

CHINA GOLD3: COMMERCIAL PROCUREMENT MODEL TRIAL OVER THREE YEARS FOR UP TO 1.95 MILLION TRAYS

DRAFT DECISION UNDER REGULATION 10A ON WHETHER THE NOTIFIED ACTIVITY 'SUPPORTS CORE BUSINESS'

DRAFT REPORT DATED 11 JANUARY, 2021 ISSUED IN CONFIDENCE TO ZESPRI FOR COMMENT

EXECUTIVE SUMMARY

1. Kiwifruit New Zealand monitors and enforces Zespri's compliance with the mitigation measures in the Kiwifruit Export Regulations 1999. The Regulations prohibit Zespri from carrying out any activities that are not its core business, unless those activities 'support core business', as defined in regulation 10A, or are approved by a producer vote under regulation 11.
2. KNZ is required by regulation 33 to monitor and enforce Zespri's compliance with regulations 10A and 11. The intent of these provisions is to establish the appropriate level of control *by producers* over Zespri's engagement in activities that are not 'core business'. It is important to note that KNZ's role is not to itself make a decision about the desirability of an activity or manage the risks undertaken by Zespri, or decide whether those risks are appropriate or whether the benefits of an activity outweigh the risks involved. Rather, its role is to ensure that producer oversight is engaged where it ought to be: that is, where the proposed activity is neither core business nor assessed as 'supports core business', either because it is not likely to enhance the core business, or, critically, where risks to producer interests are more than low.
3. The Regulations do not allow KNZ any discretion to permit Zespri to engage in activities that are not its core business or do not meet the definition of 'supports core business'. That decision belongs with producers.
4. On 28 October 2020 Zespri gave notice to KNZ under regulation 10A that it proposed to carry out an activity that was not core business, being a three-year trial of a commercial procurement model for Chinese-grown Gold3 kiwifruit, involving up to 1.95 million trays. Zespri's view is that the proposed activity meets the definition of 'supporting core business', being that it:
 - 4.1 is likely to enhance the performance of Zespri's core business; and
 - 4.2 poses no more than a low risk (if any) to the interests of New Zealand producers.
5. Regulation 10A is part of the mitigation measures introduced through amendments to the Regulations in 2017. In 2018 KNZ provided Zespri with a draft Discussion Paper setting out its proposed approach to the new regulations 10A and 11, and its expectations as to information that would be provided by Zespri. KNZ engaged with Zespri on developing this paper and following a meeting on 25 February 2019 minor final amendments have been made. The final version of this Discussion Paper is at Appendix A.

KNZ's assessment of the notified activity has been undertaken in line with the principles set out in that paper.

6. The information initially provided by Zespri in its notification was not sufficient for KNZ to form a view on whether the notified activity 'supports core business', and KNZ has engaged extensively with Zespri through November and December to obtain further and more detailed information to inform its assessment. KNZ has also sought and received input from NZKGI (the New Zealand Kiwifruit Growers Inc) specifically on the range of interests of producers potentially affected by the activity. KNZ has also obtained expert advice from Sapere Research Group and John McKinnon (former Ambassador to China) to assist it in its assessment.
7. The KNZ Board is grateful for the willingness of its executive and expert advisors to work over the Christmas break to progress this analysis but expects that a more timely and comprehensive approach by Zespri to future notifications will assist the assessment process.
8. KNZ became aware in late November that [REDACTED], shortly after giving notice to KNZ and well before KNZ could be expected to complete its assessment, or for there to be a producer vote in the event that KNZ formed the view that the notified activity did not meet the definition of 'supports core business'. [REDACTED]
9. KNZ has carefully considered the material provided by Zespri, the input from NZKGI and the advice from the Sapere Research Group working with John McKinnon. KNZ is of the view that the notified activity does **not** meet the definition of 'supports core business' under regulation 10A. KNZ is satisfied that the notified activity is likely to enhance the performance of the core business under regulation 10A(2)(a) but does not consider that the notified activity poses no more than low risk to the interests of producers under regulation 10A(2)(b).
10. KNZ now invites Zespri's views in response, before finalising its decision.

