Submission

by

BusinessNZ

to the

Primary Production Select Committee

on the

Dairy Industry Restructuring Bill 2001

1 August 2001

PO Box 1925
Wellington
Ph: 04 496 6555
Fax: 04 496 6550

Dairy Industry Restructuring Bill 2001

1. Introduction

1.1 This submission is made on behalf of Business New Zealand, incorporating regional employers' and manufacturers' organisations. Business New Zealand represents business and employer interests in all matters affecting the business and employment sectors.

1.2 Analysis of the impact of the dairy sector on the economy and its economic performance currently requires analysis of both manufacturing and wholesale sector data. The Australian and New Zealand Standard Industrial Classification (ANZSIC), is used to categorise economic activity in New Zealand. Dairy processing sales are included in the manufacturing sector statistics while the activities of the Dairy Board are included in the wholesale sector. We have discussed the impacts of the new global dairy company on economic statistics in Section 4 of this submission.

1.3 Total sales by the dairy processing companies were $7.1 billion in the year to March 2001, 12.0% of total manufacturing sector sales. This includes the cooperative dairy companies, town milk supply and ice cream manufacture. The highly capital intensive nature of the industry means its contribution to manufacturing employment is much smaller. In the year ended March 2001 total salaries and wages paid were $353 million, just 4.1% of the manufacturing total.

1.4 The industry is also characterised by much lower profit levels than the average for manufacturing. In the year ended March 2001 profits for the sector were $387 million, producing a profit to sales ratio of 5.4% compared with the manufacturing sector average of 11.6% (excluding the dairy sector). While part of this difference can be explained by the inclusion of shareholder returns in the milk price the difference between the two is much greater than average shareholder returns in other parts of the sector.

1.5 We support the proposed removal of the statutory powers for a single exporter of New Zealand dairy products. We believe, however, the removal of the export licensing provisions could occur in two stages, with more rapid removal of export licensing provisions for differentiated products occurring when the legislation is first enacted and for all other dairy products when the amalgamation is completed. We are concerned about the exclusive access given to Global Dairy Company to quota markets and believe new processors should be able to gain a share of the quota available.

1.6 At the time the removal of the statutory power to licence exports was first discussed with the Government and Federated Farmers in 1997, the Dairy Board advised that 171 export permits were current. While it was unwilling to publish a list of the export permits granted, it listed the following broad product areas where export permits were required. It should be noted that all products which contain more than 30% by weight of dairy produce must be approved by the Board:

Aerosol mousses and creams
Casein based products used in non food applications
Speciality confectionery mixes and ingredient blends
Cream and milk – fresh, frozen, condensed, UHT
Cultured products such as cottage cheese, sour cream, dips
Dairy desserts
Frozen ice creams and novelties
Goats milk products
Soft serve ice cream and yoghurt powder and UHT mixes
Speciality cheeses
Infant formula and follow on foods
Prepared animal feeds
Protein supplements and diet/weight gain formulae
Specialised minor components of milk
Sauces
Sheep milk products
Yoghurt – fresh and powder mix with cultures

1.7 In the past, exports of shortbread by Arnotts were covered by the export licensing provisions as well as buttons made from casein, but both factories have now closed. Exporters have to apply annually to the Board for licences for specific products and markets. While many exporters purchase their raw material from the Board it also retains the right to compete against the companies it has licensed. We believe this has been a significant deterrent to manufacturers considering investment in expanding production and export of value added dairy products.

2. Regulatory Impact And Compliance Cost Statement

2.1 Business New Zealand has supported the adoption of a more rigorous process for analysis of the economic and business compliance cost impacts of new legislation and regulations

2.2 We are however, very disappointed with the quality of the Regulatory Impact and Compliance Cost Statement provided with the Dairy Industry Restructuring 2001 Bill. The level of analysis is extremely weak and appears to have been drafted around an expected outcome, without the most basic and unbiased analysis of options.

2.3 The main benefits of the proposed merger were reported to be:

- moving within a relatively short time frame to allow dairy food processors to directly manage their overseas marketing and exporting (and all of the associated costs, risks, and potential benefits). This could be expected to result in the rapid expansion of the niche dairy product sector, which includes manufacturers, marketers, and exporters; and

- exposure of the industry, once the merger has concluded, to all of the commercial disciplines of the Commerce Act 1986; and
- the early integration of processing and marketing activities, which will facilitate improved market signals in the industry and some potential for rationalisation; and
- broad farmer support for the proposal, including the removal of the single desk.

2.4 These benefits however, could equally apply to the option of competition between the Kiwi Co-operative Dairy Company and the New Zealand Co-operative Dairy Company or a merger with the structural remedies of the type normally required by competition authorities. These were both noted in the Regulatory impact and compliance cost statement but seem to have been ruled out as options with the decision already made by the industry to proceed with a single company.

2.5 With regard to the second bullet point in the list of benefits, there is significant unease in the business sector, that the industry, using its political weight has been able to avoid the scrutiny of the Commerce Commission. It is clear that the merger proposal would not meet the requirements of the Commerce Act, since little change has occurred in the proposal to address the concerns the Commerce Commission raised in its draft report. These concerns did not focus solely on the weight of balance between producer and consumer interests.

2.6 The draft report by the Commission suggested the overall economic costs from the merger were greater than the expected benefits. The dairy industry was given the opportunity to provide more evidence that there were greater economic benefits from the merger or to alter the proposal to reduce the economic costs. It has done neither and has instead advanced a merger proposal that will have negative growth impacts on the economy.

