

OVERVIEW OF PRODUCER BOARD ISSUES

Summary

A vibrant, entrepreneurial and internationally competitive agribusiness sector is vital to New Zealand's economic success.

New Zealand's main agricultural and horticultural sectors, however, are generally in a depressed state. While some farmers and growers are doing well, overall the agribusiness sector is characterised by weak profits and continued dependence on unbranded commodity products with declining prices. In the current climate, and with current structures, many parts of New Zealand's agribusiness sector are unlikely to be attractive to those with ability or capital.

The Government has an important role to play in influencing the future prosperity of the agricultural and horticultural sectors. The Government cannot guarantee the prosperity of these sectors but it can, by its legislation and regulations, create a framework that encourages productivity, innovation and wealth creation.

In recent years there have been important changes in the regulatory regime for the agricultural and horticultural sectors, including some to the regimes applying to Producer Boards. However, the current regimes for the Boards still impose too many unnecessary costs on farmers and provide incentives for farmers and other agribusinesses to engage in activity that is not wealth enhancing.

Further, ongoing change in the policy environment is necessary if the Boards are to remain relevant to the future competitive environment. In tomorrow's global environment, the strength and prosperity of New Zealand's agribusinesses is likely to depend not so much on their reliance on statutory structures as on their flexibility, creativity and ability to meet customers' changing needs.

Introduction

This paper provides an overview of public policy issues relating to the agricultural and horticultural Producer Boards.

The paper first provides summary background information on the Boards. The paper then outlines recent developments in the markets the Producer Boards operate in and in the regulatory regimes governing the Boards. Finally, the paper highlights the policy issues likely to face Ministers in relation to the Producer Boards over the coming months.

Background

There are currently eight statutory Producer Boards. Table 1 (attached as an appendix) provides summary statistics for each Board.

Each Board is different in terms of its historical development, current functions and legislative regime.

The main Boards are the three big trading Boards - Dairy, Apple and Pear and Kiwifruit. These Boards had revenues of \$7.7 billion, \$784 million and \$550 million respectively in 1998. Together they account for around 23 percent of New Zealand's export revenues. These Boards currently have

a statutory near-sole right to purchase for export New Zealand-produced dairy products, apples and pears or kiwifruit.

Four of the other Boards (Meat, Wool, Game and Pork) are “non-trading” Boards, meaning they do not acquire or on-sell the basic product. Rather, these Boards provide to farmers, under statute, certain services – e.g. promotion and research and development services.

The final Board is the Hop Marketing Board, which has a statutory sole right to market hops, both domestically and offshore.

In the 1998 Budget the Government asked each Board to prepare a plan outlining how it would adjust and operate without special statutory backing.

In October 1998, the Producer Board Project Team (PBPT) was established by the Government. The PBPT is an interdepartmental unit tasked with working with the Boards and industries and advising Ministers on the public policy issues relating to the Producer Boards.

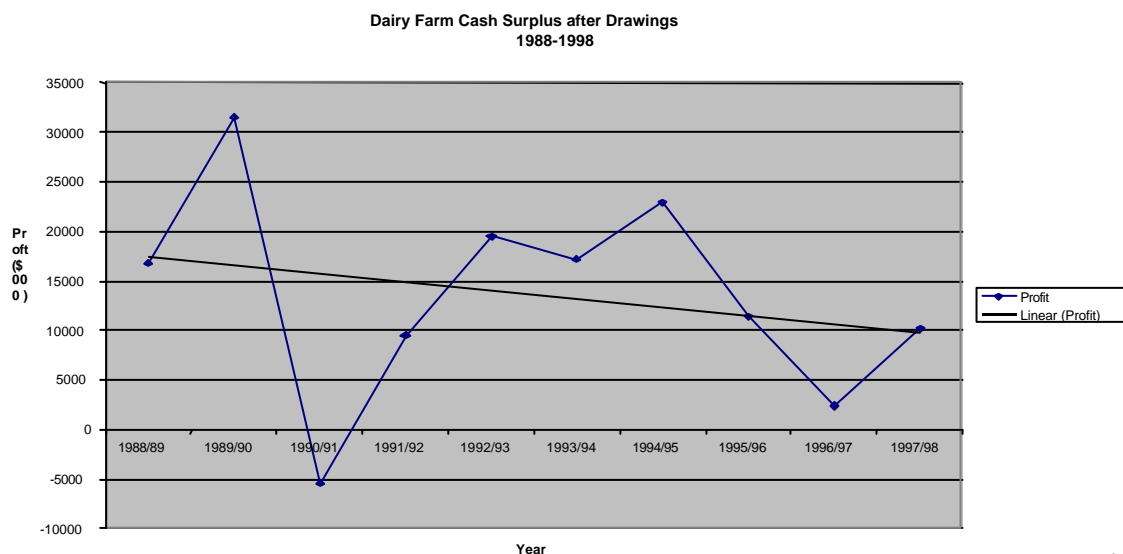
While the Government’s reform direction was initially received by the Boards and many industry players with considerable disquiet, packages for legislative change were negotiated and legislation was passed for the dairy, apple and pear and kiwifruit industries in September 1999. These legislative changes and the challenges the industries continue to face are described below.

Recent Developments

Dairy

While New Zealand dairy farmers are widely regarded as being the most efficient producers of milk in the world, their net incomes have declined significantly over the last decade (refer Figure 1 overleaf). Milk output has increased significantly, but this volume increase has been offset by falling commodity prices. Further, with 70 percent of New Zealand dairy exports unbranded, New Zealand remains highly exposed to fluctuations in international commodity prices.

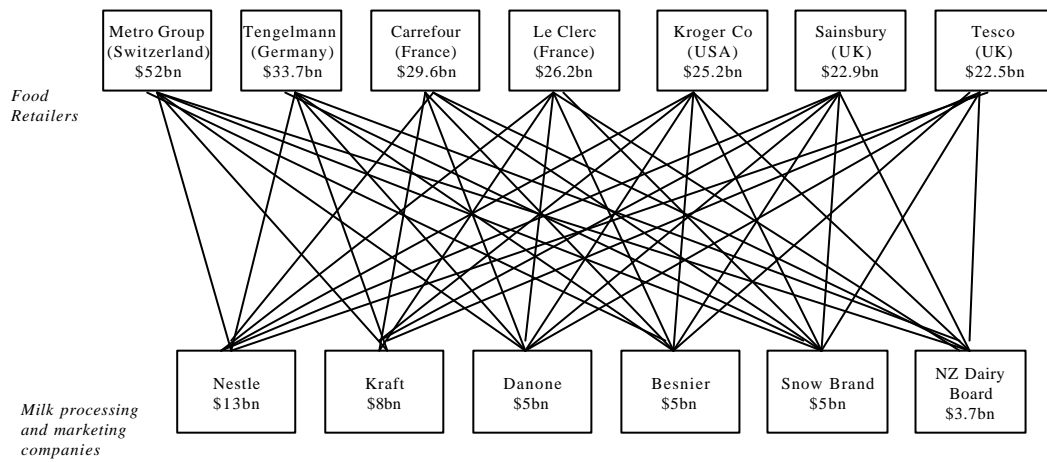
Figure 1



The dairy products industry today is a global industry. The market is dominated by huge multinational retailers: the ‘hypermarkets’ like Metro Group, Tengelmann, Carrefour and Le Clerc, each with revenues five to 10 times the size of the Dairy Board. These retailers source products from around the world. As *Figure 2* below indicates, the Dairy Board must compete with many, often much larger, milk processing and marketing companies for the custom of these ‘hypermarkets’.

Figure 2

1990s : Globalisation of the Dairy Industry



\$ figures are Revenue: \$US in 1996 - Source: Rabobank International, "The World Dairy Market"

Like other global industries, the dairy products market is changing rapidly. Processors of dairy products are generally becoming larger, while marketers are quite diverse, with most using their supply chain networks to manage a variety of food products. Domestically, the New Zealand dairy industry has responded to change, mainly by mergers at the processor level and by off-shore investments by the Dairy Board (which now total \$2.4 billion). However, the industry still faces major problems. Behind the declining trend in farmer profits are a number of underlying problems including:

- low returns on investment;
- poor price signals, leading to over production of milk;
- continued reliance on low-margin commodity exports; and
- excess politicisation of decision-making.

The industry's current proposal to improve returns is to expand offshore through mergers and acquisition, while establishing onshore a 'Megaco-op'. This 'Megaco-op' would integrate the great majority, if not all, of the processor co-operatives and the Dairy Board into a single integrated company.

After dialogue and negotiation with industry leaders, the Dairy Industry Restructuring Act (DIRA) was developed and passed in September 1999. This Act addressed the key public policy issues relating to the proposed 'Mega Co-op'.

In summary, the DIRA:

- establishes exclusive rights to export to designated (quota) markets for the 'Mega Co-op' for six and a half years, with a new allocation body established to allocate export licences to the designated markets on a phased-in basis thereafter;
- deals with taxation issues relating to the 'Mega Co-op', including transferring the Dairy Board's available subscribed capital to the 'Mega Co-op';
- allows for the Livestock Improvement Corporation to revert to a farmer-owned corporation, the Dairy Research Institute's assets to be transferred to a subsidiary company of the Dairy Board and 'industry good' activities to be funded through compulsory levies;
- converts the Dairy Board into a subsidiary company of the 'Mega Co-op';
- allows co-operatives that do not wish to participate in the 'Mega Co-op' to exit and take the fair value of their investment in the Board with them; and
- removes the statutory single desk arrangements.

The legislation only comes into effect if the merger is approved by farmers and authorised by the Commerce Commission by 1 September 2000. To establish the 'Mega Co-op' requires the merger of co-operatives accounting for at least 75% of the shares in the Dairy Board (effectively a merger of at least the two largest co-operatives, NZDG and Kiwi). A merger of the co-operatives requires

support of 75% of the votes cast, with votes held by supplier-shareholders on a milk solids-supplied basis.

