



12 September 2011

Clerk of the Committee  
Commerce Select Committee  
Select Committee Office  
Parliament Buildings  
WELLINGTON

## **SUBMISSION on Milk Price Inquiry**

### **Introduction**

1.1 Thank you for the opportunity to make a submission to the Committee's Milk Price Inquiry. This submission is from Consumer NZ, New Zealand's leading consumer organisation. It has an acknowledged and respected reputation for independence and fairness as a provider of impartial, and comprehensive consumer information and advice.

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1.2 We wish to appear before the committee to speak to our submission.

### **2. Summary**

2.1 Consumer NZ is very concerned at the high prices being paid by New Zealand consumers for dairy products. Milk and milk products are a staple part of our diet. However, in the last five years retail dairy prices have increased by 50 percent,<sup>1</sup> almost double the 26 percent rise in food inflation over the same period.

2.2 The domestic milk market is highly concentrated, dominated by one large supplier and two large supermarket chains. This raises major questions about whether consumers are paying a fair price. We therefore welcome the Commerce Committee's decision to conduct this inquiry.

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<sup>1</sup> Combined increase in retail price of 2l carton of milk, 500g of butter and 1kg of cheese.

### 3. Consumer concerns

3.1 Milk products are recognised as a staple part of the New Zealand diet. The Ministry of Health recommends eating at least two servings of milk and milk products a day.<sup>2</sup> Low-fat dairy products are also recommended in dietary guidelines as an important source of calcium, protein, potassium and vitamin D.

3.2 Rapidly rising prices create the risk that dairy staples will become less affordable, particularly for lower socio-economic groups. Community organisations such as the Federation of Family Budgeting Services have voiced concerns that this is already happening.



**Figure 1:** Price of milk, butter and cheese 2006-2011.  
Source of data: Statistics New Zealand's Food Price Index.

3.3 There is also widespread public concern about the increasing price of milk and other dairy products, and whether prices are fair. In March 2011, Consumer NZ commissioned a survey of New Zealanders to ask for their views. The survey of 1000 consumers found:

- 87 percent had noticed an increase or large increase in the price of milk;
- 91 percent believed the price of milk was high or very high;
- 76 percent were concerned or very concerned about the price of milk;

<sup>2</sup> Ministry of Health. May 2003, reprinted November 2006. "Food for Health". Wellington.

- 80 percent thought milk prices would be lower if there was greater competition in the dairy industry;
- 50 percent believed the way dairy prices were set was unclear.

3.4 Consumers should be able to have confidence the price they pay for milk, a basic commodity, is fair. However, reviews by the Commerce Commission and the Ministry of Agriculture and Forestry have failed to provide any assurance this is the case.

#### **4. Market dominance**

4.1 The domestic milk market is highly concentrated, dominated by one large supplier (Fonterra) and two large supermarket chains (Foodstuffs and Progressive Enterprises). A major risk in such a concentrated market is that the dominant participants can exploit their power to earn higher margins than would otherwise be possible.

4.2 This risk was a key reason why the Commerce Commission originally declined to give approval for the establishment of Fonterra. The Commission's preliminary decision on the proposed merger to create the cooperative stated:

*The Commission's preliminary view is that Newco would be dominant in all of these markets except that for consumer spreads (where butter faces competition from margarine and blended spreads).*

*Dominance would arise because Newco would control virtually all of the milk produced by farmers; it would be the only major supplier of domestic dairy products; it would be the only acquirer of dairy products for export; and it would [have] little potential competition from new entrants because of the high barriers to entry into all of those markets.<sup>3</sup>*

4.3 When Fonterra was subsequently established, specific provisions were included in the Dairy Industry Restructuring Act 2001 to reduce the risks of the cooperative misusing its power and to promote a functioning domestic market. However, there is little evidence that the Act and associated regulations have achieved the desired outcome.

