

## DAIRY INDUSTRY RESTRUCTURING (FONTERRA CAPITAL RESTRUCTURING) AMENDMENT BILL

### Context

The Dairy Industry Restructuring (Fonterra Capital Restructuring) Amendment Bill gives effect to the Government's response to Fonterra's intended capital restructuring. It amends the Dairy Industry Restructuring Act 2001 (the DIRA) to support Fonterra's move to a new capital structure, while also adjusting some existing regulatory measures to mitigate risks that could arise from Fonterra's new capital structure.

The DIRA was passed in 2001 to override the constraints of the Commerce Act 1986 and allow the formation of a new co-operative, Fonterra, through the merger of the two largest dairy co-operatives and the New Zealand Dairy Board. The new co-operative accounted for some 96 percent of all farmers' milk supply in New Zealand. In the face of this dominance, the DIRA included a number of safeguards to protect contestability for farmers' milk supply. This was to promote the efficient operation of dairy markets in New Zealand and to maintain incentives on Fonterra to perform efficiently and innovate over time.

Since then, the DIRA regulatory settings have evolved in response to changing market conditions, such as the development of competition in dairy processing and Fonterra's changing market share. However, Fonterra still collects and processes some 80 percent of farmers' milk in New Zealand and effectively determines the farm-gate milk price for the entire industry.

Among the safeguards included in the DIRA are provisions governing Fonterra's capital structure. This is because Fonterra's share trading arrangements have the potential to affect the contestability of farmers' milk supply. The current capital structure, known as Trading Among Farmers (TAF) involves:

- the Fonterra Shareholders' Market, where only farmer-shareholders, the market maker<sup>1</sup>, and Fonterra can trade compulsory (wet) and non-compulsory (dry)<sup>2</sup> shares in Fonterra; and
- the Fonterra Shareholders' Fund (unit Fund), where farmer-shareholders, the market maker, Fonterra and external investors can trade units in economic (non-voting) rights to Fonterra's shares (with Fonterra's Constitution capping the size of the unit Fund at 20 percent of Fonterra's total number of shares on issue).

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<sup>1</sup> The market maker is a financial institution contracted by Fonterra to ensure liquidity in the Fonterra Shareholders' Market through continuous offering of both buy and sell orders for Fonterra shares. A key role of the market maker is to ensure that the spread between buy and sell prices is restricted to a narrow range, which is achieved by the market maker participating in the trading of units and exchanging them for shares, and vice versa.

<sup>2</sup> As a co-operative, Fonterra requires its farmer-suppliers to hold shares in proportion to the volumes of milk supplied in each season. These are informally referred to as wet shares and effectively have voting rights attached to them. Within some limits, Fonterra farmer-suppliers can also hold shares in excess to the volumes of their milk supply. These are informally referred to as dry shares and do not have voting rights attached to them. Both, however, attract the same dividend and capital gains or losses.

The Fonterra Shareholders' Market and the unit Fund are linked, so that Fonterra's farmer-shareholders, the market maker, and Fonterra can effectively exchange dry shares into units and vice versa. The intrinsic link between the share and unit markets in the TAF system aims to ensure efficient price-discovery and mobility of farmers' capital investment in Fonterra, as a means of maintaining contestability in the farmers' milk market.

Fonterra's new capital structure makes significant changes. Its key features include:

- **Reduced minimum shareholding requirements:** Farmers wishing to become shareholders in Fonterra and supply milk will need to purchase and hold fewer Fonterra shares for every kilogram of milk solids supplied. This will make it less costly for new farmers to join Fonterra and will reduce incentives for existing farmers to switch their supply to other processors or pursue a land-use change away from dairy. This will help secure milk supply for Fonterra but may have negative implications for the wider dairy industry and alternative land use.
- **Restricted farmers-only market:** Fonterra intends to partially delink the unit Fund and operate a restricted farmer-only market for its shares on a permanent basis. This will mean that farmers are not able to divest "spare" shares, resulting from the reduced shareholding requirements, into the unit Fund, thus avoiding a commercial risk to Fonterra of eventually having to buy back excess surplus shares, if the unit Fund grows beyond what Fonterra sees as acceptable limits.