Apples and Kiwifruit

The fortunes of apple and kiwifruit growers have differed markedly in recent years. The incomes of apple growers have declined sharply with many claiming the industry now faces a crisis. Kiwifruit growers, on the other hand, have fared well in the last few years and are currently enjoying high prices and favourable international market conditions.

The current fortunes of the apple and pear and kiwifruit industries contrasts with the situation in the early 1990s when the apple industry was going through a strong phase but the Kiwifruit Marketing Board faced a financial crisis. Overall, neither industry has been a consistently strong performer.

In recent years the apple industry has been consolidating domestically, with average orchard size increasing and packhouses being rationalised. Much of this rationalisation was driven by the Apple and Pear Marketing Board.

The kiwifruit industry has been expanding. Onshore deregulation has seen growers benefit from reductions in cost and more responsive service with the rapid emergence of sizeable supply chain managers.

Both of New Zealand's fruit Boards face substantial challenges with increasingly competitive international markets, consolidation of buyer groups, new entrants and other producing firms increasing their market share and competitors innovating in such areas as packaging, logistics, category management and customer relations. Their competitors, such as Dole, Fyfes and Del Monte, are not restricted in their ability to use the benefits of their supply chains and customer relations to forge strategic alliances and global marketing arrangements. In contrast, New Zealand's fruit Boards are required to focus on New Zealand-grown pipfruit and kiwifruit respectively. The New Zealand fruit Boards also have limited sources of capital and are restricted in their ability to make international investments.

The Apple and Pear Industry Restructuring Act and the Kiwifruit Industry Restructuring Act were passed in September 1999. These Acts will establish, from 1 April 2000, the Boards' commercial operations (ENZA and Zespri respectively) as companies with shares tradable among producers. Regulations made under these Acts:

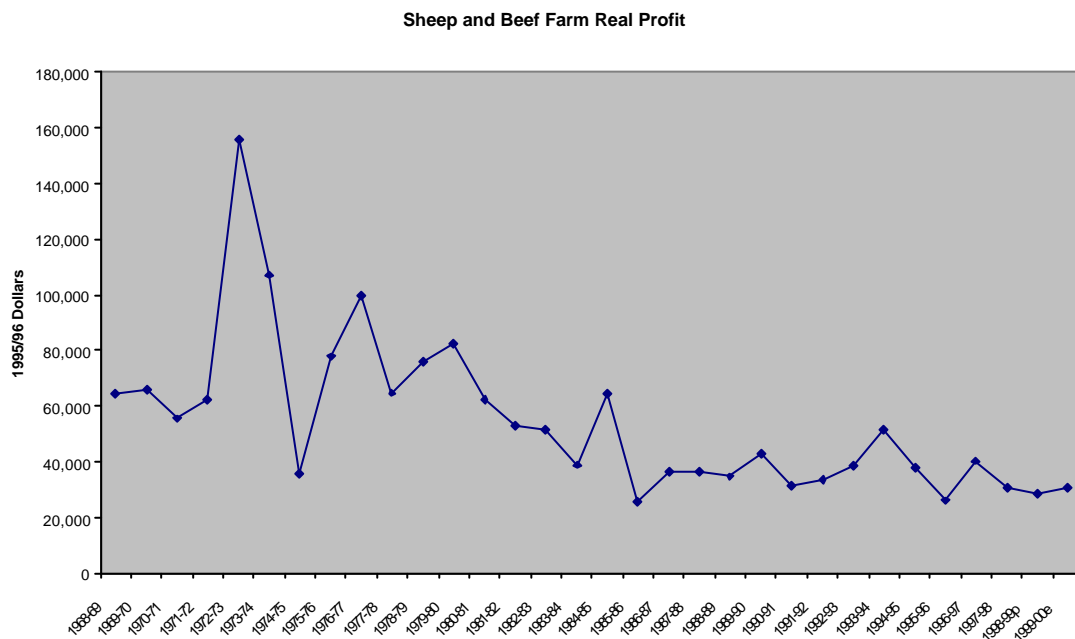
- retain the near-sole right for ENZA and Zespri to purchase growers' product for export, although other exporters can apply for export licenses;
- subject ENZA and Zespri to extensive regulations, including rules on non-diversification, non-discrimination, and information disclosure, and, in the case of ENZA, arms-length rules so it does not unduly favour its on-shore logistics business. These regulations are designed to protect growers while the export restrictions remain;

- establish new Boards (the Apple and Pear Board and the Kiwifruit Board) that are independent from the commercial activities of ENZA and Zespri and that are responsible for monitoring and ensuring ENZA's and Zespri's compliance with the regulations; and
- establish an independent Export Permits Committee for apples and pears that can grant licences for independent exporters so long as their exports do not undermine ENZA. In the case of Kiwifruit, the new Kiwifruit Board will decide on collaborative marketing applications and has the power to require Zespri to work with approved collaborative marketers.

Non-Trading Boards

As noted above, there are four non-trading boards (Meat, Wool, Game and Pork). Farmers in these sectors are under pressure with generally static or declining real incomes in the face of steadily declining commodity prices (refer Figure 3). Prices for wool growers have been especially depressed.

Figure 3



Source: NZ Meat and Wool Board Economic Service

In 1998/99, farmers were levied \$71m to fund the non-trading Boards.¹ The Boards' funds were used to finance the Boards' activities in such areas as generic promotion, advertising, research and development and administration.

¹ The average sheep farmer paid \$3,300 in levies in 1998.

At present, farmers have no direct say in how much they pay to the Boards or what the funds are spent on. Farmers' influence is only indirect, that is, through their election of Directors to the Boards and views expressed at, for example, Annual Meetings.

In addition, while farmers are recognised as the underlying owners of the non-trading Boards, they:

- have no specific share interest in these Boards
- have no choice over how much they invest in the Boards; and
- receive any return on their investment indirectly, in the form of Board activities such as research and promotion.

The non-trading Boards have held substantial reserves on behalf of their owners, but these reserves have run down considerably in recent years (from around \$650m in 1988 to around \$250m now).

The non-trading Boards are each established and funded under their own individual statutes or regulations². Earlier this year, the Producer Board Project Team developed, in consultation with the Boards and industries, a generic funding regime for the Boards. The regime would give farmers direct say in the level and allocation of the levies, tightly define the activities levies could be used to fund and impose greater accountability on the Boards for the use of the funds. This proposal is set out in a draft Compulsory Levies Bill. The Bill was not finally agreed to by the Boards and has yet to be finalised by the Government.

Issues Facing the Government

Dairy

With the passage of the DIRA, the direction and pace of structural change in the dairy sector is primarily in the hands of the industry.

The industry's initial application to the Commerce Commission, however, was rejected at the draft determination phase and was subsequently withdrawn by the industry. The Commission considered that the anti-competitive costs outweighed the benefits. The Commission expressed particular concern that farmers would lack choice about whom they could supply milk to. They were also concerned that domestic consumers would have limited choice of suppliers of dairy products. The Commission also noted that much of the asserted benefits were able to be gained without a 'Mega Co-op'. The industry has yet to submit a second application, and is now not expected to submit it till February/March 2000. The industry will have to address the Commission's concerns, including in particular the right for farmers to exit the 'Mega Co-op' with the fair value of their capital, if the application is to be successful.

If the industry can effect a merger of NZ Dairy Group and Kiwi Dairy by 1 September 2000 on terms that are acceptable to farmers and the Commerce Commission, the industry will move towards a standard commercial legislative environment. The industry would then be free to evolve and respond to the changing international market place without the restrictions imposed by current

² The Game Industry Board is established under the Primary Products Marketing Act.

legislation (such as the requirement to get Parliament's approval to change their domestic payment arrangements or the constitution of the Board).

If, however, the industry cannot agree on merger terms that are also acceptable to the Commerce Commission, the DIRA will not come into effect. If this happens there may well be demands on the Government to provide an exemption from the Commerce Commission process for the industry. We would strongly argue against any such exemption as it would expose farmers and domestic consumers to an entity with considerable market power, create a precedent for other industries and harm the domestic and international credibility of New Zealand's current competition policy.

Alternative options if the DIRA does not come into effect include maintaining the status quo or revisiting specific elements of the DIRA. Maintaining the status quo, however, is not considered a viable option given the challenges facing the industry.

One option, if the DIRA does not come into effect, would be to move the industry to general competition and governance law based on the current industry structure of effectively two very large co-operatives. (Assuming the Kiwi/Northland merger is approved by farmer-shareholders.) Such a step, if the co-operatives are fully exposed to competition, could offer significant advantages to farmers and the New Zealand economy. In particular, it would enable the industry to capture the benefits of vertical and horizontal integration while retaining the current advantages (such as benchmark competition) of having more than one major domestic processor. The implications for the Dairy Board and for the tax and quota elements of the DIRA would need to be worked through thoroughly before making any decisions in this regard.

Fruit

Both the Kiwifruit Marketing Board and the Apple and Pear Marketing Board are required by their respective legislation to submit restructuring plans to the Minister. The restructuring plans include a share allocation plan, a constitution for the new company and associated documentation.

The Kiwifruit Marketing Board's plan was received before the General Election and was approved by the previous Minister on 24 November 1999 to progress to a producer referendum. Seventy-five percent voter approval is required at the referendum for the plan to come into effect. The results of the referendum are expected before Christmas.

The Apple and Pear Marketing Board submitted its restructuring plan on 1 December. No decision was made on the plan by the previous Minister. The Minister must approve the plan, as soon as practicable, to enable it to progress to a grower referendum.

The share allocation plan for apples and pears has proved controversial with the Canterbury Fruitgrowers Association who have filed a claim in the High Court seeking an interim declaration from the Court stopping the Minister approving or declining the plan. The plaintiff's concerns relate to the proposed basis for allocating shares. A hearing was held in the High Court on 6 December 1999, while interim orders were not granted, an application for review was set down for hearing on 2 to 4 February 2000. This means the Minister can proceed to consider, and if appropriate, approve the plan, but on the clear expectation of a judicial review.