4.4 Fonterra continues to dominate the domestic milk supply chain. The cooperative collects the majority of milk produced in New Zealand (89% in 2009/10).<sup>4</sup> While there are several small dairy processors, Fonterra acknowledges it "doesn't have a competitor anywhere near as big as us".

4.5 This situation has not changed substantially in the 10 years since legislation was passed to allow the formation of the cooperative and it is not expected to change in the foreseeable future. As the Commerce Commission's recent review concluded:

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<sup>3</sup> Commerce Commission Media Release. 27 August 1999. "Commission's preliminary determination says 'no' to dairy 'mega-merger'". Wellington.

<sup>4</sup> Commerce Commission. 2011. *Milk markets: Consideration of whether to initiate a Commerce Act Part 4 inquiry into milk prices*. Wellington, p15.

*...there appears to be little or no competition in the market for the factory gate supply of raw milk, and little or no likelihood of a substantial increase in competition in this market.<sup>5</sup>*

4.6 Fonterra's creation resulted from a deliberate decision by the government to establish an entity that could compete in world markets and drive export earnings. Its dominance in the domestic market was also foreseen. However, the mechanisms put in place to promote the operation of a local market have been largely ineffective.

4.7 Lack of competition at both the farm and factory gates raises critical questions about the downstream impacts on the retail prices that consumers pay. Compounding this situation is the very limited competition at the retail level. Most milk and dairy products are likely to be purchased from the two large supermarket chains.

## **5. Raw milk price**

5.1 Independent processors have alleged that Fonterra's milk pricing is a major barrier to competition. The allegations are, first, that Fonterra's "notional" pricing model artificially inflates the milk price and, second, that the cooperative has increased the milk price while reducing the share price component of its payout, thus making it difficult for others to enter the market.

5.2 Concerns about Fonterra's influence have been exacerbated by changes to the raw milk regulations that effectively equate the milk price with Fonterra's farmgate price. Commenting on the changes in 2008, the Commerce Commission stated that "no other regulated firm in New Zealand has ever had such discretion over the regulated prices it is allowed to charge".<sup>6</sup> The Commission argued that the changes would:

*... grant Fonterra direct influence over the regulated milk price. Fonterra may be incentivised to manipulate the regulated price in order to deter further entry. Specifically, Fonterra could strategically set higher farmgate prices and lower the dividend component of its total payout. Under its current co-operative structure, Fonterra's payouts are fully fungible between the dividends paid to shareholders and the price of milk. This means Fonterra's shareholders would be indifferent if it lowered dividend payouts and commensurately increased the farmgate price of milk. The impact on competing processors, however, could be far from innocuous.<sup>7</sup>*

5.3 These concerns have not been resolved. The Commission's 2011 review did not reach a conclusion on whether Fonterra's pricing model is appropriate to "provide workably competitive outcomes".<sup>8</sup> We are aware that officials are reviewing Fonterra's pricing. However, no timeframe has been set for the conclusion of this work.

5.4. Given the lack of "normal" competitive pressures in the supply chain, it is fundamentally important that pricing is transparent. If the price is being inflated as

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<sup>5</sup> Commerce Commission Media Release. 2 August 2011. "Price control into milk not warranted". Wellington.

<sup>6</sup> Commerce Commission. 22 May 2008. "Review of the Raw Milk Regulations: Draft Views from the Commerce Commission." Wellington, p6.

<sup>7</sup> Ibid.

<sup>8</sup> Commerce Commission. 2011. p36.

alleged, the economic implications for both consumers and potential market entrants are substantial.

5.5 Our view is that an Independent Milk Price Commissioner should be established to set the price of raw milk. We believe this is an appropriate and necessary intervention in such a highly concentrated market. The current situation where the price is effectively set by Fonterra is inadequate.

## 6. Access to raw milk

6.1 The Dairy Industry Restructuring Act and associated regulations require Fonterra to supply a set amount of milk (currently 600 million litres) to other processors in order to foster a functioning domestic market. Goodman Fielder takes 250 million litres. The remainder goes to Open Country Dairy, Tatua Cooperative, and a number of other companies.

