06 May 2022
New Zealand Commerce Commission
PO Box 2351
Wellington 6140
Attention: Louise Stephenson

Open Country Dairy Limited—Submission on the proposed focus areas of Commission's review of Fonterra's 2021/22 base milk price calculation

Dear Louise,

Thank you for the opportunity to make a submission on the Commerce Commission's (Commission's) proposed focus areas for its review of Fonterra's base milk price calculation for the 2021/22 season. This submission responds to the Commission's paper dated 19 April 2022.

Open Country Dairy Limited (Open Country) is the largest independent dairy processor in New Zealand, is entirely New Zealand-owned and operates in sites across regional and urban New Zealand.

We refer the Commission to our submission on the Commission's Draft Report on milk price calculation from 1 September 2021, as well as our submissions in previous years on the underlying incentives of Fonterra to use a variety of approaches to establish a milk price that is non-transparent and not reflecting contestability and efficiency. This submission sets out the following:

- We support the Commission's proposed focus areas and recommend they form part of the Commission's review. In particular, we stress the need to ensure Fonterra's approach to the asset beta complies with the law

However, we also strongly urge the Commission include two further focus areas:

- Capital asset base: We ask the Commission to ensure Fonterra correctly calculates the capital costs for the notional producer's capital asset base in a manner consistent with the contestability dimension, given the high and rising capital goods prices in recent years.
- The use of off GDT sales: Again, we ask the Commission to ensure Fonterra's off-GDT sales inputs are made transparent and the discrepancy between GDT and off-GDT RCP prices is fully explained

The Commission's proposed focus areas are appropriate, and we encourage the Commission to consider the inherent bias in Fonterra's construction of asset beta

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We agree with the Commission's rationale to include the post-tax market risk premium (PTMRP) and qualifying materials and incremental cost adjustments as focus areas for its review of Fonterra's base milk price calculation.

The Commission is justified in including the asset beta in its focus areas. We explain why.

In the 2020/21 milk price calculation review, the Commission reached the conclusion that an asset beta of 0.45 is likely to be practically feasible[1]. An asset beta of 0.45 is not practically feasible because it is at the extreme low end of a range of statistical possibilities. Independent experts have previously calculated the range and shown that the likely value should be significantly higher.

The Commission's 2021/22 Final Report on the manual review recommends that Fonterra review the asset beta value in its base milk price calculation now (and well ahead of the next review year specified in the Manual)[2]. The Commission also concluded that Fonterra is not permitted to calculate an asset beta that is adjusted away from the comparator set based on Fonterra-specific risk. We fully support the Commission's conclusion that Parliament intended to constrain Fonterra's discretion in how it calculates the base milk price, by requiring that it use an asset beta that is consistent with other dairy and food processor asset betas. Further, the requirements for the calculation of asset beta in s 150C(4) must be applied. In short, Fonterra should comply with the law.

Fonterra must now apply an amended Rule 42 in the Manual that is in line with the Commission's findings in its Final Report on the Manual dated 15 December 2021.

We request the Commission include two additional matters in its review

There are two additional matters that should be included in the focus areas:

Capital asset base should be a focus area

Fonterra's capital asset base and the costs of replacement assets should be a focus area. The Commission is required to monitor Fonterra to ensure any notional cost is "practically feasible" for an efficient processor to satisfy the contestability dimension of section 150A. The Commission considers the base milk price setting is *"consistent with the contestability dimension if the assumptions adopted, and inputs and process used are practically feasible for Fonterra, or another processor, that is efficiently building an incremental plant."*[3]The contestability dimension of DIRA is not satisfied if Fonterra does not update their inputs into the capital asset base and ignores rising capital costs. It is not practically feasible for an efficient processor building an incremental plant to build a Reference Asset at costs determined using very low historical reference prices.

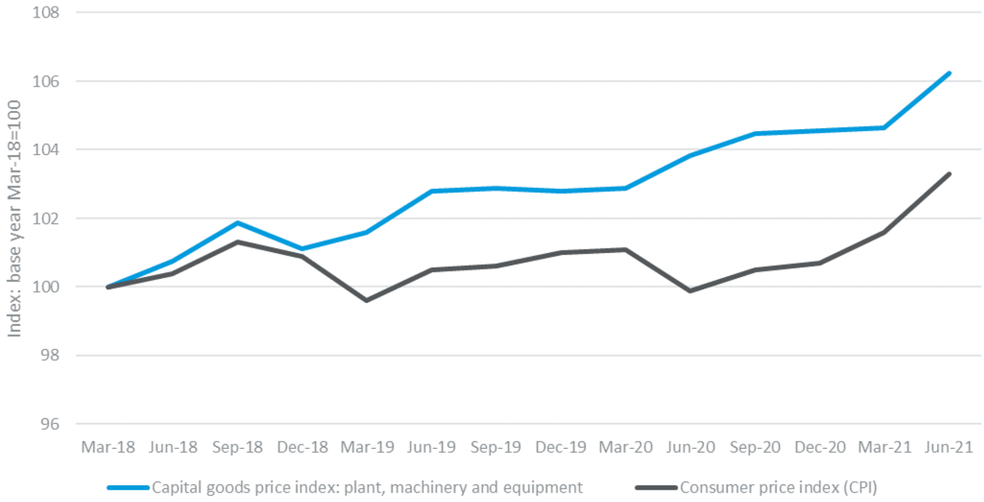
In its latest milk price statement, Fonterra is ascribing what appears to be a relatively low capital value to the processing assets. In reality, capital goods costs have increased materially in the recent past. Valuations of required replacement capital expenditure have risen. Figure 1 shows the increase in Capital Goods Price Index relative to CPI inflation since June 2015. Figure 2 shows the increase in building construction costs. This official statistical data is supported by Open Country's own direct experience with dairy and agri-processing