The new regulatory regimes for the apple and pear and kiwifruit export industries provided by the recent legislation are expected to offer some advantages. With growers' ownership rights in ENZA and Zespri being explicit and tradeable, and with the domestic logistics business for apples also deregulated, the two organisations are expected to face greater commercial pressures to perform. In addition, the requirements for greater financial disclosure, the rules on non-diversification and the arms-lengths rules (for ENZA) are designed to help protect growers and others' interests while ENZA and Zespri retain the sole or predominant right to buy fruit for export.

However, the industries will continue to face major change, both domestically and offshore. The results of the recent legislative changes were agreed by the Boards and the Government in a negotiation process and will need to be monitored closely. It is likely that further changes will be required sooner rather than later to allow the industries to keep pace with the rapidly changing marketplace.

Non-Trading

As noted above, the non-trading Boards are significant users of farmers' money, at a time when farmers' incomes are under pressure.

The current legislative backing for the non-trading Boards could be improved and in a way that would reduce costs for farmers. In particular, legislative changes could permit farmers to decide how much they have to pay for the Boards' services, what services they buy, how much they are required to invest in the Boards and the appropriate organisational form and governance arrangements for their Boards.

Consultation

The Department of Prime Minister and Cabinet, Inland Revenue Department, Ministry of Agriculture and Forestry, Ministry of Commerce, Ministry of Foreign Affairs and Trade, Te Puni Kokiri and the Treasury have been consulted in the preparation of this report.

Next Steps

The new Government will be required to make several key decisions, and may face some demands for legislative changes, in the Producer Board area.

The critical next step in dairy restructuring is for NZDG and Kiwi to agree the terms of their merger. If this occurs by the end of January, the industry is likely to submit an application for authorisation to the Commission by around March, with a vote of shareholders around May. If the 'Mega Co-op' gets both farmer and Commerce Commission approval, the Dairy Industry Restructuring Act comes into effect.

However, if NZDG and Kiwi fail to agree on merger terms, or the 'Mega Co-op' fails to get farmer or Commerce Commission approval, the industry may well come back to the Government looking for legislative changes. In such circumstances, a further round of Government/industry consultation seems inevitable. The Government will want to have a well-developed policy direction in such an event.

In the case of the fruit Boards, the key next steps for the Government are:

- the consideration of the Apple and Pear Marketing Board's plan (which was submitted to the Minister on 1 December 1999 and is subject to a High Court review on 2-4 February);
- consideration of the information provided to growers by the Kiwifruit Marketing Board and the Apple and Pear Marketing Board for their respective referenda on the restructuring plans (as approved by the Minister);
- approval of the enforcement regime for the new (regulatory) Boards in time for the new regimes to apply (1 April 2000 for apples and pears and 1 June 2000 for kiwifruit); and
- monitoring the effective implementation of the new regulations by the new Boards.

For the non-trading Boards, there are no actions currently under way that require immediate Government decisions. However, increasing grower dissatisfaction with the status quo for the non-trading Boards suggests further legislative change will be necessary.

Phil Barry
Team Leader

Table 1 - Summary of Producer Board Operations 1998

	Annual Turnover (\$ million)	Assets (\$ million)	Equity (\$ million)	Contributing Members (Estimates)
NZ Dairy Board	7,677	4,200	1,599	14,500
NZ Apple and Pear Marketing Board	784	288	139	1,200
NZ Kiwifruit Marketing Board	550	53	3	1,800
NZ Hop Marketing Board	0.4	0.4	0.3	26
NZ Meat Board	37	142	133	16,800 ^a
NZ Wool Board	54	145	128	
NZ Game Industry Board	8	5	3	3,500
NZ Pork Industry Board	5	5	5	600
TOTAL	9,115	4,838	2,010	38,426

Source: Annual reports

Note:

- a. The figure for total commercial beef and sheep farms was provided by the NZ Meat and Wool Economic Service. Not included in this figure are small holdings, government-run farms, studs and mixed-use farms, and farms run in conjunction with other properties. It is estimated that including these would add around 6,000 extra members for wool and 14,000 extra for meat.

Briefing for the Incoming government on the dairy industry

Executive Summary

1. There is a tremendous amount at stake for New Zealand in the future of the dairy industry.
2. While NZ dairy farmers are widely regarded as the being the most efficient in the world, it is generally accepted that the industry now faces significant challenges. Farmers' net incomes have declined significantly over the last decade and returns on investment are poor. Further, the industry continues to rely heavily on unbranded products whose prices are volatile and trending downwards.
3. In response to these challenges, dairy industry leaders have proposed establishing a 'Mega co-operative' integrating most, if not all, of the processing co-operatives and the Dairy Board into a single company.
4. After negotiations with the industry leaders, the Government passed the Dairy Industry Restructuring Act (DIRA) in September 1999. The Act addresses the key public policy issues relating to the Mega co-op, including tax, quota and industry good issues and the removal of the single desk. The Act only comes into effect if the Mega co-operative is approved by farmers and authorised by the Commerce Commission by 1 September 2000.
5. If, however, the industry cannot agree on merger terms that are also acceptable to the Commerce Commission, the DIRA will not come into effect. If this happens there may well be demands on the Government to provide an exemption from the Commerce Commission process for the industry. We would strongly argue against any such exemption as it would expose farmers and domestic consumers to an entity with considerable market power, have a dangerous precedent effect for other industries and harm the domestic and international credibility of New Zealand's competition policy.
6. Options if the DIRA does not come into effect include maintaining the status quo or revisiting specific elements of the DIRA. Maintaining the status quo, however, is not a viable option given the challenges facing the industry.
7. The most viable option in the absence of a Mega co-operative would be to move the industry to operate under general competition and governance law, based on the current industry structure of effectively two very large co-operatives. Such a step could offer significant advantages to farmers and the NZ economy if the industry was opened fully to competitive pressures. In particular, it would enable the industry to capture the benefits of vertical and horizontal integration while retaining the current advantages (such as benchmark competition) of having more than one major domestic processor.
8. This 'two company' option is likely to be a less risky strategy than the single Mega co-operative model, which effectively places all the industry's eggs in one basket. The implications of this option for the Dairy Board and for the tax and quota elements of the DIRA would need to be worked through thoroughly.

Introduction

9. This briefing describes:

- the structure of the New Zealand dairy industry, its economic prospects and relevant international trends;
- historical and current roles of the New Zealand Dairy Board;
- the drivers of change in the New Zealand dairy industry;
- recent industry changes, and the current state of play on proposals for industry restructuring; and
- the industry's options for change and the choices faced by the Government.

The Dairy Industry in New Zealand

10. There are approximately 14,700 dairy farmers, mainly in the Waikato and Taranaki areas, but with significant recent expansion in Southland.

11. Dairy farmers are currently grouped into:

- Three Main Co-operatives:

- New Zealand Dairy Group	58%;
- Kiwi	27.8%;
- Northland	8.6%;

- Five Smaller Co-operatives:

- Westland	2.5%;
- Tasman	1.5%;
- Tatua	0.8%;
- Marlborough	0.5%;
- Kaikoura	0.3%.

The percentages relate to shares in the Dairy Board and exclude supplies to smaller liquid-milk supply co-operatives that are not part of the Board structure.

12. NZDG and Kiwi dominate the domestic milk market. The only other North Island supplier is Northland (now merging with Kiwi and also involved in the mega merger). In the South Island there are other small producers but these largely sell under franchises. The liquid milk market is dominated by national or island-wide supply agreements with supermarkets and petrol stations. The dairy co-ops are the only significant producers of products such as cheese and yoghurt.

13. New Zealand dairy farmers have steadily expanded production through more efficient methods and farm aggregation, to maintain profits in the face of declining prices.

Overseas Trends

14. Huge retail chains dominate overseas markets. These chains require sophisticated management of their supply chains to minimise costs and to meet growing pressure from consumers on safety and environmental issues. Competition on the supply side is dominated by large domestic co-

operatives and firms such as Nestle or Parmalat who expand mostly by buying into new countries.

15. Most of New Zealand's dairy exports are general products that earn little or no brand premium but, apart from quota and similar markets, most profits internationally are in branded specialist products.
16. New Zealand represents a very small share of total world production and consumption of dairy products. Although New Zealand's share of traded dairy products is higher, this does not translate into an ability to affect world prices.

The Dairy Board

17. The Dairy Board was originally responsible for co-ordinating overseas sales by a large number of small co-operatives serving strictly local collection areas. These small co-operatives were concerned to counter-balance the power held by the middlemen in overseas markets - effectively Britain. The Board was in a very strong position given its advantages in resources and information and the lack of a formal share structure to define its ownership.
18. The Dairy Board's position is now weakened because of domestic consolidation. Domestic consolidation has created three major producers/shareholders. The continued exercise of the Board's allocation powers for production of high-value products now clashes directly with the interests of each of those companies, creating potential conflicts for its directors. The Dairy Board Act prevents resolution of these clashes because no company can elect a majority of the Board or buy any other company's shares without a full merger.
19. The Board's role is also weakened by the greater range of overseas markets into which New Zealand's dairy products are now sold. As a result, the uncertainty that was always present about whether the Board has any market power to influence prices is stronger than ever.
20. Further, the current legislation imposes weak governance on the Board, limits the Board's access to capital, requires the Board to have multiple objectives (as both an exporter and regulator) and limits the scope for innovation in the industry.
21. In essence, the current legislative structure for the Board, rather than being a solution, may now be a problem in itself. It impedes the ability of the industry to adjust and compete in a much-changed international market.

Issues Facing the Dairy Co-operatives

22. The dairy co-operatives are also now facing problems with the current legislative structure, partly because of the industry's success. The key areas are pricing, capital and governance.

