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**SUBMISSION ON THE COMMERCE COMMISSION'S 2015/16 BASE MILK PRICE CALCULATION REVIEW DRAFT REPORT**

1. Synlait Milk Limited appreciates the opportunity to provide its views on the Commerce Commission's draft report on the calculation of the 2015/16 base milk price (**Draft Report**).
2. This submission addresses Synlait's concerns about the persistent deficiencies in the review regime.
3. Synlait is concerned that four years after the 2012 reforms that introduced the regulation of the milk price there are issues that have not been properly addressed and which are damaging to the objectives of the Dairy Industry Restructuring Act 2001 (**DIRA**). We have not reached 'business as usual', and more needs to be done for DIRA to support a genuinely contestable market which benefits farmers, consumers, and current and future producers and investors.
4. Synlait outlines six key concerns in this submission. They are:
  - (a) the interpretation of the purpose of Subpart 5A of DIRA;
  - (b) the application of Subpart 5A of DIRA to the notional producer's asset beta;
  - (c) the evidential onus on submitters;
  - (d) the "over-optimisation" of the notional producer;
  - (e) the proposed changes to how the Reference Commodity Products are set; and

(f) the continuing lack of transparency in the calculation of the milk price.

5. We discuss these issues in turn below.

### Interpretation of the purpose of Subpart 5A of DIRA

6. Section 150A of the DIRA says that the purpose of that Subpart of DIRA is to “*promote the setting of a base milk price that provides an incentive to new co-op to operate efficiently while providing for contestability in the market for the purchase of milk from farmers.*”

7. These two aspects are generally termed the “efficiency” and “contestability” dimensions. The Commerce Commission’s role is to report on whether Fonterra has complied with them.<sup>1</sup>

8. The Commerce Commission’s previous reports<sup>2</sup> have stated that efficiency and contestability are two separate dimensions which should be assessed independently of each other. This is arguably ambiguous as to whether the Commerce Commission considered one dimension to be subsidiary to the other.

9. Synlait’s view is that in interpreting s150A, regard must be had to the overall purpose of DIRA, which states among other things that the purpose of the legislation is to:

*(f) promote the efficient operation of dairy markets in New Zealand by regulating the activities of new co-op to ensure New Zealand markets for dairy goods and services are contestable;*<sup>3</sup>

10. This section expresses a clear Parliamentary intent that contestability in the relevant markets is as important as efficiency. Further, the two concepts are not distinct; they are connected by the words “*while providing for*” in s150A and “*to ensure*” in s4(f).

11. The contestability purpose of the legislation is clear: it is to regulate the activities of Fonterra in order to “*ensure*” and to “*provide for*” contestability. Contestability means that “*assumptions taken into account in calculating the base milk price are practically feasible for an efficient processor.*” A milk price that is contestable is one that allows processors that are more efficient to obtain the volume of milk that they can efficiently process to deliver the greatest value for New Zealand.

12. In this respect we note that in “Our approach to reviewing Fonterra’s Milk Price Manual and base milk price calculation” dated 15 August 2016 (Milk Price Calculation) the Commission said:

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<sup>1</sup> Sections 150L and 150P.

<sup>2</sup> For example Final report – Review of Fonterra’s 2014/2015 base milk price calculation” dated 15 September 2015 (Milk Price Calculation) at B12.

<sup>3</sup> Section 4(f)





*"9. The regime monitors whether the base milk price set by Fonterra provides incentives for it to operate efficiently while not precluding efficient processors from potentially competing."*

13. Synlait's view is that this understates the purpose of the legislation, which is aimed at *ensuring* that contestability is *provided for* rather than *not precluded*.

#### **Application of Subpart 5A to setting the notional producer's asset beta**

14. This year, Synlait and others had the opportunity to review and make submissions on expert reports about the asset beta of the notional processor, and the specific risk premium for asset stranding. This was an improvement in terms of transparency of the weighted average cost of capital (**WACC**), a key component of the milk price model.

15. The Commerce Commission's draft conclusion is that the WACC has been calculated consistently with the efficiency and contestability dimensions.<sup>4</sup> In making this statement, the Commerce Commission said:

*"Although these experts have different point estimates for asset beta, they are relatively close given the difficulty of reliably estimating beta, and do support our conclusion that the estimate used by Fonterra is reasonable."*<sup>5</sup>

*"there is no clear evidence that the specific risk premium for asset stranding risk of 0.15 is unreasonable, and an asset beta of 0.38 is within an acceptable range for an official processor with the notional producer's risk profile."*<sup>6</sup>

