

Allocation mechanism for Gold3 License (October 2016)

1. Purpose

The purpose of this paper is to summarise feedback and views on the license release mechanism used in 2016 to release 400 ha of Sungold (Gold 3, G3). Zespri (Board and Staff) will be asked to consider all of the elements raised in this paper in their deliberations on the mechanism for further G3 license release - expected to be announced in November 2016.

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 summarises the views of growers on the most appropriate license release mechanism and will be provided to Zespri who are ultimately responsible for the decision on G3 license release.

2. Background

The variety 'Sungold' also known as G3 was first released by Zespri in 2010. Its commercialisation was fast-tracked in response to Psa as G3's tolerance to the disease comparative to Hort16A became apparent. Existing Hort16A growers were able to purchase G3 license for \$8,000 per hectare on a GOFO (gold one for one) basis (1 ha of Hort16A for 1 ha of G3) and a wider release was also made at a similar fixed price. All growers were able to access up to 10% of their productive area which allowed Hayward growers to also access the variety. Since being introduced, G3 has performed extremely well and is now the preferred Gold variety globally. There is significant demand in export markets for the fruit and as a result, in 2016, Zespri announced it would release up to 1600 ha of G3 license over a four year timeframe. Zespri announced the intended mechanism for license release and allowed for a short consultation period. There was significant feedback provided to Zespri with the most contentious issue being the pricing mechanism. NZKGI provided a view that growers were strongly in favour of a fixed price mechanism being available to existing growers with a smaller pool of license available as closed tender to both existing area and new greenfields development.

Zespri chose to proceed with a closed tender pricing mechanism because they felt that the 400 ha to be released would be significantly oversubscribed and it would then be difficult to pro-rata the license across all bidders. Bidders may end up with a license amount that was too small to be practical.

Prior to the next release of G3 license, Zespri sought feedback on the license mechanism to be used for the next and future releases. NZKGI discussed the issue with its Forum of representatives on several occasions and views from these discussions inform this paper. In addition, views received during the July Zespri roadshows (attended by NZKGI) and views received during the October discussion paper consultation process have been considered.

The paper begins by summarising the license release mechanism used in 2016 and summarising outcomes from the release. It then considers the desired outcomes from license release and provides feedback on specific elements of the license release. Views from the consultation process on the discussion paper have been included but it is important to consider all views received both prior to the release of the discussion paper and additional comments generated through that process.

3. 2016 Release mechanism

In March Zespri made 400ha of Gold 3 license available in a closed tender allocation process. The key elements of the license release included:

- 200 ha available only to Hayward/Green 14 growers
 - Closed tender
 - Bid area could not exceed existing canopy area of Hayward/Green 14 (from which fruit has been supplied to Zespri)
 - Must be grafted (stump or notch) by 31 January 2017
- 200 ha unrestricted
 - Closed tender
 - Maximum total bid area per legal entity = 20ha
 - Must be grafted/planted by the bidder by 31 January 2018
- Payment
 - If growers settle in full by 29 July 2016, they will receive a 9% discount on their bid price
 - Deposit of 25% required at the time of bid submission
 - Deferred payment available (where price after deposit exceeds \$10,000)
 - 25% payable 31 August 2018
 - 25% payable 31 August 2019
 - 25% payable 31 August 2020

In June, Zespri released an analysis of the license release outcome. Key points included:

- There were 1081 bids, of which 153 were successful in the restricted pool and 113 in the unrestricted pool.
- A total of 1,359 ha were bid for (400 ha successful)
- The average size of successful bid was 1.31 ha (restricted) and 1.77 ha (unrestricted)
- Of the 400 ha released, 191 ha was for Hayward growers converting to G3 and 9 ha were from G14 growers converting to G3.
- Bids were received from all regions except Nelson but the majority was from the Bay of Plenty.

- Only one bid of the 266 was over 10 ha in size, the vast majority (206) were for areas less than 2 ha.

