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21 November 2023

Attention: Andrew Harrison
Manager – Dairy, Market Regulation Branch
Commerce Commission
WELLINGTON
By email: market.regulation@comcom.govt.nz

Dear Andrew

Re: INDEPENDENT DAIRY PROCESSORS' JOINT SUBMISSION ON THE COMMISSION'S DRAFT REPORT ON ITS REVIEW OF FONTERRA'S 2023/24 MILK PRICE MANUAL

Thank you for the opportunity to comment on the independent dairy processors' (IDPs) joint submission on the Commission's draft report on its *Review of Fonterra's 2023/24 Milk Price Manual: Dairy Industry Restructuring Act 2001*.

As requested, we have largely confined our response to your specific queries with respect to foreign exchange hedging, and to matters which we understand to be within the scope of this season's Manual review. Specifically, we believe the matters raised by the IDPs in the following portions of their submission fall outside the scope of the current review: paragraphs 12 and 13 (practically feasible yields); paragraphs 24 – 29 (the relationships between Fonterra's internal and external forecasts at various points in time and between the 'base milk price' and Fonterra's forecast Farmgate Milk Price and the forecast required under DIRA of the Farm Gate Milk Price); paragraphs 30 and 31 (the s 150B(1)(a) 'network of facilities' assumption, which the Commission has explained it will be considering in the course of the 2023/24 base milk price review); and the discussion of standard product offerings in paragraphs 32 – 45, which mainly restates the IDPs' previous arguments with respect to the selection of Qualifying Materials. If our understanding that the IDPs' submissions on the matters covered in these paragraphs are out of scope is not correct, we would appreciate the opportunity to provide brief comments in response, noting we disagree with a number of the positions advanced by the IDPs.

Foreign exchange hedging

You invited us "to respond to the point about whether Fonterra's currency management policy could be described as passive, and whether the use of options requires taking certain views on volatility, strike price and duration in a way that implies active management. Reference to the example and analysis of the September milk price disclosure provided by IDPs would be useful context to your response. It would also be helpful if Fonterra could provide its views on the independent dairy processors' arguments that Fonterra should make ongoing disclosures of the conversion rate, no less frequently than each time Fonterra updates its forecast FMGP, to provide for contestability and to give transparency to the otherwise unpredictable NP conversion rate."

We note:

- Fonterra's programme to hedge foreign exchange (FX) risk is largely passive or mechanistic, involving the progressive build-up of a hedge portfolio of forward FX contracts and FX options in accordance with benchmarks defined by reference to forecast monthly USD cash flows. Options provide more flexibility in scenarios which may lead to downward revisions in forecast exposures, such as declining commodity prices or reduced milk supply, and so require a reduction in the level of FX hedges.¹ Fonterra seeks (and meets) the requirements for the application of hedge accounting treatment for the entire FX hedge book and would be precluded from undertaking hedging activity that could be construed as speculative in nature.
- The IDPs' argument that Fonterra should be required to provide ongoing disclosures of the forecast conversion rate for a year is premised on an argument that this is required for consistency "with the intent of s 150A (contestability)," on the basis that Fonterra's superior knowledge of the conversion rate which will inform its milk price creates a competitive disadvantage for the IDPs. This argument is not consistent with the Commission's longstanding interpretation of the s 150A practical feasibility test, which the Commission interprets as requiring that it must be "possible for an efficient processor operating in New Zealand to replicate or achieve the component being assessed."² The Commission agreed in its final report on the 2022/23 base milk price that the process used to generate the base milk price conversion rates satisfies this test. (We acknowledge that absent complete and current information on Fonterra's hedging activities IDPs will generally be unable to perfectly mimic Fonterra's conversion rates. But where an IDP is attempting to replicate Fonterra's hedging programme, any forecast errors will be non-systematic and can be expected to be symmetrically distributed. They will therefore not affect the IDP's cost of capital and therefore its ability to compete against Fonterra.)
- While we do not agree that a requirement for additional within-year disclosures can be justified by reference to the s 150A contestability principle, Fonterra is nonetheless willing to commit to providing additional FX-related disclosures in the course of each season. Specifically, we propose releasing the following information as soon as is practicable in the monthly Global Dairy Update subsequent to each forecast Farmgate Milk Price announcement:³
 - The percentage of the forecast full-year exposure which is hedged.
 - The forecast full-season average conversion rate if the spot rate was to remain at the announcement date rate for the balance of the season.
 - The percentage of option cover included in the hedged amount.

