Departmental Disclosure Statement

Dairy Industry Restructuring (Fonterra Capital Restructuring) Amendment Bill

The departmental disclosure statement for a government Bill seeks to bring together in one place a range of information to support and enhance the Parliamentary and public scrutiny of that Bill.

It identifies:

- the general policy intent of the Bill and other background policy material;
- some of the key quality assurance products and processes used to develop and test the content of the Bill;
- the presence of certain significant powers or features in the Bill that might be of particular Parliamentary or public interest and warrant an explanation.

This disclosure statement was prepared by the Ministry for Primary Industries.

The Ministry for Primary Industries certifies that, to the best of its knowledge and understanding, the information provided is complete and accurate at the date of finalisation below.

23 August 2022

Contents

Part One: General Policy Statement

The Dairy Industry Restructuring Act 2001 (the Act) was passed to enable the formation of Fonterra and to manage risks arising from Fonterra's dominance in New Zealand dairy markets. Subparts 5 and 5A of Part 2 of the Act promote the efficient operation of dairy markets in New Zealand by regulating the activities of Fonterra to ensure that New Zealand markets for dairy goods and services are contestable. To this end, the Act includes requirements relating to Fonterra's capital structure, as its share trading arrangements could impact on contestability in the market for farmers' milk supply.

Enabling Fonterra's new capital structure

Fonterra intends to implement a new capital structure to enable it to better compete for farmers' milk supply in the face of forecast static, or declining, milk production, and to efficiently use its existing processing infrastructure. Two key elements of Fonterra's new capital structure are —

- 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; and
- a restricted farmers-only market: the reduced minimum shareholding requirement will see Fonterra's existing farmer-shareholders potentially seeking to divest around one billion surplus Fonterra shares. If those shares were exchanged for units in Fonterra's unit fund it could cause the unit fund to grow significantly, increasing the proportion of external investor ownership in Fonterra. To avoid the cost of having to buy back shares to manage that risk, Fonterra intends to partially delink the unit fund and operate a restricted farmer-only market for its shares on a permanent basis. This will support Fonterra's ability to allocate capital to other competing business priorities but could constrain or deter farmers from exiting Fonterra, as they may not be able to realise the full value of their capital investment in the co-operative on exit. This could in turn constrain entry into the market or expansion by potentially more innovative or efficient dairy processors. Over time, this could reduce pressure on Fonterra to perform optimally and innovate.

The Act does not explicitly prohibit Fonterra from proceeding with its new capital structure. However, because key elements of the current capital structure are embedded in the Act, Fonterra could face the risk of a legal challenge if it partially delinks the unit fund on a permanent basis under the current provisions in the Act.

This Bill therefore amends the Act to explicitly enable Fonterra to keep the unit fund partially delinked on a permanent basis. Currently the Act 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. The amendment specifically excludes 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. This provision will remove the risk of a legal challenge that Fonterra may otherwise face if it proceeds without the proposed amendment to the Act. This will enable Fonterra to pursue its commercial objectives with certainty and to contribute to the benefit of farmers, rural communities, and the wider New Zealand economy.

Mitigating risks arising from new capital structure

The Bill also introduces 2 sets of measures to mitigate the risks arising from Fonterra's new capital structure.

Fonterra's base milk price-setting arrangements

A transparent, independent, and robust base milk price-setting process is important, as Fonterra's s dominance in the market for farmers' milk means that Fonterra essentially sets the milk price for the whole dairy industry. To attract and retain farmers' milk supply, other processors need to exceed Fonterra's milk price. The base milk price setting process promotes efficiency across the whole industry. The Act therefore includes provisions that govern the calculation of the base milk price, including monitoring by the Commerce Commission.
To improve the transparency and robustness of the governance and operation of Fonterra's base milk price-setting arrangements, the Bill —

- increases the number of Ministerial nominees to Fonterra's Milk Price Panel (the Panel) from 1 to 2, and provides for a maximum and minimum number of Panel members to ensure that the Ministerial nominees' contribution to the Panel's recommendations cannot be diluted; and
- requires the Chair of the Panel to be fully independent of Fonterra, appointed only with the approval of the Minister, and to be additional to the two Ministerial nominees to the Panel; 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.

