



NEW ZEALAND INSTITUTE FOR THE STUDY  
OF COMPETITION AND REGULATION INC.

# Welcome Brazilian Co-operative Companies

## Co-operatives in New Zealand: the particular case of dairy\*

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<http://iscr.org.nz>



# Outline

- Co-operatives in New Zealand
- Co-operatives in New Zealand Dairy
  - Short history to 2000
  - Deregulation in 2000
  - Interaction between regulation and performance in 2001- 2010
  - Dairy co-operative Issues today 2010-2012



# Co-operative or Investor firms

- Many firms are a hybrid mix of cooperative and investor organisation
- Mix changes over time with changes in
  - technology
  - substitutes, consumer tastes, and
  - capital and labour markets
- The best test of the appropriate organisational structure is the survivor of competition, with legal and regulatory neutrality




# New Zealand Co-operatives

- Are in many industries including,
  - agriculture: dairy, meat processing, fertiliser, irrigation
  - supermarkets, electricity lines
  - insurance, finance and banking
- The Co-operative Association reports 55 members about half of which are in agriculture
- Are treated as companies very similarly to investor firms, except for
  - variation in tax treatment of dividends
  - variations in company rules that allow co-op-structure



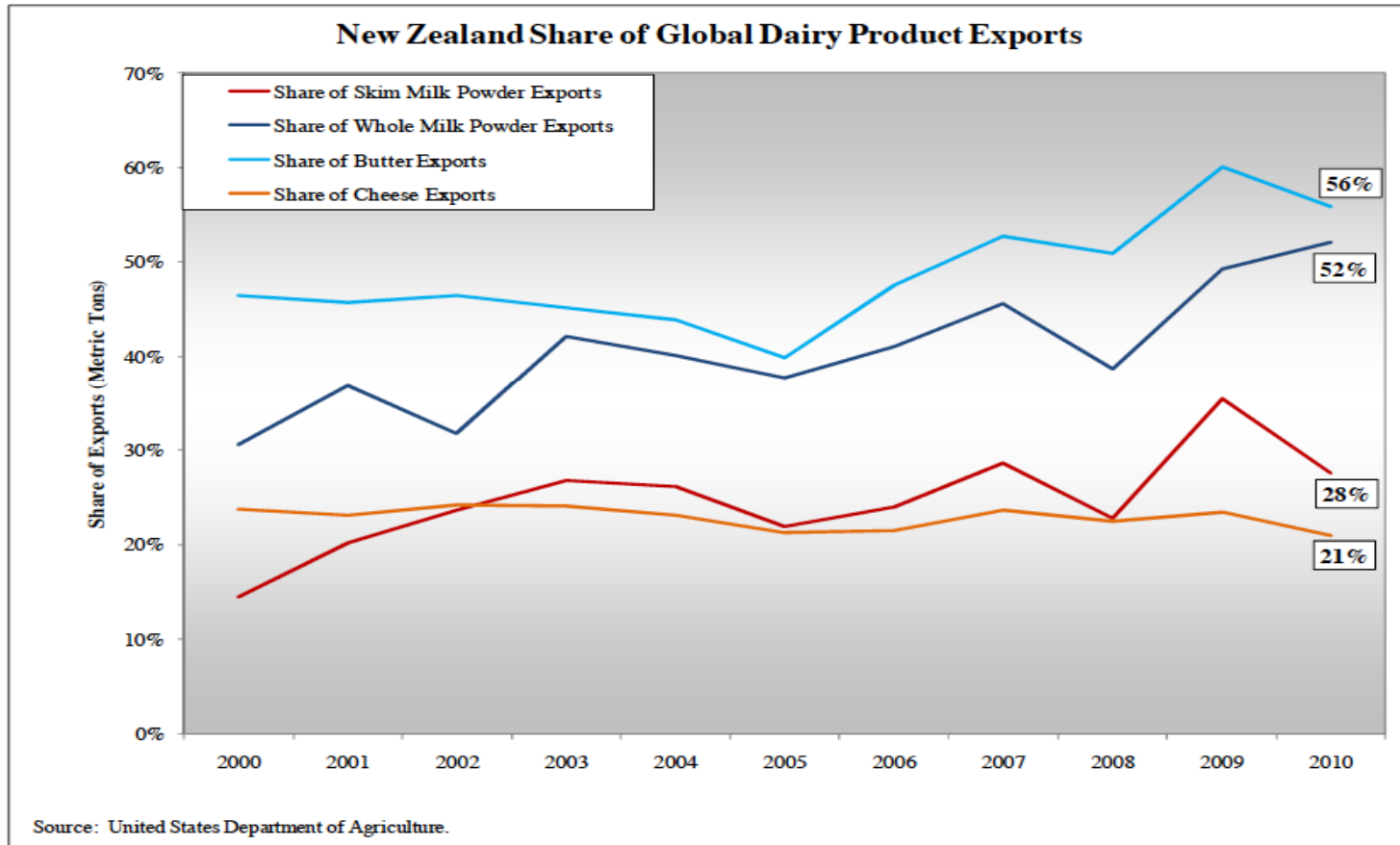
# New Zealand Co-operatives

- Arise as solving combinations of:
    - contracting for reliable service
    - potential market power concerns
    - economies of scale in transactions costs
    - having an industry with a collective voice
  - Have changed dynamically
    - competing with other organisational forms
    - with firms switching between cooperative and investor organisation.
  - Have a significant presence where there are many stakeholders: e.g. agriculture, insurance and some forms of banking
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# Importance of NZ Dairy

- Share of NZ exports
  - 1890 7%
  - 1920 22%
  - 1930 42%
  - 2012 25%
- In 2012
  - NZ produces 2-3% of world milk supply
  - NZ exports 95% of milk produced
  - NZ produces a very low share of milk supply in any one country, so has negligible market power in world markets despite large share of world trade

