

# Grower Feedback on the Allocation Mechanism for G3 License (September 2017)

## 1 Introduction

Following the 2017 release of G3 license, NZKGI sought feedback from growers on the process and its outcomes. Incorporating initial feedback, a discussion paper on the allocation mechanism was issued in June 2017 and growers were asked to complete a survey to provide their views on specific questions asked in the discussion paper. Several other submissions were received alongside the survey and the subject was discussed at NZKGI regional meetings. Feedback showed there are high levels of frustration from growers relating to the price of license, the uncertainty of being able to access it and, high debt levels and therefore risks to the industry that are being created.

This paper summarises the outcome of the survey and identifies areas where there is consistent feedback and areas of continuing contention. Consultation on this subject has shown that views are varied and are generally influenced by the circumstances of the person giving the view. NZKGI represents all kiwifruit growers and given the wide range of opinions expressed by NZKGI members, it would be inappropriate for NZKGI to support a single view on this issue or attempt to achieve a consensus position. Therefore, this document will be provided to Zespri to consider as they make their decision on the ongoing mechanism for G3 license release.

## 2 Survey Results

On 30 June 2017 NZKGI released a discussion paper on the allocation mechanism for G3 Licence. This follows consideration given to the topic by NZKGI in September 2016 following the first licence release. Now that there have been two years of release using largely the same mechanism, NZKGI sought to determine if views had changed prior to the next release.

A G3 Licence Allocation survey was issued in conjunction with the discussion paper to seek the views of growers. The survey was open for one month and closed on 31 July 2017.

172 respondees completed the survey; 168 (98%) were growers and 4 (2%) advised they were non-growers. Further analysis of the 4 non-growers indicated that 1 was a Kiwifruit Management Company, 1 was a grower's son, 1 was an actual grower (owned the land and grew kiwifruit) and 1 did not provide an explanation for their response.

The Executive Summary of the survey report is provided below. The full report is available on request from NZKGI.

- **Grower Demographics**
  - The Bay of Plenty areas of Katikati (21.05%), Tauranga (13.45%) and Te Puke (35.09%) represented 119 of the responses (69.6%).

- 124 (72.5%) of the respondents were growers who had been in the business for more than 10 years.
  - 118 (69%) growers advised that they had an orchard size of 10 hectares or less.
  - 85 (49%) growers advised that they had bid in previous years and their bids were successful while 110 (64%) growers advised that their bids had been unsuccessful. 26 (15%) growers had not bid in previous years.
- **Release Principles**  
The top 3 release principles most supported by growers are:
    - Controlled growth of the G3 market (not oversupplying) (87%),
    - Spread of license - not allowing license to be purchased by a small number of larger growers (80%), and
    - Equity of opportunity - all growers have an opportunity to grow G3 (70%).
- **Pricing Mechanism**
    - Fixed price is the preferred license release mechanism of growers (50%).
    - There was a variation in the fixed price per ha suggested by growers. Of those who provided commentary:
      - 52% suggested a fixed price of \$100k or less/ha, with 39% of those being \$20k or less/ha.
      - 27% suggested a fixed price of \$101k - 200k/ha, with 81% of those being \$150k or less/ha.
      - 21% suggested a fixed price of \$201k plus/ha, with 75% if those being \$250k or less/ha.
- **Deferred payment**
    - Most growers do not support deferred payment and are in favour of its removal (67%).
- **Maximum bid size**
    - 5 ha is the most supported maximum area that growers believe can be allocated to any one entity (37%).
    - Most growers do not support different maximum bid sizes for green cutover and greenfields (58%).
- **Restricted pools**
    - A single bidding pool is the most supported pool system by growers (50%).
    - Growers are equally divided on whether a separate pool should be made available to green only growers with a small maximum bid size (e.g. 0.5 ha) restricted to a total of 50 ha. There is no definitive answer on this point.
    - Growers support a small pool being made available to allow them to buy small amounts of license for finishing off existing blocks (i.e. a small pool of 50 ha for completing an existing block with a maximum bid size of 0.25 ha) (56%).
- **Implementation restrictions**
    - The grafting restriction most supported by growers is 1 year for all (55%).
- **Administration**
    - Growers overall are satisfied with the administration of the bid process, believing it to be sound and well run.
- **Additional comments**
    - Of the comments received, most growers do not believe that the current process is doing the industry any favours. They advise that they feel the license fee has got

out of control and the small grower has been disregarded and left behind by being priced out of the market, both in terms of initial outlay, as well as the time to break even when the total cost of cutover is considered.

