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Submission on Cambridge Economic Policy Associates' Final Report on the Notional Processor's Asset Beta

Open Country Dairy (Open Country) welcomes the opportunity to make this submission on the independent report (the Report) on the notional processor's asset beta prepared by Cambridge Economic Policy Associates (CEPA).

Commission must act

After carefully considering the Report, Open Country remains of the view that there is no reasonable basis to justify a reduction in the asset beta of the notional processor. Fonterra has consistently used an asset beta which is demonstrably too low to be practically feasible. The resulting cost of capital is significantly below the level necessary to attract investment for any real-world processor. It is well past the time that the Commission expressly acknowledge this fact, and if Fonterra continues its current practice the Commission must state unequivocally that the base milk price calculation is inconsistent with statutory purpose set out in section 150A of the Dairy Industry Restructuring Act 2001.

CEPA's approach

In respect of the Report itself, we welcome CEPA's approach of decomposing beta so as to isolate the component long-term and short-term effects. It seems obvious that both long-term and short-term systematic risks matter. This approach clearly demonstrates our point that using electricity utilities as comparator businesses is fundamentally flawed. It also confirms that global dairy businesses are the most appropriate comparator.

If more evidence was needed to demonstrate this point, we would add that CEPA's analysis is perfectly consistent with the reality of how investors allocate capital across their portfolio. Investors allocate funds within a portfolio on a sector-by-sector basis, focusing on the longer-term prospects of the sector.

We note, however, that CEPA appears to have erred in its finding that any short-term systematic risks faced by the notional processor are sufficiently comparable to that of a regulated utility. This conclusion overlooks that the notional processor is exposed to commodity price risk, which is a material difference between the two comparators. It also concluded that the notional processor bears no foreign exchange risk, which is incorrect as the notional processor is exposed to foreign exchange movements to the extent that its hedging is different to Fonterra's. While CEPA's views on short-term systematic risks do not appear to directly affect its choice of the comparators or its estimation of the asset beta, we remain concerned that superficial analysis of the nature of dairy processing will continue to perpetuate unhelpful myths about the ability of dairy processors to effectively transfer all systematic risks to their suppliers. After all this time, it is just as important to get the underlying principles right.

Asset beta estimate

CEPA's estimated range for the asset beta is 0.45 to 0.58. This estimated range is reasonable and defensible given the available evidence and CEPA's approach and use of a more appropriate comparator

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set. Despite this improvement on the Uniservices methodology, CEPA itself points out that its estimated range is not all that different from the UniServices estimate of 0.49 to 0.53 prepared on behalf of Fonterra. Therefore, the main issue is the appropriate point to pick within the range.

In this regard, CEPA's discussion of notional processor having lower risks than the sample is unconvincing. This is all the more so given its own stated view that long-term systematic risks are clearly the most relevant factors. The possible considerations that CEPA mentions which could differentiate the notional processor from the sample — including more price passthrough or fewer commodity products — are short-term factors which CEPA is comfortable dismissing elsewhere in its report. Open Country remains adamant that the evidence shows that the notional processor is in fact exposed to the same range of risks in the short term as its industry comparators, but even accepting CEPA's analysis on its own terms means that such short-term revenue variability makes virtually no difference to the asset beta. As should be clear to all parties by now, the asset beta is primarily influenced by the long-term factors that link demand for dairy products to GDP growth.

Given CEPA's own analysis, there is no rationale and certainly no reliable information for selecting anything other than the midpoint of the estimated range (that is, an asset beta of 0.515). CEPA arbitrarily proposes that the Commission consider applying the same downwards adjustment of 0.05 as it does for airports in the Part 4 information disclosure context. There is simply no evidential basis to support such an adjustment whatsoever in the case of the notional processor. In any case, it is telling that even if such an adjustment were applied, the resulting asset beta is still comfortably higher than that derived by Uniservices and applied by Fonterra.

Conclusion

There was never any real doubt on the basis of the available evidence that Fonterra's use of asset beta of 0.38 for the 2016/17 base milk price calculation was not practically feasible for an efficient notional processor, and that the base milk price calculation was inconsistent with the section 150A purpose as a result. CEPA's analysis, while limited in some respects, simply confirms that position. Open Country looks forward to the Commission applying this evidence in its review of the 2017/18 base milk price calculation and beyond.

Best regards,

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Open Country Dairy