NEXT STEPS AND CONFIDENTIALITY

11. Zespri is invited to provide its views and response by 5 pm on Monday 18 January 2021. KNZ will then consider that response and reach a final decision.
12. It is important for the integrity of the regulatory regime that producers and other stakeholders are informed of Zespri's proposals and the reasons for KNZ's assessment of whether the notified activity supports core business. Producers in particular need to be fully informed about the nature of the activities and KNZ's assessments of whether they enhance performance of Zespri's core business and/or pose no more than low risk if (any) to their interests: this is important for the transparency of the regime and will be critical in the event of a producer vote. KNZ will accordingly notify its final

- decision to NZKGI and MPI and publish its final decision report (including annexures) on its website.
13. Zespri has claimed that the entire content of its notification is confidential on the grounds of commercial sensitivity. KNZ does not agree with this assessment.
 14. KNZ accepts that there may be certain specific aspects of the information in the notification and the information provided subsequently by Zespri that are genuinely commercially sensitive but expects that these will be narrowly confined. KNZ will consider redacting this information from its final decision report and annexures, but this must be done in such a way that does not compromise the ability of producers and other stakeholders to understand the notification and the reasons for KNZ's decision.
 15. KNZ accordingly invites Zespri to include in its response to this draft decision report a marked-up version of this draft report and its annexures identifying the specific information that Zespri considers to be genuinely commercially sensitive. For each proposed redaction, Zespri should in the text of the document:
 - 15.1 Set out the grounds upon which Zespri considers that the specific information should be withheld from publication; and
 - 15.2 Provide a short summary of the redacted information sufficient to inform producers and stakeholders of its general nature and content.
 16. If KNZ's final decision is that the notified activity does not support core business, then Zespri will need to obtain the approval of producers through a producer vote under regulation 11 before it can lawfully engage in the notified activity.
 17. As set out in the Discussion Paper at Appendix A, KNZ's role in monitoring compliance with regulation 11 will include monitoring whether:
 - 17.1 Zespri has carried out a process in which all producers have been informed of the proposed activities, and asked to agree by vote to Zespri carrying out the proposed activities; and
 - 17.2 The required proportion of votes have been obtained in support; and
 - 17.3 Zespri has minimised, as far as reasonably practicable, the risks arising for producers who have not agreed to the activity.
 18. KNZ expects that Zespri will fully engage with KNZ before commencing a process under regulation 11 to ensure that its proposed processes are sufficient to meet these requirements. The Discussion Paper in Appendix A sets out in more detail KNZ's expectations of what this process should involve.

19. Part of the producer vote process involves ensuring that producers are fully informed of the details of the proposed activities and clearly understand potential risks to their interests. This requires careful consideration of how Zespri proposes to deal with relevant information that it considers to be commercially sensitive. KNZ expects that Zespri will undertake early engagement with it and with producer groups to pro-actively manage this issue in such a way that does not compromise the ability of producers to exercise their vote.

INTRODUCTION: REGULATION 10A AND KNZ'S ROLE

20. The Kiwifruit Industry Restructuring Act 1999 established a monopsony arrangement with Zespri as the single desk exporter of New Zealand grown kiwifruit, other than to Australia. To offset and mitigate the risks and costs inherent in Zespri's monopsony position, the Act established KNZ as the regulatory body charged with monitoring and enforcing a range of mitigation measures set out in the Kiwifruit Export Regulations 1999. Following a review of the regime, the mitigation measures were amended and expanded in 2017.
21. The amended Regulations prohibit Zespri from carrying out any activities that are not its core business unless those activities 'support core business', as defined in regulation 10A, or are approved by a producer vote under regulation 11.
22. Regulation 10A defines an activity as 'supporting core business' if the activity:
- (a) is likely to enhance the performance of the core business; *and*
 - (b) poses no more than a low risk (if any) to the interests of producers.
23. KNZ is required by regulation 33 to monitor and enforce Zespri's compliance with regulations 10A and 11. The intent of these provisions is to establish the appropriate level of control *by producers* over Zespri's engagement in activities that are not 'core business'. KNZ's role is not to itself manage the risks undertaken by Zespri, or decide whether those risks are appropriate or whether the benefits of an activity outweigh the risks involved. Rather, its role is to ensure that producer oversight is engaged where it ought to be: that is, where the proposed activity is neither core business nor assessed as 'supports core business', either because it is not likely to enhance the core business, or, critically, where risks to producer interests are more than low.
24. KNZ does not have any discretion to allow Zespri to engage in activities that are outside its core business or do not meet the definition of 'supports core business'. The Regulations absolutely prohibit Zespri engaging in such activities unless they are approved by producer vote.
25. The regulatory regime and KNZ's approach to its functions of monitoring and enforcing the mitigation measures are discussed in more detail in the Discussion Paper at Appendix A.

