Dairy industry:
Core problem – lack of diversity

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Fonterra’s legislated dominance continues more than 100 years of suppressing diversity and experimentation in how to best capture value beyond the farm gate, to the significant cost of the New Zealand economy.

Diversity and adaptation

- Diversity and adaptation is not an outcome but a process. It refers to a relentless dynamic in which people and firms — trying to achieve returns over time that properly reflect the risk they are prepared to take — continuously adapt the use their resources to changing risks and opportunities.

- This generates an ever evolving array of ideas and strategies — reflecting the fact that innovation is not the domain of experts but ordinary people seeking to find better ways of doing things.

- As economist Tim Harford highlights, adapting to a complex changeable world is best achieved by a multiplicity of experiments from many different players.

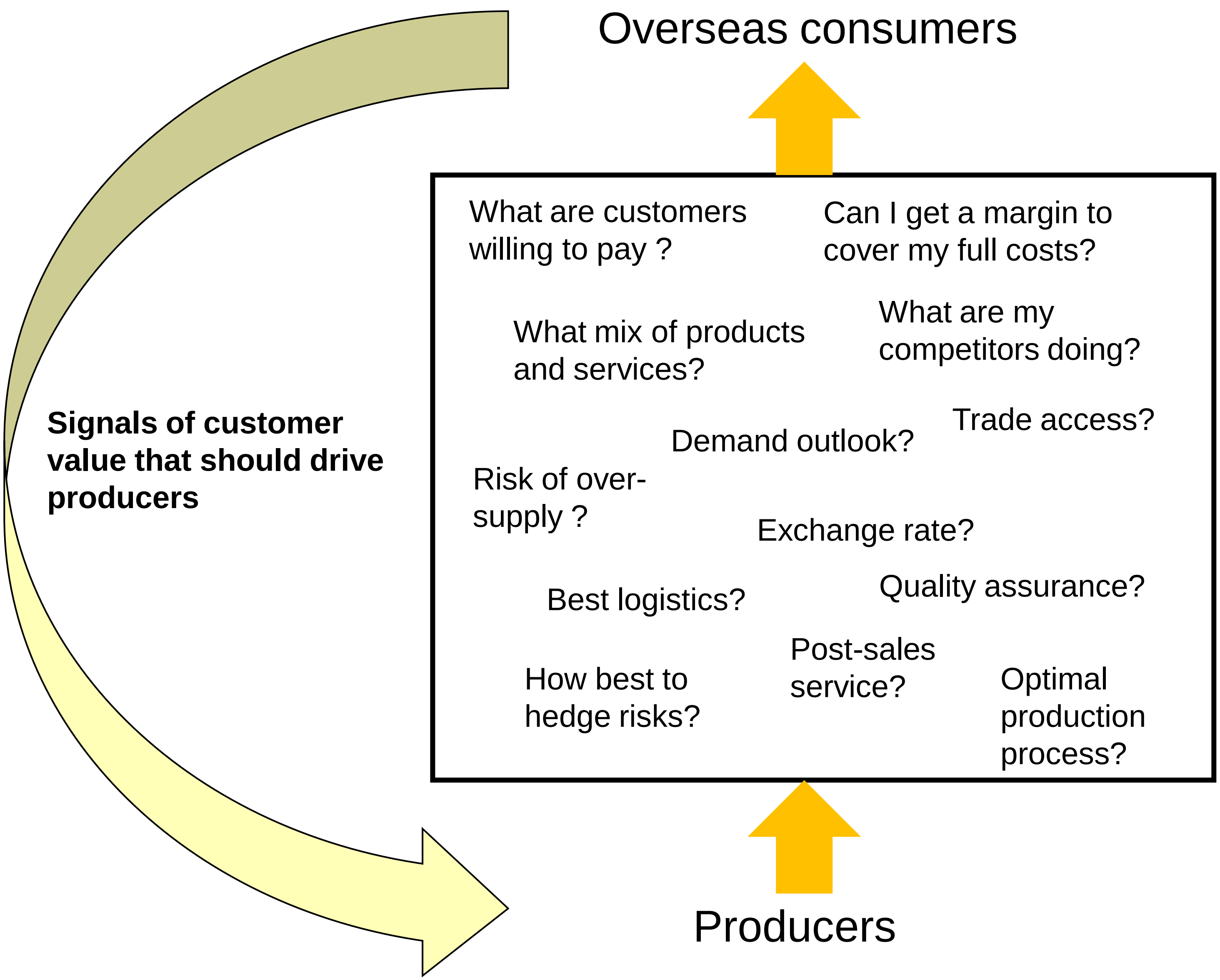
Diversity and adaptation *(cont'd)*

- Since the early days, dairy farmers have relied on a relatively small group of Government and industry insiders to deal with the value-chain between their farm gate and overseas end-customers.

