is required to supply MPI with data outlining how much regulated milk was supplied to processors and how much regulated milk processors are proposing to take for the season. MPI would play an active role in monitoring this data to assess whether the total volume cap is likely to be breached for that season and if the pro rata rationing rule would need to be used.

Appendix 1: Impact analysis of secondary issues

ISSUE 5: MANAGING EXCESS DEMAND FOR REGULATED MILK

Status quo

121. The Regulations stipulate a pro rata quantity rationing rule in the event that total demand for regulated milk exceeds the total quantity available under the Regulations, whereby all independent processors would be equally scaled back, irrespective of their ability to switch to alternative sources of raw milk.

122. Prior to June 2009, the Regulations did not contain a mechanism for managing excess demand for regulated milk. Increasing demand pressures on regulated milk resulted in the Regulations being amended to include the pro rata rationing rule as a mechanism to manage excess demand.

Problem definition

123. The pro rata rule is a simple and effective rule to ensure that demand for regulated milk does not exceed the total volume limit. This rule however is a blunt tool which does not take account of whether an independent processor still needs regulated milk in order to meet the objectives of the Regulations.

OPTION 1: Retain the status quo **(recommended option)**

124. This option creates regulatory uncertainty since independent processors do not know in advance if the pro rata rationing rule will need to be applied in a particular season. The rule is applied part way through the season, leaving independent processors with little option to secure alternative milk supply other than to buy on commercial terms. In most cases, purchasing this milk from Fonterra will be the only realistic option for processors.

125. Scaling back all independent processors may not ensure that access to regulated milk is targeted to meeting the objectives of the Regulations. That is, it may not ensure sufficient milk for an entrance pathway for new processors. It may also disproportionately affect smaller processors, which tend to be those without any of their own supply.

126. Retaining the status quo would, however, provide some regulatory certainty since independent processors are already familiar with this rule and how it works. Other changes that are proposed, such as limiting access to regulated milk for three seasons and increasing the total quantity of regulated milk available, should reduce the likelihood that excess demand occurs. Moreover, the other changes that are proposed would ensure that regulated milk is better targeted to meeting the objectives. Therefore, the issue of the pro rata rule not prioritising processors who take regulated milk in support of the objectives is removed.

127. None of the alternative options below would better achieve the objectives, and therefore amending the system could result in increased administrative and compliance costs, with no additional benefit.

OPTION 2: Introduce “priority ranking”

128. This option would see the least established independent processors with their own farmer supply, and those without own farmer supply, having the first call on the total quantity of regulated milk available.

129. The key benefit of this option is that it would ensure that those processors who most need regulated milk would have full access to it.

130. This option would be complicated to administer (therefore likely more costly) and comply with. It would create a great degree of uncertainty for those processors with lower priority. Deciding who should be top priority would be subjective and open to challenge.

OPTION 3: Introduce an auction mechanism

131. Under this option, if there is excess demand, regulated milk would be allocated via an auction mechanism whereby independent processors would bid for the right and the obligation to access regulated milk.

132. This option would ensure efficient allocation of milk as regulated milk would be purchased by those who value it most. It would incentivise those with cheaper or more efficient alternative sources of supply to switch away from regulated milk.

133. Smaller independent processors however have complained that due to financial constraints they may not be able to access sufficient financing to be able to participate in the auction. An auction system would also create uncertainty of supply.

134. This may be the most efficient way to manage excess demand, however, designing such an auction mechanism is highly complex and would likely be costly to administer.

PREFERRED OPTION Option 1: Retain the status quo (pro rata rationing).

