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Submission on the Commerce Commission's Process and Fonterra's 2016/17 Milk Price Manual

Open Country Dairy (Open Country) is pleased to make this submission on the Commerce Commission's (Commission) process and Fonterra's 2016/17 milk price manual (Manual).

Open Country affirms its belief that the Dairy Industry Restructuring Act 2001 (DIRA) is demonstrably not working and that greater integrity, transparency and objectivity in the milk price is the only way forward for the regime. We refer the Commission to our submission on the 2015/16 milk price calculation for full details of our position.

Open Country's comments on the Commission's process are that:

- The Commission must make an independent assessment of whether the Manual satisfies DIRA, and its report must clearly outline the reasons for that assessment
- We are concerned with the wide discretion Fonterra currently has under the Manual and the risk of this effectively delegating the Commission's statutory functions to Fonterra.

Open Country's comments on the proposed Manual are that:

- Using off-GDT sales does not improve the representativeness of the notional processor's revenues
- Fonterra's proposed approach to setting the capacity of secondary Reference Commodity Products (RCPs) is not practically feasible and gives Fonterra an unjustified level of discretion
- Fonterra still refuses to include winter milk premiums in the milk price calculation which fails to satisfy practical feasibility.

Below we explain these points in further detail.

1 The Commission's Process

A key part of the Commission's role under DIRA is to manage any scope for flexibility within the milk price monitoring regime in a way that promotes benefits to the wider dairy sector and the New Zealand economy as a whole. In this section of our submission we set out what this requires.

For the regime to be applied successfully, each of Fonterra and the Commission must discharge their particular roles:

- Fonterra is required to present a substantive justification for its belief that the Manual positively satisfies the criteria set out in the section 150A purpose
- The Commission is required to provide an independent assessment of those substantive justifications, and report an objective view on whether the criteria in section 150A of DIRA have in fact been satisfied.

It is not the intention of DIRA that any flexibility inherent in the regime should be transformed into a discretion for Fonterra to set the base milk price according to a process that is arbitrary, unjustified or solely to satisfy its own interests. However, this could occur in a number of ways, for example if Fonterra is able to:

- apply its own gloss on the statutory criteria, rather than being guided by an authoritative interpretation from the Commission
- establish an open-ended process within the Manual that can potentially be satisfied ex post in a number of ways
- treat the efficiency and contestability requirements as a superficial 'tick the box' exercise, rather than engaging with the purpose and substance of the milk price monitoring regime
- avoid providing a full, clear, logical justification for its belief that the Manual is consistent with the section 150A purpose.

When the statutory standard is consistency, the Commission's review of the Manual is required to be alive to these issues. In appropriate circumstances, and if an adequate justification is provided, a degree of flexibility in the Manual may be appropriate. However, this cannot occur at the expense of the integrity, transparency and objectivity of the regime as a whole. If Fonterra is able to capture a meaningful degree of discretion over what is properly the Commission's assessment of consistency, then it is the duty of the Commission to state plainly that it cannot be satisfied that the Manual is consistent with the section 150A purpose.

The risk involved in overlooking these aspects is that the Commission effectively delegates to Fonterra its statutory role to assess the Manual for consistency with DIRA. This should concern the Commission because it would be in breach of standard public law principles, and leave the Commission's decisions vulnerable to legal challenge. Of more immediate concern for us, however, is that it reveals a fundamentally flawed decision-making process that cannot deliver the outcomes intended by the monitoring regime.

It does not appear to us at this stage that Fonterra's approach to preparing the Manual has been alive to these points, and it would be of real concern if this allowed Fonterra to exercise an undue amount of unchecked discretion. If the necessary integrity and objectivity is to be incorporated into the milk price monitoring regime then the Commission's assessment process, and ultimately its draft decision, must explicitly address these points.

2 The Proposed Manual

The Manual Fonterra has proposed has made significant changes. These changes are not consistent with the section 150A purpose.

Using off-GDT sales does not improve the representativeness of the notional processor's revenues

As Open Country stated in its submission on the draft report on the 2015/16 milk price calculation, the notional processor's sales must satisfy DIRA by giving Fonterra an incentive to be efficient while providing for a milk price that is practically feasible. Put simply: what should the notional processor be assumed to sell and how should it be assumed to sell it?

Open Country does not view GDT as being perfect, but it is certainly both the most representative and transparent price data available for estimating the notional processor's sales. On the other hand, incorporating off-GDT sales would be inappropriate for three reasons.

First, off-GDT sales are characteristically different to on-GDT sales in that they are generally under longer-term contracts providing greater price and/or supply security. We draw the Commission's attention again to Castalia's report to Open Country on this matter.[1] In addition, the fact that prices differ between on-GDT and off-GDT sales provides empirical evidence supporting our point. If the products were truly part of the same market and substitutable, the Commission should expect that prices on an international platform open to many buyers would tend to converge with off-GDT prices. Why would people pay more off-GDT than on-GDT if the two provide the same product? This convergence is not happening—and in the absence of a satisfactory explanation from Fonterra it must be assumed by the Commission that these sales are different.

Accordingly, incorporating these sales is changing what the notional processor is assumed to sell. Rather than selling products on an open market platform based on prices achievable at the time, the notional processor would be being assumed to enter into longer-term contracts which are more like financial products. Selling such products involves greater costs—and we have not seen Fonterra proposing to include those costs in the Manual. Our position is that off-GDT sales should not be included because such different sales would not have been intended to be included under DIRA—and for the transparency and discretion reasons set out below. However, if off-GDT data were incorporated in the notional processor's sales, these costs would need to be included for these changes to be accepted by the Commission as being consistent with the statutory criteria. Further, we are interested in the Commission's view on whether including such different sales would have been intended by DIRA.