4. Release Principles

A number of key outcomes have been identified as desirable through release of new G3 license. These included:

- Controlled growth of the G3 market (not oversupplying)
- Encouraging Hayward-only growers to diversify by having some G3 license
- Continuing to re-balance the industry's variety portfolio by shifting Hayward hectares into higher-performing varieties
- Return on investment to Zespri for breeding the variety
- Equity of opportunity - all growers have an opportunity to grow G3.
- Spread of license - not allowing license to be purchased by a small number of larger growers

During the consultation process, there was mixed feedback on these principles. While most supported the controlled growth of the G3 market and equity of opportunity, there was significant disagreement over the principles referring to shifting growers from Hayward to Gold and on the need for Zespri to receive a return on investment for breeding the variety. A key to this discussion is that green growers believe that the development of the G3 variety was due to investment from green growers originally and that there should be some recognition of this over greenfields growers who have not yet contributed to the industry. Alternatively, others felt that the green only pool made available in the first year was sufficient recognition and going forward there should be no segregation of the pools. It was also suggested that a principle of allowing new entrants into the industry should be included.

At the conclusion of the 2016 license release, Zespri indicated they were comfortable that they achieved the majority of the aims of the release including that there was a good amount of Hayward cutover, a good spread of growers receiving license and the average hectare size was not too large.

5. Elements of Release Mechanism

There are five key elements to the license release mechanism. This section of the discussion paper outlines the feedback that NZKGI has received on each of these key areas. The Zespri Board will be asked to consider each of these key areas when making a decision on the future mechanism for license release.

5.1. Pricing mechanism

There are varying views on the most appropriate pricing mechanism. Prior to the 2016 release, NZKGI felt that a fixed price model was most appropriate to ensure that growers had equal opportunity to access G3 license. The recommendation from NZKGI was for a mixed of closed tender (100ha) and fixed price (300ha). A price of \$35-70,000 per hectare was considered appropriate. The Zespri Board chose to proceed with a closed tender pricing mechanism.

The 2016 license release was highly oversubscribed and it is likely that future releases will also be oversubscribed.

Grower feedback received following the 2016 allocation has indicated that while a fixed price mechanism would have provided equity and certainty for growers, the high level of demand meant that a fixed price mechanism would be very difficult to manage. License would have to be pro-rated across all bidders and would potentially result in areas of license being too small to be practical. Given the high demand scenario, feedback has been received that the closed tender mechanism is the most appropriate. It also allows for a market price to be set on a purely commercial basis and maximises the value of the license to Zespri. Growers are now familiar with the closed tender process, it is simple to understand and simple to administer.

Two alternative options have also been discussed- book build and open tender in the form of an online auction. The online auction process provides the same outcomes of commercially driven pricing as a closed tender but allows for transparency in the bidding process. It was felt that the open bidding mechanism would result in a more realistic commercial price as growers would not need to guess what might be required to be successful. Conversely there are views that the open auction process would increase the bid price and growers may feel pressured to increase their bids beyond their calculated level in order to secure license. There would need to be some investigation as to a platform that could be used for an online auction system.

The concept of a book build was discussed prior to the first license release but was discounted as a feasible option due to the short timeframe that was available to organise the system. Book build operates by the lowest successful tender price becoming the price for all successful tenders. An external provider would be needed to operate the book build. Education of growers would be required to explain the system of a book build.

Consultation on the discussion paper resulted in equal support for the status quo closed tender system and the book build system with one submitter requesting a fixed price for green growers. A significant number of submitters did not specifically comment on the pricing mechanism.

5.2. Deferred payment

Due to the short timeframe between announcement of the license release and the close of the tender process, Zespri made a deferred payment system available to growers. This enabled growers to spread the cost of the license over four payments stretching over five years. Conversely, a discount was offered for those growers who made payment in full. This deferred payment system resulted in debt of approximately \$50 million owing to Zespri which will need to be closely managed. Historically, there have been issues collecting owed monies from some growers for license purchase even when the cost was significantly less.

While the reason for offering the deferred payment option in 2016 is understood, there is significant concern from growers that Zespri should not be operating as a bank. Many growers feel that if the license release is a commercial process then commercial terms should apply and deferred payment should not be offered. It is more appropriate for banks to fund license purchase and this may provide some

discipline to the bidding process. It was noted by growers that if there was no deferred payment system then there would also be no need for a discount for full payment as everyone would be operating on the same terms. Deferred payment was considered by some growers as a contributor to the tender price and it was felt that removal of the deferred payment system may reduce the bid price.

