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Goodman Fielder New Zealand Limited  
Company No. 1508360

2/8 Nelson Street  
Auckland, New Zealand 1010  
PO Box 90450, Victoria Street West  
Auckland, New Zealand 1142  
[www.goodmanfielder.co.nz](http://www.goodmanfielder.co.nz)

Commerce Commission  
PO Box 2351  
**Wellington 6140**

Email: [keston.ruxton@comcom.govt.nz](mailto:keston.ruxton@comcom.govt.nz)

For: Keston Ruxton, EAD Regulation Development

## **GOODMAN FIELDER - 2017/18 MILK PRICE CALCULATION REVIEW - ASSET BETA REVIEW**

Goodman Fielder welcomes the opportunity to make a submission on the Cambridge Economics Policy Associates (CEPA) Asset Beta Report in connection with the Commerce Commission's review of Fonterra's 2017/18 milk price calculation review.

We agree with the approach taken by CEPA to review the approach taken by Fonterra to derive an asset beta for the Notional Processor (NP). Asset betas are derived from market observations. CEPA observed that companies with similar cost pass-through characteristics as the NP have similar asset betas to those companies that are exposed to commodity prices and concluded therefore that the full data set used by Fonterra is sufficient to establish the NP's asset beta without needing to refer to an alternative data set and without requiring any other adjustment.

As requested by the Commerce Commission, CEPA conducted a review of Fonterra's calculation of the NP's 2017 asset beta. The asset beta is a key input into the capital charge component of the Farmgate Milk Price (FGMP).

The asset beta is a measure of systematic risk, which is the extent to which changes in the value of a company are related to changes in the value of the stock market as whole. The asset beta therefore reflects the way that investors view the company.

By design, the risks faced by the NP are limited. In particular, under the DIRA, commodity price risk is passed through to farmers via the FGMP calculation and therefore the NP does not bear this price risk. The Commerce Commission's approach to estimating asset betas is to look at the asset betas of a sample of companies operating in the same sector.

Fonterra argues that the NP's cash flows are less like a comparable international dairy company and more like an electricity lines business (ELB) that faces price / revenue cap regulation and therefore ELBs are a more appropriate comparator set.

The comparison with ELBs follows on from an argument that the NP's true systematic risk profile is unobservable and therefore ELBs, which face price / revenue regulation by the Commission, are a more appropriate proxy for the NP due to certain similar characteristics.

The key question to be answered by CEPA was which comparator set is more relevant and therefore appropriate – a sample set of companies operating in the same sector or some other sample set of companies?

CEPA's approach to answering the question was to challenge the proposition that the NP's true systematic risk profile is unobservable. To begin with, its comparator set was the same full data set of 39 companies selected by Fonterra. According to CEPA, the full set of companies had an average asset beta of 0.50 – 0.58 in the most recent five-year period, and between 0.45 – 0.50 in the five-year period to 2013.

CEPA then broke that sample set down into sub-samples. The sub-samples comprised those companies that are predominately dairy focused, those that are commodity exposed, those NP-like companies that enjoy cost pass-through arrangements, and those with regulated prices. The results of CEPA's analysis of the sub-samples for the latest five-year period, to January 2018, was that the asset betas for the different sub-groups were similar and between 0.49 and 0.59. For the previous five-year period to January 2013, the asset betas for the commodity exposed and NP-like cost pass through groups were similar but the dairy comparators had lower asset beta averages being 0.41 to 0.47, and two companies with regulated milk prices had a much lower asset beta of 0.3.

In other words, while the cost pass-through characteristic of the NP suggests that the business is very low risk compared to comparator companies that may face commodity price risk, the observable market analysis indicates that dairy price variation is not correlated with general stock market movements and so may not be systematic and so the NP will not necessarily have a lower asset beta. The market analysis shows little difference between commodity exposed and cost pass-through businesses.

CEPA's key findings, in our view, were as follows:

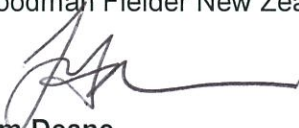
1. There are companies within the comparator sample that have the same sort of cost pass-through characteristic as the NP does and therefore their asset betas are observable.
2. Because the asset betas of companies that have the same sort of cost pass-through characteristic as the NP can be observed, the ELB comparison is not relevant or appropriate.
3. The asset betas of the cost pass-through companies and the commodity exposed companies are similar and therefore no downward adjustment to the asset beta is required.

Aside from CEPA's analysis recognising the similarity in the asset betas of the commodity-price exposed and cost pass-through businesses, it would be our contention that the asset beta used to determine the NP's cost of capital should be that of commodity-price exposed businesses in any case given that all of the competing dairy companies in New Zealand are exposed to commodity prices. See Table 1 below.

Table 1 is Fonterra's disclosure regarding its sales of reference commodity products over the last two financial years. In FY2016, Fonterra generated similar revenue to the NP from the sale of its reference commodity products and paid \$3.84 / kgMS for its milk compared to the FGMP of \$3.90. In FY2017, the disclosure reveals that Fonterra only generated revenue of \$7.39 / kgMS from the sale of its reference commodity products compared to the NP's \$8.13 and was only able to pay \$5.79 / kgMS for its milk compared to the NP's \$6.13 / kgMS (and the FGMP of \$6.12 / kgMS).

We contend that Table 1 is a graphic illustration of the way that Fonterra and all the other competing dairy companies in New Zealand are exposed to commodity prices and suggest that the NP, if it was actual rather than notional, would similarly be exposed to commodity prices.

Yours faithfully  
Goodman Fielder New Zealand Limited



**Tim Deane**  
Managing Director

Table 1 Fonterra's sales of reference commodity products

FY2017				
	Hypothetical Efficient Processor	Hypothetical Efficient Processor	NZ Fonterra Ingredients Reference Products	NZ Fonterra Ingredients Reference Products
	(\$Ms)	(\$/kgMS)	(\$Ms)	(\$/kgMS)
Revenue	12,400	8.13	7,846	7.39
Lactose (or other ingredients)	415	0.27		
Net Revenue	11,985	7.85		
Milk Cost (FGMP)	9,349	6.13	6,147	5.79
Gross Profit	2,636	1.73	1,699	1.60
Cash Costs	1,763	1.16		
EBITDA	873	0.57		
Depreciation	265	0.17		
EBIT	608	0.40		
Interest	175	0.11		
OPBT	433	0.28		
Tax	121	0.08		
NPAT	312	0.20		
Volume (millions kgMS)	1,526		1,061	

FY2016				
	Hypothetical Efficient Processor	Hypothetical Efficient Processor	NZ Fonterra Ingredients Reference Products	NZ Fonterra Ingredients Reference Products
	(\$Ms)	(\$/kgMS)	(\$Ms)	(\$/kgMS)
Revenue	9,134	5.83	6,290	5.81
Lactose (or other ingredients)	302	0.19		
Net Revenue	8,832	5.64		
Milk Cost (FGMP)	6,101	3.90	4,163	3.84
Gross Profit	2,731	1.74		
Cash Costs	1,815	1.16		
EBITDA	916	0.58		
Depreciation	265	0.17		
EBIT	651	0.42		
Interest	183	0.12		
OPBT	468	0.30		
Tax	131	0.08		
NPAT	337	0.22		
Volume (millions kgMS)	1,566		1,083	