13 October 2015

Ms Sue Begg
Convenor, Dairy Division
Commerce Commission
PO Box 2351
WELLINGTON 6140

By email: regulation.branch@comcom.govt.nz

Dear Sue

CONCERNS REGARDING THE COMMERCE COMMISSION'S FINAL REPORT ON THE 2014/2015 BASE MILK PRICE CALCULATION

(Not for Public Submission)

Introduction

1. I am writing to express Synlait's concerns regarding several aspects of the Commission's final report on Fonterra's 2014/15 base milk price calculation. I would be happy to include the comments below in a formal public submission in due course, but feel compelled to write to you at my earliest opportunity.
2. Our concerns fall into four categories:
    i. inadequate disclosure;
    ii. delays in considering key issues;
    iii. inconsistency of capital cost assumptions; and
    iv. the Commission's approach to assessing aggregate feasibility.

Disclosure

3. We acknowledge that our calls for better disclosure have been noted in a few places (e.g. paragraphs X28 and 6.95), and that the Commission plans to pursue these with Fonterra. We are grateful for the Commission's efforts in this area, and we understand the limits on the Commission's powers under the milk price monitoring regime. However we believe that, within the constraints of the regime, the Commission could express more forcefully the merits of full disclosure of the milk price calculation.
4. The explanation provided in paragraphs 9.19 and 9.20 for the 130% scaling of tax relative to economic depreciation remains inadequate, and the new section (paragraphs 6.93 – 6.109) regarding the capital cost assumptions begs as many questions as it answers. These are just two examples where textual descriptions of Fonterra's process are inadequate substitutes for full disclosure of the actual underlying calculations.

Synlait Milk Ltd
1028 Heslerton Road
RD13, Rakaia 7783
New Zealand
P +64 3 373 3000
www.synlait.com

Delays in considering key issues

5. Synlait's submission on the Commission's draft report included the following:

   i. a summary of new mass balance calculations we have performed that call into question the yields and/or GDT prices assumed for the notional producer;

   ii. concerns regarding aspects of the notional producer's WACC (in addition to the Commission's own concerns);

   iii. a critique of the points made by Fonterra on paper 45 of its "Reasons" paper; and

   iv. our arguments that, if the notional producer was practically feasible, then Fonterra's NZMP business should be able to match its performance at the EBIT/kgMS level rather than lag materially behind.

6. We are disappointed that in all four areas the Commission has deferred consideration of the issues raised until the 2015/16 milk price review. In particular we note that:

   i. the mass balance issue is potentially material to the milk price, and the Commission could have engaged with Synlait in the first half of September to understand our calculations;

   ii. the Commission presumably has the necessary in-house expertise to address the WACC issues; and

   iii. our critique of page 45 of Fonterra's Reasons paper is not difficult to understand.

7. We hoped that the Commission would have addressed these matters with more urgency in this year's review, devoting more resources to its process if necessary to do so. While the negative ongoing financial consequences for Synlait and other independent processors of an over-optimised milk price are unfavourable the key issue is the economic and environmental consequences of over-stimulating milk production at the expense of returns on processing capital. If this is out of balance it will cause over investment in land and marginal inputs at the farm level and under investment in processing capacity and value adding activity – of which there are numerous examples in our industry.

Inconsistency of capital cost assumptions

8. We are deeply concerned that only now, three years after the Commission's role commenced with the dry run review, has there been acknowledgement and some disclosure regarding the inconsistency in the capital charge assumptions (paragraphs 6.93 – 6.109).

9. In our submission to the Commission dated 21 September 2012 we noted that:

   "assuming a depreciated asset base with plants of varying age (presumably up to 25 – 30 years old) for the purpose of calculating the capital charge is inconsistent with using yields across the whole portfolio based on current technology."

10. The Commission has until now maintained that the capital cost assumptions used in the milk price model are internally consistent, because they include adequate capital expenditure (including for advanced process control technology) to bring older vintage plants up to current performance levels in terms of yields and operating costs (paragraphs 6.47, 6.64 and 7.67).