6.2 Fonterra has argued that some of the processors buying its milk are not selling it domestically. Instead, they are turning it into products for export. The cooperative argues that this is contrary to the intent of the Act. In response, the companies claim Fonterra's pricing and dominance in the domestic market creates a major barrier to entry and this means their only option is to export.

6.3 We have sympathy with the view that milk supplied under the raw milk regulations should be for domestic consumption, given the intent of legislation is to support a functioning local market. However, if the milk price is creating a barrier to entry, as alleged, then urgent action is required to address this. We reiterate our view that the price should be set by an Independent Milk Price Commissioner.

## 7. International comparisons

7.1 International comparisons are complicated by the specific market conditions and retail tax regimes that exist in any one country. However, there are grounds for suggesting that the concentrated nature of New Zealand's market means consumers may be paying more than a fair price for milk.

7.2 Figures published by the International Farm Comparison Network (IFCN) show the average cost of producing milk in New Zealand is cheaper than in any other OECD country and cheaper than in many non-OECD nations. New Zealand ranks between India and China on the IFCN's production costs table.<sup>9</sup>

7.3 While production costs are low by international standards, IFCN data suggests wholesale and retail margins here have been higher than in the many other countries.<sup>10</sup> These high margins suggest New Zealand consumers may have been paying more than is fair.

7.4 Ministry of Agriculture and Forestry figures show that in five of the last seven years domestic retail prices have been between four and five times the farmgate milk price.<sup>11</sup> In the UK and the US, retail prices have only been between 1.8 and 2.4 times the farmgate price.<sup>12</sup>

7.5 A comparison can be made with the UK. In the year to February 2011, wholesale and retail competition contributed to a **drop** of 1.25 percent in UK fresh

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<sup>9</sup> International Farm Comparison Network. 2010. *Dairy Report 2010*. Germany.

<sup>10</sup> International Farm Comparison Network. 2006. "Margins for processing and retailing". Germany.

<sup>11</sup> Ministry of Agriculture and Forestry. Domestic Milk Market in New Zealand, 1 March 2011, Document number: BL10-391.

<sup>12</sup> Based on data from the UK's Dairy Co and US Bureau of Labor Statistics.

milk prices. Over the same period, milk prices here rose seven percent (excluding the October 2010 GST increase).

7.6 Data from the UK's DairyCo show the equivalent of two litres of milk averaged \$2.14 in UK supermarkets over the five months to February 2011. Statistics New Zealand's Food Price Index shows that the cheapest two-litre container here averaged \$3.63 (\$3.16 ex GST).

7.6 Statistics New Zealand data also show price increases were higher here when world dairy last spiked in 2008. In the year to May 2008, domestic prices rose 23 percent. UK prices rose as well but the increase was lower (16.6 percent). It was also lower in the US (11 percent) and Australia (10 percent).<sup>13</sup>

7.7 There are factors that make the New Zealand market unique. Most of the milk produced here is turned into commodities for export. In contrast, milk produced in other countries is mostly for domestic consumption and there is normally competition between processors for supply.

7.8 We believe these factors point to the need for much greater scrutiny of the New Zealand market. New Zealand farmers are considered to be among the most efficient dairy producers in the world. However, it cannot be said with any certainty that New Zealand consumers are paying a fair and efficient market price for milk.

## **8. Recommendations**

We recommend:

- The Committee considers the establishment of an Independent Milk Price Commissioner to set the price of raw milk. We believe this is an appropriate and necessary intervention in such a highly concentrated market.
- The Committee considers additional safeguards to support the functioning of a domestic market. This should include ensuring milk supplied under the raw milk regulations is available to processors intending to sell domestically.

Thank you for the opportunity to make a submission. If you require any further information, please do not hesitate to contact me.

Yours sincerely

Suzanne Chetwin  
Chief Executive

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<sup>13</sup> Statistics New Zealand. "The rising cost of food in New Zealand". [www.stats.govt.nz](http://www.stats.govt.nz)