Summary of issue 5: management of excess demand for regulated milk

	Entrance pathway	*Self-sufficiency*	*Equivalence*	*Economic costs to Fonterra*	*General principles*	*Overall assessment*
Option 1: Retain status quo	• Risk processors will have sufficient regulated milk for an entrance pathway since all processors are scaled back equally • Planning is difficult since the rule is applied part way through the season	Not applicable	Not applicable	Not applicable	• Regulatory certainty because processors are familiar with the current process • Processors have no certainty as to the amount of milk they will be able to access if the rule is employed • Government bears some administrative costs	**Recommended**, on balance, no alternative option would result in an improved outcome
Option 2: Introduce "priority ranking system	• Only partially meet objectives since only some processors will be allocated their full entitlement	Not applicable	Not applicable	Not applicable	• Regulatory certainty would depend on the design of the system • Designing and implementing this option will require some judgement	Not recommended, like the status quo, this option would also result in some processors not having access to sufficient regulated milk but this option is more complicated. The status quo would be more equitable since all processors are scaled back equally.
Option 3: Introduce an auction mechanism	It is unclear if sufficient quantities of regulated milk will be available to independent processors – depends on their willingness (and ability) to pay for this milk	Not applicable	Not applicable	Not applicable	• Design of an auction system will be highly complex and costly to run • Processors will have no certainty until the auction is completed	Not recommended, this option may provide additional benefits but the additional costs and complexity of designing such a system would outweigh these benefits.

ISSUE 6: QUANTITY OF REGULATED MILK AVAILABLE TO EACH INDEPENDENT PROCESSOR

Status quo

135. Each independent processor has access to a maximum of 50 million litres of regulated milk (with the exception of Goodman Fielder who can access up to 250 million litres) in a season.

Problem definition

136. This issue was reviewed and assessed against the key objectives of the Regulations to ensure the Regulations provide independent processors with a critical mass of raw milk to kick-start their processing operations, while incentivising them to seek alternative sources of raw milk supply rather than relying on regulated milk from Fonterra on an ongoing basis.

OPTION 1: Retain the status quo **(recommended option)**

137. The status quo of 50 million litres of regulated milk in a season has proven to be a sufficient quantity in the past to enable independent processors to enter the market. MPI understands that 50 million litres would be sufficient to fill approximately one quarter of a standard milk processing plant.

138. While this quantity of regulated milk might be sufficient in providing an entrance pathway, it may not be as effective as some of the alternative options in incentivising independent processors to seek alternative sources of milk supply. A time limit on access however should provide sufficient incentive for seeking own supply.

139. Retaining the status quo would provide regulatory certainty to independent processors and keeping the quantity fixed at 50 million litres would simplify the regime compared to the alternative options considered.

OPTION 2: Introduce a gradual reduction in quantity for those with their own farmer supply

140. This option would provide independent processors intending to develop their own farmer supply with access to a diminishing quantity of regulated milk over the period of the entry pathway. For example, up to 50 million litres in the first season, 40 million litres in the second season, etc. Thereafter the independent processor would be ineligible for further regulated milk.

141. This option may not be as effective in providing the critical mass of raw milk needed to kick start new processing operations but would be more effective in signalling the need to develop alternative supply options sooner. This option would be more complicated to administer and comply with than the status quo.

OPTION 3: Introduce a smaller cap for those without own farmer supply

142. This option would be additional to either of the options above. Under this option, independent processors not seeking own farmer supply would have access to up to 10 million litres of regulated milk a season (with the exception of Goodman Fielder, who would continue to access up to 250 million litres).

143. Based on historical data, this option would still provide small independent processors with sufficient quantities of regulated milk but it would also provide the incentive to consider alternative supply options should these businesses wish to grow.

144. However, this option would create a more complex regime, with two different limits to administer. [Withheld under section 9(2)(b)(ii) of the Official Information Act]

PREFERRED OPTION Option 1: Retain the status quo (individual cap of 50 million litres).