26. This paper sets out KNZ's views on whether the activities notified by Zespri on 28 October 2020 meet the definition of 'supports core business' under regulation 10A.

ZESPRI'S NOTIFICATION AND TIMING ISSUES

27. Regulation 10A requires Zespri to inform KNZ before carrying out any activities that are not core business but do support core business. KNZ then has the function of assessing whether the notified activity meets the definition of supporting core business. The Discussion Paper at Appendix A sets out KNZ's approach to that assessment and its expectations as to the information that is to be provided by Zespri to support that assessment.

28. Zespri provided 'prior notification' to KNZ on 28 October 2020 for a three-year commercial procurement model trial of Chinese-grown Gold3 kiwifruit (Appendix B). The notification identified three new activities which were outside core business but which Zespri considered would meet the definition of 'supporting core business':

28.1 On-orchard extension and quality assurance activities in relation to Chinese-grown Gold3, including winter pruning, soil and leaf analysis, infrastructure management and a fertiliser and spray management programme with a view to determining yield and packout improvement (with/without Zespri involvement).

28.2 Post-harvest extension and assessment in relation to the management of Chinese-grown Gold3 through the packhouse, and provision of quality assurance in relation to Chinese-grown Gold3.

28.3 Purchase and sale of Chinese-grown Gold3 kiwifruit.

29. Despite the early engagement with Zespri in 2018 in formulating the Discussion Paper, the information provided by Zespri in its initial notification was unclear and insufficient to allow KNZ to reach an informed view under regulation 10A.

30. In addition, [REDACTED]
[REDACTED]
This obviously complicated our assessment process.

31. Zespri also did not initially provide information about the likely timing of its proposed engagement in the notified activities, other than an indication that "over the next few months, [it] will be undertaking partner assessment and contracting with relevant orchard stakeholders for the provision of fruit in October 2021". In response to KNZ's questions, Zespri advised on 7 November that its key decision points were in October/November 2021 and

February/March 2022, but also indicated that there were 'some key phases in establishing the trial before harvest' including:

- 31.1 November 2020, entering into a Memorandum of Understanding with the Sichuan Provincial Government in support of the trial;
 - 31.2 November/December 2020, 'confirming' supply agreements with around [REDACTED] of Chinese Orchards;
 - 31.3 March/April 2021, deciding retail and consumer sensory testing criteria for the 2021 harvest including volumes, retail channel and branding, and packing options for market assessment.
32. KNZ has expressed concern that the timing of Zespri's notification was patently insufficient to allow a proper assessment of whether the notified activities met the definition of 'supporting core business' and, if not, for a producer vote to be held before Zespri's proposed commencement. The challenges for Zespri in dealing with Chinese-grown Gold3 are neither new nor sudden, and KNZ has been emphasising to Zespri for a considerable period the importance of early engagement and allowing sufficient time for an orderly process under the Regulations.
33. [REDACTED]
34. [REDACTED]
35. Zespri has also subsequently asked for an expedited decision-making process, advising on 4 December 2020 that this was necessary to allow it "to proceed with certainty with the Sichuan SOE and the orchards" and to allow it to "demonstrate our commitment to the China trial ... ahead of the January/February grafting window...". While KNZ continues to express concern at Zespri's approach it has nonetheless endeavoured to complete its assessment as expeditiously as possible, and the KNZ Board acknowledges that this has involved staff and expert advisors working through the Christmas break, for which it is grateful. KNZ trusts that such unnecessary time pressures on staff and external advisors will be avoided in future.

