

27 July 2021

Tēnā koutou stakeholders,

**We seek your views on the advice from our expert advisors, CEPA, on the appropriate asset beta and specific risk premium for a notional milk processor in the context of our 2020/21 Milk Price Calculation review**

#### **Purpose of this consultation**

1. The purpose of this letter is to inform stakeholders that the Commerce Commission (**the Commission**) engaged Cambridge Economic Policy Associates Ltd (**CEPA**) to provide expert economic advice (**the CEPA advice**) on the estimates for asset beta and specific risk premium (**SRP**) by the Milk Price Group (**MPG**) in the context of our 2020/21 Review of Fonterra's Base Milk Price calculation (**the 2020/21 calculation review**), as well as to seek stakeholder views on the CEPA advice.
2. This letter provides the context for the CEPA advice, summarises the key parameters estimated by MPG and CEPA, and outlines the main questions on which we are seeking stakeholder views.
3. We will publish our draft report on the 2020/21 calculation review on 16 August 2021 and our final report on 15 September 2021. Stakeholder submissions on the CEPA advice will be considered as part of our final report on the 2020/21 calculation review.

#### **The context for the CEPA advice**

4. Our primary role under the Dairy Industry Restructuring Act 2001 (**DIRA**) is to publicly report on the extent to which Fonterra's milk price setting processes and calculations provide incentives for Fonterra to operate efficiently and are consistent with contestability in the market for purchasing farmers' milk. DIRA requires us to complete two separate, but related, reviews of Fonterra's setting of the base milk price for each dairy season – a review of Fonterra's Milk Price Manual and a review of Fonterra's base milk price calculation.
5. We are currently in the process of reviewing Fonterra's base milk price calculation for the 2020/21 season. The focus areas for this year's review include, among others:<sup>1</sup>
  - 5.1. asset beta; and
  - 5.2. specific risk premium.

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<sup>1</sup> Commerce Commission "[Proposed focus areas for our review of Fonterra's 2020/21 base milk price calculation](#)" (8 April 2021).

6. The asset beta and specific risk premium are key inputs to the cost of capital and are thus material to the base milk price calculation.
  - 6.1. The asset beta provides an allowance in the weighted average cost of capital for 'systematic risk' faced by shareholders, comprising risk which cannot be diversified away by holding a portfolio of shares in different companies.
  - 6.2. The specific risk premium, another component of the weighted average cost of capital, was introduced to compensate shareholders for potential downside risk associated with stranded assets.
7. As part of its reasons paper in support of the base milk price for the 2020/21 season, Fonterra provided a report by MPG on the asset beta and SRP.<sup>2</sup>
8. In estimating the asset beta for the notional milk processor, MPG has sought to apply the new requirements contained in s 150C of DIRA, which came into effect in June 2021 for the 2021/22 season. We note that there is no obligation on Fonterra/MPG to apply the new s 150C(4) requirements for the current 2020/21 season. In any event, we are interested in stakeholder views on Fonterra's compliance with the new s 150C(4) requirements, even though that provision has not yet entered into force. We confirm that we will apply s 150C without the subsection (4) amendments in the current 2020/21 calculation review.
9. We consider that there is value in seeking independent expert advice on the asset beta and SRP, given:
  - 9.1. the materiality of these parameters for the base milk price calculation;
  - 9.2. our focus on these parameters for the 2021/21 calculation review; and
  - 9.3. the changes in methodology based on the new s 150C requirements incorporated in the MPG analysis.
10. We asked CEPA to comment on whether the MPG methodology and estimates of the asset beta meet the requirements of DIRA, and specifically the new s 150C(4) requirements (even though Fonterra is not yet required to apply s 150C(4) for the purposes of the 2020/21 calculation review). We also asked CEPA's advice on whether an SRP may be appropriate.

#### **Summary of key parameters estimated by MPG and CEPA**

11. Table 1 below summarises the key parameter estimates by MPG and CEPA and briefly notes the main reasoning, where relevant.