### 3 Principles

During 2016 consultation with growers there were a number of principles agreed that the license release should aim to achieve. The survey has confirmed three principles that were supported by over 69% of growers that completed the survey.

#### 3.1 Controlled growth of the G3 market

The first principle supported by over 86% of growers was that the system should ensure the controlled growth of the G3 market and avoid oversupplying. The current system of determining how much license should be released on the basis of market demand on an annual basis does support this principle. However, recent information released by Zespri on the growth of the G3 markets over the next 10 years would indicate that there is insufficient license being released to meet this demand. When considering the amount of license to release, growers want certainty that returns for G3 will be maintained but consideration also needs to be given to meeting growth targets and not undersupplying the growing market. The necessity of maintaining returns for the variety will result in always having demand that is greater than supply. The 2017 license release was oversubscribed by 3.2 times which is slightly less than the 2016 release (3.4 times). Of the 586 bidders, 26% were successful. The median price increased from \$171,000 to \$235,000 (GST excl) between 2016 and 2017. Zespri needs to consider the maximum amount of license that they can release to satisfy demand but also maintain value of the variety. It seems clear that the amount of license released needs to increase but it is unclear whether an increase in the license amount will result in reduced pricing. With an oversubscription of 3.4 times, it is extremely unlikely that Zespri would release enough license to satisfy that demand without impacting on returns. A high proportion of growers' support controlling the growth of the variety and the impact of that is that there will be greater demand than supply which will continue to impact on prices paid.

#### 3.2 Spread of License

The second principle achieving support of over 80% of survey respondents is that there should be a spread of license and that the system should not allow license to be purchased by a small number of larger growers. In the 2017 license release, six bidders received 23% of the license and 21 bidders received nearly 50% of the license with bids greater than 5 ha. When considering that 13% of bidders were successful in securing 50% of the license area, then it does not appear that the principle of spreading license has been achieved. The maximum bid area of 20 ha in the 2017 release will have had some impact on spreading the license, but over 64% of growers who responded to the survey felt that the maximum bid size should be reduced. The strongest support was for the maximum bid size to be reduced to 5ha to support the principle of a spread of license. However, comments were also received from other growers that there should be no limit on the maximum bid size. Feedback received outside the survey from Trusts has also indicated that the maximum bid size is unfair as Trusts may have many owners and many beneficiaries and the maximum bid size impacts on wealth creation of a large number of people in these circumstances. Suggestions have also been made that the maximum bid size should be focussed as a percentage of KPIN area. This would allow for everyone to have equal opportunity at expansion comparable to the size of their operation. In this case, there would need to be some consideration for how to deal with oversubscription and it was suggested that a ballot be used to address this.

### 3.3 Equity of Opportunity

The third support principle was that of equity of opportunity - that all growers should have an opportunity to grow G3. In general, comments from growers consider that this principle is supported by the current system. All growers, whether current or new, have the opportunity to bid for license and bid what they think the license is worth. However, these comments are tempered by other comments which note that young growers and small green growers may not have the same financial situation as larger, established growers who already have significant gold plantings or new growers with strong financial backing. It is a recognised fact that gold fruit earns significantly more than green and that means that gold growers may have greater opportunity to pay for license. Similarly, young growers starting out in the industry may not be able to obtain the necessary finance to successfully bid for G3 and are therefore disadvantaged in the bidding system. The availability of a restricted pool available only to green growers addresses this issue to an extent as in this pool, green growers are only competing against other green growers. It should be noted however, that a large proportion of green growers also have gold and will be able to utilise the profits from gold to fund the purchase of more license to convert remaining green to gold. In the survey, growers were asked whether they supported a small pool of 50 ha for green only growers with a maximum bid size of 0.5ha. 46% of growers advised that they were in support, while 45% advised that they were not in support (9% were undecided). This does not indicate strong support for a green only pool although it was noted that the suggested maximum bid size for this pool of 0.5ha was too small to be feasible. The current system sets out to meet the principle that all growers have equal opportunity but to an extent also recognises the differential position of green growers.