Growers did however note that if a key desired outcome of the license release process was to see Hayward growers switch to G3, then the deferred payment system will assist with this. Feedback has been received from green only growers that they are not financially in a situation where they can take on debt to the extent required to purchase G3 license. While for some growers the deferred payment may make this investment easier, it will still require Hayward growers to fund the full license price so a grower reluctant to take on debt is unlikely to bid for license regardless of the deferred payment option. A suggestion was made that the deferred payment option be made available only to Hayward growers as a means of encouraging those growers to invest in G3 license.

There is also a question of equity. If growers in the first round of license release were given the deferred payment option, some growers believe it should also be made available to growers in the future. However, the reason for offering the deferred payment was due to the short timeframe making it difficult to obtain bank financing. This is no longer the case with growers having had notice since the release in 2016 of the likely financing required and banks indicating that they are willing to talk to potential licence bidders about financing. It was suggested that all growers be given the opportunity to utilise deferred payment once as a means of ensuring equity. However this does not address the issue of Zespri debt levels or the potential impact on bid price. Further it would place growers in inequitable bidding situations if some had access to deferred payment and others did not and they were bidding in the same pool.

Feedback from the discussion paper consultation process was clearly in favour of removal of the deferred payment system. One submitter who supported it continuing, was also in favour of deductions being made from grower payments as a means of risk reduction to Zespri and another submitter indicated that license from any defaulted payers would easily be on sold reducing the risk to Zespri. There was support for deferred payment for green growers only

5.3. Maximum bid size

While the maximum bid size for the first release was 20ha, there was only one bid larger than 10ha and the average bid size was less than 2 ha. Therefore the desired aim of spreading the license appears to have been successful. However, it is noted that one grower may have made several bids which are not captured by this information. The original principle of spreading the license across as many growers as possible continues to be supported by growers. However, there is some support for introducing more discipline to this by reducing the maximum bid size. Feedback has been received that the maximum bid size for green cutover should be reduced to 2-5 ha and the unrestricted bid size be restricted to 5-10 ha.

An alternative option of restricting bid size by a maximum percentage of KPIN area was proposed. A level of 10% was suggested but feedback was received that if the bid size was too small, it would potentially increase the price.

A suggestion was also received that maximum bid sizes should be set by related party rather than by entity to ensure some parties were not circumventing the maximum bid restriction.

Feedback from the discussion paper was mixed with some growers supporting the status quo and others supporting reduced maximum bid sizes and having a differential split between green cutover and greenfields.

5.4. Restricted pools

Feedback received prior to release of the discussion paper generally supported the differentiation in the bid process of existing growers vs greenfields developments. However it was suggested that this could be achieved through a single pool rather than separate pools to ensure consistency in pricing across the pools. In this case, there would be one pool but a proportion of license would be set aside for existing green growers. There was also significant support for increasing the restricted pool to 300 ha and the unrestricted being 100 ha or 250/150ha. This would support the outcome of transferring green area to gold area which was a key principle. However, as the restricted pool is available to all green growers (including those that also have gold), this may not achieve the desired outcome. Green growers that also have gold have a greater economic basis on which to bid for license and therefore the basis on which they are bidding is not equitable. It has been suggested that in order to allow green only growers the greatest opportunity to access some gold license, that a separate pool be made available to green only growers. The pool would have a small maximum bid size (e.g. 0.5ha) and be restricted to a total of 50 hectares. This would mean that 12.5% of the 400ha license release each year would be allocated to green only growers and would transition 100 growers in each year to become green and gold growers, achieving a key focus of the license release process.

There was also some support for a small pool being made available to growers to allow them to buy small amounts of license for finishing off existing blocks. It could also be used in situations where GPS mapping has altered a grower's licensed area and would provide a much fairer outcome than having to buy treasury stock. This pool would have a small maximum bid size (e.g. <0.5ha) and growers would need to demonstrate that the license will be used for completing an existing block. It was suggested that this pool could have a fixed price set at a commercial level.

It was noted that having two pools does allow for some flexibility if required, particularly around grafting timeframes that may differ for existing vs greenfields developments.