The partial delinking of the unit Fund and a restricted farmer-only share market could impact on the extent to which farmers can exit Fonterra. While it will be cheaper for farmers to join Fonterra as a shareholder-supplier, it will be more challenging for existing shareholder-farmers to exit to supply another processor, or to invest in alternative, potentially more sustainable, land use.

## **The content of the Bill**

### *1 Entry into force*

With the exception of some technical amendments and clarification of the existing safe harbour provisions, which come into force on 1 January 2023, the Bill will come into force on 1 June 2023. The 1 June 2023 commencement date is the start of the next dairy season and is intended to allow several months between passage and commencement to provide time for implementation work to be undertaken, including appointment processes, putting in place additional Commission capability and processes, and Fonterra making changes to its Constitution and contractual arrangements.

### *2 The Bill supports Fonterra's move to a new capital structure*

The DIRA does not expressly preclude Fonterra from proceeding with its capital restructuring. However, under the current DIRA settings, Fonterra could face the risk of a legal challenge if it partially delinks the unit Fund on a permanent basis. This is because the DIRA prohibits Fonterra from engaging in conduct that restricts or prevents farmer-shareholders from exchanging their co-operative shares for units if the purpose of that conduct is to deter them from entering or exiting Fonterra.

To enable Fonterra to proceed with certainty, the Bill amends the DIRA to specifically exclude Fonterra's ability to set a limit on the size of the unit Fund (irrespective of its purpose) from conduct that could otherwise be prohibited.

### 3 *The Bill improves the transparency and robustness of the governance, operation, and the Commerce Commission's oversight of Fonterra's base milk price settings*

To manage the resulting potential risks to contestability of milk supply, the Bill also amends and strengthens a number of base milk price-related DIRA settings.

Fonterra's size, comparative to other dairy processors, means that Fonterra essentially sets the milk price for the industry. The DIRA has, since 2012, included measures to provide for transparency and independent monitoring of Fonterra's calculation of the base milk price (that is, the reference price that provides the starting point for the actual milk price farmers are paid in a season). The DIRA measures do not involve price control, or regulated price-setting. They simply allow for the Commerce Commission to annually review and publicly comment on the consistency of Fonterra's base milk price methodology and the calculation with efficient and contestable market outcomes. Under current DIRA settings Fonterra does not need to take account of the Commission's views.

To further strengthen the transparency and robustness of the governance and operation of Fonterra's milk price-setting arrangements, the Bill:

- increases the number of Ministerial nominees to Fonterra's Milk Price Panel<sup>3</sup> from one to two, and prescribes both the maximum and minimum number of Panel members to ensure that the Ministerial nominees' contribution to the Panel's recommendations cannot be diluted;
- requires the Chair of Fonterra's Milk Price Panel to be fully independent of Fonterra, appointed only with the approval of the Minister, and be additional to the two Ministerial nominees to the Panel: it will no longer be possible, for example, for a Fonterra director to act as Chair; and
- requires Fonterra to contract out the day-to-day administration of the base milk price calculation to an external party, and to periodically replace the contracted party to maintain its independence from Fonterra.

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<sup>3</sup> An advisory body appointed by Fonterra to oversee the base milk price calculation and recommend the base milk price to Fonterra Board.

The Bill also strengthens the Commerce Commission's oversight of the base milk price-setting regime. The Bill:

- gives the Commerce Commission the ability to give directions to Fonterra on matters arising from the Commission's review of Fonterra's Milk Price Manual and the base milk price calculation: this amendment does not extend to giving directions on the base milk price itself;
- clarifies the scope of the Commission's existing review functions, in relation to the boundaries of the existing "safe harbour" provisions in section 150B of subpart 5A of Part 2 (Subpart 5A)<sup>4</sup> so that the Commerce Commission can review and direct on the way in which Fonterra's chosen method for applying the assumptions described in section 150B is consistent with the purpose of the base milk price regime; and
- requires Fonterra to publish information that it provides to the Commerce Commission as part of the Commission's reviews, and that is not commercially sensitive. The Commerce Commission would also be able to direct Fonterra on further disclosures. The Bill as reported back widens the grounds on which Fonterra could withhold information. These now include not only commercial sensitivity but also personal privacy and material which is subject to legal professional privilege.

