6 May 2022

Miraka Submission to the Commerce Commission:
Proposed focus areas for the review of Fonterra's 2021/22 base milk calculation 19 April 2022

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Subject: Proposed Focus Areas Paper_21/22 Review of Base Milk Price Calculations

Introduction

1. The Commerce Commission has issued a paper (19 April 2022) outlining its proposed focus areas for its annual statutory review (DIRA Section 150 O) of the 2021/22 Base Milk Price Calculations. The Commission has sought views of interested parties on the proposed focus areas by 6 May 2022.

2. The Commerce Commission paper proposes the following focus areas:
   a. Qualifying materials and incremental cost assumptions (subjects on which Miraka has submitted extensively and which assumed greater significance when Fonterra expanded the inclusion of off-GDT sales in the calculation of Notional Producer (NP) selling prices).
   b. Two components of the NP weighted average cost of capital calculation (WACC) being:
      i. asset beta; and
      ii. post tax market risk premium

3. The Commission is not required to seek the views of interested parties on its proposed focus areas. The Commission however actively seeks input from interested parties and Miraka places importance on supporting the Commission in the milk price reviews to ensure the Fonterra processes are consistent with the purposes of Section 150A of the DIRA:

   "*to promote the setting of a base milk price that provides an incentive to new co-op* [Fonterra] *to operate efficiently while providing for contestability in the market for the purchase of milk from farmers*".

4. Miraka would welcome any opportunity to assist the Commission in its consideration of the Miraka views expressed in this submission.

Miraka comments on the proposed focus areas

Qualifying Materials and Incremental Cost Assumptions

5. Fonterra expanded the use of off-GDT sales to inform the Notional Producer (NP) selling prices and revenues from the 2016/17 Season. Miraka considers the manner in which

Fonterra carried out this change in policy has broken the NP economic model[1]. Prior to the 2016/17 season, the economic model was a relatively coherent and (in the case of revenues) transparent model in which both the cost and revenue limbs of the milk price calculation were based on a consistent view of the simple NP business model – i.e. revenues were based almost exclusively on just 5 actual commodity products sold at arms-length and at demonstrable prices on GDT, and costs reflected a highly efficient cost structure that broadly matched the basis on which revenue was determined. While gross revenues and costs were fictitious and unrelated (in total) to any real world dairy processing business in New Zealand, the unit average revenues and costs and therefore crucially the unit milk price per kg MS could be considered a coherent assessment of the NP assumed business model.

6. Since the expanded use of off-GDT sales (from virtually nothing prior to the 2016/17 Season, to as much as 45% of the NP notional sales), Miraka has concluded that while NP costs still largely reflect the highly efficient costs of a simple business model (massive volumes of just 5 products sold on the minimalist GDT auction platform[2]), revenues now reflect the earnings of a far more complex business model: revenues are thus inflated by comparison to costs, and the crucial calculation of unit milk price per kg MS is inflated compared to a proper assessment of the costs of the now complex NP business model.

7. Miraka freely acknowledges and does not apologise for the fact that ***this conclusion is an uninformed view***. It is uninformed because Fonterra refuses to disclose crucial information concerning assumptions procedures calculations and outcomes following the change in policy (its commitments at the time of the policy change to ensure transparent outcomes have been proven to be hollow). The lack of transparency is not justified by commercial sensitivities, and Miraka concludes in the absence of other evidence the Fonterra purpose is to obscure a further upward bias in the milk price calculations (meeting the priorities of its constitution and its suppliers, and to reinforce its competitive power in the raw milk market). Miraka has consistently raised this point of view since Fonterra introduced the off-GDT policy now over six years ago. Limited progress has been made since that time to allay Miraka concerns. Miraka expects this latest review by the Commission will be a circuit breaker in this matter and Miraka appreciates the Commission prioritising this crucial area of work.

8 Miraka interprets the Commission scope for this focus area centres on two broad issues:

   a. whether the products Fonterra includes as “price inform” off-GDT sales can properly be classified as NP commodity products (i.e. are properly considered “qualifying materials”, including whether the definition of qualifying materials is adequate)

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[1] “Model” in this sense refers to the assumptions calculations and procedures whereby the NP assumed business model is interpreted and translated into a milk price.

