



27 May 2020

Regulation Branch
Commerce Commission
PO Box 2351
Wellington 6140

By email: regulation.branch@comcom.govt.nz

Subject Line: Base milk price calculation review 2019/20

Miraka Submission to the Commerce Commission:

Proposed focus areas for our review of Fonterra's 2019/20 base milk price calculation (22 April 2020)

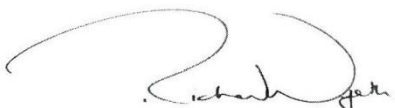
1. Due to an oversight the Miraka advisor on Dairy Regulatory matters only became aware of the opportunity to submit on this matter on the 27th May. The submissions had been due on 1 May. Miraka appreciates the opportunity to make this late submission.
2. Miraka supports the focus areas outlined by the Commerce Commission. Miraka further requests the Commission include the following issue in the "Focus Areas" for the review of the 2019/20 base milk price calculations.

Notional Producer Foreign Exchange Conversion Rate

3. Miraka has previously raised concerns that the Notional Producer conversion rate is a lottery. While it is suggested that the Notional Producer conversion rate is in effect the same as the Fonterra conversion rate that is not and cannot be the case. The Notional Producer is a construct which is materially different to Fonterra. It has different revenue streams, different sales phasing, different currencies of sale, different absolute quantity of foreign currency exposures, different timing of recoveries from debtors, and different foreign currency cost exposures (its imports of ingredient lactose for example will be much higher than Fonterra actual requirements). Miraka has assumed there is a significant and complex procedure to translate the Fonterra hedge book outcomes to determine a conversion rate for the Notional Producer. Miraka has long believed that translation process is unlikely to be demonstrably practically feasible, and the outcome of the process is a lottery.
4. The Commission considers the DIRA Section 150B "safe harbours" are in effect exceptions to the "practical feasibility" requirement of Section 150A (2). The issue of currency hedging is alluded to in the Section 150B (c) safe harbour, and arguably a "practical feasibility" test does not therefore apply to the Notional Producer conversion rate.
5. Section 150B (c) provides that the "gains and losses experienced by [Fonterra] resulting from foreign currency fluctuations, including from [Fonterra's] foreign currency risk-management strategies, are [or can be] incorporated in the base milk price". However the Notional Producer conversion rate is not or does not appear to be determined in a manner consistent with Section 150(B) (c). Rather, it is only the Notional Producer conversion rate itself which is based on Fonterra's own conversion rate achieved in its own hedging operations. This Fonterra rate is then extrapolated across the very different Notional Producer business outcomes presumably by the complex process referred to above. A different average conversion rate then almost certainly

ensues. Fonterra “gains and losses” are thus neither explicitly nor implicitly “incorporated in the base milk price”. Accordingly the Notional Producer conversion rate is not sheltered by the Section 150B (c) safe harbour, and the conversion rate is therefore subject to the practical feasibility test. The manner in which Fonterra translates its own conversion rate into the Notional Producer rate lacks transparency. Miraka considers a forensic assessment of that methodology is needed before it can be concluded that the conversion rate is in fact practically feasible.

6. The arcane nature of the process for converting a Fonterra conversion rate into the Notional Producer rate was reflected in two separate Fonterra perspectives on conversion rates provided firstly in the Fonterra 2018/19 Financial Statements (year end 31 July 2019), and then in the disclosures made in the Fonterra Farmgate Milk Price Statement for the 2018/19 Season.
 - At page 48 of Part 2 of the Fonterra Financial Statements it was noted that Fonterra held (**as at 31 July 2019**) USD cash flow hedges amounting to \$9.3 billion (nominal NZD) with a weighted average rate of 0.6852 (refer Appendix A).
 - At the same time, in the 2018/19 Milk Price Statement (Appendix 8), Fonterra explained that “**As at 31 July 2019**, Fonterra had hedged approximately 70% of the forecast cash flows related to the 2020 Season Farmgate Milk Price. If the remaining 30% of the forecast cash flows were to be hedged at the 31 July spot rate [0.6613¹], the average NZD/USD conversion rate would be around 67 cents”.
7. Regardless of what the 0.67 forecast conversion rate for the Notional Producer might have been to four decimal places (which Fonterra should reasonably disclose but chooses to round to 2 decimal places), it is not obvious how the Fonterra actual hedge book at 0.6852 translates to a Notional Producer forecast hedged conversion rate of 0.67. The Notional Producer’s deemed 70% hedged position as at 31 July 2019 must have been subsumed within the then existing Fonterra hedge book. The Notional Producer’s forecast conversion rate would therefore have included at most² an additional 30% of the Notional Producer forecast net cash flows hedged by instruments entered into in accordance with the forward points relevant to the 31 July 2019 spot rate of 0.6613. In these circumstances, it does not appear feasible for the forecast Notional Producer conversion rate to be 0.67. **Similar issues are assumed to arise between any actual Fonterra conversion rate (for a period matching the Notional Producer period) and the Notional Producer deemed conversion rate.** A translation process must be occurring.
8. The conversion rate is a crucial parameter in the base milk price calculations, second only to the selling prices and product mix attributable to the Notional Producer. Small basis point movements in the Notional Producer conversion rate have a highly material impact on the base milk price. Miraka requests that the Commission review the process whereby the Fonterra conversion rate is translated to the Notional Producer conversion rate for the purpose of confirming the practical feasibility of the Notional Producer conversion rate.



Richard Wyeth
Chief Executive Officer

¹ Fonterra used a USD/NZD spot rate of 0.6613 for evaluating relevant balance sheet items as at 31 July 2019.

² In the same way that Fonterra is unlikely to hedge 100% of its cashflows, the Notional Producer is unlikely to hedge 100% of its cashflows.

Appendix A

Extract from Fonterra Financial Statements for the Year Ended 31 July 2019 (Part 2, page 48) – Notes to the Financial Statements – Foreign Exchange Risk

HEDGING INSTRUMENT USED	GROUP \$ MILLION						
	AS AT 31 JULY 2019 ¹					YEAR ENDED 31 JULY 2019 ²	
	CARRYING AMOUNT					HEDGE EFFECTIVENESS IN RESERVES	
	NOMINAL AMOUNT ³	DERIVATIVE ASSETS	DERIVATIVE LIABILITIES	ACCUMULATED COST OF HEDGING	CHANGE IN VALUE USED TO CALCULATE HEDGE EFFECTIVENESS	RECOGNISED IN OTHER COMPREHENSIVE INCOME	RECLASSIFIED TO THE INCOME STATEMENT ⁴
Cash flow hedging							
<i>Foreign currency forwards and options</i>							
Maturity: 0-18 months							
Weighted average NZD:USD rate: 0.6852	9,267	37	(182)	(14)	(144)	(238)	309
Maturity: 0-11 months							
Weighted average USD:RMB rate: 6.9117	491	4	(1)	(1)	2	(2)	(7)
Maturity: 2-11 months							
Weighted average NZD:EUR rate: 0.5890	97	-	-	-	-	-	-
Total	9,855	41	(183)	(15)	(142)	(240)	302

1 Life-to-date amounts as at balance date.
2 Year-to-date amounts recognised during the year.
3 Nominal amount represents forecast foreign currency transactions in cash flow hedge relationships, translated into New Zealand Dollars using the exchange rate at balance date.
4 Recognised in revenue.