

2 September 2019

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Attention: Stephen Bass
Manager, Compliance, Regulation Branch
Commerce Commission
WELLINGTON
By email: regulation.branch@comcom.govt.nz

Dear Sir,

Re: **SUBMISSION ON THE COMMISSION'S DRAFT REPORT ON ITS REVIEW OF FONTERRA'S 2018/19 MILK PRICE**

This submission sets out Fonterra's response to the Commission's draft report on its *Review of Fonterra's 2018/19 base milk price calculation: Dairy Industry Restructuring Act 2001*, released on 15 August 2019 (the 2018/19 Draft Report).

We comment in this submission on the Commission's observations on materiality, administration and other overhead costs, and asset beta.

We do not have any comments on any other aspect of the Commission's draft report.

Please contact me if you have any questions or would like further information.

Yours sincerely,



Andrew Cordner
Director, Legal
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Introduction

Our comments below are set out below under the headings materiality, administration and other overhead costs, and asset beta.

In summary:

1. We generally agree with the Commission's observations on materiality, but believe it may be helpful to note two matters not addressed by the Commission, relating to:
 - Fonterra's auditor's treatment of matters below its reporting threshold: all matters identified are raised with the Milk Price Group (MPG) and Fonterra management, and all matters beyond a de minimis threshold are brought to the attention of the Milk Price Panel.
 - Materiality in the context of the contestability dimension of s 150A, where we consider that an under-statement or over-statement of the milk price relative to its 'true' value would generally have to be reasonably substantial to unduly distort farmers' decisions about which processor to supply their milk to.
2. We welcome the Commission's draft finding that our allowance for administration and other overhead costs is practically feasible, and look forward to engaging with the Commission on matters relating to the efficiency of the allowance in the course of the 2019/20 base milk price review.

While we continue to consider that the Commission and its advisor Cambridge Economic Policy Associates (CEPA) do not adequately allow for the very substantive differences in the sources of exposure to systematic risk of the 'notional milk price business' (NMPB) relative to CEPA's comparator set, we have confined our comments to two technical matters that will be of continued relevance if the draft asset beta-related amendments to the Dairy Industry Restructuring Act 2001 (DIRA) are reflected in final legislation:

- We refute CEPA's principal arguments for excluding Fonterra from the comparator set, and
- We explain our view that the Commission (and CEPA) have cited a paper by Dr. Martin Lally out of context in support of the proposition that regulation does not impact on asset beta.

Materiality

We generally agree with the Commission's comments on materiality, but consider the following contextual observations may be useful:

1. In paragraphs 2.69 – 2.70 the Commission observes that Fonterra's external auditor PwC has this year applied an audit materiality threshold of 1%, or approximately 6.4 cents per kgMS at the current forecast of the 2018/19 Farmgate Milk Price. Some readers may mistakenly infer that, for example, an issue with an impact of say 3 cents per kgMS would therefore be ignored by the external auditor. We advise that this is not the case: all stakeholders are focused on ensuring all inputs into the milk price are calculated accurately, and the auditor therefore raises with Fonterra management and the MPG all matters identified in its work, and advises the Milk Price Panel of all matters above a de minimis reporting threshold agreed with the Panel.

2. One dimension of materiality which the Commission does not comment on is the question of 'how large' an 'under' or 'over' statement of the milk price has to be before it is likely to affect farmers decisions, particularly whether to switch processors.

The answer to this question is not clear cut, but in our view will be reasonably substantial.

Key reasons for this view include:

- To the extent that milk price is one of the determining factors in farmers decisions about who to supply, it is expectations of future milk prices that will matter (and particularly expectations of differences between processors in future milk prices). Historical prices are relevant only if farmers consider they contain information about the future. So a large one-off difference between prices paid by two processors in a particular year may convey little information about the future if it is attributable to an easily articulated one-off circumstance. But a series of small differences over a number of years may be viewed as having significant information content if there is no reason not to expect them to persist into the future.
- It is difficult, and sometimes impossible, to convert the headline milk prices paid by most processors other than Fonterra to the actual average prices that will be received by individual suppliers given differences between processors in a range of matters, including the treatment of premiums in headline milk price announcements, differences across processors in penalty regimes, the impact of differences in the timing of payments, and the impact of differences in approaches taken to setting prices for milk components (fat, protein and lactose).

While not directly relevant to the Commission's assessment, Fonterra has previously highlighted the lack of transparency around other processor's pricing regimes as a major impediment to farmers making fully-informed decisions about which processor to supply their milk to, and therefore to the dynamic efficiency of the NZ dairy industry.