[2] Fonterra contends that it does include an adjustment to selling costs for off-GDT sales, but the adjustment appears small and Miraka considers it is unlikely to reflect the more sophisticated sales and marketing model implied by the volume of off-GDT sales attributed to the NP.

b. whether the “incremental product cost” (IPC) adjustments for those qualifying reference sales which are not “standard specification products” mean those sales may be considered practically feasible for the NP

Qualifying Materials

9. Miraka seeks the scope of work for qualifying materials be expanded to include “qualifying reference sales” (sales of qualifying materials which are deemed to be commodity sales and thus included in the NP selling price calculations). In particular Miraka requests the Commission revisit the manner in which price is or should be used as a filter for identifying qualifying reference sales. Miraka acknowledges the Commission has addressed this issue several times. However in Miraka view the issue is not resolved and the role of price in selecting qualifying reference sales is ambiguous and does not comply with the Milk Price Manual.

10. The Fonterra Milk Price Manual requires that qualifying reference sales can be “reasonably regarded” to reflect “prevailing market prices”[3]. At the time of introducing the expanded off-GDT policy, Fonterra signalled that GDT prices would provide a benchmark for determining “price inform” off-GDT sales. Fonterra continues to refer to GDT prices as “a key reference point” for determining qualifying (off-GDT) reference sales. For example, in the Fonterra Reasons Paper for the 2020/21 Milk Price Calculations, Fonterra stated that all of the “price informing” off-GDT sales included in the NP revenues “used the most relevant GDT price as a key reference point”[4]. It was then appropriate for Miraka and others to conclude and rely on the fact that a simple and objective price test existed in the procedure to select “price inform” off-GDT sales (i.e. a ***comparison*** with “the most relevant GDT price”[5], GDT prices being undoubtedly an appropriate measure of “prevailing market prices”).

11. Commerce Commission reviews of this matter have however identified a very different picture: in practice the requirement in the Milk Price Manual that price inform off-GDT sales reflect “prevailing market prices” appears to be a hollow principle. Fonterra is in fact unable to demonstrate that off-GDT sales reflect “prevailing market prices” for the simple reason it does not perform a “prevailing market price” test when filtering for price inform off-GDT sales. In its final report on the 2020/21 Milk Price Calculations, the Commission included a Fonterra decision tree for filtering off-GDT sales to identify qualifying reference sales[6] (price inform sales). That decision tree makes no reference to “prevailing market prices” nor indeed to “the most relevant GDT price”[7].

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[3] Fonterra Farmgate Milk Price Manual 2021/22 Season, Part C (Definitions)

[4] Reasons Paper in Support of Fonterra’s Base Milk Price for the 2020/21 Season, page 17

[5] A “comparison” of course does not mean a requirement for equality which would defeat the purpose of including off-GDT sales; rather it means an appropriate band around “the most relevant GDT price” would be established and a simple calculation metric would filter out sales of qualifying materials which do not fall within that band.

[6] Commerce Commission Review of the 2020/21 Base Milk Price Calculations, Appendix B

[7] There are in fact no price filters in the procedure with the indirect exception that tender sales, which are typically sold at lower prices, are explicitly excluded from qualifying reference sales. These sales are a normal and expected consequence of the scale of Fonterra commodity business (and would be even more so for the much larger scale of the NP). This provide a further illustration of the NP procedures creating a bias towards a higher milk price.

12. Fonterra instead appears to rely on an internal control policy the purpose of which, understandably, is to require that sales contracted off-GDT achieve prices which are higher than (or at least equivalent to) GDT. As a result of this policy, Fonterra then concludes it does not in fact have to validate that its selection of qualifying reference sales actually reflect "prevailing market prices". This is simply assumed to be the case. In other words, while price inform off-GDT sales are probably sold at prices at or above GDT, ANY price above GDT prices will be deemed to be sold at "prevailing market prices" – i.e. there is in fact no "prevailing market price" test.