2.7 To this extent we are concerned that much of the debate has focussed on the benefits of a major global exporter and the impacts on domestic consumers for basic dairy products. The debate has, however, completely overlooked the impacts on other manufacturers of food products in New Zealand which use dairy products as an ingredient. The draft Commerce Commission identified concerns by food processors about their ability to buy dairy products at competitive prices, particularly when there were examples of New Zealand dairy products being sold more cheaply on overseas export markets than in New Zealand. An example was documented where a local manufacturer resorted to importing New Zealand dairy product since that was a cheaper option to purchasing locally.

2.8 This is a key issue which may impact detrimentally on exporters of value-added dairy products and other processed foods, for which dairy products are an important ingredient. Successful export markets have been developed for a number of these products, where there are high import barriers on basic dairy products but much lower barriers for higher value products. A good example of this is the success of exporter Old Fashioned Foods, a recent Export Awards winner. They are successfully exporting steam puddings for sale in UK supermarkets, in part because high raw material prices in the UK make manufacturers of steam puddings less competitive there.

2.9 We are also aware of exporters selling to lower volume and/or higher specification customers the Dairy Board is unwilling to service. While these exporters will benefit from no longer having to gain annual export licences from the Board, their competitiveness is very dependant on being able to source dairy products at competitive prices.

2.10 We believe there are considerable risks from the merger proposal, and we agree with those that are listed in the Bill. We are also concerned with the regulatory model proposed and believe in the long term effective competition between two major processors would contribute more to economic growth than will be able to be achieved by a regulator.

3. Amalgamated Dairy Company

3.1 Business New Zealand considers there is a major question mark over the economic merits of amalgamating the processing capacity of the dairy industry so that it can take over the functions of the Dairy Board. We recognise there have been problems integrating the marketing and processing activities of the industry but have significant questions over the effectiveness of the Board as a global marketer or in moving the industry away from its focus on commodity products.

3.2 We are particularly concerned that the new structure will do nothing to move the industry forward through stimulating innovation in the industry or encouraging the further development of high value specialty products. We note that the highest paying dairy company over the past 10 to 12 years has been the Tatua Co-operative Dairy Company, with its focus on producing high value specialty dairy products.

3.3 We are also disappointed at the unwillingness of the industry to give consideration to the notion of external ownership of some part of the new company and the requirement for all suppliers to hold shares in the new company. Ownership by suppliers of the new organisation has been treated as a non-negotiable component of the discussion on structure by the industry, based on the view that external owners will reduce the level of returns to farmers.

3.4 Part external ownership would bring with it additional much needed capital to enable the sector to move forward. There is currently insufficient capital within the industry itself to provide the necessary finance required with, as a consequence, a high and increasing level of debt servicing in the sector. It has been acknowledged that significant capital is required to achieve the growth targets promised but these do not seem achievable with the proposed capital structure.

4. Tax Issues

4.1 Business New Zealand fully appreciates the tax issues being addressed in the Bill are important to the dairy industry and it is important they are resolved equitably. The problems faced by the dairy industry merger proposals however are generic to every other business sector. These are continuing issues for all businesses involved in mergers and company restructuring and can require a significant amount of resource to minimise the tax impacts. It is very disappointing the Government has chosen to only provide a resolution to this problem for the new Global Dairy Company and to not address the broader issues faced by industry. There is no basis for a special case for the dairy industry and the proposed concession creates a very negative impression for the balance of the business sector.

4.2 It is important these tax issues are addressed on a much broader basis, as they are an important impediment to restructuring in the business sector. If it is agreed to proceed with the present Bill we request that work be initiated to address the broader tax issues which impact on mergers and company restructuring.

5. Statistics

5.1 We noted in the introduction that the processing of dairy products is currently classified as a manufacturing activity under Division C of the Australia and New Zealand Standard Industrial Classification (ANZSIC) while the activities of the Dairy Board are classified as a wholesale activity under Division F of ANZSIC. We understand Statistics New Zealand are considering whether it is still feasible to split the returns from the new company into the two existing activities. We however, believe that the increased integration of manufacturing and marketing activities in the new company means it is preferable to classify all of the activity in the manufacturing sector. This will create a significant statistical break in current economic series but is a more sustainable long-term solution than trying to retain the status quo.

5.2 We also note that the current confidentiality provision within the Statistics Act means that sector data (apart from trade date) will no longer be released unless Global Dairy Company grants permission. We believe the Select Committee should address this issue and assurances should be sought from shareholding companies that they will agree to the release of the data. It is essential that data is available to allow for external scrutiny and analysis of the performance of the new company.

6. Conclusion

6.1 Business New Zealand is concerned with the poor quality of the Regulatory Impact and Compliance Cost Statement presented with the Bill. The Statement has been used to justify the Government's announced decision to allow the dairy industry to over-ride the competition provisions of the Commerce Act. This brings into serious question the value of including the Regulatory Impact and Compliance Cost Statement in new legislation if the Committee accepts the inadequate analysis provided with the Bill.

6.2 Business New Zealand recognises that reform of the dairy industry is urgently required. We however, favour a competitive structure with two major competing dairy companies over the single company, constrained by regulation, proposed in the Bill.

6. Recommendations

6.1 That the Committee establish more rigorous processes for the development of Regulatory Impact and Compliance Cost Statements and wider consultation with interested parties.

6.2 That for statistical purposes the whole of the activity of the Global Dairy Company be classified to ANZSIC Division C.

6.3 That an undertaking be sought from Global Dairy Company that it will not object to the release of dairy industry data collected under the Statistics Act.

6.4 That the creation of Global Dairy Company should be subject to the normal scrutiny under the Commerce Act.

6.5 That work be initiated to address the broader tax issues which impact on mergers and company restructuring.