In our submission to MPI on the 2019 review of DIRA, we explained that:

Efficiency and informed decision-making by farmers would be improved if the transparency of price setting and payments was spread throughout the industry. We support all processors being required to publish the average price they pay to farmers, the key parameters of their milk price and examples showing the payout that would be received for different parameters, in a way that is consistent across processors to allow proper comparison ... This would be consistent with the purpose of DIRA to promote contestability in New Zealand dairy markets, by reducing the asymmetry of information between farmers and independent processors.¹

We continue to consider that a requirement for disclosure of this nature by all processors would significantly enhance farmers' decisions about who to supply, thereby improving both farmer returns and sector performance.

Administration and other overhead costs

We welcome the Commission's draft conclusion that the provision for administration and other overhead costs, including the increased provision for 2018/19, is practically feasible, and therefore consistent with the s 150A contestability dimension.

¹ Fonterra, Response to MPI's discussion document on its review of the dairy industry, 8 February 2019

We look forward to engaging with the Commission in its review of administrative and other overhead costs and allocation methodologies more generally in the course of the 2019/20 base milk price calculation review.

Asset beta

The Commission concluded in its 2017/18 final report on the base milk price calculation that “an efficient processor with a similar risk exposure to the NP is unlikely to have an asset beta as low as Fonterra’s estimate of 0.38, and on balance, we consider that this beta estimate is therefore unlikely to be practically feasible for an efficient processor”, and has maintained this conclusion in the 2018/19 Draft Report.

Fonterra continues to consider that the analysis and advice underpinning the Commission’s position that our current asset beta of 0.38 is unlikely to be practically feasible is flawed. However, given the proposed changes to DIRA in this context, we have restricted our comments in this submission to matters that will potentially be most relevant to future assessments under the proposed amendments to DIRA in the event those changes become law.

We first note that under Rule 42 of the Milk Price Manual Fonterra is required to use an asset beta recommended by an appropriately qualified independent expert. The expert engaged by Fonterra, Dr Alastair Marsden of the University of Auckland Business School, has repeatedly affirmed his recommended asset beta of 0.38 after considering all matters raised by the Commission and its advisors. Absent a recommendation from an expert engaged by Fonterra, Fonterra does not have any ability to alter the value employed in the Milk Price calculation while still complying with its Milk Price Manual. We acknowledge that the Commission understands this situation, but make the point given an apparent belief on the part of some third parties that Fonterra is wilfully disregarding the Commission’s position on this matter. The Manual requires that we commission a fresh review in the current 2019/20 season, for implementation in the 2020/21 season. The terms of reference for that review will reflect the final asset beta-related amendment to DIRA.

The relevant draft amendment to DIRA provides that “the asset beta used ... must be consistent with the estimated asset betas of other dairy and commodity processors”. We will directly address our questions regarding the scope and interpretation of this language during the legislative process. For the purposes of this submission we assume the intent is that we will be required to apply the Commission’s six step process, but that in ‘step 1’ (identify a sample of relevant comparator firms) we will not be able to consider firms outside the dairy processing or broader commodity processing sectors. We also assume that we will be expected (and permitted) to apply conventional analytical approaches in determining which of the permitted comparators should be included, and that we will be expected (and permitted) to apply Step 5 (adjustments for regulatory differences or differences in systematic risk relative to the average of the comparators).

We briefly comment below on matters raised by the Commission that are relevant to the future application of Steps 1 and 5. The limited nature of our response should not, however, be read as an expression of agreement with other aspects of the Commission’s and CEPA’s analysis, much of which we disagree with², or agreement with the proposed asset beta-related amendment to DIRA.

² The report prepared for Fonterra by Graham Partington and Stephen Satchell titled “Report to Fonterra: Asset beta and CEPA’s response to Partington and Satchell” addresses various aspects of CEPA’s response to the initial Partington and Satchell report, and should be regarded as part of our submission.

A. Step 1 - the relevance of Fonterra as a comparator

The Commission considers that “CEPA has made a strong case suggesting Fonterra is not a relevant comparator, mainly because share trading in Fonterra is driven by factors that are very different from that of other shares” but explains that it “remain[s] open to considering further arguments for including it as an additional data point in the sample”.³

CEPA provide two reasons for excluding Fonterra from a comparator sample:⁴

1. “Changes in the value of the processing business don’t necessarily feed through to the listed share value, but rather may be reflected in a change in the value of the supply contracts, which are unobserved.”