13. As noted, the Commission has previously addressed these issues. In its most recent response, it concluded that "we do not consider that price or price achievement of itself is a reliable indicator that might provide a basis for differentiation of commodity products"[8]. The Commission offers two examples in support of this conclusion[9]. One of these concerns SMP sold to a client holding country-related SMP quota, where a premium was achieved due to the tight logistics requirements (volume and delivery) imposed by the quota. It is telling that of the two examples presumably offered by Fonterra to justify high price premiums for what it classifies as commodity sales, this is a sale which does not in fact comply with the Milk Price Manual own description of commodity sales: "Reference Commodity Products are … predominantly sold in the most freely-contestable export markets with low trade barriers"[10].

14. The Commission position on the matter has become unclear. On the one hand, responding to submissions from Miraka and others, the Commission appears to place importance on the definition of "prevailing market prices" and has sought Fonterra to clarify that definition[11]. On the other hand, the Commission now seems to dismiss the relevance or importance of price (prevailing market prices) as a factor in selecting qualifying reference sales.

15. In any event, the acknowledged failure to include a "prevailing market price" test in filtering for qualifying reference sales undermines Miraka confidence in the processes for determining NP revenues. It significantly contributes to the Miraka view that the policy to include off-GDT sales in the NP revenues provides a loophole to artificially inflate the milk price. This is reinforced by the fact that on introduction, Fonterra estimated the off-GDT sales would increase the FGMP by 5 c/kg MS. In the event, it has increased the FGMP by twice that amount.

16. A simple further procedure could be added to the Fonterra filtering process to confirm qualifying reference sales meet a prevailing market price test. This would compare price achievement (net of IPCs) with "the most relevant GDT price" (to be defined). Sales falling outside an identified band around the GDT price would be excluded from qualifying reference sales. In the first instance the band could be established by setting it at a low level and re-calibrating until it captures most sales which, through a review

[8] Commerce Commission Review of 2020/21 Milk Price Calculations, para 3.122
[9] Ibid: para 3.121
[10] Farmgate Milk Price Manual 2021/22 Season, Part A (Executive Summary)
[11] Fonterra responded in the 21/22 Milk Price Manual by changing "prevailing prices" to "prevailing market prices; Miraka considers that change adds no new information nor additional nuance of meaning.

process, can reasonably be considered as qualifying reference sales. Once established, the band might be subject to annual review (and oversight by the Commerce Commission), and an exception review process could be introduced. In reality however, if properly established the band would be unlikely to require further calibration.

17. The Commission is requested to expand the focus areas for the 2021/22 Milk Price Calculations review to explicitly request Fonterra demonstrate that qualifying reference sales do in fact meet a "prevailing market price" test and that the Commission consider requesting Fonterra to implement the procedure described in paragraph 16 above.

Incremental Product Costs (IPCs)

17. Fonterra adjusts selling prices for relevant qualifying reference sales by the IPC (product cost of the relevant product compared to the product cost for the standard specification product). The adjusted selling price is then included in the calculation of NP weighted average selling prices on the basis that all selling prices are measured on a comparable basis with the relevant standard specification product (being the only product the NP is actually assumed and modelled to produce).

18. The milk price manual defines incremental product cost specifically with reference to direct and indirect manufacturing costs. These comprise milk component costs, variable manufacturing costs, and allocated fixed cost. As part of the scope of work, Miraka seeks that the definitions of these components be reviewed and clarified:

    a. In the case of milk cost, this is described in the Manual as "the implied value of milk components <u>at the time the product is manufactured</u>". That potentially describes a complex process but in practice Miraka assumes milk components are costed in accordance with the finally determined Fonterra FGMP. If that is not the case, Miraka requests the Commission review the process for determining the cost rate for milk price components.

    b. In the case of fixed costs, the Manual implies these are only taken into account if that portion of the IPC "is in the normal course of events recovered by Fonterra from its customers through a higher selling price". Miraka considers that any failure to include fixed production costs in the IPCs would mean the selling price after IPC adjustments would not be practically feasible for the NP. In practice however, it would seem to be inconsistent that a sale already deemed to be a qualifying reference sale was unable to recover the fixed cost portion of the IPC. Miraka requests the Commission include in its review whether this exception (excluding fixed costs from the calculated IPC) occurs in practice and if so to consider whether the resulting selling price can be deemed "practically feasible" for the NP. The Commission might also consider recommending the Milk Price Manual be changed to make it clear that fixed costs must be included in the IPC calculation.