Summary of issue 6: regulated milk available to each independent processor

	Entrance pathway	*Self-sufficiency*	*Equivalence*	*Economic costs to Fonterra*	*General principles*	*Overall assessment*
Option 1: Retain status quo	50 million litres has proven to be a sufficient quantity since new independent processors have been able to enter the market	No incentive for processors to seek alternative sources of supply	Not applicable	Fonterra would face costs but this is an acceptable cost to meet the objectives of the Regulations	Low administration cost, simplistic design	**Recommended**, this option is simple in design, easy to administer and the additional cost to Fonterra is acceptable (and relatively small given the quantities of milk involved)
Option 2: Introduce a gradual reduction in quantity for those with their own farmer supply	This would ensure that regulated milk is freed up sooner for other independent processors to access	Strong incentive for processors to seek own supply	Not applicable	Cost to Fonterra falls as the quantity of regulated milk supplied decreases over time (this would be dependent on the total volume of regulated milk taken)	Complex to design and high administration cost	Not recommended, more difficult to design and administration costs are higher outweighing potential benefits of increased incentives
Option 3: Introduce a smaller cap for those without own farmer supply	Sufficient regulated milk will be available for all processors to be able to enter the market	No incentive for smaller processors to seek alternative sources of supply, unless they want to grow beyond the cap	Not applicable	Less cost to Fonterra than under the status quo	• More complex to design and administer, in effect two regimes would have to be administered • Most scope for perverse incentives	Not recommended, improves on the status quo but more complex to design and most scope for perverse incentives (this option would be in addition to the other options)

ISSUE 7: REPLACING THE “OCTOBER RULE” WITH THE “NOVEMBER RULE” IN THE SOUTH ISLAND

Status quo

145. Currently, under the October rule, the quantity of regulated milk available to an independent processor in each month in the dairy season (except for winter months) is set at 110 percent of the quantity of regulated milk taken by that independent during the month of October. This rule applies to both the North and the South Island of New Zealand.

Problem definition

146. The provisions under the “October rule” are based on the premise that the peak of the seasonal supply of raw milk occurs in October. In July 2011, MPI consulted on whether there should be a “November Rule” for the South Island on the basis that peak milk supply tends to occur a month later – in November – in the South Island. This would mean that applying the “October rule” in the South Island could result in South Island processors getting access to more regulated milk in the shoulder seasons than processors based in the North Island. This is due to the fact that the amount of milk a processor can take during the peak determines how much they can get access to through out the remainder of the season.

OPTION 1: Retain the status quo **(recommended option)**

147. Examination of milk supply in the last three dairy seasons illustrates that this is not currently an issue. In all three seasons, October was the peak supply month in both the North Island and South Island. There is therefore no current basis for change. Irrespective of this, the status quo would have the benefit of maintaining the current nationally uniform approach, which ensures consistency and ease of application.

OPTION 2: Introduce “November rule” for the South Island

148. This option would replace the “October rule” with the “November rule” in the South Island. As noted under Option 1, recent data indicates that this would not provide a better fit with regard to the seasonal supply curve in the South Island. It would also create a degree of complexity and administrative difficulty, especially for independent processors whose operations span both Islands.

PREFERRED OPTION
Option 1: Retain the status quo (October Rule in both Islands).

Summary of Issue 7: October versus November rule in the South Island

	Entrance pathway	*Self-sufficiency*	*Equivalence*	*Economic costs to Fonterra*	*General principles*	*Overall assessment*
Option 1: Retain status quo	Not applicable	Not applicable	• Neither option would provide "equivalence" because processors would be able to access more regulated milk in the shoulder months relative to what Fonterra can access (processors would pay a margin for this benefit)	• Fonterra face costs due to processors accessing more regulated milk in the shoulder months relative to what Fonterra collects • Fonterra is compensated for this cost through a margin that paid for regulated milk	Regulatory certainty as this rule is already in place	Recommended, this option is simple in design and easy to administer. The additional costs will be relatively small.
Option 2: Introduce a "November rule" for the South Island	Not applicable	Not applicable	Neither option would provide "equivalence" because processors would be able to access more regulated milk in the shoulder months relative to what Fonterra can access (processors would pay a margin for this benefit)	Fonterra may face higher costs if the peak in the South Island falls in November rather than October. However, recent data illustrates this is not currently an issue.	• More complex than the status quo since a different rule will need to be administrated in each Island • Higher administration cost to administer two regimes	Not recommended, submitters did not support this option since it will overly complicate the regime. Recent data illustrates it is not currently an issue.