Second, using off-GDT sales raises significant methodological challenges. Fonterra seems to suggest that only a subset of off-GDT sales would be incorporated in the milk price calculation—those off-GDT sales that are characteristically similar to on-GDT sales.[2] Leaving aside that the price difference between the two provides strong evidence that they are different types of sales, it is unclear how Fonterra would analyse which sales qualified as sales of the notional processor. There must be a robust, objective and transparent way of allocating such sales.

Third, this issue raises even greater issues for transparency and the discretion Fonterra has to influence the milk price. Unless Fonterra will disclose the prices it achieves under its contracts, and the way in which it selects off-GDT sales as qualifying sales, neither the Commission nor industry can have any confidence that these prices are efficient or practically feasible. Further, if Fonterra will be left to the task of allocating sales to the notional processor, this provides Fonterra with yet another area of discretion in which it may set the milk price to further its own interests.

We urge the Commission to reconsider its recommendation that off-GDT sales be used in setting the milk price—and request that the Manual be amended to clarify this important

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1 Castalia 'Review of 2015/16 Milk Price Calculation: Report to Open Country' September 2016, accessible at this link.

2 Fonterra 'Reasons Paper in Support of Fonterra's Milk Price Manual for the 2016/17 Season' 1 August 2016, at p.8, accessible at this link.

matter. A further 4 to 5 cents increase in the milk price increases the gap between the notional processor construct and a practically feasible milk price.

Fonterra's proposed approach to setting the capacity of secondary Reference Commodity Products (RCPs) is not practically feasible and gives Fonterra an unjustifiable level of discretion

Fonterra currently sets the level of processing capacity for manufacturing the RCPs as the average daily capacity of Fonterra's actual plants. We are comfortable with this approach because the Manual assumes that the volume of milk the notional processor collects is the same as Fonterra's volume of milk. This approach promotes practical feasibility because it helps provide comfort that the notional processor pays the capital and operating costs necessary to process the volume of milk it is assumed to process.

It is unclear to us why, then, Fonterra is proposing such a different approach to setting capacity for the secondary RCPs.

Fonterra wants to use the average daily processing capacity of plants currently available from equipment suppliers to set the capacity for plant processing the secondary RCPs. Since the processing capacity of plants available from equipment suppliers varies, the Commission will be unable to conclude that the processing capacity is practically feasible because there is no basis to confirm that it is:

- Sufficient to process the volume of milk collected in any given year
- Efficient—taking into account the need to hold processing capacity to process an uncertain volume of milk. We note again that Fonterra still refuses to transparently explain how buffer capacity in the model is set and at times has said that there is no such buffer capacity.

We also note Fonterra's proposed approach introduces greater discretion into the milk price. Fonterra states that it will set the notional processor's processing capacity "erring toward" the average capacity of plants currently included in the asset base. We find it difficult to believe that in a document with regulatory force, and one that is required to positively satisfy specific statutory criteria, that the Commission would allow Fonterra to use such uncertain language.

Transparency is a critical part of the regime, and adequate transparency is needed from Fonterra before the Commission can positively conclude that the section 150A purpose is satisfied. For that reason, the Commission should recommend that Fonterra simply provide a schedule to the milk price manual setting out the number, type and capacity of the notional processors' processing assets. Since Fonterra discloses the processing capacity of its plants on its website, those plants are notionalised to form the notional processor's asset base, and this cannot credibly be considered confidential, we recommend this approach be taken with a revised Manual released for the upcoming season. All such plant should be in the milk price model in any case so little work should be required. This approach would finally provide clarity on a key component of the Manual.

Fonterra is still refusing to include winter milk premiums in the calculation which fails to satisfy practical feasibility

As Open Country has stated in the past two seasons, Fonterra's approach to winter milk is not practically feasible.[3] Fonterra in the past has said that it assumes the notional processor pays no premium for winter milk. In its reasons paper on the Manual, Fonterra now states that "a portion" of winter milk premiums feed into the milk price model and that these have the effect of reducing payments available for milk.

We are frustrated that, much like buffer capacity, Fonterra appears to change its position and industry stakeholders are left wondering how the Manual really works.

The Commission's position in the draft report on the 2015/16 milk price calculation was that the notional processor would not incur winter milk premiums because the notional processor would not pay such premiums to supply product on international markets which do not provide a seasonal price premium.[4] We agree—however, the notional processor is assumed to collect the same volume of milk as Fonterra. Accordingly, the notional processor is receiving the volume benefit of Fonterra paying winter milk premiums without paying that premium itself. This approach is not practically feasible—and involves the notional processor receiving additional milk for which it does not pay the full cost (approximately 5 percent of supply).

We reiterate that we cannot see how this approach satisfies practical feasibility, and would appreciate the Commission clarifying its views on this issue.

Conclusion

Open Country believes a more realistic approach to the issues described in this letter will better reflect the world that all processors face; leading to a Manual and milk price that satisfies DIRA.

Open Country looks forward to continuing to engage with the Commission as part of its current regulatory oversight role, and to positive steps in the evolution/application of the existing regulatory regime.

Best regards,

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Open Country Dairy Ltd

3 See Open Country 'Submission on the Commerce Commission's Draft Report – Review of Fonterra's 2014/15 Milk Price Calculation'.

4 Commerce Commission 'Review of Fonterra's 2015/16 Base Milk Price Calculation: Dairy Industry Restructuring Act 2001: Draft Report at para 5.12.