16. These and other passages in the draft report are of concern to Synlait because in concluding that Fonterra's position was "*reasonable*" or "*not unreasonable*" the Commerce Commission may have failed to apply the statutory test, which is whether the milk price, and components underlying the milk price, provide Fonterra with an incentive to be efficient while providing for contestability in the market for the purchase of milk.
17. This test applies to the asset beta and assumptions about the notional producer's business that inform the asset beta.
18. Synlait and others challenged the key assumptions that underpinned the reports of both Dr Marsden and Dr Lally (see for example the Castalia Report June 2016).
19. Most importantly, Dr Marsden and Dr Lally assume that the notional producer is "*close to riskless*". This assumption leads them to consider the notional producer as akin to a tolling operation and therefore as having a very low asset beta. In Dr Lally's case,

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<sup>4</sup> Draft Report X25.

<sup>5</sup> Draft Report 4.40.

<sup>6</sup> Draft Report 4.53.

this assumption is derived from his own interpretation of DIRA (see Dr Lally's Report August 2016, p.13).

20. Since the interpretation of DIRA is a legal question, it is for the Commission to determine its own view on what assumptions satisfy Subpart 5A of DIRA. The role of experts is then to take those assumptions and develop an estimate of the asset beta that is consistent with those assumptions. Dr Lally has been retained by the Commission as an economic expert, and has not been engaged to provide legal advice.
21. DIRA does not provide specific direction on these matters, which must be determined based on what assumption best satisfies the purpose statement in Subpart 5A. The Commission must determine whether assuming that the notional producer is "*close to riskless*" provides Fonterra with an incentive to be efficient while providing for contestability.
22. We cannot see how the Commission could independently form the view that such an assumption satisfies DIRA. To be practically feasible, an attribute of the notional producer must be able to be replicated by an efficient producer in the market. We are unaware of any dairy producer that allocates risks in the way that the notional producer is currently being assumed to allocate risks, so this assumption cannot be practically feasible.
23. Further, assuming the notional producer is "*close to riskless*" also immunises the notional producer from the profit or loss associated with how it optimises its production of the Reference Commodity Products. Since commodity prices fluctuate significantly, the optimisation of what products to produce is a significant driver of profitability. Accordingly, it would better satisfy both practical feasibility and efficiency for the notional producer to be assumed to allocate risks in the way that efficient producers do.
24. Synlait's view is that the notional producer should be assumed to allocate risks in a way that is practically feasible for an efficient producer. Since existing markets include a range of world-class producers, the way they share risk is the most appropriate benchmark for the notional producer. This is especially the case when international producers consistently share in the risks the notional producer is currently assumed to pass on to farmers.
25. For the above reasons, Synlait maintains the position raised in its previous submission that the most appropriate benchmark for the notional producer's asset beta is market comparators.





## The evidential onus on submitters

26. In relation to its WACC analysis in the draft report, the Commerce Commission commented:

*“we have not received any information from interested parties on what an alternative asset beta or specific risk premium should be, or what discounts should be applied to the various market comparators’ asset betas.”<sup>7</sup>*

27. Synlait is concerned that the above comment and others like it indicate an inappropriate over-reliance on the evidence of submitters.

28. The Commerce Commission’s review is one of the measures to *provide for* and *ensure* contestability and incentivise efficiency. In its regulatory role under DIRA, the Commerce Commission must satisfy itself as to Fonterra’s compliance, or otherwise, with the objectives of the legislation. There is no onus of evidence on a submitter, nor should their submissions be discarded if they provide conceptual arguments without necessarily providing empirical evidence. For example:

- (a) the input from economists on the application of economic principle is evidence that the Commerce Commission should have regard to.
- (b) the Draft Report says the Commission would use comparable cost information from interested parties to help identify any cost components in the milk price calculation that are potentially “over-optimised,” but that no such information was provided.<sup>8</sup>

29. However, like many independent manufacturers, Synlait have not been able to provide the Commission with comparable cost information. This for a number of reasons:

- (a) Fonterra does not provide sufficient detail and definitions associated with the cash costs they use in their milk price model. As a result, it makes it almost impossible for Synlait to provide the Commission with comparative data as an independent benchmark to match against what Fonterra use, as Synlait does not know the starting point used by Fonterra in order to make the comparison.
- (b) It has become almost impossible for Synlait to distinctly identify cash costs that would relate to its production of the Reference Commodity Products. Given Synlait’s mix of products and also the significant investments Synlait has made in operating costs to support its Infant Formula business as well as the development of non Reference Commodity Products related opportunities, to identify those costs related to Reference Commodity Products production is not practically feasible, as it would involve substantial work and require so many cost allocation assumptions that it would render the outcomes meaningless.

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<sup>7</sup> Draft Report X29.

<sup>8</sup> Draft Report 3.8.