To strengthen the Commerce Commission's oversight of the base milk price-setting regime, the Bill —

- gives the Commerce Commission the power to give directions to Fonterra on matters arising from the Commission's reviews of Fonterra's Milk Price Manual and the base milk price calculation; and
- sets out the scope, criteria, process, and means of enforcement for directions that the Commerce Commission could issue if Fonterra does not voluntarily comply; and
- clarifies the boundaries of the current safe harbour provisions that relate to the setting of the base milk price; and
- requires Fonterra to publish information relevant to the Commerce Commission's reviews, except where that information is commercially sensitive.

Liquidity in trade of Fonterra shares in its restricted farmer-only market

A restricted farmer-only market can impede the ability of farmers to trade shares and therefore limit farmers' ability to exit from Fonterra, either to switch their milk supply to other processors, thereby supporting contestability, or to move to alternative more sustainable land use. The Bill supports liquidity by —

- specifying that there will be a market maker in co-operative shares designated under relevant market rules to support ongoing liquidity; and
- requiring Fonterra to make independent market analysis of its performance accessible to farmers and unit holders; and
- requiring Fonterra to maintain and publish a dividend and retentions policy.

Technical amendments

The Bill also includes minor and technical amendments to —

- adjust the time frames for the Commerce Commission’s base milk price calculation review process; and
- expand the scope of leviable activities to cover the cost associated with the Commerce Commission’s issue of directions to Fonterra and any additional enforcement; and
- correct minor drafting errors and cross-references in the Act.

Part Two: Background Material and Policy Information

Published reviews or evaluations

2.1. Are there any publicly available inquiry, review or evaluation reports that have informed, or are relevant to, the policy to be given effect by this Bill?	YES

- Castalia: Independent analysis of Fonterra's proposed capital restructure , February 2022
- TDB Advisory Limited: Fonterra's Capital Restructuring Proposal – A Financial and Economic Assessment, December 2021
- Northington Partners: Fonterra Co-operative Council Capital Structure Review, October 2021
- Sapere: Fonterra capital structure review – competition effects, October 2021
- Frontier Economics: Fonterra's proposed capital restructure report, August 2021
- Sapere: Benefits of a strong co-operative, Kieran Murray , March 2021

Relevant international treaties

2.2. Does this Bill seek to give effect to New Zealand action in relation to an international treaty?	NO

Regulatory impact analysis

2.3. Were any regulatory impact statements provided to inform the policy decisions that led to this Bill?	YES

Review of Dairy Industry Restructuring Act 2001 in response to Fonterra's capital restructure – Regulatory Impact Assessment, Ministry for Primary Industries, April 2022
https://www.mpi.govt.nz/dmsdocument/50989-Review-of-Dairy-Industry-Restructuring-Act-2001-in-response-to-Fonterras-capital-restructure-Regulatory-Impact-Assessment

2.3.1. If so, did the RIA Team in the Treasury provide an independent opinion on the quality of any of these regulatory impact statements?	NO

The MPI Regulatory Impact Analysis Panel reviewed the Regulatory Impact Assessment "*Review of Dairy Industry Restructuring Act 2001 in response to Fonterra's capital restructure*" produced by MPI and dated April 2022. The review team considered that it partially meets the Quality Assurance criteria and stated as follows:

The Panel found the RIA met the *complete* QA criteria. However, while the Panel appreciates that efforts were made to make the RIA more clear and concise, there was too much detailed background information which obscures the problem definition, for this reason the Panel considered the RIA only partially met the *clear and concise* QA criteria. This also meant that the options analysis was not as convincing as could be, hence partially meeting the *convincing* QA criteria. The Panel notes there may be further consultation at a later stage but that there was no mention of Treaty partners or their involvement in the consultation process, further, there was a lack of clarity around who may be part of any wider consultation. The Panel therefore determined that the RIA partially met the *consulted* QA criteria. The Panel therefore concluded this RIA only partially meets.