## 4 Areas of agreement

The grower survey provided some direction from growers on aspects of the current license mechanism. These included:

- Deferred payment not supported (67%);
- Differential maximum bid sizes for green and gold not supported (58%);
- No strong support for small size bids available to either green growers (46% support / 45% not in support);
- A small majority of growers supported a pool being available to finish blocks (0.25ha) with 56% in support and 40% against this option. But it was noted that growers can already bid for small areas under the current system;
- A single pool for bidding is supported (as per 2017) by over 50% of the respondents;
- No major changes were requested to the administration but some suggestions for improvement were made:
  - Electronic payment.
  - Removal of pre-paid deposit.
  - Increased timeframe to submit bids.

Based on this feedback, and with the exception of the issues identified in the section below, the current system is generally supported.

## 5 Areas of contention

### 5.1 Grafting timeframe

In the 2016 release, there was a differential grafting timeframe for unrestricted bidders (2 years) and restricted bidders (1 year). In the 2017 release, all successful bids regardless of the pool were restricted to grafting by 31 January 2019. The survey asked respondents which grafting restriction they supported. Grower responses were as follows:

- 93 (55%) supported 1 year for all;
- 56 (33%) supported 2 years for all;

- 18 (11%) supported a split (2 years for unrestricted and 1 year for restricted); and
- 2 (1%) Other.

In supporting a 1-year timeframe, growers noted that this would stop speculators and would allow Zespri to better support consumer demand if they knew that 400ha each year would become available to the market at the same time. Those that supported a 2-year timeframe noted that most growers would be looking to graft as soon as possible given the cost outlay of buying the license.

Given the majority of responses supported a shorter 1-year timeframe, Zespri should reassess this restriction.

## 5.2 A reduction in maximum bid size

As discussed in section 3.2, there was significant feedback on the maximum bid size with the majority of growers supporting a reduction. This is a reaction to the 2017 release where 13.5% of bidders were successful in securing 50% of the license area. Over 64% of growers who responded to the survey felt that the maximum bid size should be reduced with support strongest for a 5ha maximum size. The current oversubscription of license area available by more than 3 times supports a reduction in maximum bid size if the principle of spreading license is to be met. A maximum bid size is likely to be necessary even if the amount of license available is increased given the level of oversubscription.

## 5.3 Price setting mechanism

The price setting mechanism has been and remains the most contentious issue for growers. Survey results indicate that the **fixed price model** is still the preferred licence release mechanism with 85 (50%) of the respondees favouring this. The overall results were:

- 85 (50%) Fixed price;
- 15 (9%) Book build;
- 25 (15%) Open tender; and
- 46 (26%) Closed tender.

In the survey, growers who supported fixed price were asked to consider what price it should be fixed at. The results were:

- 52% suggested a fixed price of \$100k or less/ha, with 39% of those being \$20k or less/ha.
- 27% suggested a fixed price of \$101k - 200k/ha, with 81% of those being \$150k or less/ha.
- 21% suggested a fixed price of \$201k plus/ha, with 75% if those being \$250k or less/ha.

The survey information is provided to Zespri as evidence of many growers' preference for a fixed price mechanism. However, it is also noted that a number of growers in regional discussions have indicated that they understand that the open tender process is the most commercial option that is a true reflection of supply and demand.

# 6 Alternative mechanisms for consideration

## 6.1 Utilisation of a royalty system

During the survey and in discussions with growers many have asked why Zespri treats its New Zealand and offshore growers differently with respect to access to G3 license. Growers have questioned why Italian growers are not required to purchase license but instead are licensed to grow the variety and pay a higher commission and whether that system should be available in New Zealand. In order to progress that discussion, it is important to understand the difference between the Italian and New Zealand markets.