19. While yields are an implicit factor in the definition of IPCs, Miraka notes and strongly supports the Commission scope of work makes this an explicit aspect of its review.

20. Miraka believes (but is unable to confirm) that Fonterra simply uses its internal product costing system to measure the IPCs. If that is the case, the IPCs are being calculated on an incorrect basis, and the IPCs are understated.

21. The IPCs are intended to neutralise that part of the selling price of a qualifying reference sale which is deemed due to the different costs of producing the product relative to the costs the NP incurs in producing the standard specification products. The NP is assumed to produce just one product for each product group (and therefore only includes the costs of that one product). The volumes assumed produced by the NP for each of the standard specification products far exceeds the actual Fonterra production of those singular products. The NP has then been able to assume to operate endless production runs on square curved plants (plants operating for extended periods at peak capacity) and which are thus highly efficient. Unit costs (milk, variable and fixed cost allocations) for the NP production of the standard specification should accordingly be materially lower than the costings that Fonterra will reflect in its real-world costing system for the same products.

22. While the IPCs in the NP calculations are an adjustment to selling prices, in effect they account for the higher production costs the NP would incur for the more complex business model reflected in the NP sales revenues. The IPCs should therefore be determined by a comparison between the NP modelled unit costs for the standard specification products, and costs the NP would incur to deliver the full range of products included in the qualifying reference sales (also taking into account the Fonterra nimble and market responsive production scheduling underpinning the direct marketing premiums Fonterra achieves, such as was illustrated in the Fonterra transaction noted in paragraph 13 above).

23. While it would need to be validated, it is possible that Fonterra real world costing systems provide a reasonable proxy for the NP costs of products which are not standard specification products. It is however not reasonable to assume the Fonterra costing system will provide a proxy for the NP costs of the standard specification products. Those latter costs must be drawn from the NP model itself. That procedure should be simple given the NP model only includes one product for each relevant commodity product group.

24. Miraka requests that the scope of work for the 2021/22 Calculations Review include an assessment of whether the costing systems used to determine the IPCs are fit for purpose, and consider the Miraka view that for purposes of practical feasibility, the costs for the standard specification product (the benchmark for the IPC calculations) must be drawn from NP model itself.

Weighted average selling prices

25. From the perspective of external parties, the process by which Fonterra selling prices (GDT and off-GDT) are rolled up, transformed and represented as the NP selling prices is a “black box”. It is presumably complex. Selling prices input to that process are assessed as practically feasible (because they are based on arms-length actual Fonterra sales). It is not however clear how the output of the “black box” (the presumably different NP selling prices) are deemed to be practically feasible.

26. The transformation of Fonterra real world selling prices to the NP selling prices presumably involves:

- the selection of those GDT sales (and their prices – after IPCs) which are deemed to be sourced from the current season milk supply
- the merging of relevant off-GDT selling prices (after IPCs) and volumes with the GDT sales
- the identification of the Fonterra “volume informing” sales, comprising a broader range of sales and a sales phasing which is unlikely to be the same as “price inform” sales
- weighting the average (weighted average?) selling prices of the price inform sales, by the sales phasing of the volume inform sales (a process which could follow any number of pathways)

27. Miraka considers Fonterra should provide a sufficiently detailed description of these processes so they can be replicated and thus provide assurance that they are reasonable. Selling prices represent the single most important and (now) obscured part of the NP metrics, and this level of disclosure is essential to provide confidence in the base milk price.

28. Miraka below highlights two (assumed) procedures (phasing and yields equivalence) in the transformation of the Fonterra real world selling prices to the NP assumed selling prices and which could have a material impact on the practical feasibility of those NP selling prices:

Phasing

29. The difference in phasing between the price inform sales and the volume inform sales drives a wedge between prices which are demonstrably practically feasible, and prices which are an artefact of a calculation procedure which mismatches commercial metrics of price and volume. The mismatch of price and volume metrics is problematic and it would be more difficult to attribute practical feasibility to the calculated outcome.