KNZ'S PROCESS

36. As outlined above, a considerable period of time has been spent seeking and obtaining further information from Zespri to inform KNZ's assessment. The final tranche of information was received on 23 December 2020.
37. KNZ also consulted with NZKGI specifically on the identification of the potential risks to the interests of producers posed by the notified activity. NZKGI provided their input on 11 December 2020 (Appendix C). KNZ understands that in formulating that response, NZKGI's processes included a briefing from Zespri and access to Zespri's notification document, followed by a closed-door session with its Forum members with no Zespri staff or non-growers in attendance.
38. KNZ engaged Sapere Research Group to undertake a detailed analysis and provide advice on whether the notified activity met the definition of 'supports core business'. Zespri facilitated engagement between Sapere and its own expert advisors and staff which has been a very useful process.
39. KNZ also engaged John McKinnon, former Ambassador to China, to work with Sapere.
40. Sapere's final report dated 6 January 2021 is at Appendix D.
41. KNZ's views were provided to Zespri for comment and response in the form of a draft of this decision report.

KNZ'S ASSESSMENT

Scope of the notified activity

42. The notified activity is the three-year commercial procurement model trial for Chinese-grown Gold3, involving a maximum of 1.95 million trays. For simplicity this is referred to as a single activity, acknowledging that it is made up of a number of component activities, as detailed in the notification of 28 October 2020.
43. Zespri has appropriately delineated this three-year trial phase as a separate activity from any future decision on whether to extend the trial or to commence commercial procurement of Chinese-grown Gold3 (or any other variety) as an ongoing activity. Zespri has acknowledged that such activities would require further notification under regulation 10A and potentially approval by producer vote under regulation 11.
44. Our assessment is therefore confined to the three-year trial programme only. We agree with Sapere's view that any enhancement of core business that might arise from later decisions to enter into an ongoing activity, and any risks that might result from that ongoing activity, are not relevant factors to our consideration of the notified activity. However, we also agree that commencing the trial brings with it the consequences that might result from ending the trial, including in circumstances where the decision is made not to proceed to an ongoing commercial procurement activity. These consequences are matters that should be considered in assessing whether the

trial is likely to enhance core business or is no more than low risk to producers.

Is the notified activity likely to enhance performance of Zespri's core business?

45. KNZ's approach to this assessment has been informed by the principles set out in the Discussion Paper at Appendix A, at paragraphs 24 and 25.

46. In its notification Zespri explained that a key objective of the trial is to "conduct necessary research and due diligence to enable consideration by the Zespri Board of whether to commence commercial procurement of Chinese-grown Gold3 ...". Zespri states:

Zespri does not now hold the information needed to assess whether such ongoing procurement activity would enhance core business and/or be low risk to the interests of New Zealand producers. Zespri will gain this information through the commercial procurement model trial. In parallel, Zespri will continue to engage with KNZ and New Zealand producers to understand better how those interests should be defined and develop a framework for assessing the level of risks.

47. In summary, Zespri's view is that the notified activity is likely to enhance performance of its core business in the following ways:

47.1 Due diligence and risk assessment of potential future commercial procurement options;

47.2 Confirmation/expansion of existing knowledge to permit more robust assessment of potential competitive threat of unauthorised G3 in China and other core New Zealand kiwifruit markets;

47.3 Supporting existing government and industry relations platforms through working directly with local kiwifruit industry stakeholders, including creating a platform to leverage industry and political support in China to help mitigate the spread and impact of unauthorised Gold3 plantings; and

47.4 Reduction of immediate and future financial and reputational risk.

48. KNZ agrees with Sapere's assessment that the notified activity is likely to enhance performance of Zespri's core business by providing information that may:

48.1 Reduce current or future costs or risks of carrying out the core business; and

48.2 Increase current or future prices or demand for New Zealand-grown kiwifruit.

49. KNZ's assessment is that the first limb of regulation 10A(2) is met for this notified activity.

Does the activity pose no more than low risk (if any) to the interests of producers

