

Commerce Commission

Our Draft Report on Fonterra's 2015/16 Base Milk Price Calculation 15 August 2016

Sue Begg, Deputy Chair



Overview of presentation

Today we released our draft report on our review of Fonterra's 2015/16 base milk price calculation

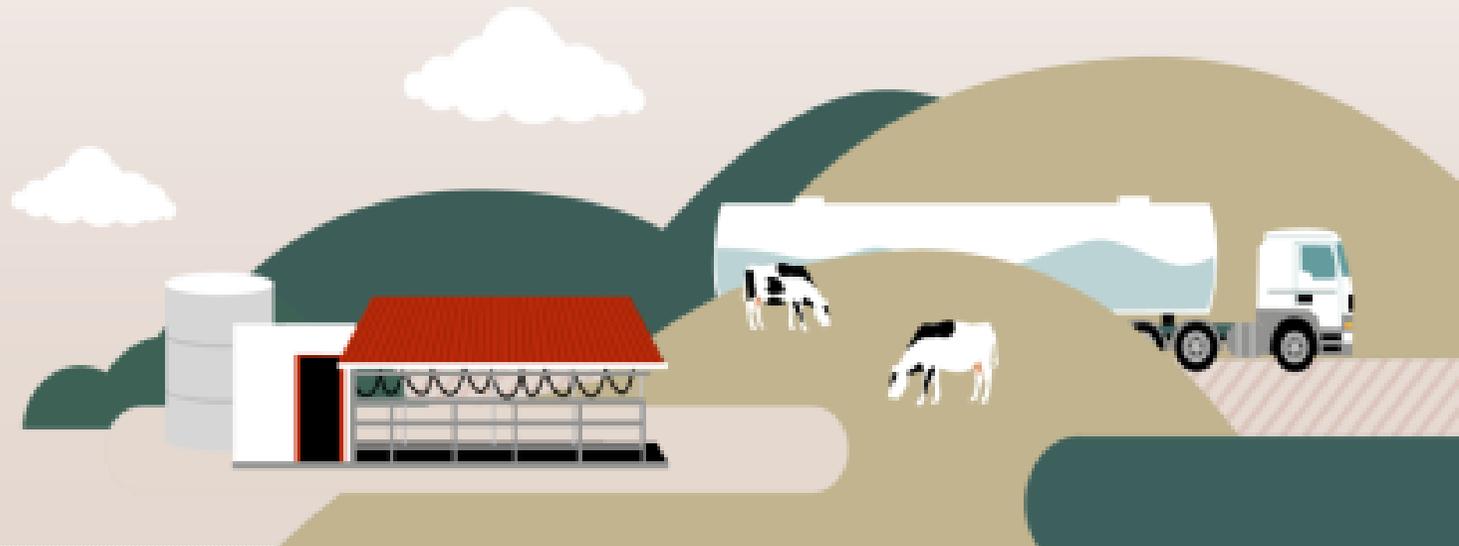
- What this year's review focused on
- Our overall draft conclusions and recommendations
- Progress made in this review
- Our draft conclusions on focus areas
- Our next steps



This year's review

This was our fourth statutory review of the base milk price calculation

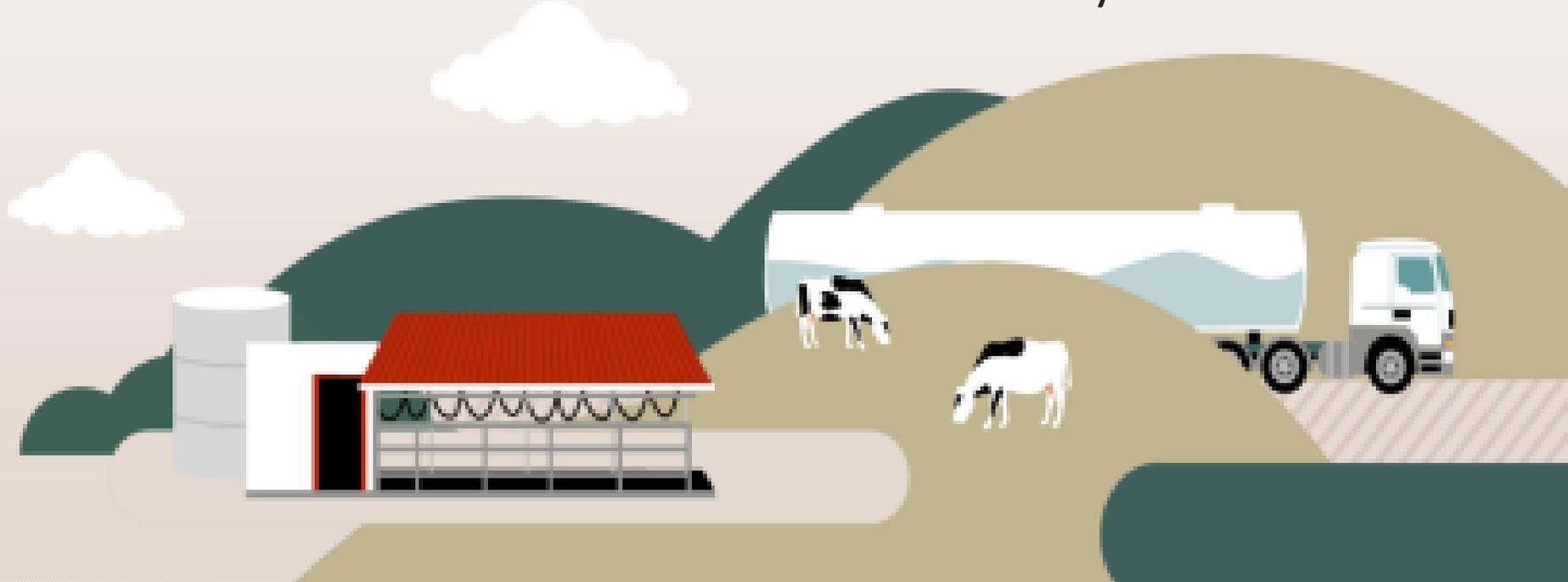
- It builds on our previous reviews of the Manual and calculation
- We focused on looking at the practical feasibility of the notional producer as a whole
- We worked on resolving outstanding issues