Other matters

While not directly relevant to the Commission's review of the 2023/24 Manual, we believe it may be useful to correct two apparent misunderstandings in the IDPs' submission.

First, the IDPs assert in paragraph 18, based on their review of the email correspondence published by Fonterra in compliance with our new disclosure obligations under s 150QA, that "it seems that in fact there is no available comparison between a Fonterra actual average USD conversion rate and the NP average

¹ We also note that any entity with FX options in its hedge book will routinely evaluate the effectiveness of those FX options in providing a hedge of FX risk in light of subsequent significant currency movements, and that circumstances may occur in which an entity seeking to maintain benchmark levels of effective hedging consistent with its appetite for exposure to FX risk will move to close out deeply out-of-the money options and replace them with forward FX contracts. A circumstance of this nature occurred in September and October of 2022, due to the steep decline in the spot exchange rate highlighted in Chart 1 on page 16 of the IDP submission, leading to Fonterra closing out some deeply out of the money FX options and replacing them with forward FX contracts. Movements in the third of our proposed disclosures – the percentage of option cover included in the hedged amount – will provide the IDPs with insight into when Fonterra has made adjustments of this nature to its hedge book.

² Commerce Commission, *Our approach to reviewing Fonterra's Milk Price Manual and base milk price calculation*, 1 August 2023, paragraph 51.

³ This will ordinarily be in the first Global Dairy Update (GDU) published after a Farmgate Milk Price announcement, but there may be instances where an announcement occurs after the close-off for GDU content but prior to publication of the GDU.

conversion rate. The scale of the lottery implied in the NP conversion rate procedure is therefore apparently unknown. This is not satisfactory to the IDPs and it is surprising it is satisfactory to Fonterra.”

The IDPs may have overlooked the comparison of 12 monthly average conversion rates for the period 2021 – 2023 for Fonterra and the NP presented on page 96 of the PDF of email correspondence, and replicated below:

	Aug - July FACR	
	Fonterra	MP
2021	0.6655	0.6653
2022	0.6910	0.6913
2023	0.6426	0.6424

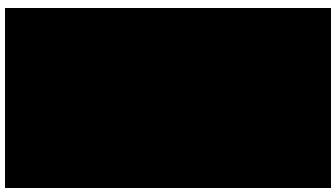
These rates do not precisely correspond to reported annual average conversion rates for either Fonterra or the NP, since they relate to all cash received by each business over the 12 months from August to July in each period, irrespective of the season to which the cash relates, but nonetheless provide a true ‘apples-for-apples’ comparison of the impact of hedging on the two businesses, showing a virtually identical average 12 monthly impact over this period.

Secondly, in relation to the discussion in paragraphs 24 – 29 of the relationships between Fonterra’s monthly internal ‘base milk price’ forecasts and its publicly-announced:

- The monthly forecast is generated for internal purposes in the course of Fonterra’s standard business practices, most importantly as an input into the management accounting systems. Given the interrelationships between the various routine forecasting processes, the month-end price invariably incorporates some information that is known to be out of date at the time the forecast is generated.
- In contrast, Fonterra’s publicly announced forecast Milk Price represents Fonterra’s best estimate of the price which will be calculated under the Manual for the full year, based on the information available at the time the forecast is finalised (normally only a few days prior to the public announcement). It also captures the consensus view of the outlook for commodity prices (among other factors) among a group of internal experts which includes but is larger than the specialist team responsible for the commodity price forecasts which inform the monthly calculation. Not surprisingly, the combination of timing differences and the involvement of a broader group of internal stakeholders frequently results in differences between the most recently calculated month-end price and the most recent publicly announced Farmgate Milk Price forecast.
- The lack of movement between the 31 January and 30 April internal forecast prices and the actual year-end price noted by the IDPs in Table 1, relative to the movements over that period in the publicly announced price, was coincidental, and mask a reasonable amount of variance in the intermediate months (the month-end internal forecasts for February and March respectively were \$8.35 and \$8.26).

I confirm that none of the information contained in this letter is confidential. Please contact me if you have any questions or would like us to comment on any other matters raised by the IDPs.

Yours sincerely



Jackie Floyd
Director Legal