Feedback from the consultation paper generally supported having a single pool available to all bidders as this represents the most commercial option. Submitters noted that the outcome of the first round showed the bidders in the two pools acted in a similar way which supports the use of a single pool. However, there are also views that behaviour in future rounds may be different as greenfields are now

more prepared to participate in the process. The importance of allowing new entrants into the industry was noted. There was also support for the status quo and for a 300/100 split with one submitter supporting a single green only pool.

5.5. Implementation restrictions

Growers had varying opinions on how soon the license should be utilised (grafting timeframe). Some felt that there should be no differentiation between existing plantings and greenfields but others felt that was unrealistic and it was necessary to provide a longer timeframe for greenfields. In general, there was support for the existing timeframes which were considered as short as practically possible.

Responses to the discussion paper generally supported the status quo although one submitter suggested that no timeframe for grafting was necessary given the economic pressures that growers would be under. Another submitter suggested a 2 year timeframe for all bids was appropriate. The principle of equity was discussed in that if green growers were competing with greenfields in the same pool, then they should have to meet the same timeframes, to allow greenfields longer was providing them with preferential terms which is not acceptable.

5.6. Other

Zespri is asked to give further consideration to whether the bids should be made GST inclusive or GST exclusive. Growers reported some confusion in the 2016 process, particularly around the bid announcement process.

In order to provide certainty to growers and potentially stabilise the tender price, Zespri is asked to confirm the license allocation for the next 3 years now. While the desire for flexibility is understood, the market demand is well known

6. Administration of the bid process

Feedback was provided on several aspects of the bid process.

6.1. Opening the bids

While recognising that the last bid process was undertaken under significant time constraints, it is recommended that bids are not opened until after the closing date for bids. This is to remove the risk that information on bids received could be passed on to any potential bidders.

Feedback on this issue from the discussion paper supported this suggestion. While it is understood that this means clarification of issues with bids will not be possible until after bids close, the bid process should no longer be under any time pressure and timeframes can be adjusted to allow this to occur.

6.2. Announcement of bid outcome

It is strongly recommended that both successful and unsuccessful bidders are notified at the same time and that deposit cheques are not cashed until the completion of the notification process.

Discussion paper feedback also strongly supported this recommendation.

6.3. Cooney Lees Morgan

Some feedback has been received that the bid process should be handled by a firm that does not have client relationships with potential bidders. This would avoid any potential or perception of potential for conflict of interest or bias.

Where submitters commented on this aspect of the discussion paper, they supported the suggestion that a firm without conflicts should be chosen to administer the process.

7. New concepts

7.1. Release programme

Several submitters to the discussion paper requested that Zespri either commit in advance to the G3 license release for several years, or, accept tenders for multiple years in the same process. Submitters commented that the high prices in the first round were as a result of limited supply and strong demand coupled with uncertainty on access to license in future years. While it is understood that Zespri would prefer to make the decision year on year based on market conditions, current indications from the market strongly support the growth of G3. The 5 year plan already includes the planned license release which indicates Zespri is confident in the future of the variety. Submitters felt that Zespri should commit to future license release now and if necessary, include a clause on unforeseen circumstances that would enable them to void the release if absolutely necessary. This certainty could allow for more moderated prices and allow growers to plan ahead for investment.

Zespri is asked to update growers on their plans for G3 market growth and explain how this relate to the release programme.

7.2. Treaty of Waitangi

Within one submission, Zespri is asked to report on how the G3 license mechanism takes into account the principles of the Treaty of Waitangi.

8. Summary comments

There is clear and understood tension between growers on the subject of the G3 license release mechanism. Views range from those that strongly support a commercial and largely unrestricted model and those that feel existing growers, and in particular green growers, should receive concessions in their access to license. It would be extremely difficult to satisfy the desires of all growers through the license release mechanism as the views are so widely apart. Therefore Zespri must consider what it believes is in the best, long term interests of kiwifruit growers. It must provide commentary as to how it has come to this decision and the industry must accept that whatever the decision, it will not satisfy all growers.

In coming to its decision, Zespri is strongly encouraged to review the following key points:

- Identify the principles that Zespri believes are critical and set the mechanism on the basis of these, then communicate
- Undertake a thorough consideration of the book build pricing mechanism without focussing on time or education constraints
- Consider the opportunity to commit to future license releases or release license for multiple years in a single bid
- Review the administration of the bid process ensuring that it is an independent and fair as possible