Our draft conclusions

The assumptions, inputs and processes Fonterra used to calculate the 2015/16 base milk price are consistent with the DIRA regime's purpose

- The calculation is **consistent** with the efficiency dimension
- The calculation is **consistent** with the contestability dimension



Our recommendations for Fonterra

We would like to see continued development in the following areas in coming reviews

- More frequent reviews of the current reference commodity product basket, given the volatility in commodity markets
- Increased transparency of forecast information (in particular prices used in calculation)
- Ongoing annual publication of the results of the cost performance of Fonterra's Global Ingredients and Global Operations (GOGI) businesses' RCP operation to allow interested parties to compare with the notional producer



Our focus areas in this year's review

- Aggregate assessment of the notional producer
- WACC (*Asset beta and specific risk premium*)
- Production yields and related pricing
- Consistency of fixed asset assumptions (*Fixed assets, depreciation, and repairs and maintenance*)
- Corporate costs (*Administration, plant labour, some supply chain, overheads and selling costs*)



Progress made in our review

- Our aggregate assessment of the notional producer's 2014/15 performance compared with Fonterra's GOGI RCP operation indicates the notional producer is practically feasible as a whole
- We concluded that the asset beta and specific risk premium are practically feasible
- Fonterra has improved its transparency of information in:
 - Addressing key concerns of interested parties (eg fixed asset assumptions, losses calculation)
 - Engaging with us on areas where transparency is needed (eg forecast information, pricing)



Aggregate assessment of revenues

Fonterra's GOGI RCP operation achieves significantly higher commodity revenues off-GDT

- Using the GDT as the primary basis for RCP reference prices may no longer be appropriate
- Fonterra has also come to this conclusion and has proposed amendments to the 2016/17 Manual
- We will assess those amendments in our next Manual review
- The amendments are expected to result in a higher milk price in 2016/17 by approximately 5 cents per kgMS



Aggregate assessment of costs

We reconciled the differences in non-milk costs

- Our analysis indicated that the notional producer's non-milk costs were 18 cents lower than Fonterra's GOGI RCP operation's costs
- The differences between the two businesses relate to:
 - Selling costs (particularly off-GDT sales) (around 8 cents)
 - Logistics setup (around 2 cents)
 - Performance of plants (some of the remaining 8 cents attributed to this)
- These reasons explain the gap – the analysis indicates that the notional producer is practically feasible



WACC: Asset beta & specific risk premium

We are satisfied the WACC has been calculated consistent with the efficiency and contestability dimensions

- We are satisfied that the approach taken by Fonterra's WACC expert is consistent with s 150A of DIRA
- The notional producer faces low systematic risk
- We consider an asset beta of 0.38 as used by Fonterra to be within an acceptable range for an efficient processor with the notional producer's risk profile
- We have seen no evidence that the risk premium for asset stranding risk of 0.15% as used by Fonterra is not reasonable



Production yields and related pricing

We have concluded that the notional yields have been calculated consistent with the efficiency and contestability dimensions

- We engaged a yields expert to help us conclude on the practical feasibility of the yields. We consider:
 - The losses are practically feasible but challenging
 - The specification offsets are practically feasible
- We are satisfied the mass balance calculation reconciles
- We also conclude that the product specifications meet GDT specifications and the notional producer can achieve GDT prices



Fonterra has reset corporate costs

We have concluded that the corporate costs have been calculated consistent with the efficiency and contestability dimensions

- The cost components of the calculation have been reviewed and reset by Fonterra as required by the Manual (every four years)
- The reset includes a restructuring adjustment to the number of FTEs required by the notional producer
- Adjustments to the value of 2014/15 cost components are consistent with scale and assumptions of the notional producer
- In the absence of any other comparable data, we consider this approach reasonable



Consistency of fixed asset assumptions

Overall, we are satisfied that the fixed asset assumptions are consistent with the efficiency and contestability dimensions

- As a package the fixed asset assumptions are consistent with the contestability dimension, even though the ‘practical feasibility’ of individual components in a real-world sense may be unclear
- The assumptions are consistent with the notional producer being able to achieve high performing yields across its plants
- To aid transparency of information, we have published Fonterra’s simplified model to enable testing of cost recovery scenarios



Our next steps

Our draft report released

15 August 2016

Submissions on draft report by

1 September 2016

Our final report released

15 September 2016



Questions?



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