# NZ Dairy Share of World Trade



# Evolution of Dairy Processors

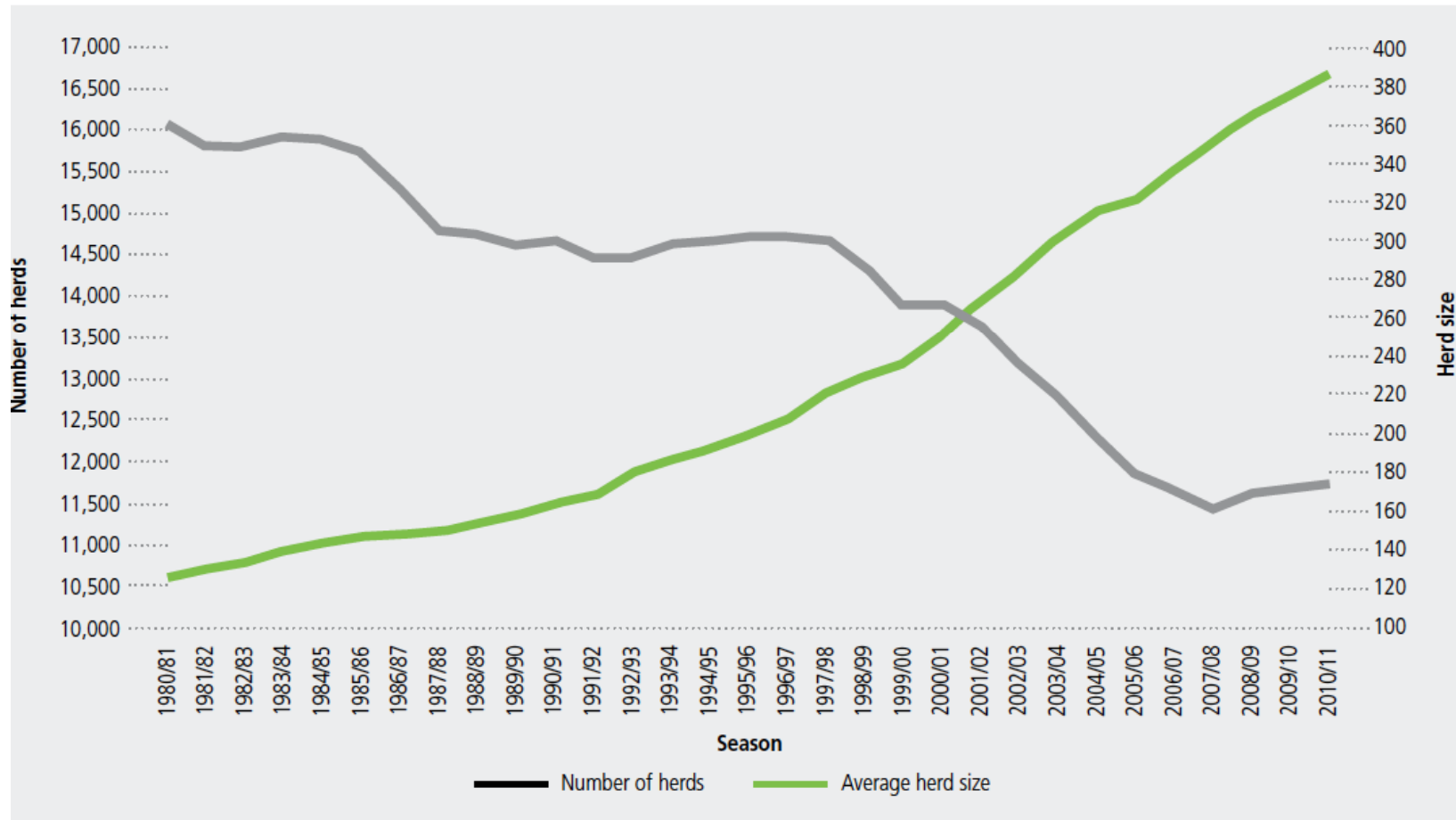
| Date        | Number of Co-operatives (%)       | Export                   | Government                               |
|-------------|-----------------------------------|--------------------------|--|
| 1882        | Co-ops starting<br>Investor firms | First frozen<br>shipment |  |
| 1920s-50s   | 220-240 (> 50%)                   |                          | Quality +<br>marketing+ price<br>control |
| 1960s-1980s | 100=>20 (100%)                    | 1 Exporter (co-op)       | + subsidies                              |
| 1980s       |                                   | 1 Exporter (co-op)       | De-regulation of<br>whole economy        |
| 2000        | 4 (100%)                          | 1 Exporter (co-op)       |  |
| 2001        | 3 (100%)                          | competitive              | De-regulation of<br>dairy                |
| 2012        | 3 (50%)                           | competitive              | Revise regulation                        |



# Evolution of Milk Suppliers

## Increase in Size and Decrease in Number

### 2001-2011: 50% increase in size




# Whole Economy NZ Deregulation 1980s Affected Agriculture:

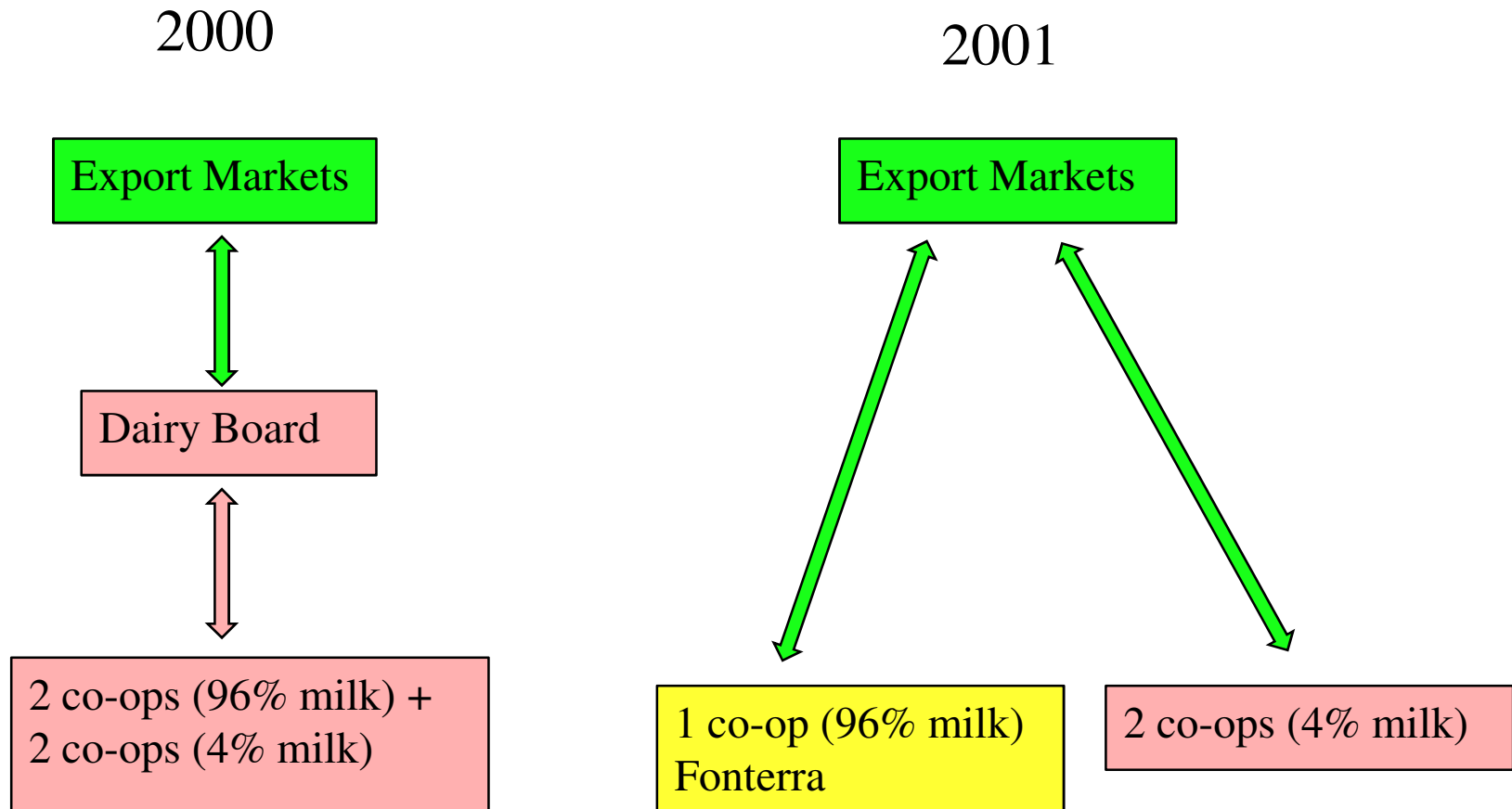
- Removal of subsidies in 1985 led to
  - immediate reduction in agricultural profitability; recovery in the 1990s
  - major change in agricultural product mix
  - major adjustment away from “uneconomic” use of inputs
  - major enhancement in productivity and quality
- Deregulated agriculture without subsidies 1980s-2012; with increasing environmental regulation
- Dairy de-regulation not complete by 2000.