Pricing

23. The price paid to farmers per kilo of milk solids is a combination of the value of milk as a raw ingredient, the value added by processing and the value added by marketing. Since milk from new farms or from growth at existing farms is paid this *bundled* price (which exceeds the marginal value of the milk), there is an incentive to produce milk which costs more than it is worth. This penalises existing farmers and requires ongoing capacity expansion.
24. Changing pricing policy is difficult because of:

- an industry focus on equality that requires cross-subsidisation;
- the type of co-operative structure operating in the dairy industry, (for example, all shareholders are producers with shareholding in proportion to supply and dividend payments vary with production in the same way as payments for milk);
- the absence of outside equity and market-determined share values; and
- the need to change legislation to alter payment arrangements. Commercial flexibility will continue to be limited as long as a specific statutory framework for the dairy industry remains.

Capital

25. There are three distinct problems relating to the industry's use of capital:

- price bundling means that the limited capital available to rural New Zealand is being diverted into farm conversions where the returns to New Zealand as a whole are less than the costs;
- the Board and co-operatives face few disciplines in borrowing as their debt commitments can be met before paying the residual income to farmers. Farmers conversely face strong disciplines because of their uncertain commitments to provide additional capital and the residual nature of their incomes; and
- as additional capital is required to handle the additional milk encouraged by price bundling, the capital is obtained by either loans (repaid by reducing payouts) or directly by reducing payouts. Equity is not raised externally and the management faces limited incentives to use the capital efficiently.

Governance

26. There are several related problems in regard to governance in the dairy industry:

- as co-operatives have increased in size, the ability of individual farmers to monitor the co-operatives effectively has been reduced;
- monitoring has been addressed by ward systems of election, meaning that any director's tenure can depend on local political factors more than commercial expertise;
- at the same time, minorities cannot in practice exit the company without exiting the industry;
- although farmers can, and do, challenge directors to demonstrate performance, the size of the companies means farmers have relatively little power to ensure that the promised performance occurs;
- unlike shareholders on standard companies, farmer-shareholders cannot sell their shares and the share price cannot act as a signal of investors' concerns; and
- external pressures on co-operative management have been further reduced by the declining number of co-operatives against which to benchmark performance.

Conclusion

27. These problems in the areas of pricing, capital and governance combine to restrict the options of industry participants and distort their incentives. As a result, the industry is unlikely to be close to maximising the return on its substantial capital investment (at the farm, processing or marketing levels) or exploiting the full scope for innovation in the face of changes in technologies and markets.
28. It is important to note that these problems do not mean that the co-operative structure is somehow inappropriate for the dairy industry. There are good reasons why co-operatives can and do make good economic sense in the dairy and other industries. From a public policy perspective, the problem is the existing legislation mandates a co-operative structure for the dairy processors and puts in place restrictions on the type of co-operatives that dairy co-operatives can be. As a result, the legislation prevents the evolution of alternative co-operatives or other corporate forms that may suit farmer-shareholders better.

Recent History and State of Play

29. The Government announced in the May 1998 Budget that it considered it inevitable that Producer Boards would have to operate without specific legislative protections. Dairy industry leaders approached the Government in May 1999 requesting that it pass legislation to facilitate the implementation of a merger of the Dairy Board with all its shareholding co-operatives.

Issues

30. Any significant changes to the Board's structure and practices required the industry to approach the Government to discuss:
 - competition issues, particularly the ability of competitors to enter the markets to buy raw milk in New Zealand and to sell dairy products within New Zealand. The Government agreed with the industry that implementation of the mega-merger legislation would be dependent on removal of the single desk and approval by both farmers and the Commerce Commission (under existing competition law); and
 - other policy issues, including access to foreign quota markets, tax issues, access to Livestock Improvement Corporation data and shifting regulatory powers from the Board to the Government.
31. These agreements were then reflected in the Dairy Industry Restructuring Act (DIRA) and a statement of Government policy provided to the Commerce Commission under section 26 of the Commerce Act.

Commerce Commission

32. In October 1999, the Commerce Commission provisionally declined the industry's initial proposal in a preliminary assessment using the "public benefit test" that considers the benefits to the public of a merger against the competitive detriments. The Commerce Commission expressed a preliminary view that while there may be benefits from the merger, the detriments arising from the merger (in terms of allocative, productive and dynamic efficiency) were likely to be much greater.

33. The industry is now developing a revised proposal. The DIRA remains available as long as the merger is approved by farmers and the Commerce Commission and becomes effective before 1 September 2000.
34. Authorisation by the Commission would be likely to require guarantees to remove or substantially reduce barriers to entry to the dairy industry in a way that could not be achieved within the industry's original proposal.

Waitangi Tribunal Claim – Wai 790

35. A claim has been lodged with the Waitangi Tribunal by PKW (Parininihi ki Waitotara Incorporation) subsequent to the legislation. The claim relates to any impact that unbundling (i.e. separating out the payments for milk from the return on farmers' off-farm investments) might have on the unimproved value of Maori reserved land and any interaction between that impact and the Crown's obligations regarding the land.
36. There has been some debate as to whether unbundling was a consequence of Crown action, or was an industry process that was already underway.
37. The Waitangi Tribunal issued directions in September 1999 indicating that it will sit in urgency if the Crown and the claimants do not constructively meet and discuss the issues. To the extent the claimants do not consider the Crown is taking appropriate action in discussing the merits of its claim, the issue is likely to revert to the Tribunal early next year. In the meantime, officials and the claimants have outlined a process for information sharing that is likely to require Ministerial endorsement by the end of January. Officials will report separately on progress in this matter.

Current Industry Debate

Need for Change

38. The dairy industry is united on the need for change but not on the nature of that change. The primary focus of discussion is currently on the mega co-operative. However, if that merger fails, attention is likely to shift to the "two or more companies" structure.

Single Entity

39. The dairy industry has emphasised the perceived benefits of a mega-merger. The merger:
 - fits with industry practice of co-operative ownership and consolidation; but
 - is a high risk option as it puts all the industry's eggs in one basket, relying on one corporate strategy and organisational form to achieve greater prosperity; and
 - relies on internal mechanisms to substitute for effective governance by shareholders or competitors (given that non-participating co-operatives would be very small).
40. This mega-merger would meet the Dairy Industry Restructuring Act requirement for a merger representing at least 75 percent of milk supply.

41. The Commerce Commission will determine whether the mega-merger proposal has net benefits overall. However, key issues that it is likely the industry will have to address include:
- pricing distortions from the artificial mechanisms by which share value and the milk price must be established, if the direct link between shareholding and production is retained;
 - productive inefficiencies and limited innovation implicit in a large dominant entity; and
 - weak governance from dispersed shareholdings with no ability to aggregate or otherwise exit holdings.

“Two or More Companies” Structure

42. The most likely alternative if the mega-merger does not proceed is a “two or more companies” structure with the two companies open to competition. Such a structure would retain the advantages achieved to date by domestic consolidation while allowing unified selling to specific quota markets through the quota mechanisms in the DIRA (although adjustments may well be required to the transition period). It also leaves the nature of selling arrangements to other overseas markets up to the industry.

Future of the Dairy Board

43. A key issue to be worked through if the “two or more companies” model were adopted would be the future role and structure of the Dairy Board. Options include:
- a separately floated company;
 - a joint venture of the co-operatives;
 - a subsidiary of NZDG or Kiwi, with other shareholders bought out; or
 - a physical separation of the Board’s assets between shareholders.
44. Each approach carries its own risks and opportunities in terms of preserving value, accessing future capital and clear governance signals. The choice should be made by the industry (rather than by Government) within normal legal frameworks so as to capitalise on the industry’s commercial knowledge and avoid distorting their incentives. Any of these options, however, would require legislative action to remove the existing special legislative framework.

The Government’s Role

45. There is a tremendous amount at stake for the future of the dairy industry in terms of export earnings and the need for a return on the immense level of scarce capital resources tied up in farms, processing infrastructure and marketing channels.
46. The Government is heavily involved in the industry at the moment and will remain involved as long as statutory protection is provided to industry structures. If these issues are not resolved now, they will come back. The industry recognises that the status quo is not sustainable.
47. In terms of the mega-merger, the key next steps for the industry are to resolve the terms of the NZDG/Kiwi merger and to submit a revised application to the Commerce Commission. If the Commission approves the application the existing legislation (DIRA) will come into effect (if

farmers approve). The Government's involvement in the dairy industry will then be to provide the generic legislative framework.

48. If the merger does not proceed, the Government will need to consider modifying the DIRA to facilitate some version of the "two or more companies" model.
49. The industry may suggest the Government over-rules the Commerce Commission. Any such action would have very serious negative consequences as it would:
 - undermine the future basis of competition policy in New Zealand;
 - create major uncertainty about New Zealand's attitude towards the acquisition and exploitation of market dominance;
 - encourage other industries to seek to bypass the Commission, risking politicising the competition policy process;
 - possibly make New Zealand's exports subject to anti-trust action in key markets while the resultant entity might still be regarded by trading partners to be a State Trading Enterprise in the WTO context; and
 - be unlikely to achieve the objective of facilitating the efficient use of resources across the economy and the growth of an internationally competitive export sector.

Next Steps

50. Regardless of the progress of the mega-merger, the Government will need to:
 - act before 1 July 2000 to establish certification procedures for dairy products exported to the EU. This will require legislation to replicate provisions currently incorporated in the DIRA; and
 - determine its position on the WAI 790 claim.
51. If the dairy industry agrees on merger terms and the Commerce Commission approves their application the next steps for the Government will be to:
 - determine the future ownership of and access to the herd testing database and determine whether compulsory provision of data (and, therefore, Government involvement) is required; and
 - establish Quotaco, the new quota allocation body (the constitution of Quotaco can only be finalised after the DIRA comes into effect).
52. If the dairy industry does not agree on merger terms or the Commerce Commission rejects its application, the next steps will be to:
 - determine whether the industry can move further to achieve an acceptable application; and if not
 - work with the industry to develop alternative ways to move forward.

briefing for the incoming government on the apple and pear and kiwifruit industries

Executive Summary

1. State of Industries

- The apple and pear industry in New Zealand is facing major challenges. Many observers consider the industry has reached a crisis point. An increasing number of growers and others in the industry are questioning whether the export restrictions are in their best interests.
- In contrast the kiwifruit industry is experiencing buoyant returns. Nonetheless, a significant section of the industry continue to press for the freedom to export.