50. Consistent with the purpose of the mitigation measures, KNZ considers that regulation 10A requires a conservative approach to risk. The threshold test of “no more than a low risk (if any)” is obviously low, in line with the primary function of reg 10A, which is to distinguish between non-core activities that must be approved by 75% of producers, and those that can proceed without any oversight by producers at all.
51. KNZ’s view is also that a balancing or weighing of risks, positive and negative, is not intended under this regulation. The assessment required under regulation 10A is only whether there is a low risk of adverse effects on producer interests. A decision on whether it would nonetheless be worthwhile incurring a modest or large risk of negative outcomes in the pursuit of a potential gain or benefit is a matter for producers to vote on under regulation 11.
52. Regulation 10A(3) directs that consideration of the nature of any risk must take into account any measures that Zespri proposes to put in place to mitigate the effects of any risk event, and then to consider:
- 52.1 The likelihood of the risk event occurring; and
- 52.2 The impact on the interests of producers if a risk event occurred.
53. KNZ has followed this approach, and its assessment has been further informed by the principles set out in in the Discussion Paper at Appendix A, at paragraphs 26 to 31.

What risks to producer interests are engaged?

54. KNZ set out in 2018 in its Discussion Paper its expectation that Zespri would directly engage with producers to identify the set of interests against which risk would be assessed. This acknowledged that the experience and knowledge of individuals affects their perceptions of potential outcomes and likelihoods and what they might consider a risk to their interests. Zespri personnel, for example, may have different perceptions of some risks from its producers and from KNZ. Zespri’s own ‘in house’ assessment of the scope and range of interests of producers potentially affected by a proposed activity is therefore unlikely to be sufficient.
55. Zespri was accordingly advised in 2018 that KNZ would expect to see information from Zespri identifying the scope and range of interests of producers that may be impacted by the proposed activity, and an explanation of the basis for Zespri’s assessment that it has identified all relevant interests. [REDACTED]
56. Zespri has instead provided details of its communications to producers about the general issue of Gold3 grown in China in contravention of Zespri’s PVR rights, and their engagement with producer concerns on that issue. That is not the same as engaging with producers to understand and identify

their perspective on the nature of their interests that could be at risk from *this* proposed activity. We agree with Sapere’s observation that it would be reasonable to expect Zespri to keep data on grower interactions, their concerns, the extent to which they held different views and the proportions holding those different views. We reiterate that we expect to see a more thorough and evidence-based identification of potential risks to producer interests and a more comprehensive record of direct engagement with producers on this aspect in future.

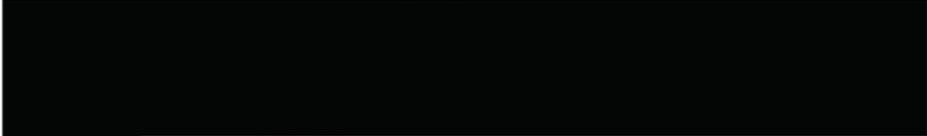
57. Based on its own assessment, Zespri identified in its notification only three potential risks to producer interests engaged by this activity:
 - 57.1 Reputational matters relating to Zespri’s brand and by extension, the “NZ producer” brand of being a producer of high quality, premium kiwifruit;
 - 57.2 Financial returns OGR delivered by Zespri for fruit produced, and related factors such as timing and potential stability of returns;
 - 57.3 Risk of leakage of New Zealand on-orchard expertise in China: Zespri’s involvement in on-orchard and postharvest extension and quality assurance activities risks specific skills and techniques used by New Zealand producers being copied or adopted more broadly by Chinese producers and post-harvest operators. Zespri noted that this could both inadvertently hasten the development of volumes and quality of the unauthorised GoldG3 production, and reduce the competitive advantage of New Zealand kiwifruit producers.
58. KNZ agrees that these are relevant areas of risk.
59. Given Zespri’s approach to identifying producer interests potentially at risk, KNZ engaged with NZKGI and asked it to provide input on what it saw to be the interests of producers potentially at risk from this activity. NZKGI’s response of 11 December (Appendix C) identified the following producer interests as potentially engaged in this context:
 - 59.1 Grower returns;
 - 59.2 Asset values (ie orchard capital values);
 - 59.3 Brand reputation and customer perception especially with regard to food safety and quality;
 - 59.4 Market access with regards to the New Zealand China relationship;
 - 59.5 Future industry stability including ongoing support of the Single Point of Entry and financial sustainability; and
 - 59.6 Orchard practice intellectual property.
60. KNZ agrees that these are relevant areas of risk.