2.3.2. Are there aspects of the policy to be given effect by this Bill that were not addressed by, or that now vary materially from, the policy options analysed in these regulatory impact statements?	**NO**

Extent of impact analysis available

2.4. Has further impact analysis become available for any aspects of the policy to be given effect by this Bill?	**NO**

2.5. For the policy to be given effect by this Bill, is there analysis available on:	
(a) the size of the potential costs and benefits?	**YES**
(b) the potential for any group of persons to suffer a substantial unavoidable loss of income or wealth?	**YES**
Qualitative and some limited quantitative analysis of the potential costs and benefits are summarised in the Regulatory Impact Assessment prepared to support the policy in this Bill.	

2.6. For the policy to be given effect by this Bill, are the potential costs or benefits likely to be impacted by:	
(a) the level of effective compliance or non-compliance with applicable obligations or standards?	**YES**
(b) the nature and level of regulator effort put into encouraging or securing compliance?	**YES**
A key risk mitigation measure in this Bill relates to giving the Commerce Commission the powers to make binding directions about its Milk Price Manual and base milk price calculation review findings. The effectiveness of this measure will depend on Fonterra's compliance with the Commission's directions. The effectiveness of the policy will depend on sufficient resourcing of the Commerce Commission to support its enforcement function.	

Part Three: Testing of Legislative Content

Consistency with New Zealand's international obligations

3.1. What steps have been taken to determine whether the policy to be given effect by this Bill is consistent with New Zealand's international obligations?
MPI has consulted the Ministry of Foreign Affairs and Trade on the policy given effect by this Bill. No international obligations have been identified or raised through the policy process as being relevant to the Bill.

Consistency with the Government's Treaty of Waitangi obligations

3.2. What steps have been taken to determine whether the policy to be given effect by this Bill is consistent with the principles of the Treaty of Waitangi?
MPI has consulted Te Puni Kokiri on this Bill. No inconsistencies between the proposals and the principles of the Treaty of Waitangi have been identified or raised through the policy process. The Bill does not specifically impact the rights or interests of Māori. There might be a concern about the fall in Fonterra's share price and its impact on Māori customary landowners' ability to leverage share equity. In contrast, a fall in Fonterra's share price would also enable Māori farmers to more easily become Fonterra farmer-shareholders given the reduced price of entry. We note that these effects arise from Fonterra's decision to change its capital structure and not directly from the Government's regulatory decisions.

Consistency with the New Zealand Bill of Rights Act 1990

3.3. Has advice been provided to the Attorney-General on whether any provisions of this Bill appear to limit any of the rights and freedoms affirmed in the New Zealand Bill of Rights Act 1990?	**YES**
Advice provided to the Attorney-General by the Ministry of Justice, or a section 7 report of the Attorney-General, is generally expected to be available on the Ministry of Justice's website upon introduction of a Bill. Such advice, or reports, will be accessible on the Ministry's website at http://www.justice.govt.nz/justice-sector-policy/constitutional-issues-and-human-rights/bill-of-rights-compliance-reports/	

Offences, penalties and court jurisdictions

3.4. Does this Bill create, amend, or remove:	
(a) offences or penalties (including infringement offences or penalties and civil pecuniary penalty regimes)?	**YES**
(b) the jurisdiction of a court or tribunal (including rights to judicial review or rights of appeal)?	**NO**

Clause 8 amends section 118 to provide that a failure to comply, without reasonable excuse, with new sections 109LA and 109LB (requirement to commission and publish financial markets research and analysis), section 135A (requirement to maintain and publish a dividend and retentions policy), and section 150ZD(2) (requirement to provide information requested by the Commerce Commission) is an offence. The above offences carry a maximum penalty, liable on conviction, of a fine not exceeding $200,000, and a fine of $10,000 for each day that the offence continues. The penalties are consistent and appropriate given the existing offences and penalties in the Act. Clause 16 amends section 150E to add new requirements on Fonterra regarding appointment of members of the Milk Price Panel. These requirements in s150E(1)(a) and (c) become subject to existing offence and penalty provisions in section 150E(3). Clause 17 creates a new section 150EA (requirement to engage and periodically rotate independent person(s) to calculate a base milk price). Under s150EA(6) it is an offence if Fonterra contravenes the requirements of s150EA. Clause 27 (section 150Z) provides for pecuniary penalties: failure by Fonterra to comply with a direction will be a civil contravention attracting a pecuniary penalty of up to $500,000 for each act or omission. Pecuniary penalties resulting from non-compliance with a direction, or a compliance order associated with a direction, will be able to apply to natural persons directly involved in the contravention as well as Fonterra as a corporate entity.