2. Corporatisation

- The new kiwifruit restructuring plan has been approved and is expected to go to a producer referendum before Christmas. Corporatisation is on track for 1 April 2000.
- The apple and pear restructuring plan currently is being assessed by officials. The plan is subject to litigation that is expected to proceed to hearing in early-February.

3. Regulatory Framework

- The regulatory framework is similar but not identical for both industries.
- Mitigation duties are imposed on the new monopsony companies. These are to be enforced by new industry regulatory boards.
- In the apple and pear industry, an export permit regime applies. A requirement to move the point of purchase to 'Free Alongside the Ship' (FAS) from 1 February also applies. In addition, ENZA's onshore logistics business is required to be operated at arms-length from the core monopsony business.
- The new regulatory regime has applied to the apple and pear industry since 1 October 1999. It will apply to kiwifruit from 1 April 2000.

4. The Future

- The new regulatory frameworks are negotiated outcomes and reflect the Government's decision to retain export controls. The changes do not move the industries to a fully commercial basis and, as such, do not maximise incentives for value adding, innovation and efficiency.
- Although the corporatisation process for both industries is a step forward, industry participants are increasingly realising the limitations of a regulatory-based system and are likely to seek the flexibility to undertake further value-adding activities in the future.
- The Government's role will be to maintain a watching brief, maintain and, if necessary, improve the integrity of the system in place, and encourage further competitive commercial evolution.

Introduction

5. This paper provides a briefing on two separate horticultural industries: the apple and pear industry and the kiwifruit industry. Both industries are in the midst of substantial reorganisation and change following the passage of legislation by Parliament in September 1999.
6. The regulatory package for both industries is very similar, although not identical. Accordingly, this paper deals with both industries under common generic headings. Where differences exist between the two industries specific comment is provided.
7. This briefing:
 - describes recent trends in the apple and pear and kiwifruit industries;
 - describes the current changes occurring in the apple and pear and kiwifruit industries;
 - identifies the key issues that have arisen or which may arise and the decisions Ministers will be required to make over the next few months; and
 - places the new regulatory arrangements in the context of future changes to the industry.

Industry Background

Key Features of Apple and Pear Industry

8. The apple and pear industry in New Zealand is facing some challenges. Many observers consider the industry has reached a crisis point. The poor financial situation of growers has been compounded by the very low returns received this season for a key apple variety, Braeburn. The Braeburn variety makes up approximately 40 percent of the New Zealand crop.
9. Informal soundings from within the industry indicate that many growers are under financial stress and may seek to exit the industry over the next two years.
10. Domestically, the apple and pear industry has been consolidating with average orchard- size increasing. Packhouses have been consolidating, particularly in the Hawkes Bay region with a number of smaller packhouses closing.
11. Off-shore, competition has been intensifying. Overall, New Zealand produces only about 1.3 percent of world pipfruit production. International apple production has been increasing steadily and this trend is expected to continue. The overall demand for apples has been growing at a slower rate than apple production has been increasing. In addition, New Zealand's window of opportunity for selling pipfruit in the Northern Hemisphere has decreased. A key reason for this has been recent improvements in storage technology, coupled with increased production from other Southern Hemisphere countries (e.g. South Africa and Chile).
12. The market place is becoming increasingly competitive with continuing innovation by existing players and new entrants. Overseas marketers are integrating with producers to achieve economies and overseas retailers are consolidating. At the same time, marketing companies have diversified into other product types. Product lines in apples are becoming more sophisticated. Overall the business has become significantly more complex.

Key Features of Kiwifruit Industry

13. The kiwifruit industry is facing similar strategic trends as the pipfruit sector i.e. the power of retail buyers and diversified competing suppliers.
14. After a long period of relatively low returns, the kiwifruit industry is now experiencing buoyant returns. New Zealand kiwifruit exports account for around 30 percent of world annual supply and, during a small part of the New Zealand selling season (May to October/November), accounts for up to 60 percent of total global sales of kiwifruit. The recent flotation of Kiwifruit International Limited represents a move to diversify and provide 12 month supply.
15. It is expected that the average per-tray payment for growers at FOBS (stowed on board the ship or aircraft on which the fruit is exported) for the export of:
 - 50.5 million trays of the main kiwifruit variety 'Hayward' will be approximately \$7.30;
 - 1.4 million trays of organic Hayward kiwifruit will be approximately \$9.45; and
 - 300,000 trays of the new variety 'Zespri Gold' will be approximately \$13.85.

16. As a result, production is expanding. For example, in the Bay of Plenty a number of dairy farms are converting to the production of kiwifruit.
17. Overall, there is generally strong positive industry outlook for the next few years.
18. In the light of the advantageous commercial environment for kiwifruit, there was a strong and widespread desire for corporatising KNZ into Zespri Group Limited (although the model of corporate form was widely debated). This desire was reflected in the overall industry support for the recent legislation.
19. That said, and despite the strong returns being generated at present, a significant minority of growers, (around 30 to 40 percent by number and higher by volume), want the export controls on kiwifruit removed. Maori growers particularly are active in this context.

New Regulatory Framework: Overview

20. On 9 September 1999, the Apple and Pear Industry Restructuring Act 1999 (“APIRA”) and the Kiwifruit Industry Restructuring Act 1999 (“KIRA”) came into force.
21. The APIRA provides for:
 - corporatisation of the New Zealand Apple and Pear Marketing Board (“the NZAPMB”) into a limited liability company registered under the Companies Act 1993 (to be known as ENZA Limited); and
 - regulations to be made that control the export of apples and pears.
22. The KIRA provides for:
 - corporatisation of the New Zealand Kiwifruit Marketing Board (“KNZ”) into a limited liability company registered under the Companies Act 1993 (to be known as Zespri Group Limited); and
 - regulations to be made that control the export of kiwifruit.

Corporatisation

23. The corporatisation process requires both the NZAPMB and KNZ, respectively, to prepare a restructuring plan and to submit that plan for approval to the Minister by 1 December 1999. The key components of the plan are a share allocation plan and a draft constitution for the new companies.
24. Following approval by the Minister each restructuring plan is voted on by growers. If 75 percent of those voting approve, the plan will proceed and each producer board will convert into a company on 1 April 2000. If the 75 percent majority is not achieved, the Minister has the power to specify the contents of the restructuring plan following consultation with the industry. Either way, conversion to a company will occur on 1 April 2000.
25. The regulatory framework requires the company constitutions to meet certain minimum corporate governance standards designed to ensure management accountability to shareholders. These requirements must be present before the Minister may approve the restructuring plan. The regulations require that the specified requirements remain part of each new company's corporate governance for so long as the regulatory controls remain in place.

Regulatory Controls

26. The Apple and Pear Export Regulations 1999 and the Kiwifruit Export Regulations 1999 contain the rules relating to each export monopsony. For the apple and pear industry, the new regime came into force on 1 October 1999. For kiwifruit, the new regime applies from 1 April 2000.
27. The key aspects of the regulatory regime are:
 - retention of controls over exporting;
 - authorisation of ENZA Limited to export apples and pears, and of Zespri Group Limited to export kiwifruit;
 - the creation of industry regulatory bodies (the Apple and Pear Board, and the Kiwifruit Board) to oversee the activities of ENZA Limited and Zespri Group Limited as the authorised exporters;
 - the imposition of obligations on ENZA Limited and Zespri Group Limited to mitigate the risk of distortion and anti-competitive conduct arising from each company's dominant position; and
 - the Minister is to approve the enforcement regime.

28. For the apple and pear industry, the regulatory regime also:
- creates an Export Permits Committee to determine applications to export apples and pears from potential exporters other than ENZA Limited; and
 - provides for transitional arrangements to cover the period from 1 October 1999 to 1 April 2000.
29. For the kiwifruit industry, the regulatory regime also provides that decisions on the industry's existing collaborative marketing arrangements be made by the Kiwifruit Board.

Mitigation Measures

30. The mitigation measures imposed on ENZA Limited and Zespri Group Limited are the most important aspects of the new regimes. The Apple and Pear Board and the Kiwifruit Board are to monitor and enforce these measures against ENZA Limited and Zespri Group Limited, respectively.

31. The mitigation measures are:

- (a) Non-Diversification Rule – A requirement on ENZA Limited and Zespri Group Limited to seek grower and shareholder approval for any use of capital (“capital” is widely defined in the regulations) resources in business ventures which are not part of each company's defined core business³. Where any grower or shareholder does not agree, that person must be insulated effectively from the commercial risks of the proposed venture.

In the case of ENZA Limited, the non-diversification duty does not apply to all ENZA Limited business activity. Certain diversified business activities now being carried on by the NZAPMB have been “grandparented” from the rule. Those activities are specified in Schedule 2 to the Apple and Pear Export Regulations. The activity levels indicated in that Schedule are subject to verification by independent audit. This audit currently is being undertaken;

- (b) Non-Discrimination Rule – Under the new regulatory regime, ENZA Limited and Zespri Group Limited will no longer be obliged to purchase all fruit that meets their specified standards. Purchase of fruit will be driven by market demand, not production push. The non-discrimination rule allows each company to discriminate in its contractual arrangements between growers but only if differing contractual arrangements can be shown to be justifiable on commercial grounds. This rule is designed to prevent discrimination on non-commercial grounds; and
- (c) Information Disclosure – ENZA Limited and Zespri Group Limited will be required to disclose financial statements in a manner designed to distinguish between core activities and other activities. Each company will also be required to disclose its purchase conditions (and variations). An Information Disclosure Handbook for each industry

³ For apples and pears, the core business is defined as the purchase of New Zealand grown apples and pears for export. For kiwifruit, the core business is primarily the purchase at FOBS of New Zealand grown kiwifruit for export.

published by the Director-General of Agriculture and Forestry in November supplements each information disclosure regime.