ISSUE 8: FORECASTING RULES

Status quo

149. The Regulations require independent processors to provide a forecast to Fonterra three months prior to delivery. This forecast is then confirmed seven days prior to delivery, with a plus or minus 40 percent margin. The forecast is confirmed again one day in advance of delivery with a plus or minus 20 percent margin. An independent processor is only required to pay for what it takes (not what is said earlier it would take), within the bounds of the above requirements.

150. There is provision in the legislation for Fonterra to seek redress if independent processors do not meet the forecasting rules specified in the Regulations.

151. These forecasting rules were slightly amended in the Regulations in 2009 to clarify the intent of the Regulations.

Problem definition

152. Independent processors have a fair amount of ‘un-priced’ flexibility with regard to the actual milk that they take. Fonterra is carrying the cost of this flexibility. For example, if a processor chooses not to take all the milk that they have forecast they will need, Fonterra has to process that milk at short notice.

153. The table below illustrates the variation that can take place between the forecast provided and actual volumes delivered (showing maximum increase and decrease in forecast volumes). For example, at the 3 month forecast, a processor may provide an estimate of 10,000 litres. Based on the forecasting rules, the actual volume of milk delivered could vary between 4,800 litres and 16,800 litres.

	Lower limit of forecast	No change	Upper limit of forecast
Estimate at 3 month forecast	10,000 litres	10,000 litres	10,000 litres
Estimate at 1 week forecast	6,000 litres	10,000 litres	14,000 litres
Volume of milk delivered	4,800 litres	10,000 litres	16,800 litres

OPTION 1: Retain the status quo **(recommended option)**

154. This option would retain the existing degree of ‘un-priced’ flexibility in the forecasting rules. Retaining the status quo would have the advantage of no regulatory change. The risk of unwanted regulated milk would continue to sit with Fonterra. Fonterra is arguably best placed to manage this risk due to its significant number of processing plants and the relatively small volumes of milk in question. Fonterra would be best placed to manage this risk by transferring the “surplus” regulated milk to another of its processing plants or delivering it to another independent processor who is also purchasing regulated milk.

Anecdotally officials understand that the flexibility is mostly used by new processors who, arguably, are not well placed to manage the risk.

OPTION 2: Reduce current flexibility

155. This option would reduce the current degree of flexibility to make it more reflective of standard commercial terms. For example, the 40 percent margin could be reduced to 30, 20 or 10 percent. Similarly, the later 20 percent margin could be reduced to 10 percent. This option would reduce the degree of potential inefficiencies stemming from 'un-priced' flexibility, but it is still a relatively blunt tool that may be providing unnecessary flexibility at a cost to Fonterra. This is particularly the case given the difficulty in determining exactly what degree of flexibility is necessary.

156. Given that this does not appear to affect a significant volume of regulated milk, this option would add unnecessary complexity with little additional benefit.

OPTION 3: Introduce 'pricing of the option'

157. Under this option, independent processors could 'opt in' to retain access to existing (or amended) flexibility provisions but be charged a certain additional margin, set in the Regulations, to compensate Fonterra for any changes in delivery forecasts.

158. This option could result in a more efficient system, where those who need the flexibility would have it, but independent processors would compensate Fonterra for passing on this risk. This option would, however, result in a significantly more complex system where some independent processors would 'opt in' while others wouldn't, requiring the operation of different systems for different independent processors. Including this option in the Regulations could also have the effect of inhibiting parties from developing commercial solutions of their own to address the issue.