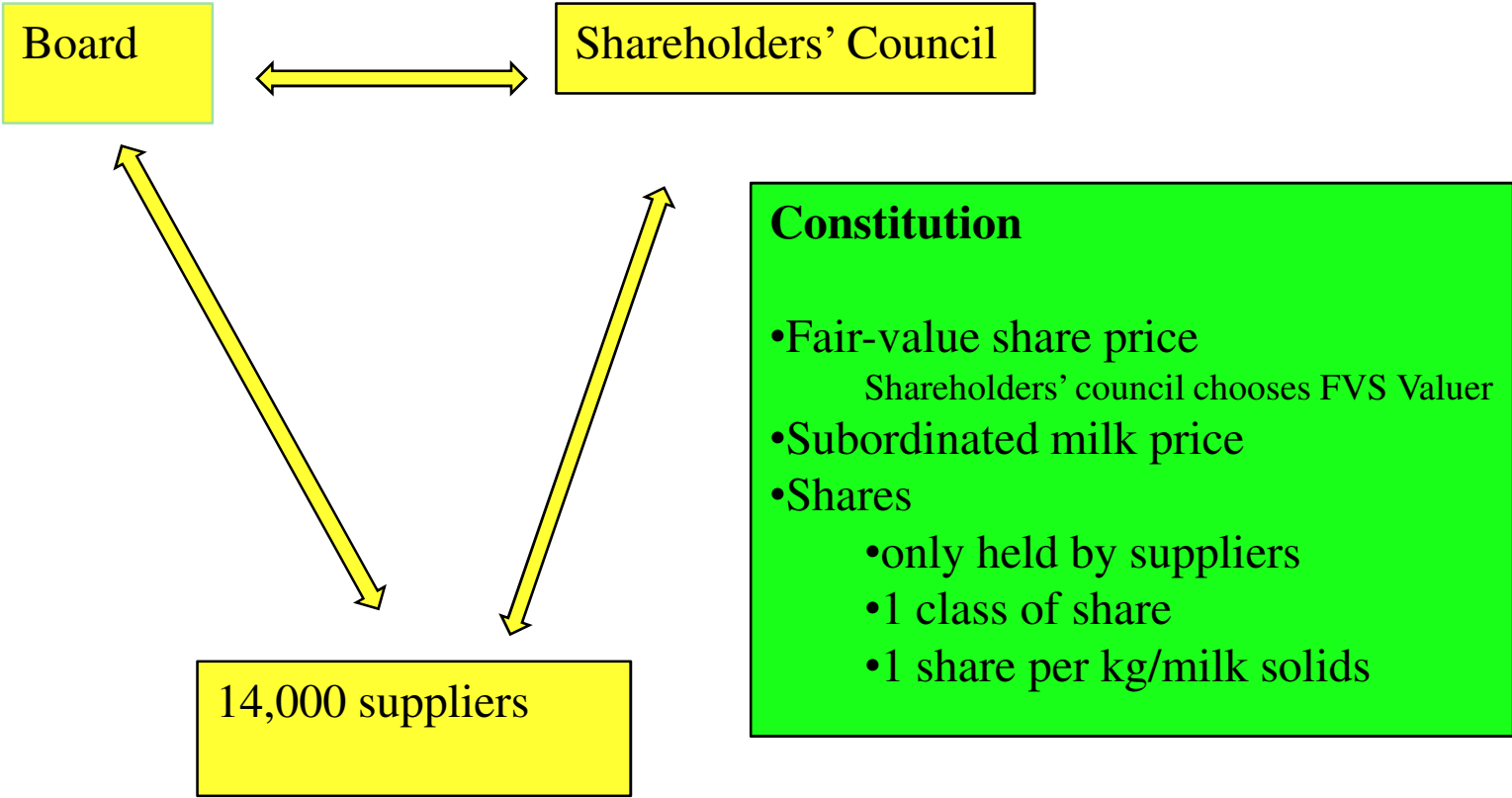
# Dairy Issues in 2000

1. The presence of a single-desk exporter: the Dairy Board
  2. The single desk restricted
    1. coordination between foreign customers and domestic supply
    2. Competition between existing co-ops and potential investor entrants
  3. Desirable for “workable” competition in 3 Markets
    1. in the farm-gate milk market
    2. in the milk products market (which is competitive because selling in foreign markets)
    3. in the domestic (fresh and confectionery) products market
  4. Required removal of the single-desk exporter
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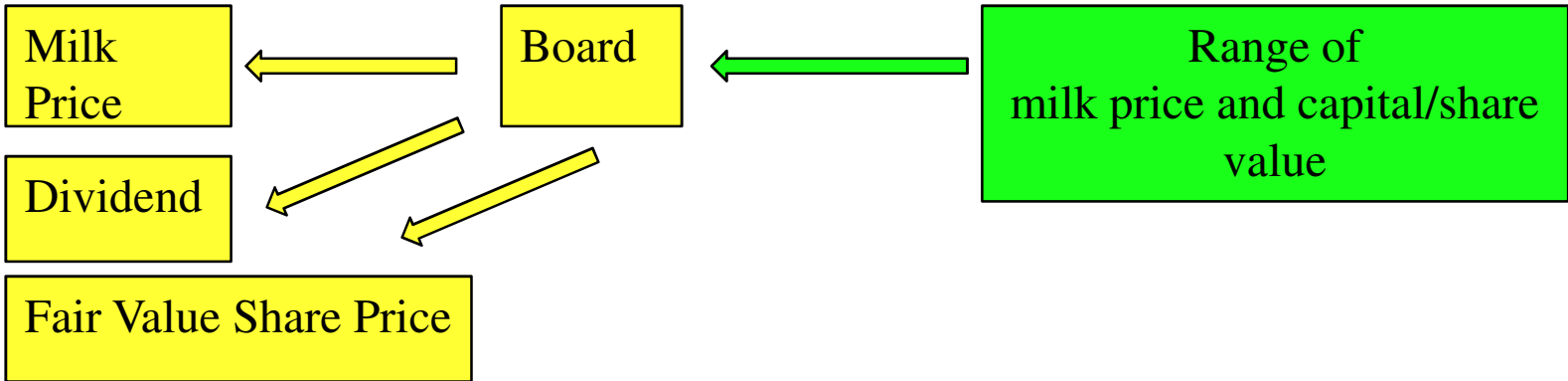
# Dairy De-regulation 2000/1



# Fonterra in 2001



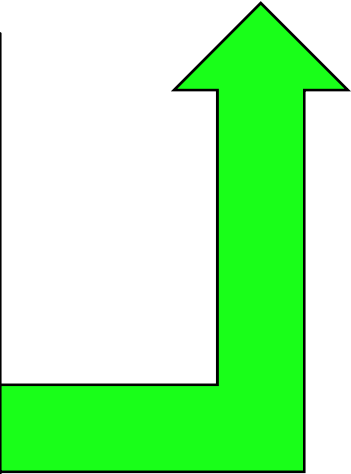
# Fonterra 2001 Fair Value Pricing



**Valuer Calculation**

Gross revenue  
Less operating costs  
Less capital costs

Surplus = factory-gate payment for milk only



## Why Regulate in 2001?

- Fonterra with 95% of the farm-gate milk market: virtually a monopoly
- Fonterra a monopoly and supplier co-operative:
  - so will not lower the wholesale price of milk to suppliers
  - but may overprice the milk to suppliers
- Bundling dividend and milk price may for periods
  - Produce a relatively high milk price
  - Inhibit legitimate competition