Further Requirements for Apples and Pears

32. The Apple and Pear Export Regulations require ENZA Limited to meet two further requirements.

FAS

33. Unlike the kiwifruit industry, the NZAPMB currently acquires title to the fruit onshore (at coolstore). From 1 February 2000, the point of acquisition of title is required to move to FAS (free alongside the ship or aircraft on which the apples and pears are exported from New Zealand). This will allow growers choice on domestic transport and other onshore logistical arrangements.

Arms-Length Rules

34. ENZA Limited has been allowed to retain its current onshore logistics activities. However, it is required to operate this business on an arms-length basis from its core monopoly activities. Schedule 1 to the regulations identifies a series of arms-length duties that must be complied with to satisfy the arms-length obligation.

The Corporatisation Process: Specific Issues

35. The Producer Board Project Team has been liaising with the producer boards in the preparation of their restructuring plans. The key issues that have arisen and the current state of play are noted below:

Constitution

The Apple and Pear Industry

36. The draft constitution was submitted to the Minister as part of the overall restructuring plan on 1 December 1999. The plan has yet to be approved but there do not appear to be any major problems with the constitution.

The Kiwifruit Industry

37. The Minister approved the draft constitution as part of the restructuring plan on 24 November 1999.

Share Allocation Plan

The Apple and Pear Industry

38. The draft share allocation plan was submitted to the Minister on 1 December 1999. It has yet to be approved.
39. The number of shares to be issued to each eligible grower has been calculated on the basis that each such grower would be issued one share for each tray-carton equivalent of apples and pears supplied to the NZAPMB according to the following formula:
- 15 percent of the total number of tray-carton equivalents supplied to the NZAPMB by the grower in the 1992/93 season;
 - 15 percent of the total number of tray-carton equivalents supplied to the NZAPMB by the individual grower in the 1993/94 to 1997/98 seasons, divided by 5; and
 - 70 percent of the total number of tray-carton equivalents supplied to the NZAPMB by the individual grower in the 1998/99 season.
40. Allowances have been made for hail and other seasonal damage and for product exported under export licences in the 1998/99 season.
41. The Canterbury Fruitgrowers Association (“CFA”) filed proceedings in the High Court on 2 December in relation to the share allocation plan. The first defendant is the NZAPMB. The second defendant is the Minister. The CFA dispute the fairness of the allocation methodology. A substantive hearing has been set down for the first week of February 2000. In the meantime, agreement has been reached between the parties that the Minister should continue with the approval process. However, it is unlikely, the referendum will proceed until the litigation is resolved.

The Kiwifruit Industry

42. The Minister approved the draft share allocation plan on 24 November 1999 and the plan is now proceeding to grower referendum. The results of the referendum are expected before Christmas.

The Regulatory Framework: Specific Issues

The Apple and Pear Industry

43. Under the new regulatory regime, most of the new obligations to be imposed on ENZA Limited now apply to the NZAPMB (as if it was ENZA Limited) by way of a transition regime through to 1 April 2000. The new Apple and Pear Board is required to act as a regulator now in respect of actions carried out by the NZAPMB.
44. In this regard, officials are aware of at least two commercial arrangements involving the NZAPMB that give rise to questions of consistency with the new non-diversification rule. Both arrangements involve the apparent entry by the NZAPMB into joint venture arrangements with other parties in areas of business outside of the core monopsony business. It will be an important test of the long-term effectiveness of the new regulatory regime to see how the Apple and Pear Board investigates and rules on these commercial arrangements.

45. Before 1 April 2000, the Apple and Pear Board is required, after consultation with persons who are to be the initial directors of ENZA Limited, to prepare the formal text of ENZA Limited's export authorisation. The critical element of that will be the enforcement regime. The proposed enforcement regime must be submitted to the Minister for approval by 1 April 2000. To the extent that the proposed enforcement regime is inadequate, the Minister may seek amendments. Note that a transitional enforcement regime is included in the regulations for the period 1 October 1999 to 1 April 2000.
46. As noted above, the NZAPMB is required to move to FAS by 1 February 2000. In extraordinary circumstances the Minister may extend that deadline to 1 April 2000. The NZAPMB's progress is being monitored. The NZAPMB advises that it does not expect that an extension will be required. Given the current state of the industry and the consequent rationalisation occurring, any delay in implementation of FAS from 1 February 2000 would be costly to the industry.
47. Finally, and as noted above, the level of business activity specified in Schedule 2 of the Act (the 'grandparented' non-core businesses) currently is being verified. Ministers wrote to the NZAPMB in September 1999 advising that to the extent the stated figures could not be verified, amendments to Schedule 2 would follow to ensure accurate information was contained in the Schedule. Present indications are that amendments to Schedule 2 may be required.

The Kiwifruit Industry

48. Before 1 June 2000, the Kiwifruit Board is required, after consultation with persons who are to be the initial directors of Zespri Group Limited, to prepare the formal text of Zespri Group Limited's export authorisation (a transitional regime applies between 1 April and 1 June). The critical element of that will be the enforcement regime. The proposed enforcement regime must be submitted to the Minister for approval by 1 June 2000. As with the apple and pear model, the Minister may seek amendments if the proposed enforcement regime falls short of requirements.

Further Evolution of the Regulatory Regimes

49. The regulatory regimes described above represent some progress towards a more commercial environment for exporters of pipfruit and kiwifruit. They define ownership of the Boards, move the Boards to a more responsive corporate structure, decrease their reliance on special legislation and have mechanisms intended to partly mitigate the costs of statutory controls over the industry and New Zealand.
50. However, the regimes are negotiated outcomes and reflect the Government's decision to retain export controls. The changes do not move the industries to a fully commercial basis and, as such, do not maximise incentives for value adding, innovation and efficiency.
51. Looking to the future, it is likely that further commercial pressure will come to bear on the legislative environment for the statutory monopolies. Markets will become more demanding and New Zealand fruit exporters will have to become increasingly commercial and niche-oriented. Commodity prices are likely to continue trending downwards in real terms and this will continue to require increased efficiency and innovation. The New Zealand industry is likely to continue consolidating and, as the emerging commercial players develop greater resources and competencies, the Government can expect to face increased pressure for the export controls to be removed.

Conclusion

52. Although the corporatisation process in train for both industries is a step forward, the continuing export controls do not allow either industry to become fully commercial; nor do the controls allow maximum incentives for value-adding, innovation and efficiency over time. Industry participants are increasingly realising this and are likely to seek further flexibility in a more commercial operating environment.
53. The regulatory restraints on each Board are extensive and would not be necessary in the absence of the export controls.
54. The regulatory restraints are designed to help protect growers against abuse by the Boards' continuing near-monopsony powers. But problems with the regulatory regime may well emerge. For example, it may be possible for the new companies to exercise an excessive degree of influence over the regulatory Boards, particularly because the Boards will have access to considerably less information than the companies. Alternatively, the new Boards themselves may become overly aggressive regulators, imposing unnecessary costs and commercial inflexibility.
55. Further, as some of the regulatory measures start to bite – particularly the non-diversification rule – the companies may begin to chafe against them and pressure the Government to allow bypass (at the likely expense of growers and shareholders).
56. The key for the Government will be to maintain a watching brief, continue (and, if necessary, improve) the integrity of the system in place, and encourage further competitive commercial evolution.

briefing to incoming government: Non-Trading producer Boards

Executive Summary

1. There is likely to be an ongoing role for collective organisations in the meat, wool, pork and game sectors to provide services which would be provided by farmers acting individually. It is important that any such organisations operate efficiently and to the net benefit of their funders and owners.
2. The non-trading boards, however, currently operate in an environment that allows the Boards to:
 - levy producers without producers being able to determine directly whether they should be levied, the size of that levy, and what the levy is to be spent on;
 - operate inefficiently because of little effective accountability to levy payers; and
 - spend levy income and reserves on commercial activities, prejudicing the quality, quantity and scope of services that would otherwise have been provided through voluntary means.
3. Further, the Boards' current special statutory form makes it difficult for them to respond quickly and effectively to the opportunities and challenges facing their industries. It also makes the Government a major player on matters of corporate governance.

4. In developing options to promote the Boards' ability to work more effectively in the interests of their industries, it is important to consider a number of key objectives. In particular, it is important to consider ways by which:
 - the Boards can be made more accountable to their levy payers;
 - the Boards can operate within generic governance legislation;
 - the activities of the Boards can be constrained to areas that will not replace or 'crowd out' commercial activity;
 - decisions as to how the Boards' reserves are used can be made by the beneficial owners of those reserves; and
 - the quality of Board activities can be improved so as to generate real returns for their industries.
5. Whichever option is chosen, the paramount consideration must be the extent to which that option uses scarce resources to the greatest possible value in a growing and dynamic economy.

Introduction

6. This briefing addresses issues relating to the Wool Board, Meat Board, Game Industry Board and Pork Industry Board (the non-trading producer boards).
7. The brief is in two sections. The first section provides an overview of the wool, meat, game and pork industries, and their respective Boards. Key industry trends are identified, the predominant being the long term fall in commodity prices. The Boards' current activities, size and powers are also outlined, as are some of the key questions posed when considering the current legitimacy of their role and functions.
8. The second section provides an overview of the work the Producer Board Project Team and the non-trading boards have done in seeking to develop a regime that will better serve the interests of producers and their industries. Problems with the current institutions, their structures and powers are identified, and a number of options are discussed.