3.4.1. Was the Ministry of Justice consulted about these provisions?	**YES**
The Ministry of Justice (Offences and Penalties Vetting team) was consulted on the proposed pecuniary penalties, and indicated they were comfortable with the proposals. MPI provided information on the need for penalties to deter particular conduct, and information on precedents for similar levels of penalties in other legislation, to assure the Ministry of Justice of the necessity of including pecuniary penalties at their proposed levels. The Ministry of Justice has also queried the need for a daily fine of $10,000 for ongoing non-compliance (consistent with existing DIRA penalties). Justice officials commented that the use of such continuing penalties can lead to indeterminate and large financial sanctions with no effective maximum, and that they can also undermine the certainty of the law as the maximum amount someone can be fined is not able to be easily determined. MPI considers that a daily fine can serve an important purpose, namely providing an additional incentive to stop non-compliant behaviour in a timely manner. Fonterra share and unit holders trade their relevant securities on a daily basis. The new publication requirements could be a material driver for Fonterra’s share and unit prices, which may therefore be adversely affected by Fonterra’s potential non-compliance with the requirements. The Ministry of Justice ultimately indicated they were comfortable with the proposal.	

Privacy issues

3.5. Does this Bill create, amend or remove any provisions relating to the collection, storage, access to, correction of, use or disclosure of personal information?	**NO**

External consultation

3.6. Has there been any external consultation on the policy to be given effect by this Bill, or on a draft of this Bill?	**YES**

MPI undertook public consultation on Cabinet's in-principle policy decisions from 27 April to 3 June 2022. A consultation document was published on the Ministry for Primary Industries (MPI) website, along with the proactively released Cabinet paper, MPI's Regulatory Impact Assessment, Cabinet Minute (DEV-22-MIN-0085), expert reports commissioned by MPI, Fonterra, and other independent processors, and Fonterra's published details of its proposed capital restructure (see https://www.mpi.govt.nz/consultations/the-governments-proposed-response-to-fonterras-capital-restructure/ Written and oral submissions were received from 20 submitters: eight farmers/farmer organisations (suppliers to Fonterra and independent processors), four independent dairy processors, two investors in the unit Fund and the Subcommittee of the Manager of the unit Fund, one Māori agribusiness collective, two environmental groups, one taxpayer advocacy organisation, and Fonterra. Comments covered a wide spectrum ranging across: a) The Government should not amend the Dairy Industry Restructuring Act (DIRA) to support Fonterra's capital restructuring. b) The Government should amend the DIRA to support Fonterra's capital restructuring but not impose any other regulation (proposed mitigations) on Fonterra. c) If the Government amends the DIRA to support Fonterra's capital restructuring, it should impose much more stringent regulation, particularly in respect of Fonterra's milk price. d) The Government should take holistic decisions in the context of a comprehensive regulatory review and bring forward the statutory review of the DIRA that would otherwise commence between June 2025 and June 2027.

Other testing of proposals

3.7. Have the policy details to be given effect by this Bill been otherwise tested or assessed in any way to ensure the Bill's provisions are workable and complete?	**YES**
MPI has worked closely with the Commerce Commission on the draft Bill to ensure the Commerce Commission, as the regulator, will be able to implement and enforce the proposals.	

