Synlait

Commerce Commission
44 The Terrace
Wellington
1 September 2021

Submission to the Commerce Commission on the "*Review of Fonterra's 2020/21 base milk price calculation: Dairy Industry Restructuring Act 2001*" draft report (16 August 2021).

Synlait Milk Limited (Synlait) appreciates the opportunity to make a submission on the Draft Report on the 2020/21 milk price calculation review.

Our submission will focus on the Commerce Commission's draft conclusions[1] that states

i. the Asset Beta of 0.45 is "*within a reasonable range for asset beta values for an efficient processor*"; and
ii. "*…an SRP value of nil is reasonable*".

i. <u>Asset Beta</u>

CEPA's results[2] of their review on the dairy asset beta shows consistently higher average betas compared to that of the Milk Price Group (MPG), irrespective of whether the core, extended or full samples are used. Specifically, the results published by CEPA shows a core sample average asset beta of 0.53 (vs MPG's 0.47), an extended sample average of 0.65 (vs MPG's 0.59) and a full-sample average of 0.55 (vs MPG's 0.50). Removing Fonterra from the CEPA samples, which Synlait regards as appropriate for the analysis, results in an average asset beta of 0.56 for the full sample.

In addition, CEPA recalculated the asset beta for their 2018 comparator sample using more recent data and found that the asset beta estimates are slightly higher, increasing to 0.56 from 0.55 (2018).

Based on the range of the beta values, CEPA states that an asset beta of 0.45 *could* be justified for a notional processor. However, Synlait wants to emphasise that such a value is towards the lower end of the range and no practical feasibility test is provided to support such a low level.

Based on the above, CEPA's results and their level of independence compared to the MPG, Synlait encourages the Commerce Commission to revise their conclusion on the asset beta. Specifically, we recommend that a value within the range of 0.53 and 0.56 would be more appropriate and reflective of the results of the research conducted by CEPA.

ii. <u>Specific Risk Premium (SRP)</u>

Synlait recommends that the Commerce Commission review their draft conclusion that an SRP of nil is appropriate based on the following:

a. There appears to be some contradiction in the Commerce Commission's statements of whether asset stranding risk should be regarded as systematic, specific, or nil.

[1] Commerce Commission "Draft Report – Review of Fonterra's base milk price calculation 2020-21" (16 August 2021), paragraphs 3.6.1 and 3.6.2.
[2] CEPA "Dairy asset beta and specific risk premium – supporting material – corrected – 12 August 2021", p13.

The Commerce Commission states that[3] "There is no conclusive evidence that the comparators included in either the core or full comparator sets used by MPG in estimating the asset beta have a materially different asset stranding risk to that of the NP". If all comparators face the same risk, the risk should be defined as systematic and captured by the asset beta. The next paragraph[4] however states that "…we believe that the NP may be exposed to some non-systematic asset stranding risk… we accept that such risk is currently low", implying the associated risk is specific in nature. The draft conclusion is however that an SRP of nil is appropriate, implying no (rather than low) risk, irrespective of its nature. Synlait's view is that, if the SRP was to be set to nil, the asset beta needs to be reviewed (increased) appropriately. We interpret CEPA's conclusion[5] that "Contingent on the appropriate choice of asset beta, we agree that the specific risk premium should be nil" to be supportive of our view. Setting the SRP to nil without increasing the asset beta appropriately implies the Commerce Commission's view is that there is no asset stranding risk, which contradicts both statements referred to above.

b. In Synlait's submission[6] on the Commerce Commission draft report on focus areas for the 2020/21 milk price calculation, seven risks to the future of New Zealand milk pool and investment are discussed. In response, the Commerce Commission states that "We … consider these mid to long term risks to be beyond the scope of our review of the milk price calculation for the current season." [7] In addition to interpreting the Commission's response as an acknowledgement of the NP's (and comparators') exposure to these risks (again, contradicting the notion of no asset stranding risk), Synlait notes that investors would generally consider investment options from a medium to long term view rather than short-term. Consequently, we encourage the Commerce Commission to review their current decision to disregard these risks in formulating their conclusion on SRP.

Conclusion

Due to the uncertainties discussed above surrounding the asset beta, the SRP and the inter-relation between these risk factors, Synlait is of the view that an asset beta of 0.45 combined with an SRP of nil will be inappropriate given the research conducted to date, and further investigation is encouraged to address these concerns before the Commerce Commission finalises their related conclusions. For now, Synlait recommends that the asset beta be set to a more appropriate level of between 0.53 and 0.56, while the current SRP level is retained.

Yours faithfully,

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[3] Commerce Commission "Draft Report – Review of Fonterra's base milk price calculation 2020-21" (16 August 2021), paragraphs 3.45.1

[4] Commerce Commission "Draft Report – Review of Fonterra's base milk price calculation 2020-21" (16 August 2021), paragraph 3.45.2

[5] CEPA "Dairy asset beta and specific risk premium" (27 July 2021), p3.

[6] Synlait "Submission on focus areas for milk price calculation 2020-21 – 29 April 2021" (3 May 2021)

[7] Commerce Commission "Draft Report – Review of Fonterra's base milk price calculation 2020-21" (16 August 2021), Appendix A, p37.