



22 May 2019

Matthew Lewer

Regulation Branch

Email to: Regulation.branch@comcom.govt.nz

Dear Matthew,

We would like to thank you for giving Synlait Milk Limited (Synlait) the opportunity to make a submission on the proposed focus areas for the 2019/20 milk price calculation. We have targeted our submission around the focus areas set out by the Commerce Commission and raised one additional substantive matter.

As an opening remark, Synlait believe all the focus areas outlined by the Commerce Commission for this year's calculation review ultimately come back to off-GDT sales transparency. We believe that improvement in the regime across all the focus areas could be achieved through meaningful improvement in the transparency of off-GDT sales and the returns the Notional Producer is achieving through them.

8.1. Whether it is practically feasible for the Notional Processor plant, as configured, to manufacture the specified product range included in Fonterra's Qualifying Materials

8.2. Whether production efficiencies assumed for the Notional Processor are consistent with the range and scheduling of production for the full sales portfolio of Qualifying Materials

While Synlait agree these are appropriate focus areas for this year's calculation review, we do not believe it is possible for an independent party, such as Synlait, to qualify these statements with the current information disclosed. Our ability to meaningfully engage relies on more transparency of the off-GDT sales component within the milk price calculation.

We agree with Miraka's submission to this seasons milk price manual review that the open ended nature of 'qualifying material' in the manual must be playing a role in the expansion of the range of qualifying materials that are being included in the milk price calculation through off-GDT sales.¹ For the incremental impact of off-GDT sales to increase from 8 cents in 2017/18 to 10 cents in 2018/19 while the proportion of product sold on GDT decreased from 45% to 42% to us indicates that a different range of products, justifying an increased price must be being included.² It does not match

¹ Miraka "Miraka submission to the Commerce Commission: Draft report (15 November 2019): Review of Fonterra 2019/20 Milk Price Manual" (15 November 2019), paragraph 3

² We note in Fonterra's March Global Dairy Update that off-GDT sales had contributed 8c per kgMS to the 2019/20 season as at 31 Jan 2019

our experience that more premiums could be extracted from the same off-GDT sales while selling less product off-GDT.

This considered, we are limited in our assessment of whether the published total production figures and associated yields are feasible. What we see in Fonterra's published material is essentially five individual products, WMP, SMP, Butter, AMF and BMP. To properly assess The Notional Producer's ability to manufacture the actual product mix and associated efficiencies achieved through the season by the Notional Producer, as outlined in 8.1 and 8.2 above, the following information would be required.

- Product specifications and detail on product characteristics of all 'qualifying material'. Even small changes in specifications change the production rates. This is particularly important in a plant assumed to be operating as efficiently as the Notional Producer; and
- The number of unique 'qualifying materials' and volumes of each sold. Any manufacturing business become less 'efficient' as the number of products it produces increases and invariably run lengths reduce. This is particularly true for dairy where multiple run changes add significant inefficiency.

We therefore believe that for the Commerce Commission to meaningfully engage with independent processors in assessing the focus areas outlined above the first step would be to improve transparency around off-GDT sales. We note the Commerce Commissions conclusions made in their final report on the 2018/19 calculation review:³

Given the importance of internal consistency to the assumptions, inputs and processes used in the milk price calculation, we will further examine in our 2019/20 review of the milk price calculation the process around adding products to the QMs schedule to confirm that only qualifying products are being added and appropriate adjustments are being made to other assumptions or inputs.

We may also examine in more detail the practical feasibility of the product range included in Fonterra's list of QMs.

While we support these commitments, we believe they could be taken a step further by reviewing this in line with the additional context of our comments above, and making the information supporting the review more transparent.

8.3. Whether it is practically feasible to attribute manufacturing costs to the Notional Processor using the Incremental Product Cost adjustments for products that are not standard specification products

³ Commerce Commission "Final Report – Review of Fonterra's 2019-20 base milk price manual (12 December 2019), paragraph 41 & 42

As defined in Part C of the milk price manual the ‘incremental product cost’ captures the three relevant cost buckets going into any dairy commodity product. These are broken down in the three bullet points below, taken from the milk price manual:⁴

- *Reasonable provision should be made for the difference in cost of milk components included in the product relative to the cost of milk components included in a Standard Specification Product, having regard to the implied value of the milk components at the time the product is manufactured.*
- *Reasonable provision should be made for any difference between the variable cost of manufacturing the product and the variable cost of manufacturing the relevant Standard Specification Product.*
- *Reasonable provision should be made for any difference between fixed cost or overhead recoveries where such difference is in the normal course of events recovered by Fonterra from its customers through a higher selling price.*

Costs associated with the first two bullet points are dealt with relatively easily as they can be directly allocated to a product. The third bullet point deals with fixed cost allocation which is more complex and open to interpretation. It is standard practise in dairy processing to allocate fixed costs across products by looking at product revenues. One must be careful with the circularity inherent in this statement, however.