[1] https://comcom.govt.nz/__data/assets/pdf_file/0028/265681/Final-report-Review-of-FonterraE28099s-base-milk-price-calculation-2020-21-15-September-2021.pdf

[2] https://comcom.govt.nz/__data/assets/pdf_file/0026/273338/Final-report-Review-of-Fonterra27s-2021-22-Milk-Price-Manual-15-December-2021.pdf

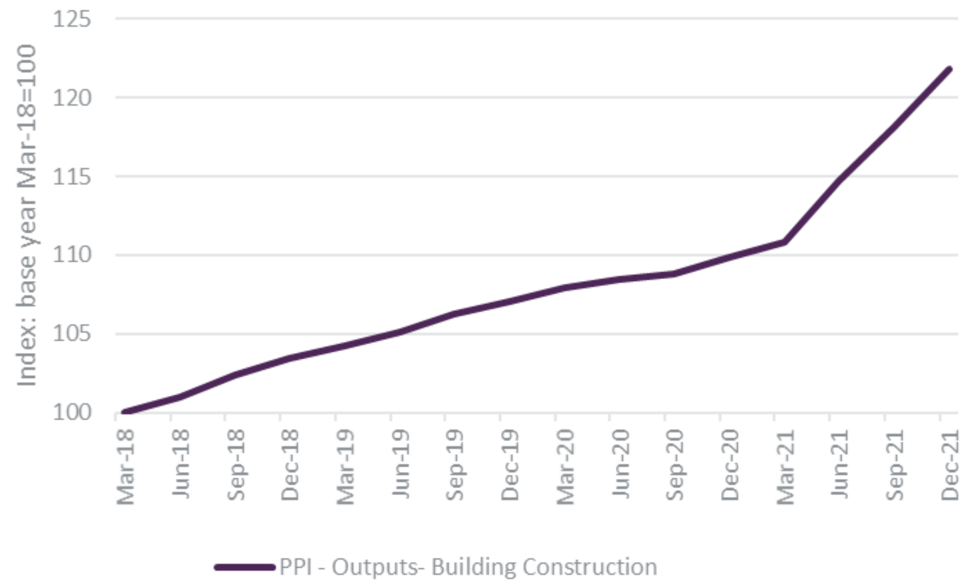
investment. The industry is operating at a level where $6-$7 per kgMS is required to cover the capital cost of new processing investment.

Figure 1: Capital goods price index compared to CPI as a reference



Sources: Stats NZ

Figure 2: Building construction index



Sources: Stats NZ

Given the high and rapidly rising prices for capital goods, the Commission should focus closely on how Fonterra applies the capital cost rules in the milk price calculation. This is essential to supporting contestability in the market for purchase of milk from farmers.

Fonterra's Milk Price Manual states *"The installation cost and specification of new and replacement Reference Assets, reflecting current and appropriate technology, will be determined in each Review Assessment Year"*[4]. The Review Assessment Year for Reference Assets is the 2020/21 Seasons. Therefore, we expect Fonterra would have:

- Commissioned revised estimates of Installation costs, processing capacity and economic lives of Standard Plants and other Reference Assets,
- Provided an estimate of the installation costs of Ancillary Assets and additional dry storage capacity, and
- Provided an estimate of a reasonable provision for, and the timing of, such future capital expenditures as can be reasonably be anticipated as being required to maintain the asset's productive capacity for its projected economic life.

The updated estimates should then have been applied to reference assets notionally installed in or after the review year. Otherwise, the installation cost will be deemed to be the prior Financial Year's installation cost

[4] Farmgate Milk Price Manual – Part A: Overview: 1st of August 2021. Rule 25, page 48.

increased by the annual percentage changes in either appropriate capital goods sub-indices or in a customised index constructed by an appropriate expert.

We suggest the Commission should focus on this given the significant increase in capital costs and construction costs shown in Figure 1 and Figure 2. The Commission's close attention to these matters is important because of Fonterra's inherent incentive to understate capital goods prices in its regulatory affairs. We refer the Commission to previous submissions on the underlying incentives of Fonterra regarding the milk price.

The Commission should ensure transparency of off-GDT sales

The Commission has continually accepted off-GDT sales as a legitimate source of market prices for reference commodity products. We repeat our previous submissions on the use of off-GDT sales and refer the Commission again to our submission of 1 September 2020.

There is no logical explanation for higher prices to be paid for commodity products that are sold via direct contracts (off-GDT) than on the open market, other than selective bias. If a RCP is offered for sale by Fonterra off-GDT for a higher price than on GDT, rational buyers would buy the product on GDT. The only reason sales can proceed in bilateral private contracts off-GDT at prices higher than the prevailing public market price is if a different product is being sold. This must mean that Fonterra is selling RCPs under different terms and conditions (effectively selling different products) and can therefore achieve higher prices.

Open Country assume other independent processors can see the impact of off-GDT sales on the base milk price. It is consistently biased upwards. There is no reason for GDT to be a "floor" price and all off-GDT sales to be higher other than Fonterra engaging in manipulation of the off-GDT sales and selling RCPs that are different or have different terms of sale.

The Commission should insist on greater transparency of off-GDT sales (or at least the margins above GDT) so that Independent Processors and the wider dairy sector can appropriately evaluate Fonterra's conduct. Fonterra should be required to publish on a quarterly basis the cents per kgMS impact from the inclusion of the additional off-GDT sales for the full year in the annual Milk Price Statement. This will provide confidence that Fonterra is not acting on its underlying incentives and is in fact fairly calculating the Base Milk Price.

Yours sincerely,

[redacted]

Steve Koekemoer

Chief Executive Officer

Open Country Dairy Ltd