Fonterra – Dairy industry
Is the regulatory regime effective?

Like the dissonance between the Fonterra and the wider economy, the Government's regulatory regime for Fonterra is pulling in different directions.

One set of measures aims to grow dairy competition in and from New Zealand with a view to sustained competitive pressure becoming the main driver of efficiency, not just in reducing costs but, more importantly, in fostering the dynamic of diversity.

To this end, the regime provides various aids to help competitor processors enter and grow their market share. For example, the rules allow farmers to freely join and leave Fonterra, and Fonterra is required to make about 3 per cent of its milk available to competitors.

Another set of regulatory measures aims to promote efficiency by overseeing the way Fonterra sets its raw milk price. This approach is broadly equivalent to regulating prices of natural monopolies (like airports and electricity lines companies).

However, Fonterra is not a natural monopoly and the milk price rules seem to be delivering weaker pressure on Fonterra than intended while also narrowing the window for competitors to enter.

How much competition has the regime fostered? Since 2001, about eight relatively niche dairy processors have entered the market taking between them about 4 per cent of milk supply in the North Island and about 20 per cent in the South Island.

Overall, Fonterra has lost only about 11 per cent of its market share in New Zealand over the past 15 years. It remains highly dominant, even in the face of huge growth in milk production.

Fonterra's expectation of some-but-not-too-much competition seems to be shared by the Government. Cabinet papers express concern not to over-stimulate competition "at Fonterra's expense".

To illustrate some of the problems in the regulatory regime, let's take a closer look at three key elements.

Wholesale milk price

In simple terms, the price Fonterra pays its farmers for their milk is the money left over after deducting operating expenses and capital costs from Fonterra's commodity revenues.

However, instead of using Fonterra's actual costs and product mix, the rules assume Fonterra can match the lower costs and better product mix of a very efficient hypothetical competitor. This has the effect of boosting Fonterra's milk price.

The size of this boost has been steadily increasing with Fonterra using ever more idealised models of its hypothetical competitor.

The problem is, to get farmers to leave Fonterra, a real competing processor has to match or better Fonterra's boosted milk price. While in theory farmers should compare total returns, not just milk prices, in practice milk price is the headline driver. This means that independent processors more efficient than Fonterra, but less efficient than the hypothetical competitor used in the rules, tend to be boxed out. In effect, the rules narrow the window of competitive entry.

Setting a milk price as if Fonterra were a very efficient processor squeezes Fonterra's profits. Until it gets its costs down and improves its product mix, Fonterra can only pay the higher milk price by short-changing its profits and return on equity. This is supposed to induce Fonterra to improve its efficiency so it can deliver both the higher milk price and a proper return on equity.

However, the logic seems to have a weak link. Boosting the milk price by short-changing profits is not at all unusual for dairy co-operatives — indeed, it's what they do. Since it was formed, Fonterra has struggled to cover its cost of capital.

This is because return on a co-operative's equity is not a particularly important performance measure for its farmers. From their perspective, the co-operative is an extension of their farms — a club in which farmers jointly own assets to provide shared services (dairy processing, marketing and exporting). The club is expected to cover its costs and pay out the rest of its earnings to club members. It's seen as a tolling operation, not a profit centre. Members measure performance from the perspective of their farms.

In theory, the 7 per cent of Fonterra's shares capital held by the Fonterra Shareholders Fund should strengthen its drive to deliver profits at proper rates. However, investors in the fund have no votes and, in valuing their shares, the market recognises the reality that Fonterra's purpose first and foremost is to serve its member-farmers by maximising their milk price, and that the adequacy of Fonterra's profit is a second or third order consideration.

In short, the pressure created by the milk price rules on Fonterra to improve efficiency is likely to be weaker than assumed. If so, the regulatory regime is narrowing the window of competitive entry for limited gain, while also increasing reliance on milk price regulation rather than competition as the main efficiency discipline on Fonterra within New Zealand.

Fonterra's boosted milk price creates three other problems: it reduces funds available for value-adding activities, it over-stimulates milk production and (as a result) it causes unnecessary environmental effects.

Supplying competitors

The regulatory rules require Fonterra to make certain volumes of milk available to competitors. The Government is now proposing to phase-down this obligation.

One of the main parties adversely affected is Goodman Fielder, whose brands — Meadow Fresh, Naturalea, Puhoi and Chesdale — compete against Fonterra's brands — Anchor, Mainland, Tip Top and Kapiti — in our domestic retail markets.

In effect, the Government is saying to Goodman Fielder: there isn't enough competition at the farm gate so you need to start buying your milk directly from hundreds of individual farmers, not Fonterra as of right.

However, the problem is not with Goodman Fielder; it's due to the absence of a wholesale milk market.

In forming Fonterra, a key part of the Government's vision was that Goodman Fielder (and others) would be able to buy their milk on a wholesale milk market that Fonterra would want to create with new entrant dairy processors. It was to be like the New York Mercantile Exchange with a spot market for milk backed by contracts and derivatives trading. Until it was set up, however, Fonterra would have a regulatory obligation to make milk available to Goodman Fielder at a regulated price.

That wholesale milk market vision has not been realised. Nor is there sufficient competition for milk at the farm gate. But neither problem is the responsibility of Goodman Fielder, and nor is the solution.

The real problem rests with the Government's regulatory regime and Fonterra's artificially-created dominance. Rather than forcing Goodman Fielder to significantly change its business model, it would be more logical (and better policy) to create the intended wholesale milk market. Some of the early initiatives used to set up the wholesale electricity market may be helpful precedents.

[Extract from Tony Baldwin's 2016 article published in the NZ Herald, which is available here]