SECTION ONE: OVERVIEW

Global Trends Affecting the Industries

9. The industries the non-trading boards operate in are changing rapidly. Global trends affecting the wool, meat, game and pork industries include:
 - long term declines in commodity prices;
 - changing consumer preferences and practices;
 - rising consumer concerns, particularly about food safety;
 - demand for increasing levels of product traceability;

- vertical integration and the growing business emphasis on supply chains (as opposed to companies or countries);
 - consolidation, particularly at retail level; and
 - the challenges of developments such as biotechnology and e-commerce.
10. Some of these trends have been long term, others are more recent. Regardless, they all impact on the role, structure and profitability of New Zealand's agricultural industries.

The Current New Zealand Industries

Wool Industry

11. There are currently about 16,800 commercial sheep and beef farms, most of which produce at least some wool. Farm aggregations and conversions to dairying and forestry have seen this number decline from about 22,000 in the mid 1980s. In addition there are many smaller operators with sheep (perhaps 6,000).
12. Total wool output (to farm gate) in 1998/99 was \$656 million, down from \$908 million (1998/99 dollars) in 1991/92.
13. New Zealand has two major wool trades:
- Fine wool used predominantly in the clothing industry (approximately 11 percent of output); and
 - Coarse wool that is used in the carpet industry and for hand knitting (approximately 89 percent of output).
14. The producers are not the same, and price trends are not always parallel.
15. New Zealand's wool exports comprise 19 percent greasy wool, 53 percent scoured and slipe wool, and 28 percent further processed products.
16. The main markets are currently China/Hong Kong, the UK, India, Germany and Belgium. China has in some years taken up to 40 percent of New Zealand's wool exports, but in 1998/99 this was down to 16 percent of exports.
17. The New Zealand wool exporting industry is fragmented. There are about 100 wool exporters (although the sector is dominated by a few major players), most of which are subsidiaries of overseas wool trading companies.
18. The wool industry is depressed, and the outlook is not strong. Wool faces an ongoing challenge in competing with synthetic fibres, which are continually improving. The world wool processing industry currently has over-capacity and the resulting slowdown in demand has led to a depressed market and low prices. A slow increase in prices is projected over the next few years, but there are significant uncertainties around this.
19. The poor state of the wool industry has been reflected in producer calls for better performance from the Wool Board, culminating in a number of no confidence remits being presented (but either defeated or withdrawn) at the Board's October AGM. In response, the Board has commissioned a study from McKinsey and Company into, among other things:

- the state of the wool industry and its prospects; and
- the role of the Wool Board.

20. The report is expected to be completed by May 2000.

Meat Industry

21. As noted above, the number of commercial sheep and beef farmers is now down to about 16,800. In the meat industry there are also many smaller operators (perhaps 13-14,000).
22. Total sheepmeat output (to farm gate) in 1998/99 was \$1,209 million, up from \$968 million (1998/99 dollars) in 1991/92. Total cattle output in 1998/99 was \$1,379 million, down from \$1,653 million (1998/99 dollars) in 1991/92.
23. The meat processing and exporting industry has been consolidating (although a number of small operators have emerged to service niche markets). Currently, four companies process and export over 70 percent of New Zealand's meat. These are AFFCO and Richmond in the North Island, and Alliance and PPCS in the South Island.
24. Seventy five percent of lamb produced in New Zealand is exported, while 78 percent of beef is exported. New Zealand is heavily reliant on the US and EU markets: in 1998/99, 64 percent of beef and veal exports by volume went to the US, and 55 percent of lamb exports went to the EU. Because of trade restrictions, returns for sheepmeat in the EU are higher than returns in other markets. Beef prices have increased by 10-12 percent in the current season and sheepmeat prices are steady.
25. The meat industry has been steadily moving towards higher value products – in 1998/99 chilled product made up 21 percent of lamb exports by value (and 12 percent by volume). Carcasses represented only 15 percent of lamb exports, compared with frozen cuts at 64 percent.

Deer Industry

26. There are about 4,400 deer farmers, although many of their farms run mainly sheep and beef.
27. Total deer industry output (to farm gate) in 1998/99 was \$168 million, up from \$127 million (1998/99 dollars) in 1991/92.
28. The venison processing industry is now dominated by Richmond in the North Island and Alliance and PPCS in the South Island, although there are successful smaller operators in some areas.
29. More than 95 percent of venison and velvet produced in New Zealand is exported. In 1998/99:
- over 90 percent of venison exports were to European and Scandinavian countries, with Germany alone taking 56 percent by volume; and
 - 41 percent of velvet exports by volume went to the Republic of Korea, and 55 percent went to Hong Kong.
30. New Zealand is the world's largest exporter of deer products and farmer confidence in the industry is now growing. Herd increases are expected to continue. The effective drivers are relatively low beef and wool prices, the easy-care nature of deer, and its ability to convert dry matter to meat efficiently. Strong venison and velvet price increases in 1999 have greatly

assisted deer farming profitability. Venison production increased rapidly over the past two seasons and is expected to continue growing.

Pork Industry

31. There are about 450 commercial pig farmers. The number of small operators has decreased significantly in recent years.
32. Total pig industry output (to farm gate) in 1998/99 was \$127 million, compared with \$144 million (1998/99 dollars) in 1991/92.
33. Virtually all of New Zealand's pork is consumed domestically, with minor exports to the Pacific islands. The pig industry in New Zealand has been in decline in recent years, reflecting low world pigmeat prices and rising imports from Canada and Australia (imports meet approximately 27 percent of domestic consumption).

Current Structure

34. Legislation for the non-trading board outlines their objectives, main activities (largely promotion and research), powers (principally related to the raising the spending of levy income) and accountability.
35. The Boards are unable to trade in product.
36. Farmers own the Boards, but there is no defined ownership interest or effective ownership control.
37. The Wool Board and Meat Board hold significant farmer reserves (\$128 million and \$133 million respectively in 1997/98).
38. The following table summarises the current position of the non-trading boards.

Board	Act/Regulations	Main activities	Turnover (\$million) 1998	Equity (\$million) 1998
NZ Wool Board	Wool Board Act 1997	Promotion Research and Development	54	128
NZ Meat Board	Meat Board Act 1997	Promotion Research and Development Quota allocation	37	133
NZ Game Industry Board	Game Industry Board Regulations 1985, under Primary Products Marketing Act 1953	Promotion Research and Development	8	3
NZ Pork Industry Board	Pork Industry Board Act 1997	Promotion Research and Development	5	5

Boards' Views

39. The Boards have focused their efforts on:
- increasing prices; and
 - increasing demand.
40. Programmes undertaken by the Boards in recent years to increase net income for their producers include:
- technology development and transfer;
 - product promotion in overseas markets;
 - development of an integrated New Zealand-wide marketing strategy; and
 - development of biotechnology and genetic databases.

Key Challenges to the Boards

41. The role of the Boards has been questioned on a number of fronts. In meat, pork and game the tensions between large exporters and the Boards are increasing. The larger exporters are developing the ability and desire to set their own strategy. In wool, the pressures farmers are under has led an increasing number to question whether they are getting value for money from the Board.
42. Promotion, in particular, has come in for considerable scrutiny. Many, both inside and outside the industries, consider promotion should be left to the exporters of the product rather than planned and funded centrally. In the event a need for 'generic' promotion⁴ is identified, it is argued this could in most cases be undertaken voluntarily by exporters.
43. More fundamentally, many also ask why boards (funded by a compulsory levy) are needed to market wool, meat, game and pork, yet not for other products like paper, timber, software, aluminium and coal?
44. Further, recent intellectual property developments in areas such as plant variety rights have made it possible to fund much research and development commercially, in preference to funding through a compulsory levy.

SECTION TWO: ISSUES

45. The principal public policy issues relating to the non-trading Boards are:
- their funding: in particular their use of compulsory levies;
 - options for their financial reserves;
 - their corporate form; and

⁴ Whether this sort of promotion produces any value to farmers is hotly debated.

- implications for meat quota administration.

46. These issues are addressed below.

Compulsory Levies

Purpose of Compulsory Levies

47. In essence, compulsory levies provide for the raising of money to collectively fund activities for the benefit of levy payers, where those activities would not be provided by voluntary means. Without a levy activity may be under-provided, or not provided at all. A compulsory levy only works properly if the activities it funds provide more benefits than the cost.

Current Levies

48. The non-trading Boards, in aggregate, collected approximately \$71 million from their levy payers in 1998/99.

49. The average sheep and beef farmer pays approximately \$3,300 per annum in levies. In 1998/99, the net income (after tax and interest) of the typical sheep and beef farmer was approximately \$32,000. In the absence of the levy, a typical farmer would be able to reduce on-farm debt by over \$50,000 in ten years. On-farm debt of the typical sheep and beef farmer was approximately \$260,000 in 1998/99.

Policy Issues

50. There are a number of issues for Government to address in considering the Boards' levy powers, including:

Accountability

51. Levy payers do not have the opportunity to vote on whether they have a levy, its level, or what it is to be used for. Accountability for the levy is indirect through the election of board members and views expressed at AGMs, for example.

52. The Boards also have an information and resource advantage over levy payers. To a large extent the Boards are able to control the consultation process, which can make it difficult for opposing views to be heard and assessed impartially by levy payers.

53. Effective accountability is made more difficult by a high level of farmer apathy. For example, 1.1 percent of farmers attended the recent Wool Board AGM, with 11.8 percent participating in voting on the day (mainly through proxies).

Operational Efficiency

54. There are a number of reasons why levy funded organisations (ie: the Boards) are unlikely to be efficient compared to organisations providing goods and services in a competitive environment:

- the cost of poor investment decisions fall on levy payers rather than the Boards;
- there is no threat of take-over to discipline behaviour;
- performance is not able to be assessed through the transparent indicator of profit; and

- levy payers have neither the information, nor the sanctions available to them to ensure the Boards always operate in their best interests. This allows Boards to operate in areas best left to voluntary provision, or into areas that provide little benefit to levy payers.