30. The significance of phasing differences on practical feasibility of selling prices is a direct function of price volatility. By way of illustration Appendix I charts total WMP selling prices in the GDT auctions from August 2021 to the present (April 2022 auctions). This sample of prices is a reasonable indication of the volatility of prices that will for example inform the 2021/22 NP WMP selling price. Standard deviation of the prices in the sample is US$352/MT or 8.7% of the weighted average GDT selling price from the sample[12]. It is unsurprising (and not unusual) that price volatility is high. Any variation between volume inform sales phasing and price inform sales phasing will **in itself** therefore result in a potentially significant difference in the respective weighted average selling prices. It is unclear how that difference could be considered practically feasible.

31. In its annual farmgate milk price statement, Fonterra discloses quarterly weighted average selling prices for “GDT-only” sales, and quarterly weighted average selling

[12] These are based on weighted average “contract date” prices for all GDT WMP sales across all contracts (1 to 6). For FGMP purposes contract date prices are translated to shipment date prices, C6 is excluded, and IPCs adjustment are made. However, the volatility in the contract date price series will of course translate through to the FGMP series.

prices for the NP. The difference is represented as due to off-GDT sales. The represented "GDT only" prices cannot be strictly correct. These must in fact be the **prices** of GDT sales weighted for the **different volumes** of the volume inform sales. The reported weighted average prices are therefore not the weighted average prices of "GDT only" sales.

32. The impact of phasing differences is not therefore disclosed by Fonterra, and an assessment of the impact of phasing on practical feasibility is obscured. Fonterra should expand its reporting of selling prices in the farmgate milk price statement to include actual GDT prices weighted by actual GDT sales volume, and (separately) actual GDT plus off-GDT prices phased by the total price inform sales. The difference in these price series more properly discloses the impact of off-GDT sales. The impact of phasing would then also be identified separately. This would either provide assurance that the NP prices are self-evidently still practically feasible, or alternatively Fonterra would need to separately justify why they remain practically feasible. Miraka view is that this additional disclosure is a minimum to provide assurance that the "black box" rollup of price inform selling prices into the NP selling prices is reasonable.

Yields of qualifying reference sales which are not standard specification products:

33. The yields of qualifying reference sales which are not standard specification products will be different to the NP yields for the standard specification products. This is because of differences in product composition and product specification affecting difficulty of manufacture, but also because of the assumed NP highly efficient production of the standard specification products. The nominal volume of those qualifying reference sales which are not standard specification products will therefore be different to the nominal volume of highly efficient production of the standard specification products in effect displaced by those qualifying reference sales. IPCs will not adjust for this volume factor. Rolling up the prices for those qualifying reference sales accordingly requires a further "volume adjustment" to achieve equivalence with the volume of NP standard specification product before attributing those prices to the standard specification product. The Commission is requested to include a review of this further volume factor and its impact on practical feasibility of the NP selling prices.

34. In any event, the Commission is requested to include in its scope a review of the various processes performed in the translation of the arms-length selling prices achieved on actual sales, to the selling prices attributed to the NP, and to confirm that all the translation processes are practically feasible and that the resulting selling prices remain practically feasible. The Commission support in seeking increased transparency in this matter is also sought.

35. Milk Collection Costs

    In its submission on the 2020/21 Milk Price Calculations, Miraka again raised concerns over the practical feasibility of the NP milk collection cost.[13] In its final report, the Commission responded that it had previously reviewed this in its reports for 2011/12 and 2012/13. With respect, much has changed since those reviews, not least the

[13] Miraka submission, Commerce Commission Draft Review of the 2020/21 Milk Price Calculations, para 34 ff

implied more complex business model and production matrix implied when Fonterra expanded the use of price inform off-GDT sales from the 2016/17 season. Fonterra has also notionally mothballed NP plants which in the real world would have had an impact on milk collection costs. A review of the practical feasibility of milk collection costs is overdue and broadly fits into consideration of the IPCs. Given the greater priority of the already identified scope of work however, Miraka requests the Commission consider including a review of milk collection costs in its reviews of the 2022/23 milk price.