The Bill provides the Commerce Commission with a range of enforcement tools should these be required in relation to the exercise of the new powers under Subpart 5A. These tools are aligned with existing enforcement provisions in the DIRA that already relate to Subpart 5 of Part 2 of the DIRA (Subpart 5), which includes the ability to seek injunctions and damages. However, in the context of Subpart 5A, it is not appropriate that the ability to seek injunctions be extended to third parties, or for damages to be available. The policy intent was that the Commerce Commission should be able to seek injunctions (not damages) in relation to Subpart 5A, and that this right should not apply more widely to other persons.

- The Bill as reported back therefore amends new sections 150ZA and 150ZB so that the Bill no longer enables third parties to seek either injunctions or damages in relation to contraventions of Subpart 5A, and
- the Commerce Commission to seek damages in relation to contraventions of Subpart 5A.

The Bill also provides for the attribution of pecuniary penalties to individual persons (not just to Fonterra as a body corporate) who have personally contributed to a contravention of Subpart 5 and Subpart 5A requirements. This is intended to create a more direct incentive for Fonterra directors and other key personnel to ensure compliance with the relevant DIRA provisions. It aligns with similar pecuniary penalty provisions in other legislation that involves economic regulation and/or is administered by the Commerce Commission.

The Bill, as reported back, adds defences related to a "reasonable reliance on information supplied by another person", similar to those in the Financial Markets Conduct Act 2013.

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<sup>4</sup> The "safe harbour" provisions are certain assumptions which, if used by Fonterra in the Manual or the calculation, are deemed consistent with the purpose of the base milk price regime and therefore excluded from the Commission's reviews. The current drafting of the DIRA has limited the Commission's ability to consider how such assumptions are applied. This may have a material impact on the base milk price calculation.

4 *The Bill supports liquidity in the trade of Fonterra shares and improves transparency in relation to Fonterra's performance*

A consequence of Fonterra's intention to move to a farmer-only share market is that reduced liquidity may constrain farmers' ability to trade shares and therefore constrain exit from Fonterra, either to switch their milk supply to other processors, or to move to alternative, potentially more sustainable, land use.

To support liquidity in the farmer-only share market the Bill requires that:

- there will be market maker(s) designated under relevant market rules. The market maker provides a mechanism that can bridge the gap between the availability of a willing seller and willing buyer in what may otherwise be an illiquid share market;
- Fonterra make independent financial markets analysis of its performance accessible to farmers (both current and prospective farmer-shareholders) and current and prospective unit holders. This includes both an obligation on Fonterra to commission such analysis itself, and to collate and publish details of analysis prepared by other parties. This is to manage the risk that Fonterra's performance will have less visibility and attract less commentary once the restricted farmer-only share market beds in; and
- Fonterra maintain and publish a dividend and retentions policy. The new capital structure carries a risk that Fonterra may over time have constraints on capital for investment. A published dividend and retentions policy can provide more transparency for shareholders as to the co-operative's position in his regard. The Bill does not seek to regulate the content of that policy.

5 *The Bill makes technical and consequential changes to correct drafting errors, ensure administrative efficiency and provide for procedural matters*

The Bill:

- consolidates the enforcement provisions from subparts 5 and 5A into a new subpart 5B of Part 2 of the Act and makes consequential amendments to cross-references;
- clarifies that the amount of the annual levy paid by Fonterra may be set outside the financial year to which the levy relates, and, as a consequence of enabling the Commerce Commission to make directions updates the list of leviable activities to include any directions given;
- makes a consequential clarification regarding the role of the Milk Price Panel in relation to the external entity or entities contracted to undertake the base milk price calculation;
- provides for a definition of the term "publicly accessible";
- corrects a drafting error in section 150L to change "milk price manual" to "setting of the base milk price"; and
- improves the administrative efficiency of the Commerce Commission's review of the base milk price calculation by bringing the timing of the review process forward by two weeks.

## 6 *Cost implications*

The Commerce Commission's current base milk price review and monitoring function is funded by the Crown through Vote: Business, Science and Innovation: Commerce and Consumer Affairs: Enforcement of Dairy Sector Regulation and Auditing of Milk Price Setting. The actual annual cost of carrying out this function is then recovered from Fonterra under the Dairy Industry (Levy Process) Regulations. The Bill provides for the Commission's exercise of the new power of direction to be a leviable activity, which will therefore be cost-recovered from Fonterra, as part of the current annual Fonterra levy process.