Use of Levy Income to Fund Commercial Activities

55. The Boards can spend levy income on commercial activities. Such activities have included:

- quality assurance programmes;
- branded marketing; and
- proprietary research that has benefited processors and consumers as well as levy-payers.

State of Play

56. By September 1999, officials and the Wool, Meat and Game Boards⁵ agreed that their levy powers should be consolidated under one piece of legislation. A draft Compulsory Levies Bill was prepared as an aid to discussions with the Boards. The key features of the Bill are outlined in Appendix One. Disagreement with the Boards arose in two key areas:

- the turnout thresholds that would need to be met before a levy was imposed; and
- the range of activities able to be funded by a levy (with the Boards favouring a lower turnout threshold, and a wider range of activities).

57. The Boards were also concerned to ensure a sufficient transition period to:

- allow time to make their commercial activities more self-funding; and
- allow time for the Boards to demonstrate to farmers the value of their activities so farmers would vote in favour of a levy at a “reasonable rate”.

Options for Compulsory Levies

58. The four main options available to the Government in considering the levy powers of the non-trading boards (or the organisations that replace them) are:

Option 1:

Remove the Boards’ current specific statutory powers, but allow the organisations that replace them to seek a levy under the Commodity Levies Act.

- This has the advantage of treating the Boards in the same way as the 18 organisations currently operating under the Commodity Levies Act (CLA). Compared to the Boards’ current powers, the Commodity Levies Act provides for:
 - greater accountability to levy payers (through a referendum on whether the levy is to continue);
 - a slightly more restricted range of activities levy income is able to be spent on; and
 - greater Government involvement on whether there is to be a levy and the form of that levy.

⁵ The Pork Board sought a levy under the Commodity Levies Act and to be reconstituted as an incorporated society. However, these changes were not advanced, primarily due to uncertainty over the level of industry support for the changes.

- Of the four options, this option would take the least time to implement. But it has risks as:
 - there is no turnout threshold (under the CLA levies have been approved with as little as 17 percent industry support);
 - levy income can be used to fund many commercial activities;
 - levy organisations are not required to undertake a cost-benefit analysis of their levy proposals;
 - views opposing the levy proposals need not be represented to farmers;
 - few types of organisations are able to raise a levy (the organisation must be “representative” of levy payers), therefore reducing competition; and
 - only producers are able to be levied, even where it may be more efficient to levy others in the industry.

Option 2:

Leave the Commodity Levies Act as is, but provide generic legislation for the Boards to use (the Compulsory Levies Bill).

- This option would make the Boards more accountable to levy payers and minimise the risk of levy-funded activities replacing private sector activities. However, organisations operating under the CLA would be left unchanged. It is also likely to take longer to implement this option than *Option One* as a new Act would need to be prepared and passed.
- At this stage, officials see little justification for providing two levy regimes with different levels of enforcement, accountability, and discretionary powers.

Option 3:

Amend the Commodity Levies Act to incorporate the key features of the Compulsory Levies Bill (refer Appendix One) and place the Boards under the amended Commodity Levies Act.

- This option has the advantage of treating the Boards the same as the organisations operating under the CLA. Compared to *Option One*, it has the added advantage of making levy organisations more accountable to their levy payers. There would be less risk that levy expenditure would crowd-out private sector activity. This option would require consultation with the 18 organisations and their industries that operate under the CLA (in addition to the Boards).

Option 4:

Undertake a “first principles” review to determine whether compulsory levies achieve net gains for levy payers.

- To date, officials have sought to design a compulsory levy regime that operates better for levy payers than the current regimes. The primary question of whether organisations, other

than government, should be granted the power to effectively tax groups of individuals has not been addressed.

- It would be timely to consider again the rational for compulsory levies, the risks surrounding their use, and whether the current regimes are generating net benefits for levy payers.

RESERVES

Non-Trading Boards' Reserves

59. The Meat and Wool Boards are the only non-trading boards that hold substantial reserves. At the end of 1997/98, the Wool Board held reserves of approximately \$128 million on behalf of its producers, and the Meat Board \$133 million.⁶ Per commercial farmer, this represents approximately \$15,500.
60. The reserves were accumulated through a combination of trading revenue, levy income and return on investments. Growers own the reserves even though they are accumulated from a number of sources.
61. The accumulation of the reserves is more a result of historical accident than deliberate action on the part of the Boards. Boards have subsequently sought to assign a role for those reserves. Recent suggestions have included venture capital (Wool), and an insurance fund for industry-wide disasters (Meat).

Management and Use of Reserves

62. Producers do not have a direct say in how their reserves are used or what should happen to them (for example, being returned to levy payers). As with levy income, there are few effective limits on the uses to which the reserves are put.
63. For example, the Wool Board's reserves have fallen from a high of \$497 million in 1988 to \$128 million in 1997/98. Many farmers have questioned whether the rundown of their reserves has generated any tangible benefits. There is a concern that reserves are being treated as 'easy money' and are able to be applied to high-risk activities with little accountability for the performance of those activities.

State of Play

64. Officials presented the following proposal to the Boards:
 - the owners of the reserves should be able to withdraw their share; and
 - it would be up to the Boards to decide whether to return the funds directly to farmers or to establish a company with the reserves from which farmers would then be able to sell their shares.
65. The Meat Board did not support this option. Instead, it wanted levy payers to decide collectively, rather than individually, what would happen to the reserves. Officials did not have an opportunity to enter into discussions with the Wool Board on the future of its reserves.

Options for Reserves

66. The main options available to the Government for dealing with the reserves are:

Option 1:

⁶ Figures are for 1997/98, the latest year for which the Meat Board Annual Report is available.

Provide for the Boards to hold a referendum of levy payers to decide what happens to the reserves.

- This option ranks highly in terms of collective decision making however the options put to levy payers in the referendum may not be the best options or be presented mean that producers who wish to use the money in alternative ways, such as many Maori producers, would not be able to do so.

Option 2:

Provide for the Boards to give individual levy payers the choice of withdrawing their share of the reserves from the Boards. Under this option, the Boards could, establish a company with tradable shares from the reserves.

- This option is more likely to meet the individual preferences of levy payers and to minimise the risk that the reserves will be treated as ‘free money’ and used inappropriately.
- Many farmers, however, do not think they are entitled to any direct share of the reserves. They consider the reserves belong to the “industry”. By contrast, the Federation of Maori Authorities (FOMA) fear that the Boards will waste the reserves. FOMA would like to see the reserves invested with investment income used to reduce levies.

CORPORATE FORM

Appropriate Corporate Form

67. Where possible, organisational form should fit the functions of that organisation.
68. Government involvement in the organisation’s decision making should be kept to a minimum to promote innovation, flexibility and to achieve clear lines of accountability between producers and the organisations that represent their interests.

Non-Trading Boards’ Corporate Form

69. The Boards are established under their own individual legislation. This makes the Government a party to the Boards’ constitutional form and party to any changes to that form.
70. Further, the Boards currently undertake a number of different functions, pursuing a range of objectives. The functions include:
 - commercial activities;
 - non-commercial activities where the ‘free-rider’ problem prevents market provision of an activity and
 - regulatory activities.

Options for Non-Trading Boards’ Corporate Form

71. It has been recommended to the Boards that they reconstitute under available generic legislation, ie, as companies, incorporated societies etc. Ideally the choice of form should be decided by members, with dissenting members having appropriate rights of exit (withdrawing their share of the net assets).

72. Any change of corporate form for the Board requires legislation, which makes the Government a player in any reconstitution. The Government should therefore apply sound public policy criteria (objectives) against any option proposed, including:

- transparent process with provision for effective input from producers to decide on the corporate form;
- promoting individual choice;
- ensuring exit rights for dissenting members at fair value;
- minimising Government involvement; and
- ensuring form is the most appropriate for meeting the objectives of the organisation.

73. The form finally adopted by each Board should:

- allow the organisations to respond to changes in their industry without the need to seek government support; and
- provide for clear lines of accountability between the organisation and levy payers.

MEAT QUOTA

74. An issue specific to the Meat Board is its administration of meat quota. The Meat Board currently administers New Zealand's country-specific tariff quotas for meat, the largest of which is our sheep meat quota for export to the European Union. Any legislative changes to the Meat Board would need to be developed and undertaken in a way that ensures continued acceptability of New Zealand's quota administration.

CONCLUSIONS

75. There is likely to be an ongoing service provision role for collective organisations in the meat, wool, pork and game sectors. The non-trading boards, however, currently operate in an environment that shelters them from normal commercial pressures, allowing them to potentially crowd out alternative service providers and set levies and make expenditure decisions with little effective accountability to levy payers. Moreover, the Boards' current special statutory form makes it difficult for them to respond quickly and effectively to the opportunities and challenges facing their industries.

76. Options to promote the Boards' ability to work more effectively in the interests of the industries need to be developed. These should focus on maximising the value from levy-payers' resources and address issues relating to:

- accountability to levy-payers;
- organisational governance;
- organisational role; and
- the Boards' reserves.

APPENDIX ONE - Key Features of Compulsory Levies Bill

The key features of the Compulsory Levies Bill, as discussed with the Boards, are:

- a referendum be held within six years from the time the levy is struck to decide, among other things, whether the levy is to continue, its approximate level and what it is to be spent on;
- for the levy to continue, greater than 30 percent of **all levy payers** by output and number must support continuation of the levy, and greater than 50 percent of **voters** must support the levy;
- prior to the referendum, the levy organisation must consult on the levy proposal and provide levy payers (or potential levy payers) with, among other things, a cost benefit analysis of the proposal and represent the views of those who oppose the levy proposal; and
- the responsible Minister to determine, among other things:
 - whether the activities to be funded by the levy organisation are non-commercial activities, and therefore eligible to be funded by levy income; and
 - whether the nature and size of any impacts external to levy payers, including trade impacts, are acceptable.