WACC: Asset beta

36. The Commission proposes to limit the scope of its 2021/22 calculations review of the asset beta to the findings in its review of the 2021/22 Milk Price Manual[14]. In that latter review, the Commission concluded Rule 42 of the Milk Price Manual was not consistent with the new section 150C (4) of the DIRA (which first came into effect for the season currently under review). This was particularly because Rule 42 can result in Fonterra adjusting the Notional Producer asset beta away from that calculated for the comparator set in a manner that "would not be consistent with section 150C (4)"[15].

37. The Commission advised the same conclusion in its findings for its review of the 2020/21 milk price calculations[16]. Fonterra had voluntarily applied new section 150C (4) in advance of it coming into force. The Fonterra calculated asset beta for 2020/21 of 0.45 included a downward adjustment of 50 b.p. compared to the asset beta calculated for the comparator group; the Commission advised that the adjustment of 50 b.p. would not be compliant with section 150C (4). The Commission "encouraged Fonterra to consider our comments on their methodology when estimating the asset beta for the 2021/22 base milk price calculation"[17].

38. Fonterra nevertheless proceeded with the non-compliant Rule 42 in its update of the 2021/22 Milk Price Manual. It has also included the same non-compliant asset beta (0.45) in the calculation of the 2021/22 WACC, as confirmed in its Farmgate Milk Price statement for the 2020/21 season, issued 23 September 2021[18]. The timing of the review of the 2020/21 milk price calculations arguably means that at the time Fonterra finalised its 2021/22 Milk Price Manual, it was not fully aware of the Commerce Commission decision that the Fonterra asset beta methodology would not be compliant. The non-compliance was however well signalled by the time Fonterra advised the 2021/22 asset beta and WACC on 23 September 2021 but Fonterra still chose to proceed with the non-compliant asset beta.

39. Miraka assumes the Commission's advised asset beta scope limitation for the 2021/22 Calculations review refers to the above series of events: in the absence of any Fonterra change to the asset beta methodology, the Commission is then confirming it will

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[14] Commerce Commission Proposed focus areas for our review of Fonterra's 2021/22 base milk price calculation, para 16

[15] Ibid.

[16] Commerce Commission Review of the 2020/21 Base Milk Price Calculations, para 3.61

[17] Ibid. para 3.62

[18] While the FGMP Statement was for the 2020/21 season, Fonterra also uses the statement to advise the WACC for the coming season (2021/22 in this case)

conclude the 2021/22 asset beta is not compliant with the DIRA. The lack of any milk price compliance sanctions in the DIRA, and the usual Fonterra approach placing compliance with its published milk price manual ahead of compliance with the law suggests Fonterra will ignore the already signalled non-compliance for the 2021/22 season and offer to address this in the 2022/23 Milk Price Manual. Miraka objects in advance to this most likely sequence of events to again highlight this unsatisfactory situation, and in the hope this will be addressed in the current consultation on further government proposed amendments to the DIRA.

40. Miraka is concerned the scope limitation on the asset beta review also extends to the actual update and calculation of the asset beta for the comparator set itself (i.e. the asset beta prior to the non-compliant 50 b.p. downward adjustment). As noted, Fonterra has advised the asset beta for 2021/22 remains unchanged (and implicitly not reviewed) from the 2020/21 asset beta of 0.45. This appears to be because Fonterra Milk Price Manual defers any further review of asset beta to the 2024/25 Season. In its submission on the draft report of the 2021/22 Milk Price Manual, Miraka objected to the deferral of any further review of the asset beta to 2024/25[19], a further example of Fonterra claiming compliance with its Milk Price Manual excuses it from compliance with the law. The Commission agreed that the asset beta needed to be reviewed and reset for the 2021/22 Season[20].

41. Miraka requests that the required update of the of the asset beta for the comparables set remain in scope for the Calculations review.