The key reason why license is so expensive in New Zealand is that demand outstrips supply. The demand is driven by the demonstrated success of the variety with OGR double that of Hayward. Recent growth projections for G3 indicate that the success of the variety will continue and customer demand will exceed supply for some years to come. The same can be said for Italian grown G3 that meets Zespri requirements - demand will continue to outstrip supply. The key difference is that New Zealand growers are experiencing much greater productivity and returns than their counterparts offshore. Italian growers do not have access to same market mix with 70% of their fruit sold in Europe and 20% sold in Asian but with no access to Japan. In addition, New Zealand growers are experiencing yields of average 11,366 compared with 9,000 for their Italian counterparts. Similarly, OGR's of NZ growers are on average 53% greater than Italian growers. Further, while any New Zealand grower can buy license, Zespri chooses which growers it will allow to grow the variety to ensure they will produce the quality of fruit that the Zespri brand demands. If a grower is unable to meet Zespri's requirements, Zespri can remove the license to grow from that grower. That would not be possible if Italian growers were able to purchase license.

Growers have asked why Zespri does not allow for a royalty based system in New Zealand as an alternative to outright purchase of the license. Feedback from Zespri has been that this would still require a pricing mechanism to determine what royalty should be payable. In fairness to growers who have already purchased the license, the royalty would have to be based on a similar return. It would be unfair to those growers who have already paid for a license if Zespri was to set a royalty at a significantly reduced rate. As an example, the royalty could be set at the median purchase price of \$235,000 (excl GST) and spread over the life of the PVR which would equate to \$10,217 per year per hectare in royalties. This system is effectively a time payment system where Zespri acts as the financier. Growers have already indicated that they don't believe Zespri should be acting in this role with respect to deferred payment. Key disadvantages under this system include that a grower would not own the license and would not be able to sell it. Growers may end up paying more in the longer term because the price of license in an open market may decrease as demand is met but the royalty would be set. The major advantage in such a system is the certainty of the cost to the grower and that costs of the royalty could be paid from annual revenue from fruit sales, where no borrowing is required. This would make growing G3 more accessible to new young growers, small growers or green only growers.

Under a royalty system, there would also need to be a process of determining who should get the license assuming it continues to be over-subscribed. Zespri would need to offer the license to all growers prepared to pay a royalty (a different scenario than in Italy) but they also need to manage supply to maintain value for growers. The royalty based system would not result in any more G3 being available than under the current system. The only option would be to pro-rata or ballot the available license perhaps in 1 ha blocks. A system that restricts access to such a small area would likely not be supported by growers and would severely restrict greenfields developments.

## 6.2 Increasing release amount to reflect growth projections

The key concern that growers have with the license mechanism is the high price that is created by having significantly more demand than supply. The simplest way to resolve this is to provide more supply. The reason for the high demand is the high return that growers receive from G3. Zespri can achieve these high returns both because there is customer demand for the product and because they can demand high retail prices. If supply started to exceed demand then the retail price would decrease in order to sell more product. Zespri needs to be able to satisfy customer demand in a growing market while maintaining value for growers. The amount of license that Zespri releases needs to consider the rate at which they can grow the market while maintaining retail prices. Recently Zespri issued a 10-year

growth plan for G3 which provided an indication of what they believed could be sold while maintaining a good return for growers (estimated at a minimum of \$8/tray). It is clear that in order to achieve these growth figures, Zespri will need to release more than the 400 ha of license that it has done for the past two years. In the opposite situation to the customer demand scenario, growers want Zespri to provide as much supply as possible to meet demand and hopefully stabilise the price of license.

Zespri needs to carefully consider releasing as much license as possible while maintaining fruit returns and signalling their plans for release out as far as the 10-year plan for customer demand.