# Why Regulate in 2001

Desirable to have workably competitive markets: despite Fonterra's market share

- Regulatory neutrality for competition among coops and investor firms
- Test the relative efficiency of firms and organisations; including Fonterra
- Allow by competition alternative company strategies to emerge if they are economically efficient





# Regulation of Fonterra in 2001

- Given that Fonterra's constitution provided, "fair value share" pricing, the regulations were

Fonterra must

1. accept seamless entry and exit of suppliers (with notification) with their fair value share capital
2. supply up to 400m litres to other processors if demanded

Fonterra is free to set its own milk price

- Regulation in place as long as Fonterra's market share remained high

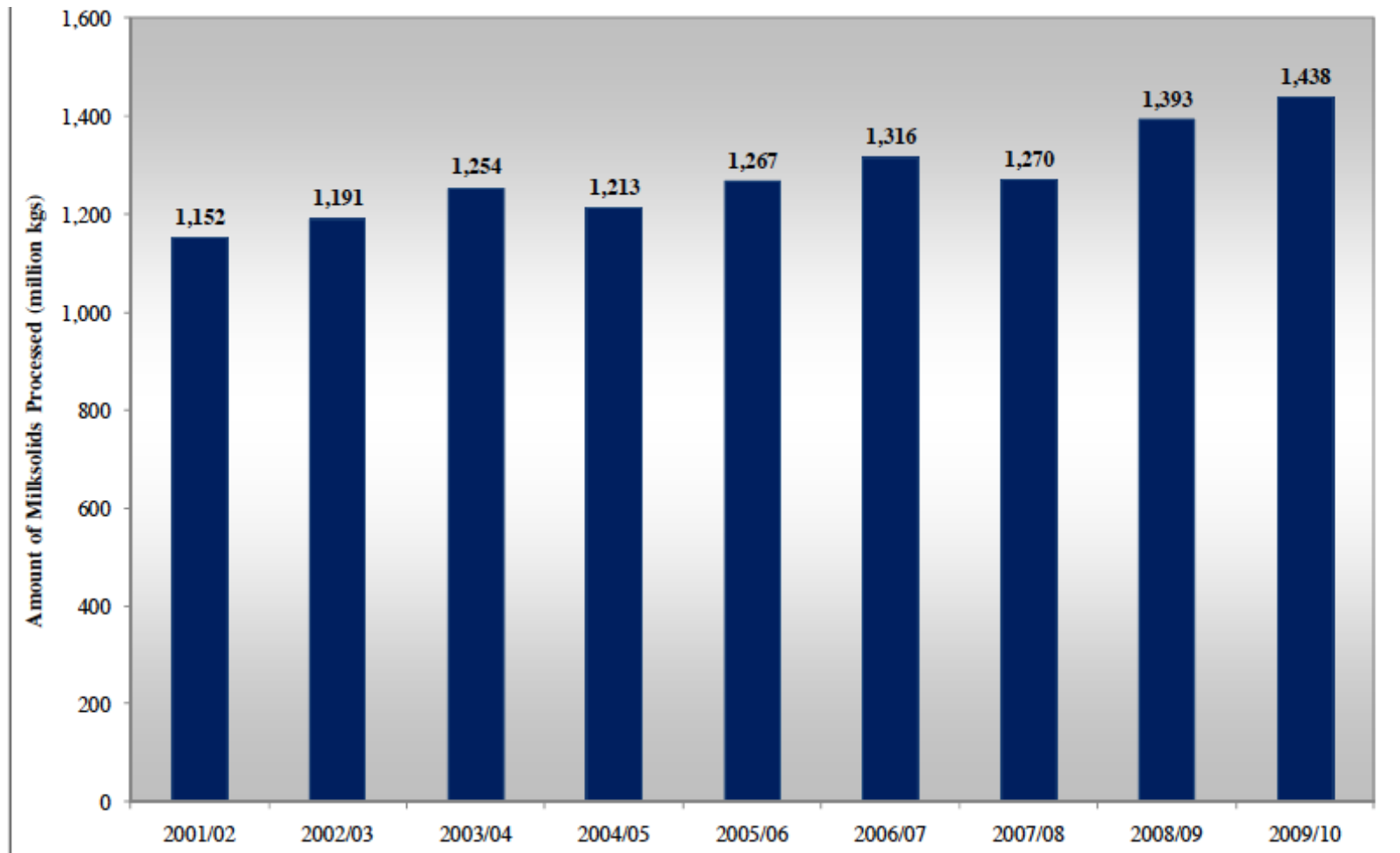


## Regulation produces workably competitive milk price

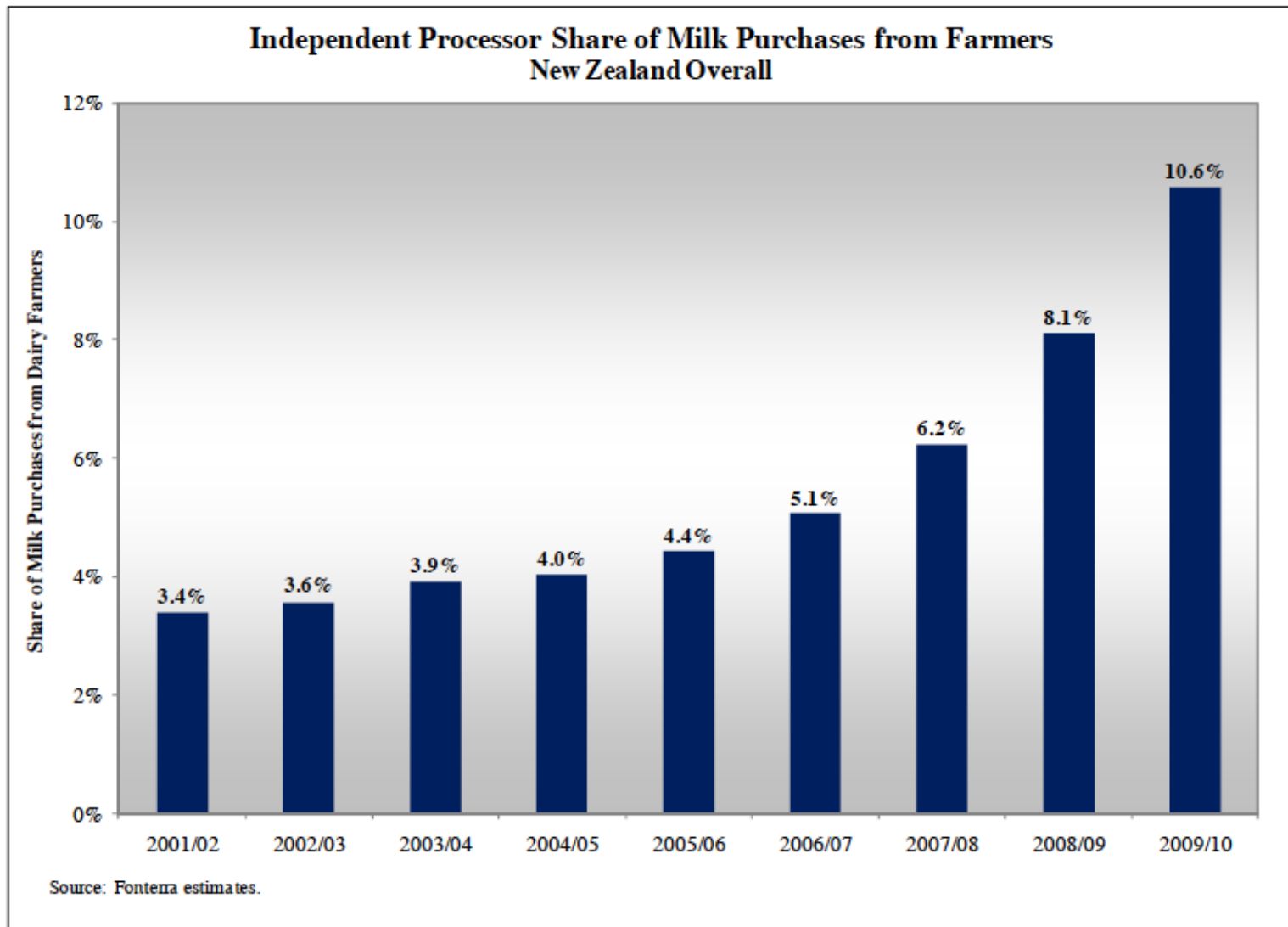
- Supplier ability to *enter or exit with their capital “fairly” priced* induced Fonterra to set competitive milk price
  - Milk price high and share price low: induce excess supplier entry (on these terms)
  - Milk price low and share price high: induce supplier exit
- Aided by co-operative managerial tensions e.g. treating suppliers equally throughout New Zealand