61. While acknowledging that KNZ's role is limited to what is outlined in the Regulations, NZKGI also set out its overall position on the notified activity, including that growers "support Zespri working with China on a small scale trial in 2021 ..." and that "it is the view of the NZKGI Forum that the proposed first year of trial of 200,000 trays is low risk to the New Zealand Grower", but that it did not at present support anything more than that.
62. Sapere, working with John McKinnon, focussed on three areas of risk (overlapping with those identified by NZKGI), being reputational risk, financial risk and risk of leakage of New Zealand expertise in China. Sapere identified two key risks in particular:
- 62.1 The potential for the trial to impact on Zespri's relationship with the provincial Chinese government stakeholders, should Zespri conclude at the end of the trial that it was not in its interests to continue (in other words, that damaged relationships on exit could result in a worse outcome for New Zealand producers than not entering the trial at all);
- 62.2 The potential for the trial to hasten the leakage in China of New Zealand on-orchard and post-harvest expertise.
63. KNZ agrees that these are relevant areas of risk. We also record that the first of these two key risks was clearly identified for Zespri's Board in October 2020 and we accordingly would have expected Zespri to include this in its notification.
64. KNZ also considers that the notified activity involves a range of broader risks around Zespri's reputation and brand, and also the wider China New Zealand trade relationship.

Does the activity pose no more than low risk to producer interests

65. KNZ agrees with Sapere's assessment that the two key risks identified by it and outlined above are more than low for this notified activity, broadly for the same the reasons set out in its report (Appendix D).
66. KNZ also considers that there is more than a low risk with regard to brand reputation and customer perception, especially with regard to food safety and quality. KNZ strongly disagrees with Zespri's position that "any such reputational damage is unlikely to accrue to New Zealand producers given that any such quality or food safety failures would be clearly linked to Chinese-grown fruit." Not only is that an unrealistic assumption in terms of market perception, but KNZ believes that quality and especially food safety failures would directly affect the Zespri brand, regardless of the country of origin of the fruit. As Zespri itself correctly records elsewhere in its notification, "any risk to the [Zespri] brand is considered to be directly aligned with risk to New Zealand producer interests."
67. We note that in the present context Sapere considers that the scale of the trial is sufficiently limited to nonetheless bring this risk down to no more than low. Based on our experience we do not agree with Sapere's view on this

aspect: although it is extremely difficult to quantify, KNZ considers that this risk is more than low even for this trial phase.

68. KNZ's view is accordingly that the notified activity does not meet the requirements of regulation 10A(2)(b).
69. KNZ considers that in line with the purpose of the Regulations, these are risks that Zespri should not incur without first engaging with and obtaining the approval of 75% of producers for this activity.
70. For completeness, and for guidance for the future, KNZ also makes the following observations about the other risks identified as potentially arising from the trial.
71. Asset values (orchard capital values): KNZ agrees with Sapere that the notified activity poses a low risk to this aspect of producer interests.
72. Future industry stability: KNZ agrees with Sapere that the limited nature of the trial means that this risk is no more than low.
73. Financial risk: KNZ agrees with Sapere's view that it is possible that the trial could affect the value of Gold3 licences either positively or negatively. Views differ on this point but overall we consider that the potential risks are no more than low.
74. 
KNZ is unable to quantify this risk but is of the view that it needs to be carefully considered and addressed by Zespri before a new direction is taken in China.

Conclusion

75. KNZ's decision is that the notified activity does **not** meet the definition of 'supports core business' under regulation 10A. KNZ is satisfied that the notified activity is likely to enhance the performance of the core business under regulation 10A(2)(a), but does not consider that the notified activity poses no more than low risk to the interests of producers under regulation 10A(2)(b). KNZ's position is accordingly that Zespri cannot lawfully engage in the notified activity without first obtaining the prior approval of a producer vote under regulation 11.

LIST OF APPENDICES

A: KNZ discussion paper: the prior notice and non-diversification rules

B: Zespri's notification dated 28 October 2020

C: NZKGI letter 11 December 2020

D: Sapere Research Group report

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