### 6.3 Commit to multiple years of license

Zespri initially indicated that while they would only commit to one year at a time, they planned to release 400 ha per year for four years for a total of 1600 ha with a likely extension of this to future years. Growers bid for 1359 ha in 2016 and 1277 ha in 2017 showing that demand in each year has exceeded Zespri's indications of release over the next three years. This high level of demand is the key factor in the license price being so high. Growers have indicated that because Zespri will only commit to one year at a time, there is uncertainty on whether the next year's release will occur and they bid for their full amount in the first year. It has been suggested that if Zespri commits to a future release programme, growers will share their demand over multiple years, thereby decreasing demand in any one year. Zespri maintains that they cannot commit to multiple years because something may happen in the market that disrupts their demand plan and they may not be able to sell all the fruit resulting in a value decrease to NZ growers. However, this could be managed by having an annual review whereby if there was significant disruption to the demand model, Zespri could revise its intentions. In the current model, Zespri indicates its intended plans but doesn't commit to a license amount until the completion of the annual review. The concept of committing to a release programme barring any major disruptions provides for significantly more certainty than the current model.

#### 6.3.1 Release multiple years at a time

An alternative proposal has been made that suggests Zespri release multiple years at one time in a single bidding process. For example, Zespri would release 1200 ha in the 2018 bidding round to cover planting in 2018, 2019 and 2020. It is proposed that by doing this, demand would be satisfied, prices would likely decrease and growers would be able to plan future orchard developments with greater certainty. To manage the risk of significant changes in customer demand, Zespri could include a covenant that allows Zespri to delay grafting or revoke the licence for either or both of the latter two years. If the licence is revoked, deposits are refunded with interest. Deposits would be payable at the time of tendering with the balance due in the year of grafting. Other elements of the proposed mechanism include:

- Tenderers to have the right of hand back for the latter two years but they must forfeit their deposit.
- Licences to not be tradeable unless grafting has occurred and not until after the end of the calendar year of grafting.
- Applicants required to demonstrate suitable plant and or land ownership or lease at the time of tendering.
- Applicants required to plant and graft within 18 months of the date of tender for the first-year allocation where new plantings are involved.

Disadvantages associated with this proposal include that it does not allow for changed circumstances within the three-year tender period. New entrants to the industry would have to wait up to three years to be able to tender for license. Similarly, existing growers

who did not bid in the first year would have to wait three years for another opportunity. It would be more complex for Zespri to manage but as the license release would only occur once in three years instead of every year, there would be other efficiencies.

## 7 Other comments

During the feedback process, NZKGI received a number of additional comments that do not relate directly to the license mechanism but are worth noting.

- Share price - concerns were regularly voiced about the impact that G3 license sales and the resulting dividends were having on share price and that shares were now considered unaffordable.
- Shareholder alignment - growers felt that they had to invest funds in buying license as an alternative to buying shares and this will negatively impact on the share alignment strategy.
- Impact on dry shareholders - as a result of the dividends payable from sales of G3 license and the increase in share price growers are concerned that dry shareholders will be reluctant to sell their shares impacting on the success of the KISP process.
- Dividend payment - a number of growers (including shareholders) were concerned with the decision to pay license revenue out as a dividend. It was felt that the funds should be reinvested into innovation and in creating a financial buffer for any major disruptions that the industry might face (e.g. a biosecurity event or a market shutdown).
- Rebate - a number of growers (including shareholders) felt that the revenue from license should be shared with all growers via a grower rebate rather than as a dividend to shareholders.

## 8 Summary

Feedback received by NZKGI over the past six months has identified both areas of agreement with the current system and suggested alternatives. Zespri is strongly recommended to address changes to the bid system in the following areas:

- Reduction in grafting timeframe to one year.
- Reduction in maximum bid size.
- Increase in the amount of license released to reflect the 10-year plan.

In addition, some alternative systems have been proposed that Zespri is asked to consider:

- Utilisation of a royalty system.
- Release of multiple years at one time.

In making their decision on the release mechanism for 2018, Zespri is asked to provide written commentary on each of the areas above including their rationale for accepting or rejecting these suggestions.

References:

NZKGI 2017, SURVEY RESULTS: ALLOCATION MECHANISM FOR GOLD3 LICENSE