OPTION 4: Introduce 'take or pay' provisions

159. Removing all flexibility by introducing a 'take or pay' provision in the Regulations would incentivise independent processors to more accurately forecast their requirements for regulated milk, thus reducing the costs on Fonterra.

160. Imposing a 'take or pay' provision would also ensure consistency between supply options as processors that contract directly with farmers, including Fonterra, have a non-negotiable obligation to take farmers' milk. However this option would mean that all the risk of unwanted regulated milk, for example in the case of a plant break down, would fall on the independent processor, who may not be best placed to manage it.

161. Independent processors who are entering the market are those most in need of the flexibility as they refine their processes. As noted above, officials understand that it is, in practice, predominantly new entrants who are utilising the flexibility provisions. Furthermore, the recommendation to limit access to three years to established independent processors (Issue 1 refers) would remove the risk that this rule could be advantaging established independent processors. Access to

regulated milk will be targeted at new independent processors and small domestic producers. In this context, and given that the Regulations are designed for new independent processors, MPI believes that Fonterra is best placed to carry this risk.

PREFERRED OPTION Option 1: Retain the status quo (forecasting rules unchanged).

Summary: Options to address forecast volume uncertainty

	Entrance pathway	*Self-sufficiency*	*Equivalence*	*Economic costs to Fonterra*	*General principles*	*Overall assessment*
Option 1: Retain status quo	Not applicable	Not applicable	• Regulated milk is not available on equivalent terms • However given Fonterra's size and number of plants, Fonterra is in a position to manage these situations unlike smaller processors	The flexibility imposes some economic costs on Fonterra but Fonterra is best placed to deal with unwanted milk (due to plant breakdowns etc.)	• Provides regulatory certainty and transparency as the rules are clearly set out in the Regulations • Design has some degree of complexity	**Recommended**, this system provides needed flexibility to new independent processors. Although Fonterra faces costs, Fonterra is best placed to carry the risk.
Option 2: Reduce current flexibility	Not applicable	Not applicable	• Reduced flexibility would be more reflective of terms and conditions that Fonterra face • Reduced flexibility may also disadvantage new processors since greater flexibility is required in the early start up phase	• Providing flexibility would still impose economic costs to Fonterra, although relatively small cost considering the amount of milk in question	• Provides regulatory certainty and transparency as the rules are clearly set out in the Regulations • Design has some degree of complexity	Not recommended, no significant advantage over status quo. Given the rules are fairly complex, the status quo would avoid any potential confusion in regime change.
Option 3: Introduce 'pricing of the option'	Not applicable	Not applicable	Not equivalent terms to Fonterra but result in a more efficient system since processors pay for this flexibility	Pricing the flexibility would have no economic cost to Fonterra as independent processors pay for the flexibility they have	More complicated to design and have increased administrative costs to manage two different systems	Not recommended, this option does not best meet the objectives of the Regulations. This option is also more complicated to design.
Option 4: Introduce	Not applicable	Not applicable	• All flexibility will be	Remove all economic	Provides regulatory	Not recommended,

	Entrance pathway	*Self-sufficiency*	*Equivalence*	*Economic costs to Fonterra*	*General principles*	*Overall assessment*
'take or pay' provisions			removed and processors will face equivalent terms to Fonterra • However all risk of unwanted milk will fall with processors who are not best placed to carry this risk	costs to Fonterra as independent processors pay for the flexibility and carry the full risk	certainty and transparency as the rules will be clearly set out in the Regulations	although regulated milk will be available on equivalent terms with no economic costs to Fonterra, this option will not best meet the objectives of an entrance pathway. Fonterra is best placed to carry the risk for this flexibility

Appendix 2: Regulated milk data

[Withheld under section 9(2)(b)(ii) of the Official Information Act]

Appendix 3: Independent processors' own supply

[Withheld under section 9(2)(b)(ii) of the Official Information Act]