While product revenues achieved and forecast inform how fixed costs are allocated, it would not be appropriate for the Notional Producer to allocate a higher fixed cost to non-standard spec products that have not in reality been manufactured and sold. Introducing manufacturing cost into a product does not automatically result in a more desirable product and subsequent higher achieved revenue.

We acknowledge Miraka’s submission on the incremental product costing as part of the 2019/20 Manual review.⁵ It is not clear to us where their claim came from, however, we believe it may be in relation to our circular reference point made above.

8.4. Whether the selling costs for all the Qualifying Materials have been appropriately provided for

Synlait is a very different dairy business to the Notional Producer so it is not overly helpful to benchmark actual selling costs between us. There is some value in looking at year on year selling costs over time however and our experience is that commodity selling costs per MT have been increasing over time. It also seems intuitive to Synlait that as the effect on the milk price of the off-GDT component increases, whether this be through increasing premium per MT or through an increase in the amount being sold through off-GDT, both would require increased sales resourcing, and therefore cost.

⁴ Milk Price manual – Part C

⁵ Miraka “Miraka submission to the Commerce Commission: Draft report (15 November 2019): Review of Fonterra 2019/20 Milk Price Manual” (15 November 2019), paragraph 9

This is supported by Miraka's prudent point in their submission to this seasons milk price manual draft decision on selling costs.⁶ Miraka point out that the Commission justified the Notional Producers selling costs being roughly half that of Fonterra's Global Ingredients and Operations business per kgMS as part of the 2015/16 milk price calculation review, on the grounds that Fonterra faces higher costs than the Notional Producer due to it selling and receiving higher revenues on product sold off-GDT.

The Notional Producer is now selling over 40% of its's product through off-GDT channels so applying the Commerce Commissions logic above it is hard to reconcile a reduction in the Notional Producers selling costs per kgMS over this time.⁷

Total processing capacity and standardising

We note the acknowledgement in last season's milk price calculation final report that 'capacity is matched on a North Island/South island basis, to peak supply.'⁸ Synlait requests a view from the Commerce Commission as to whether 150B of DIRA has the effect of geographically un-anchoring the Notional Producers manufacturing footprint. 150B(a) reads as below:

that new co-op operates a national network of facilities for the collection and processing of milk

Our reading of capacity being matched on a North Island/South Island basis for raw milk processing capacity decisions is that this would imply there is essentially a single processing plant in the North Island and the same in the South Island. We do not believe this could be interpreted as a 'national network'.

This also clouds what a 'national collection network' would look like. During peak milk supply, processing and collection resources are fully utilised. A national collection network, having trucks based at various sites nationally, makes matching processing capacity on a North Island/South Island basis impossible.

Regardless of the interpretation of 150B(a) we do not believe that this two Island capacity match could be considered practically feasible. While acknowledging that the Commerce Commission concluded on this matter as part of the 2012/13 milk price calculation review, we believe it is worth revisiting. The dairy environment has changed materially since 2012/13 with continuous season on season milk pool growth no longer existing.

We also seek further clarification on the raw milk processing capacity question we raised in our submission to the 2018/19 milk price calculation review draft decision.⁹ Synlait's submission focused

⁶ Miraka "Miraka submission to the Commerce Commission: Draft report (15 November 2019): Review of Fonterra 2019/20 Milk Price Manual" (15 November 2019), paragraph 26

⁷ While the review was carried out as part of the 2015/16 season it was done using 2014/15 information. This is therefore the time frame in question.

⁸ Commerce Commission "Final Report – Review of Fonterra's 2018-19 base milk price calculation (12 September 2019), page 34

⁹ Commerce Commission "Final Report – Review of Fonterra's 2018-19 base milk price calculation" (12 September 2019), page 34

on the Notional Producer's ability to process all the raw milk in the 2018/19 season with the reduced processing capacity available in that season. Fonterra's reasons paper supporting the 2018/19 milk price calculation outlined how the Notional Producer was operating with four fewer permanent plants than in the previous season as well as continuing to mothball four plants, in a season where they were forecasting strong volume growth until well after the peak.^{10,11}

In the final report on the 2018/19 milk price calculation The Commerce Commission offered the following response to our submission point:

The budget forecast milk supply for the 2019 season indicated that the Milk Price business had the capacity to process all peak milk without the mothballed plants, and thus the Milk Price business did not reopen any mothballed plants (this would take time in the real world, and this is reflected in the model). However actual peak volume was higher than forecast, and the Milk Price business reduced lactose standardising to cope with the capacity shortfall during peak period, particularly in the South Island.¹²

Fonterra's published Notional Producer model (NPM) for the 2018/19 season makes provision for unstandardised product, indicating that 1.28% of finished product was unstandardised in the 2018/19 season.¹³ Applied evenly across the manufacturing footprint, 1.28% of finished product would be produced in approximately two and a half peak days following a normal seasonal curve. Even if we accept that manufacturing unstandardised product was an appropriate response that would have improved production capability, potentially two and a half unstandardised production days does not reconcile with last seasons reality as outlined in our submission.