Fonterra shareholders are not required to hold ‘supply contracts’, and have a near absolute right, protected by DIRA, to supply as much milk as they wish.⁵ This argument is therefore simply wrong: there are not any rights, express or implied, held by farmers that will absorb movements in the value of the processing assets other than their shares in Fonterra or units in the Fonterra Shareholders’ Fund (FSF).

2. Over the 12-month period examined by CEPA 70% of shares in Fonterra and units in the FSF were transacted by Fonterra suppliers, and these transactions “are likely undertaken to meet obligations to own shares related to milk supply volumes”, with the consequence that “share price movements are unlikely to have the same general relationship to general stock market movements that other shares do.”⁶

CEPA’s arguments in respect of this proposition are generally weak and lack support:

“In terms of governance, Fonterra does not have pressure from shareholders to maximise returns to the processing activity, and Fonterra does not aim to maximise value for its shareholders.”

This is correct only in the very limited sense that Fonterra, through the milk price mechanism, has explicitly ruled out driving down the milk price as a means of maximising value for its shareholders. In all other respects Fonterra is exposed to identical capital market disciplines as other listed companies, and its management team faces conventional incentives to maximise returns to shareholders.

“Out of total trades on both securities of 785k per day [over the 12 months to July 2018], at least 70% is determined by farmer-shareholder decisions. The price of Fonterra shares, and the FSF, is therefore largely determined by buy and sell decisions of farmer shareholders. These are driven by decisions on milk supply, and business management. The timing of these buy and sell decisions, and thus their relationship with general market movements are

³ 2018/19 Draft Report, paragraph 2.20, p.11.

⁴ Oddly, CEPA also argues that “investors do not see the Fonterra Shareholders’ Fund as an investment substitute for electricity line businesses”, which is not relevant to an assessment of whether Fonterra should be included in a set of dairy comparators.

⁵ Fonterra’s very limited ability to decline to accept milk under DIRA is not relevant to CEPA’s analysis.

⁶ CEPA 2019, p.10.

unlikely to be the same as that for diversified investors which determines share price movements of other shares ...”⁷

In this analysis CEPA is confusing the impact on Fonterra’s share price of inframarginal versus marginal trading: if compliance trading on the part of Fonterra farmers resulted in Fonterra’s share price departing from the market’s view of its fundamental value, there is nothing preventing non-farmer investors (or for that matter farmer-investors) taking advantage of the resulting arbitrage opportunities.⁸ More generally, recent movements in the Fonterra share price make it obvious that like any other company Fonterra’s share price will change in the expected manner to new information, reflecting (marginal) investors’ consensus view on the underlying fundamentals.

B. Step 5 – adjustments for regulatory differences or differences in systematic risk

On page 10, the Commission explains that in its framework for estimating asset beta it uses “the sample average as a starting point, and only depart[s] from it where there are sound reasons for doing so”, and adds a footnote to this sentence stating that “regarding any adjustments for regulatory differences, Dr Lally concluded that ‘there is no empirical study that provides a clear conclusion on the effect of regulation on asset beta’”.⁹

The Commission does not explain the relevance of the footnote, but an obvious interpretation is that the Commission considers it supports an argument that the fact that the milk price is derived under a quasi-regulatory framework, unlike the milk price of any of the dairy comparators, does not by itself imply a downward adjustment may be warranted. If our interpretation is correct, we believe the Commission’s position is mistaken. The focus of the Lally paper, and the papers surveyed in it, is on whether there is empirical support for the proposition that differences in the form of regulation imply differences in asset beta; not on the impact of ‘regulation’ versus ‘no regulation’. Lally concludes that there are strong theoretical reasons for believing different regulatory models will imply different asset betas, but that (primarily data-related) limitations in the relevant literature mean he cannot find empirical support for this proposition. While the sentence cited by the Commission reads as stated, it is clear from the context that the appropriate interpretation is that Lally’s position is simply that ‘there is no empirical study that provides a clear conclusion on the effect of [form of] regulation on asset beta’.

⁷ CEPA 2019, p.10.

⁸ We can separately provide on a confidential basis evidence of marked increases in institutional trading in units in the FSF around major earnings-relevant announcements as support for what should be the uncontroversial claim that non-farmer investors can and do respond to perceived arbitrage opportunities in FSF units.

⁹ 2018/19 Draft Report, footnote 28, citing Martin Lally, “Review of WACC issues”, 25 February 2016.