- Governments and industry leaders did not consider ordinary farmers to be capable of finding good ways of dealing with business issues beyond the farm gate – as reflected in views of Mr Pottinger , leader of the industry in the 1930s and 1940s:

  "“The responsibility of selecting a suitable marketing medium...was laid upon the bodies of farmers [in the 1920s], who while mostly good farmers, **were in no position to judge** the markets or marketing organisation."

Issues beyond the farm gate



Government and industry response

Overseas consumers

Create government or industry bodies to control things between the farm-gate/processor and overseas customers – in particular:

1914-22:	NZ Govt purchased for UK Govt
1926:	Dairy-produce Board of Control
1934-46:	Govt Department
1946-62:	Dairy Products Marketing Commission
1962-80s:	DPMC + Dairy-product Board of Control
1980s-01:	Dairy Board
2001 –	Fonterra

Signals of customer value that should drive producers

Producers

Diversity and adaptation *(cont'd)*

- Successive Governments:
  - Promoted co-operatives over proprietary processors,
  - Banned competitive exporting, and
  - Enabled the industry to systematically eliminate competition between processors at the farm gate.
- Competition was (and, in many quarters, still is) viewed as "pernicious".
- Further, from the early days, protection from competition extended to heavily restricting the supply of non-dairy alternatives like margarine.

Diversity and adaptation *(cont'd)*

- Rather than fostering competition and diversity, the industry's approach beyond the farm gate has been a relentless drive to **homogeneity and centralisation**.
- So while our dairy industry has been highly successful in growing milk production, since monopoly exporting started during WWI, there has been minimal trialling by different parties of alternative approaches to:
  - aggregating capital,
  - pricing,
  - managing risk,
  - using global value chains, or
  - understanding customers' preferences.

Diversity and adaptation *(cont'd)*

- In short, since monopoly exporting started during WWI, there has been minimal trialling by different parties of alternative approaches to using different strategies to create wealth from the many market opportunities that a handful of decision-makers in a near-monopoly seller simply can't see, or don't have the capacity to exploit.

Fonterra v Economy

- Deregulation and the creation of Fonterra 17 years ago supposed to change all that? But it didn't – and here we hit the crux of the problem.

- There is a fundamental conflict between Fonterra's demand for dominance in New Zealand and the interests of the wider economy.

- To Fonterra's backers, its genetic purpose is to be a near-monopoly national dairy co-operative controlling the lion's share of New Zealand milk so it can be our "national champion" in global dairy markets.

- Dominance in New Zealand is encoded into its concept design — so it has scale to compete overseas and grow more value from New Zealand milk. Some competition at the margins is fine, but nothing should erode the size of its core New Zealand platform.

Fonterra v Economy

- But the wider economy is best served by competition and the process of diversity. Firms like Fonterra, with artificially high market power, typically stifle diversity. They are generally not good for an industry or the economy.

- The simple reason is that, over time, the gains from diversity typically hugely outweigh any gains from scale. With highly dominant firms like Fonterra, we miss out on those diversity gains — it's a big cost to all of us.

- Fonterra is based on an article of faith that the benefits of size and integration will outweigh those dynamic losses. Unfortunately, the opposite is almost invariably true.

Overveiw

As noted in an accompany slide pack, “Founterra foundations”, the industry’s structure over the last 100 years has been shaped and constrained by four deeply rooted but misplaced myths – namely that:

- Producers need to be protected from the complexities of business beyond the farm-gate
- ‘Outsiders’ will reduce farmer-suppliers’ wealth (in particular, squeeze the amount paid to farmers for their milk)
- Competition is “pernicious” and should be eliminated
- New Zealand dairy exporters competing against each other in foreign markets will drive the price down. A corollary belief is that a near-monopoly New Zealand dairy exporter can get higher prices than its overseas competitors. Fonterra was created on this premise — as its first chairman trumpeted: “Fonterra gives us market power”.