# Fair Value Share Price Regulation 2001-2010

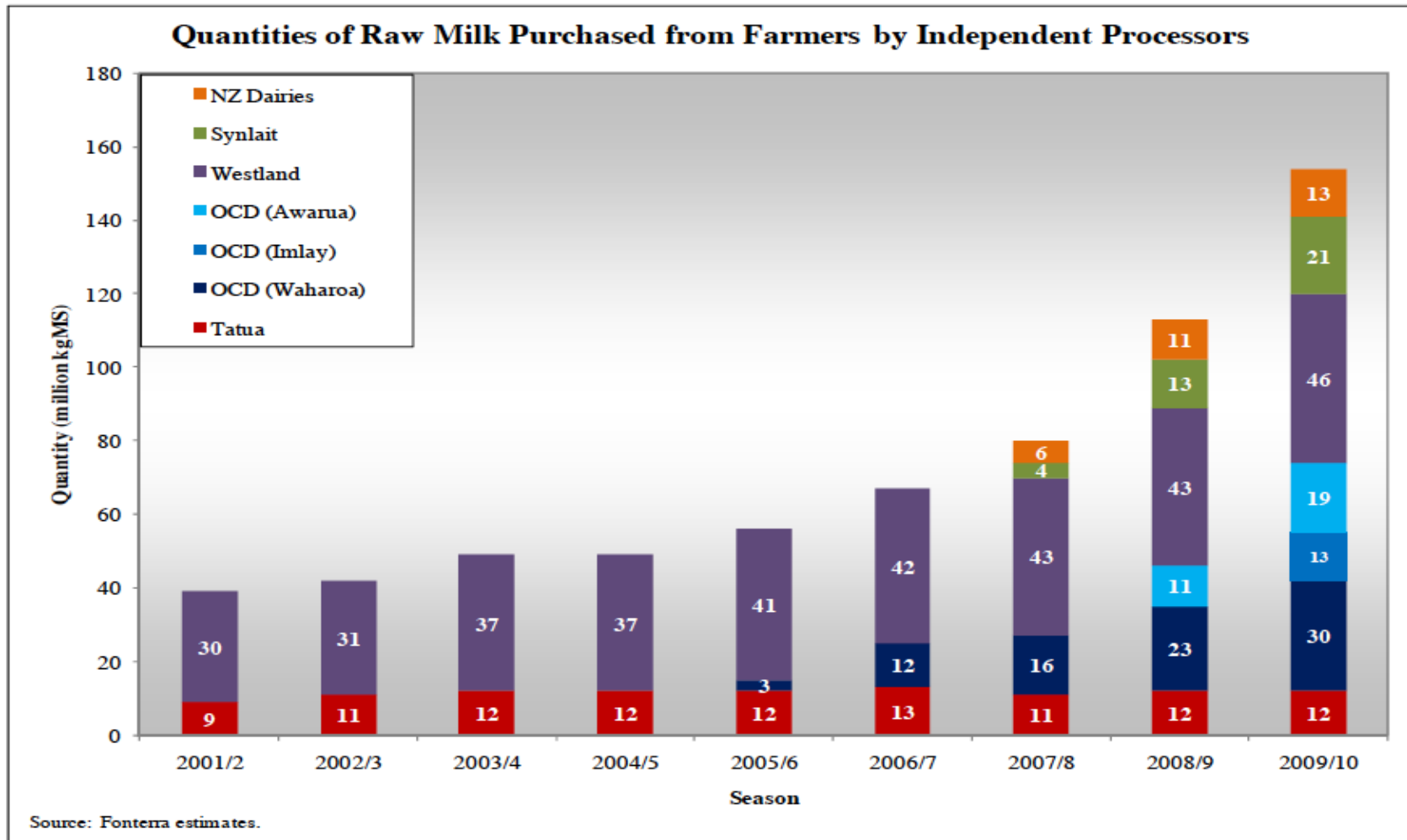
## NZ Milk Production Grew by 25%



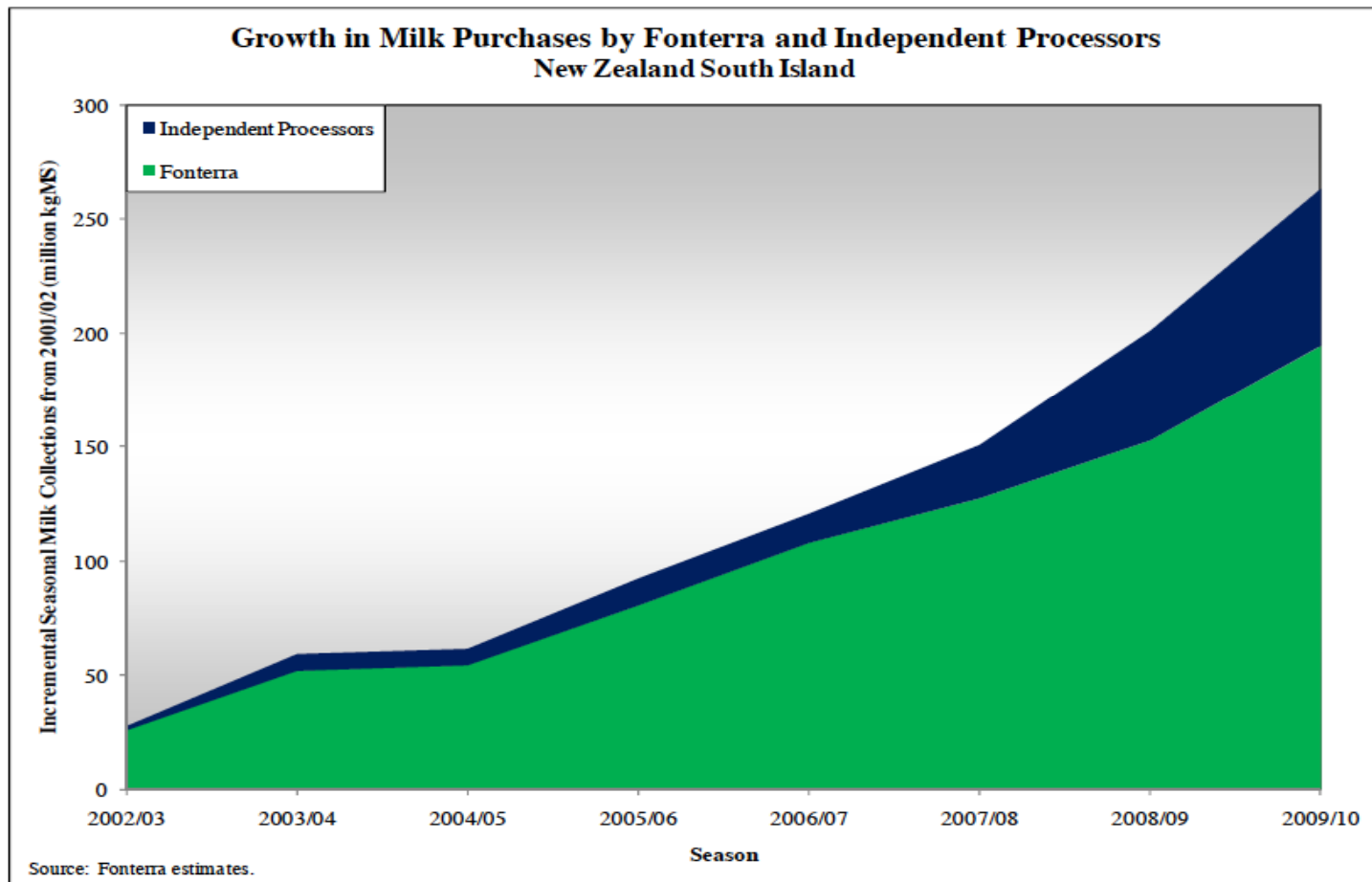
# There was Entry 2001/2-2009/10



# Particularly Entry by Investor Firms 2001/2 - 2009/10

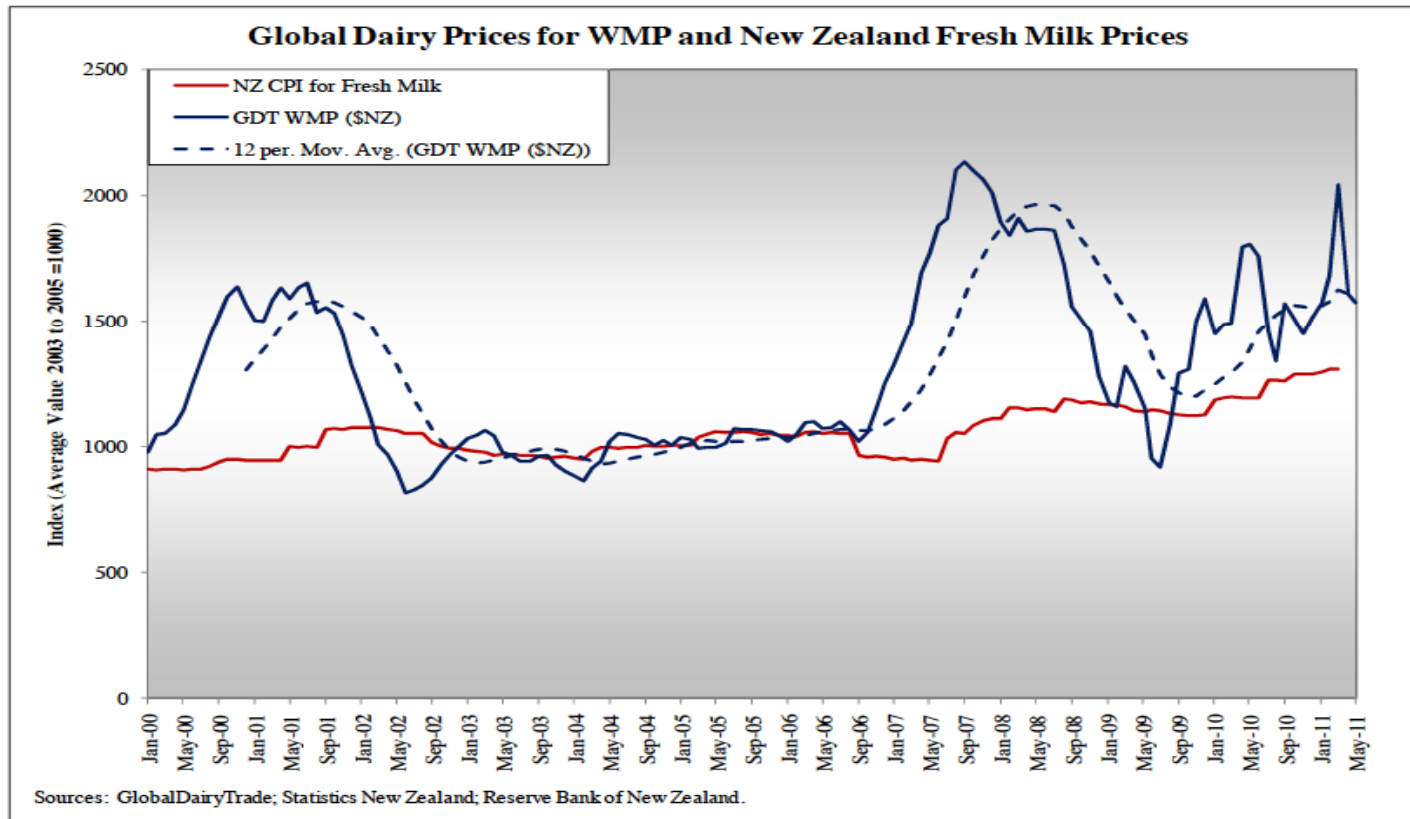


# Fonterra *and* Other Firms' Milk Processing Volume Grew: Fonterra Lost market Share (2002-2009/10)

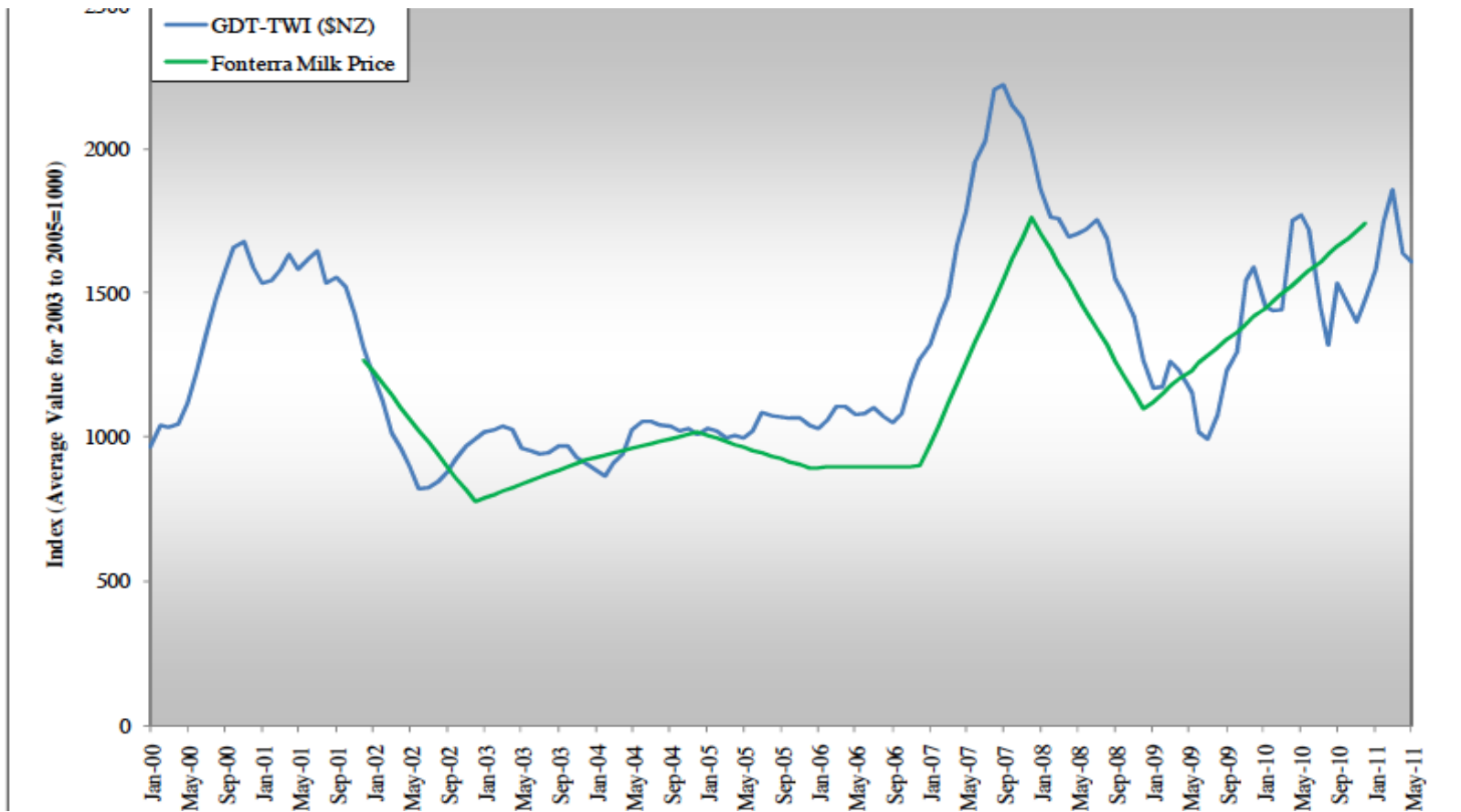


# What about NZ Consumers 2000-2011?

## Domestic Fresh Milk Price vs Export Price




# The Farm Suppliers' Milk Price Indices of export and Supplier Milk Price 2000-2011





# 2007 – 2012 Features

- Fonterra introduced milk product auctions in 2008