The cost of not standardising commodities is that you produce products with higher fat and protein levels, above minimum specifications and are therefore not compensated for the additional components in your product. A true commodity business would be essentially giving away fat and protein for free. As no product was unstandardised in the 2017/18 season according to the published NPM that season, you would expect yield, the amount of finished product achieved per kgMS of milk collected to have decreased but this was materially unchanged. In the 2017/18 season 2.886M MT of product was produced from 1,505M kgMS, a rate of 191.8% while in 2018/19 2.920M MT of product was produced from 1,523M kgMS, a rate of 191.7%, materially the same.

Outside of the excel model itself having unstandardised product mix as a calculated input, it is difficult to find support for unstandardised production having occurred in the rest of Fonterra's published

¹⁰ Fonterra "Reasons paper on Review of the 2018-19 base milk price calculation" (1 July 2019)

¹¹ In the 2018/19 season Fonterra were predicting strong milk supply growth and it wasn't until February 28th that they reduced their forecast collection volume for the season from 1550kgMS to 1530kgMS. 11,11 1550kgMS would represent their strongest milk season since 2015/16. It is hard to reconcile how four plants were mothballed when Fonterra were forecasting significant volume growth until well past the peak months.

¹² Commerce Commission "Final Report – Review of Fonterra's 2018-19 base milk price calculation (12 September 2019), page 34

¹³ Fonterra "Version of 2018/19 Milk Price Model"- calculation tab row 193 – 198

information. The purchased lactose going into the NPM increased by 1.7% in the season while the production of WMP and SMP increased by only 1.3%.

While Fonterra doesn't reveal the lactose composition in the milk they collect but instead lactose and minerals combined, this combined 'component' has stayed materially the same between seasons, therefore increasing naturally produced lactose in line with overall milk supply collection growth of 1.2%. We find it hard to hold all these moving parts together.

Going forward we believe there would be benefit in the Commerce Commission providing more detail around the assessment of processing capacity vs raw milk production each season. We have found it hard to find support for the Commerce Commission response to our submission last season by digging through the released Notional Producer information.

We would be interested in both how decisions to close permanent plants and/or mothball plants are made by Fonterra and also how these changes are subsequently assessed by the Commerce Commission. We do not believe the single paragraph provided in the 2018/19 final report on the milk price calculation addressing this reduction in processing capacity and subsequent shortfall is sufficient for interested parties to properly assess the validity of this assumption. We also believe further transparency around the Lactose composition of the milk collected would be useful information in assessing these decisions.

We also support the request made by Miraka in their submission to the milk price manual that it is difficult to discern the costs associated with mothballing a plant in the milk price calculation and agree this should be addressed in the milk price calculation review.¹⁴

Additional discussion points

As laid out in previous submissions we continue to believe the regime would be improved through further transparency around foreign exchange achieved by the Notional Producer.¹⁵ During any given milk season we get one view of Fonterra's, and the NPM's, FX position through their current season position information released in the milk price statement for the previous season in September each year. This information is rounded to the a whole cent, or 100 points. This means there is a full cent in potential variance in Fonterra's reported FX number.¹⁶ One cent of FX has a roughly 12 - 15 cent impact on the milk price, significantly affecting any independent parties ability to accurately forecast the FGMP during the season. Standard FX reporting practise is to four decimal places.

Finally, we would like to raise the use of a range by Fonterra in communication of their milk price. As a practise, within reason, we have no issues with a range being used to outline the confidence associated with a milk price announcement at any given point in time. We would however request

¹⁴ Miraka "Miraka submission to the Commerce Commission: Review of Fonterra 2019/20 Milk Price Manual draft report" (15 November 2019), paragraph 24.4

¹⁵ Synlait "Synlait submission to the Commerce Commission: Review of Fonterra 2018/19 Milk Price Calculation" (02 September 2019), page 1.

¹⁶ A reported FX rate of 0.70 could represent a rate as low as 0.6950 or as high as 0.7049



confirmation, one way or the other, from the Commerce Commission that the mid point of any announced range represents the NPM derived farmgate milk price (FGMP).

We cannot find definitive direction around the use of a range in DIRA or the Milk Price Manual, nor can we find any guidance in previous Commerce Commission documents. We believe in the spirit of the regime, and for it's integrity, that the mid point of a range should be the NPM derived FGMP.

In the same vein, as part of the ongoing DIRA review MPI have clarified that Fonterra are not mandated to pay the FGMP. We seek confirmation, one way or the other, that if Fonterra had made a commercial decision to not pay the FGMP that this would be noted at the time of an announcement being made.

Yours faithfully,

A handwritten signature in black ink, appearing to read 'L. Clement', is positioned below the closing text.

Leon Clement
CEO Synlait Milk Limited