30. It appears that, without independent comparable cost information, the Commerce Commission has simply looked at the supporting data Fonterra has provided and has formed a view that it is reasonable. There appears to have been no substantive independent analysis to independently verify Fonterra's assumptions in detail.
31. The Commerce Commission must therefore turn its mind to the information before it. Interested parties may be disincentivised to assist the Commerce Commission if their submissions and information provided are not addressed.
32. Regard should also be had to the fact that the ability of other industry participants to provide full and informed submissions together with evidence is hampered because:
  - (a) the milk price model is not transparent (this is addressed further below);
  - (b) the Commerce Commission has information and data provided by Fonterra which is not shared with other market participants; and
  - (c) the time provided for submissions is usually very short.
33. We recognise that certain timeframes are specified in the legislation. However, this emphasises the need to enable industry stakeholders to help the Commission perform its regulatory role.
34. While Synlait is willing to assist the Commerce Commission in any way it can, in this context (and given the constraints outlined above) its submissions cannot be a substitute for investigation and analysis by the Commerce Commission itself.

#### **The “over-optimisation” of the notional producer**

35. Overall, Synlait remains concerned that the milk price is “*over-optimised*” and most recently set those concerns out in detail in its submission of 1 September 2015.
36. Synlait disagrees with the Commission's conclusion that the notional producer is “*practically feasible*.”<sup>9</sup>
37. The Commerce Commission's comparison of the notional producer's with the GOGI RCP performance<sup>10</sup> does not allay these concerns, it heightens them.
38. The GOGI RCP business was found to differ from the notional producer by 77 cents per kgMS. The Commission was unable to identify the reasons for almost a third of this difference (21 cents).
39. Synlait believes that the Commerce Commission's acceptance of Fonterra's approach to the WACC adds a further assumption to the notional producer which means in reality it has the features of a “super-competitor.” This is not the result of just this decision, but is an accumulation of assumptions, some of which are defensible, but which in

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<sup>9</sup> Draft Report X20

<sup>10</sup> Draft Report Attachment A.





aggregate mean that the milk price is not achievable by a practically feasible operator operating as efficiently as it can.

### **The proposed changes to how the Reference Commodity Products are set**

40. Synlait is concerned that the Commerce Commission is recommending that the RCPs be set based on expected profitability over a one-year period, and requests that the Commission withdraw this recommendation.
41. Efficient plant investment decisions can only be made over long periods since processing assets take time to design, have consented, build, test and commission, are to a large extent sunk and have long useful lives (over 30 years typically). The notional producer would not be maximising its expected profitability nor would it be practically feasible to determine the RCPs based on profitability over a one-year period.
42. Even a five-year period is shorter than Synlait uses to determine what plant to invest in. Synlait uses a ten-year investment horizon. Requiring the RCPs to be changed based on profitability over the next year also undermines stability and predictability in the milk price regime.
43. Synlait believes the existing requirement for the RCPs to be determined based on expected profitability over the following five-year period should at least be retained (and Synlait intends to push for this to be extended as part of the reform of the DIRA) and requests the Commission to reconsider its position.

### **Transparency**

44. Synlait supports the Commerce Commission's ongoing focus on transparency.
45. The Commerce Commission's reports have frequently noted areas that Fonterra could improve. Although this is somewhat piecemeal, it has gradually improved the quality and scope of the information provided by Fonterra.
46. There remains significant room for improvement. Synlait's submission of 1 September 2015 recorded Synlait's frustration at the lack of transparency around the milk price model. A lack of transparency restricts the ability of industry stakeholders to assist the Commission in its regulatory role, and undermines confidence in both the regulatory regime and investment in the dairy industry.
47. Synlait maintains that the reason Fonterra provides for refusing to fully disclose the milk price model and calculation (commercial confidentiality) is outweighed by the benefits from disclosure in terms of increased transparency and the ability for interested parties to make more informed contributions in the Commerce Commission's review process. Further, the model incorporates notional inputs which are by definition not confidential, and it is disclosed after the fact. It is difficult to imagine how this disclosure could be detrimental to Fonterra. Accordingly, the full model should be made public.



48. As it stands, there is legitimate concern that Fonterra's decisions affecting the milk price are not subject to appropriate scrutiny and can be manipulated to Fonterra's advantage.
49. Fonterra's intention to change the balance between on and off-GDT sales of Reference Commodity Products raises precisely this concern. Synlait will provide its comments as part of the review of the 2016/17 Milk Price Manual.

Yours faithfully

A handwritten signature in black ink, appearing to read "QL", is written over a faint, dotted line that serves as a signature guide.

Quentin Lowcay  
**General Counsel & Commercial Manager**