    - Frequency, contracts and product coverage develop to 2012
    - Prices used in valuing the Fair Value Share
  - NZ Stock Exchange introduces dairy futures 2011
  - Fonterra performance was mixed:
    - low retained earnings
    - Some improvement in efficiency
    - Grew, but with reduced market share
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# Fonterra Concerns 2007 - 2012

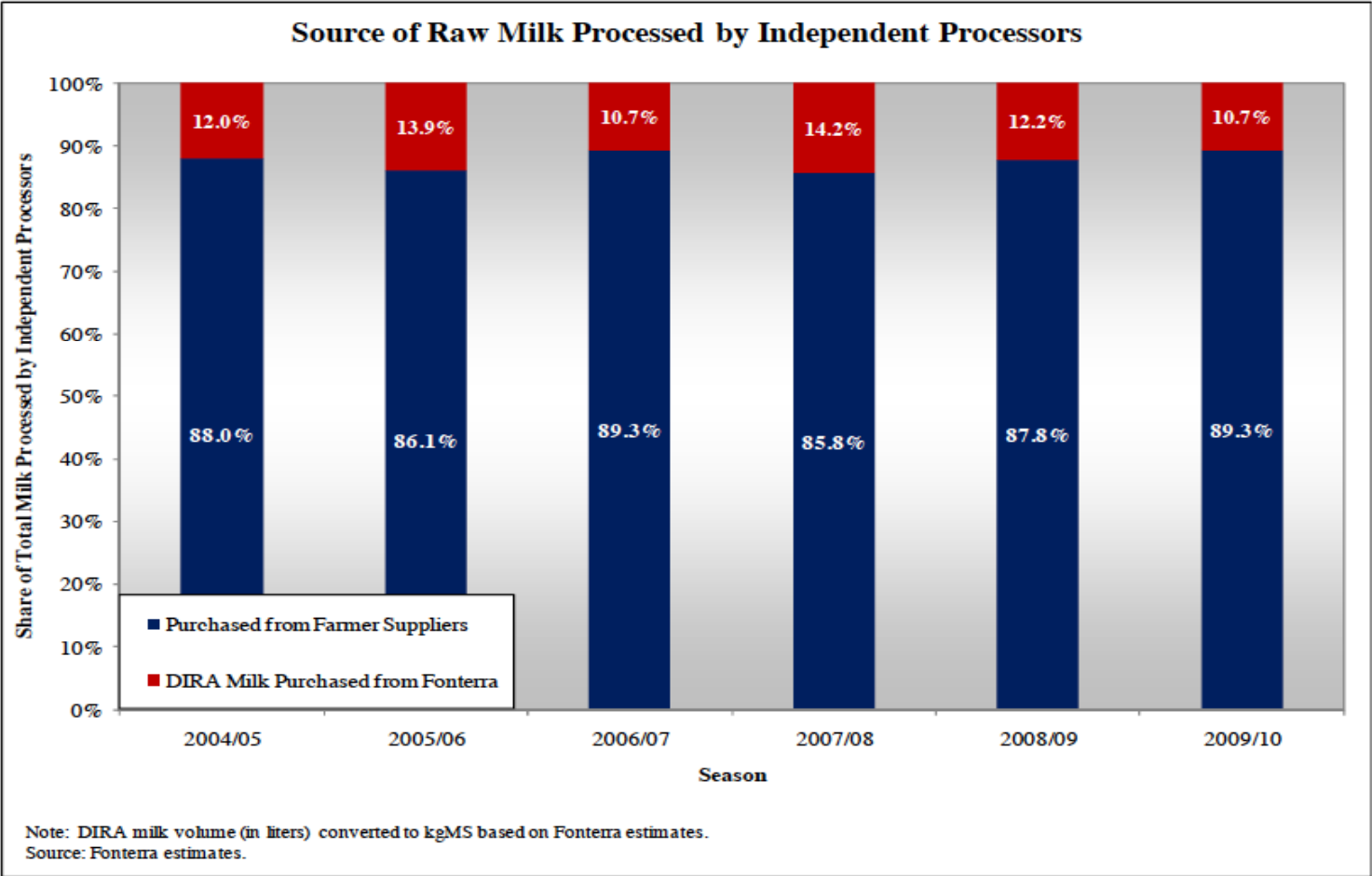
- Share redemption risk because suppliers have the *right to leave* with the *fair value* of their capital paid out
  - Internal risk: due to annual production fluctuations inducing redemption or take up of shares at the FVS price that also varied
  - External risk: due to other processors/farm activities attracting suppliers away from Fonterra
- Milk required to on-sell to other processors:
  - Amount was expanded to 600m litres
  - Pricing disputes:
  - Amounts transferred to other competing exporters long term

# Others' Concerns 2007 - 2012

- General: that Fonterra had concerns and might change its internal processes and Fair Value Share-pricing; since it was not enforced by regulation
- Investor firms (also consumers): mainly about Fonterra milk price setting
- Lack of development of a milk market
  - to support domestic fresh and confectionery product processors and
  - The incentive for the development of a milk market given that milk is provided under regulation from Fonterra