Part Four: Significant Legislative Features

Compulsory acquisition of private property

4.1. Does this Bill contain any provisions that could result in the compulsory acquisition of private property?	**NO**

Charges in the nature of a tax

4.2. Does this Bill create or amend a power to impose a fee, levy or charge in the nature of a tax?	**YES**

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 through the Dairy Industry (Levy Process) Regulations. Amendments to the DIRA will give the Commerce Commission the power to give directions to Fonterra on matters arising from the Commission's review of Milk Price Manual and the base milk price calculation. The Bill provides for the Commission's exercise of the new powers to be a leviable activity, which will therefore be cost-recovered from Fonterra, as part of the current Fonterra levy process. The extent of costs to be recovered from Fonterra as a result of the Bill will depend on whether or not the Commerce Commission needed to have recourse to the new powers. It is anticipated that this would be rare: the intent is that the existence of such powers would, in themselves, act as an incentive on Fonterra voluntarily to have close regard for the Commission's findings. In addition, there are safeguards and constraints governing the issue of directions, to ensure that the process is fair, transparent, evidence based, subject to consultation and to judicial review.

The Commission's costs of investigating and enforcing potential non-compliance by Fonterra are also levy funded. Since the Bill includes new obligations on Fonterra, the scope of the Commission's enforcement function (and therefore the potential costs and levy amounts) will be expanded to cover these new obligations.

Retrospective effect

4.3. Does this Bill affect rights, freedoms, or impose obligations, retrospectively?	**NO**

Strict liability or reversal of the usual burden of proof for offences

4.4. Does this Bill:	
(a) create or amend a strict or absolute liability offence?	YES
(b) reverse or modify the usual burden of proof for an offence or a civil pecuniary penalty proceeding?	NO

Clause 8 amends section 118 to provide that a failure to comply, without reasonable excuse with new sections 109LA, 109LB, 135A or with a requirement in a notice given under section 150ZD(2) is an offence.

The requirements provided in new sections 109LA, 109LB and section 135A are intended to mitigate risks that arise as a result of changes to Fonterra's capital structure. They provide straightforward practical obligations on Fonterra, to make available information to farmer shareholders and those considering investment in Fonterra to enable informed investment and share trading decisions. The obligations are straightforward and are not considered to give rise to compliance risks for Fonterra, given that these obligations reflect what would be considered good business practice in any event. The power for the Commerce Commission to require information under section150ZD(2) are modelled on similar powers under section 53ZD of the Commerce Act, non-compliance with which is also an offence.

Clause 16 amends section 150E to add new requirements on Fonterra regarding appointment of members of the Milk Price Panel. These requirements in s150E(1)(a) and (c) become subject to existing offence and penalty provisions in section 150E(3). Clause 17 inserts new section 150EA. New section 150EA(6) provides that contravention of the requirements of section 150EA without reasonable excuse is an offence.

These requirements strengthen the independence of the Milk Price Panel, which is an essential part of the base milk price-setting regime. New section 150EA requires Fonterra to appoint an independent person or persons (in practice known as Fonterra's Milk Price Group) to calculate the base milk price and to periodically change that person or persons to ensure that appropriate independence is maintained. The base milk price-setting arrangements have a major impact on farmers and on the wider dairy sector. Because Fonterra is dominant in the market for farmers' milk, Fonterra's decisions on pricing essentially determine the seasonal milk price across all dairying. It is therefore essential that all elements of the base-milk price-setting arrangements are credible – there is a risk that, if the base milk price is not rigorously and independently set, this could impose undue costs onto the dairy sector, and constrain long-term investment and innovation. Fonterra does not, however, face undue risk and constraint on its ability to comply – this is a function that Fonterra needs to have undertaken and the periodic requirement to rotate the contracted party (6 dairy seasons), means that Fonterra has a relatively long planning horizon for compliance.

Civil or criminal immunity

4.5. Does this Bill create or amend a civil or criminal immunity for any person?	NO

Significant decision-making powers

4.6. Does this Bill create or amend a decision-making power to make a determination about a person's rights, obligations, or interests protected or recognised by law, and that could have a significant impact on those rights, obligations, or interests?	NO

Powers to make delegated legislation

4.7. Does this Bill create or amend a power to make delegated legislation that could amend an Act, define the meaning of a term in an Act, or grant an exemption from an Act or delegated legislation?	**NO**

4.8. Does this Bill create or amend any other powers to make delegated legislation?	**NO**

Any other unusual provisions or features

4.9. Does this Bill contain any provisions (other than those noted above) that are unusual or call for special comment?	**NO**