The Commissioners
Commerce Commission
44 The Terrace
Wellington

1 September 2021

Attention: Hristina Dantcheva, Principal Economist

Dear Hristina,

Open Country Dairy Limited – submission on milk price calculation – 2020/21 season

Thank you for the opportunity to comment on the Commerce Commission's (Commission) review of Fonterra's base milk price calculation for the 2020/21 season. This submission responds to the Commission's draft report dated 16 August 2021 (Draft Report).

Open Country Dairy Limited (Open Country) has repeatedly submitted on the issues addressed in this submission. We refer the Commission to our submission from 1 September 2020 again, as well as our submissions on the underlying incentives of Fonterra regarding the milk price in previous years.

This submission addresses three matters:

- Practical feasibility of the asset beta used by Fonterra
- Stranding risk should be retained for time being
- "Black box" use of off-GDT sales in milk price calculation

Practical feasibility of asset beta

The Commission has reached a draft conclusion that:[1]

> *an asset beta value of 0.45 is within a reasonable range of asset beta values for an efficient processor and thus practically feasible*

The draft conclusion is flawed. It does not follow that the asset beta is practically feasible because it is at the extreme low end of a range of statistical possibilities. Independent experts have previously calculated the range and shown that the likely value should be significantly higher.

The Commission should not accept that statistical possibility is the same as practical feasibility. It is curious that when constructing its asset beta calculation, Fonterra has landed at the extreme lower end of what it could expect the Commission might accept. We have repeatedly drawn the

[1] Draft Report, para. 3.25

Open Country Dairy Ltd
8 Business Parade South,
East Tamaki, Auckland 2013,
New Zealand

PO Box 11 159, Ellerslie,
Auckland 1542, New Zealand

T +64 9 589 1372
F +64 9 525 0347

Commission's attention to the consistent bias the Milk Price Group within Fonterra (MPG) shows toward changes to the base milk price away from a fair and transparent level, as well as the institutional reasons for this bias.

The CEPA report calculated a level of asset beta range of 0.47 to 0.57, with an average of 0.53. Once a full comparator set was used, the range is 0.50 to 0.60, with an average of 0.55. It is not clear how the Commission has concluded that the MPG number is more robust as the reflection of practical feasibility than the CEPA number of 0.55.

Stranding risk should be retained

The removal of compensation in the WACC calculation for non-systematic risk of asset stranding is not justified. The notional processor does indeed continue to face asset stranding risk, which is probably higher than when Rule 43 (renumbered from 41) was introduced in 2014. The New Zealand milk supply outlook (for the notional processor) and specific market risks need to be properly considered before this change to the calculation is accepted. Merely citing the Climate Change Commission's draft findings (only one view on the outlook for a specific, unrelated, purpose) is not sufficient.

The risk is pronounced given the decline in milk production and plants which are likely to be under threat from stranding. A proper analysis of this question has not been undertaken by CEPA or the Commission. The market reality is acknowledged by Fonterra's own CFO ("peak milk" and "volume of milk produced in New Zealand will flatten or decline"). The statistics on national milk production and supply reveal that peak milk production is in the past.

The Commission should reconsider its draft conclusion on stranding risk ("SRP") and retain this for the time being until a proper analysis of the matter is completed.

"Black box" use of off-GDT sales in milk price calculation

The Commission has again unquestioningly accepted the elevated use of off-GDT sales as a legitimate source of market prices for reference commodity products. The Commission has stated that the key question for practical feasibility is whether "*the inclusion criteria for RCP sales are appropriate and have been applied consistently from season to season*."[2] We repeat our previous submissions on the use of off-GDT sales and refer the Commission again to our submission of 1 September 2020. There is no logical explanation for higher prices for commodity products that are sold via direct contracts (off-GDT) than on the open market other than selective bias.

Malikah Mitha

Chief Financial Officer

[2] Draft Report, para. 3.76