42. The Commission included extensive consideration of the calculation of the asset beta for the comparator set in its review of the 2020/21 Milk Price Calculation. This included expert advice from Cambridge Economic Policy Associates (CEPA). Key issues were the selection process of the comparator set of companies, and the differing and overlapping data points that can be used in calculating an asset beta (daily, weekly, monthly, five yearly, and “last five years and penultimate five years”). These two themes resulted in alarmingly wide possible variations in the asset beta for a suitable comparator set. CEPA for example identified a possible comparator set asset beta range of 0.47 to 0.59. The Fonterra calculated asset beta not only fell outside that range, it predictably was lower (rather than higher) than that range, another illustration of Fonterra bias in its milk price calculations favouring a higher milk price.

43. In its final report on the 2020/21 Milk Price Calculations the Commission signalled it would consider reviewing the list of comparator companies in its calculations review for 2021/22[21]. While not expressly updating that intention, it is assumed the Commission has decided it will not in fact review the comparator set in this current review. While disappointing, Miraka appreciates the Commission must prioritise activities and Miraka supports the increased priority that has been placed on the review of “qualifying

[19] Miraka submission, Commerce Commission Draft Review of the 2020/21 Milk Price Calculations, para 11 ff
[20] Commerce Commission Review of the 2021/22 Milk Price Manual, para 45
[21] Commerce Commission Review of the 2020/21 Base Milk Price Calculations, para 3.56

materials and incremental cost assumptions". Miraka requests the Commission consider including a review of the comparator set in its 2022/23 reviews.

44. By exception though, if it was not previously clear, it now must be clear that Fonterra itself should not be included in the asset beta comparator set and should be removed for purposes of the 2021/22 asset beta calculation. In May 2021, Fonterra announced plans to change its capital structure. Fonterra readily acknowledges that this change will give effect to a "restricted market discount" on the Fonterra share price. While the changes have not yet been implemented, developments indicate they are inevitable: shareholders have approved the changes, and the government has confirmed it intends to make changes to the DIRA to facilitate the restructure. As a result, the "restricted market discount" is already at least partially anticipated: since Fonterra announced the restructure plans in early May 2021, the Fonterra share price has dropped 41%, from $4.56 to $2.70. This implied and ultimately actual restricted market discount should disqualify Fonterra's inclusion in the asset beta comparator set.

45. In the matter of the varying datasets that can be used to determine the asset beta of the selected comparator set, Miraka considers this again should be reviewed and updated for the 2021/22 asset beta. The Commission has canvassed the various issues in determining the appropriate data set, and given its other work with regulated industries, the Commission is best qualified to assess compliance of the selected data set to the implicit requirements of new section 150C (4).

WACC: Post tax market risk premium

46. Fonterra has increased the post-tax market risk premium (PTMRP) from 7.0% to 7.5% in the 2021/22 WACC calculation[22]. Miraka understands that for purposes of the NP WACC, Fonterra adopts the PTMRP the Commission calculates for the businesses it regulates under Part 4 of the Commerce Act and Part 6 of the Telecommunications Act. The PTMRP was increased from 7.0% to 7.5% when the Commission updated the Fibre – Chorus price-path "input methodologies" as at June 2021[23]. It is reassuring that in the case of this parameter Fonterra has adopted without adjustment a truly arms-length metric, and that Fonterra has updated the metric directly in response to the Commerce Commission latest assessment. The Commerce Commission is clearly well placed to assess whether Fonterra adoption of the PTRMP for regulated input methodologies remains compliant with the DIRA.

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[22] Fonterra 2020/21 Milk Price Statement
[23] Commerce Commission Guidelines for WACC determinations under the cost of capital input methodologies 27 May 2021

Appendix 1: An illustration of GDT price volatility for purposes of considering the impact of unaligned price inform and volume inform sales

The below chart shows GDT WMP prices (all products, all contracts) for the GDT auctions from August 2021 to April 2022. These are weighted average prices for all contracts and all products sold on GDT for each of the auctions (i.e. they are "contract date" prices). With the exception of the small volume of C6 prices, all of the underlying prices reflected in these weighted averages will be included in the "price inform" series for the 2021/22 NP selling prices. Most if not all the underlying volume will be included in "volume inform" sales. As noted the chart shows contract date prices. These prices will be adjusted for IPCs, and translated to shipment date prices for purposes of translating Fonterra actual prices to the NP selling prices. The underlying price volatility reflected in contract date prices will of course similarly translate through to the prices included in that translation process.