2001 GOVERNMENT REGULATORY PACKAGE

The Government's focus was to try to reduce the barriers to new entry by competitors into the NZ markets of buying raw milk from farmers or manufacturing using Fonterra's ingredients. To this end, the new legislation requires Fonterra to:

- Supply up to 400 million litres of raw milk to anyone who seeks it in NZ (ie Fonterra competitors);
- Sell its 50.04% share of NZ Dairy Foods (which was NZDG's domestic dairy business. Fonterra's 50.04% has now been sold to Rank);
- Comply with the Commerce Act (once the merger has taken place), which prohibits price fixing and abusing its dominant position (same rules as apply to Telecom);
- Offer to buy milk from any milk supplier anywhere in NZ;
- Allow Fonterra suppliers to sell their shares back to Fonterra at 'fair value' (rather than nominal value) at any time during a specified 'window' (before the milking season starts); and
- Ensure that Fonterra allows its suppliers to sell up to 20% of his or he milk to a competing processor.
- The Government has also reserve for itself powers to regulate wholesale milk prices.

By contrast, McKinsey's 'must do' preconditions were focused on building internal disciplines on Fonterra's monopoly position - eg more independent directors, an independent milk price, market pricing between business units, separation of consumer business with tradable shares and outside equity, a 'new clean sheet culture' etc. These are the things that are supposed to deliver the much promised $310m of gains each year.

Unless Fonterra faces effective competition at the farm-gate for buying raw milk, it will retain its 97% market dominance. On this score, note:

- The Commerce Commission's preliminary determination in Aug 1999, which found no likely prospect of material competition over the next few years; and
- The recent credit rating agency report by a firm called Fitch, which reached the same conclusion and therefore gave Fonterra a very strong rating (look at the articles on the DOM and elsewhere on 16 April 2002, which set out Fitch's findings of likely continued near monopoly power in the NZ raw milk market).
- While the Government's 'regulatory package' is intended to mitigate these costs and risks, it is somewhat experimental and was prepared in a great rush *(see para 20 of Cabinet Paper One and para 33 of Cabinet Paper Two released under the OIA).* Government officials are not confident the proposed regulatory package will work.
- Its conceptual underpinning is that legislation will force Global Co to operate a neutral and transparent wholesale dairy market in NZ, with no barriers to entry or exit. In an ideal (theorietical) world, the concept *would* reduce the obvious efficiency problems caused Fonterra.
- However, the prospects of the 'regulatory package' working in practice are demonstrably low. Fonterra's means and incentives to 'game' the regulator are strong. The problems of information asymmetry and limited detection and enforcement capabilities are obvious.

- Government officials say that two competing NZ co-ops would be better than one (Global Co) *(see para 22 of Cabinet Paper One released under the OIA).* The Commerce Commission was also inclined to the same view in 1999 *(see the Commerce Commission's draft determination in 1999 at pages 135 – the 'two company' counterfactual scored much better than the one company proposal).*

The principal advisers to MAF on the regulatory regime were Prof Lew Evans and Prof Neil Quigley at VUW. The published a paper arguing in favour of their regime under the Institute for Competition and Policy Studies, which is available through the VUW wed site.