# Milk (Under regulation) Purchased from Fonterra by Other Processors 2004/5-2009/10



# Fonterra solutions

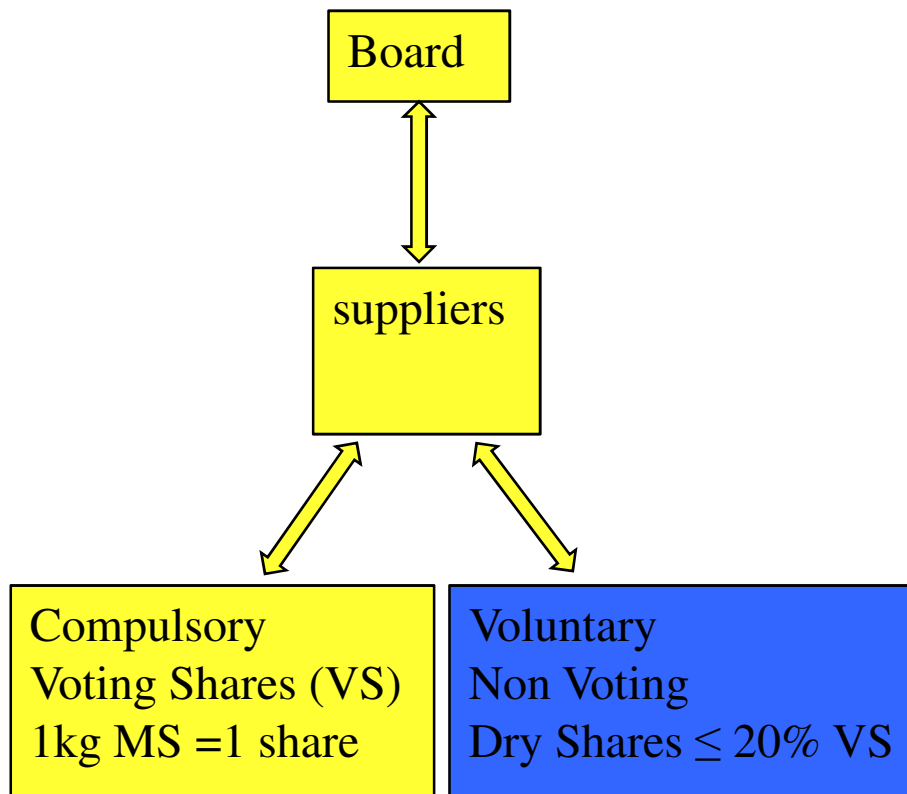
## 2007 - 2012

- 2007 Fonterra rejected a manufacturing/marketing subsidiary joint with minority investors
- 2010-12 Developed Trading among Farmers: TAF
  - Retains vertically integrated cooperative structure and control
  - Changes the form of redemption risk:
    - Fonterra not required to buy supplier shares
    - Departing suppliers sell their shares in a market
  - Links shares to investor traded instruments to provide
    - Liquidity in shares
    - Superior (independent) value of shares
    - Another source of capital



# Fonterra changed in 2010

2010



Fixed the share price pending the next phase of corporate restructuring

Means tradable subject to restrictions

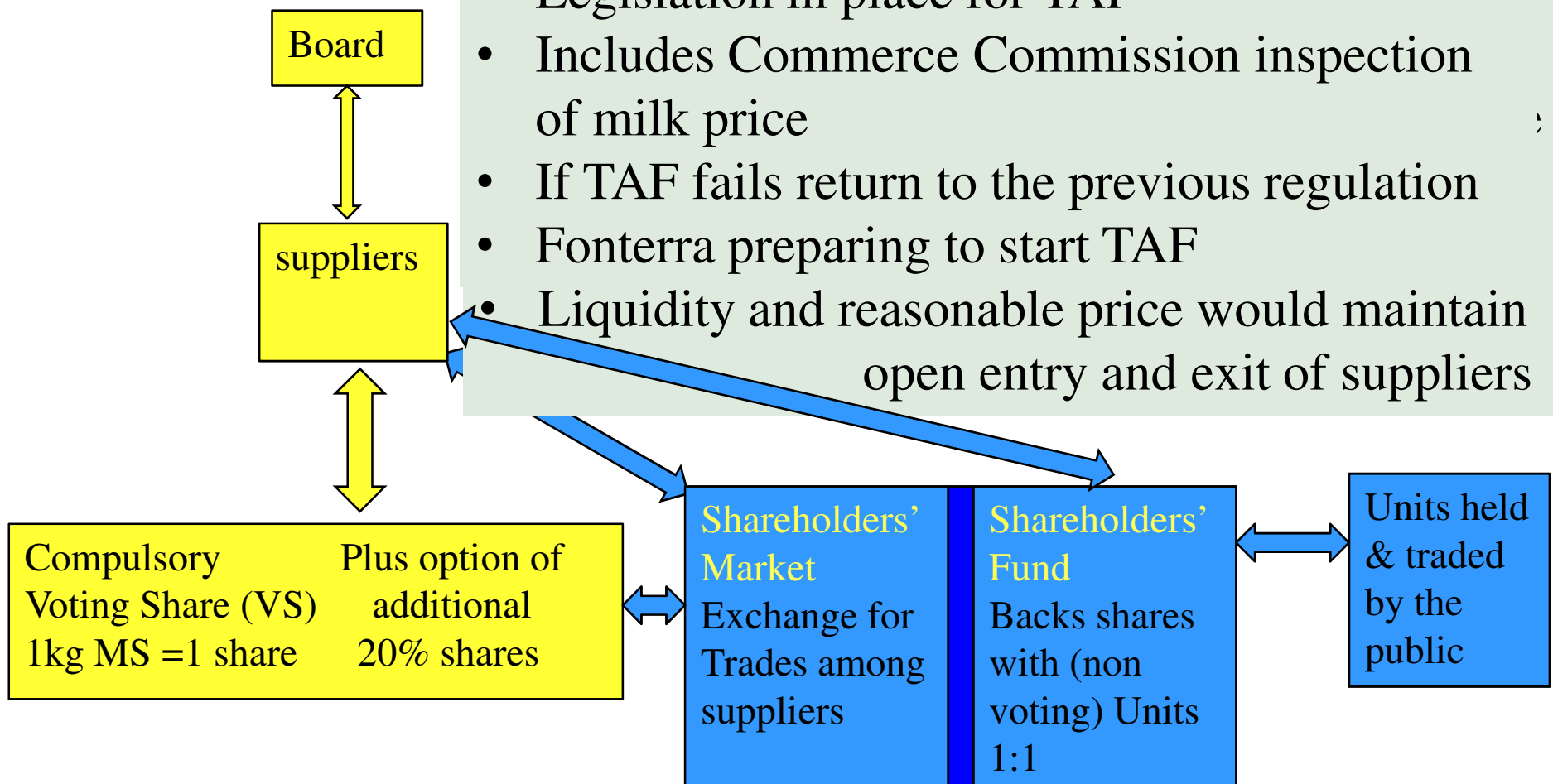
# Fonterra

(Shareholders' Council retained)

## 2012-13! Trading Among Farmers

### Present situation

- Legislation in place for TAF
- Includes Commerce Commission inspection of milk price
- If TAF fails return to the previous regulation
- Fonterra preparing to start TAF
- Liquidity and reasonable price would maintain open entry and exit of suppliers



## Final Comment

- Co-operative form and investor forms continue to be tested by competition in New Zealand dairy
- Under the Dairy Regulation of 2001
  - testing has occurred without regulating the actual price of milk: despite an almost monopoly co-op.
  - This was only possible with the co-operative form
- Co-operative and investor firms are likely to co-exist where they have different strategies; but in New Zealand dairy we wait and see





Thank you  
and best wishes on your tour



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