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<sup>2</sup> Fonterra "[Attachment 6: Asset beta and specific risk premium – Milk Price Group paper](#)" (8 July 2021) and Fonterra "[Annex to Attachment 6: Summary of comparators – Milk Price Group paper](#)" (8 July 2021).

**Table 1: Asset beta and SRP estimates for the notional milk processor**

	MPG		CEPA	
	Core set	Full set	Core set	Full set
Asset beta estimate based on comparator set <sup>3</sup>	0.47	0.50	0.53	0.55
Downward adjustment		-0.5	N/A	
Reasoning for downward adjustment	Notional processor is likely to have lower systematic risk than the comparator sample and a rounding adjustment is reasonable given the statistical imprecision of the beta estimates		No strong evidence that comparator sample is likely to have higher systematic risk than notional processor	
<b>Asset beta</b>	<b>0.45</b>		<b>&gt; 0.47</b>	
<b>SRP</b>	<b>nil</b>		<b>nil</b>	
Reasoning for SRP value	Non-systematic asset stranding risk managed through alternative methods such as retaining certain stranded assets in the asset base, non-replacement of assets falling out of the base milk price asset base and shortened asset lives		Subject to appropriate asset beta, agrees that any non-systematic asset stranding risk does not require upfront compensation	

### Main questions on which we are seeking stakeholder views

12. We welcome stakeholder views on the CEPA advice commenting on the MPG analysis and asset beta and SRP estimates. We are particularly interested to hear from stakeholders on the following questions:
- 12.1. Do you agree that the methodology used by MPG to identify the firms in the core and full comparator sets would satisfy the new DIRA s 150C(4) requirements (even though Fonterra is not required to apply s 150C(4) for this review)? Please explain why or why not.
- 12.2. Do you consider that an asset beta estimate for the notional processor of between 0.45 (MPG's estimate) and 0.53 (CEPA's core comparator set estimate) would meet the requirements of DIRA? In particular, is a downward adjustment of the asset beta from the comparator set estimate justified? Please explain why or why not.

<sup>3</sup> MPG identified 19 firms with some operations that appear to satisfy the new s 150C(4) criteria. These form their 'core' comparator set. They also identified a further five firms with operations that are arguably close to satisfying the s 150C(4) criteria – these firms are included in the MPG 'extended' comparator set, and together with the core comparator set, form the 'full' comparator set.

- 12.3. Do you agree that any non-systematic stranding risk faced by the notional processor can be managed using the rules in Fonterra's Milk Price Manual and does not require upfront compensation at this stage (subject to an appropriate asset beta)?

**We welcome your feedback**

13. We understand that this is a complex and technical topic. We are consulting on the CEPA advice in advance of our draft decision to allow interested parties additional time to consider both the MPG and CEPA analyses. We encourage stakeholders to provide their views on the CEPA advice.
14. Stakeholder submissions will be considered when we prepare our 2020/21 Review of Fonterra's Base Milk Price calculation final report in September 2021.
15. Please make your submission via the [Milk price calculation – 2020/21 season page](#) on our website, by **noon (12PM), Tuesday, 24 August 2021**.<sup>4</sup> The project page will direct you to a form with instructions on how to upload your submission. Your submission should be provided as an electronic file in an accessible form (e.g., PDF, word or an unlocked spreadsheet).
16. The protection of confidential information is something the Commission takes seriously. When including commercially sensitive or confidential information in your submission, we offer the following guidance.
17. Please provide a clearly labelled confidential version and public version, and provide reasons why you consider information to be confidential or commercially sensitive. We intend to publish all public versions on our website.
18. The responsibility for ensuring that confidential information is not included in a public version of a submission rests entirely with the party making the submission.
19. If we consider information disclosed in the confidential version to be in the public interest, we will consult with the party that provided the information before any such disclosure is made.

Nāku, nā



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Deputy Chair

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<sup>4</sup> <https://comcom.govt.nz/regulated-industries/dairy/milk-price-manual-and-calculation/milk-price-calculation/milk-price-calculation-202021-season>