11. However this year's report also now discloses that:

   i. the milk price model in fact assumes an initial asset base of 2008 vintage plants in terms of operating performance (paragraph 6.97) even though the plants are "spread back" and their costs deflated and depreciated in determining the current value of the asset base used for calculating the capital charge;

   ii. Fonterra acknowledges that this approach "gives rise to an apparent potential inconsistency" (paragraph 6.100); and

   iii. Fonterra then confirms in paragraph 6.101.1 that the inconsistency is real (rather than "apparent potential"), by acknowledging that older vintage assets would have higher operating costs or upgrade costs, leading to a lower milk price.

12. So as the model currently stands, the notional producer has the benefits of Fonterra's scale and a modern portfolio of high yield, low operating cost plants (as if the 50 or so plants were all built in 2008 or thereafter, an unrealistic assumption in itself). But the model does not have capital charges (i.e. depreciation and "WACC" charges) consistent with this. Consistency would require either:

    i. continuing to "spread back" the plants, but including the necessary additional upgrade costs which would add to the asset base and capital charges (also, repair and maintenance cash costs would probably need to increase); or

    ii. using the 2008 plant capital costs as the starting point for determining the current value of the asset base used for calculating the capital charges.

    In either case the asset base and capital charges would rise and the milk price would drop.

13. Fonterra tries to rationalise its current approach in three different ways, all of which are flawed.

14. Firstly, in paragraph 6.101.1, Fonterra implies that its approach is necessary to generate a milk price consistent with that which can be paid by the incremental efficient plant. We continue to argue against that definition of DIRA's contestability test. However putting that issue to one side, Fonterra has missed the point that even when expressed on a per plant basis, the value of the asset base and therefore the capital charges in the milk price model will still be too low for a single new plant.

15. Secondly, in paragraph 6.101.2 Fonterra says that actual historical costs would have been lower than those modelled, and the capital charges in the model are therefore higher than they could have been modelled. While that may be true, the key point is that the modelled asset base and capital charges are lower than they should be to be consistent with the yield and operating cost assumptions, which are based on a portfolio of modern plants.

16. Thirdly, Fonterra has provided the Commission with analysis which apparently shows that:

    i. the increase in the notional producer's operating costs if it had the same proportion of old technology plants as Fonterra, would be more than outweighed by

    ii. the annualised cost associated with the excess of the milk price model's replacement capex over Fonterra's actual replacement capex (as measured over 2008/9 – 2013/14).

17. Although (again) the calculations have not been disclosed to us, the description provided indicates that this is a curious and flawed analysis, for the following reasons:

    i. making comparisons to Fonterra (presumably to the NZMP business, now called Global Ingredients and Operations or "GIO") does not remove the inconsistency within the milk price model;

    ii. we are not concerned with the proportion of old technology within GIO, but that the model is made internally consistent by either of the approaches outlined in paragraph 12 above; and

    iii. the analysis put forward suggests that Fonterra believes the operating performance assumed in the model is inconsistently high relative to the average vintage of the asset base, but that this is offset by another error: the model's capex is too high. If there are errors in the model, they should be corrected. The first error (operating performance is too high) is confirmed in paragraphs 6.101.1, 6.105 and 6.109. The second alleged error (the model's capex is too high) is being raised for the first time, despite Fonterra and the Commission being comfortable for several years regarding the model's assumptions for the economic lives of the notional producer's assets. As discussed further below, we question whether capex is in fact overstated in the model.

18. In relation to the level of capex in the milk price model, we note that:

    i. the "return of capital" component of the model's capital charge is not the level of replacement capex that year, or the total capex that year, but the depreciation charge that year;

    ii. this is the correct approach, because expansion capex in the model can be lumpy and irregular but the depreciation charge will spread and smooth the cost over the life of the assets;

iii. in the real world both replacement and expansion capex can be lumpy and irregular. Clearly we cannot determine whether the six years of GIO replacement capex data used in Fonterra's analysis is truly representative of GIO's average replacement capex requirements on assets with lives of 30 or more years;

iv. what we can say with greater certainty is that in entities such as GIO and the notional producer, with multiple plants of varying ages and in relatively stable states, the depreciation charge will approximate the average required level of replacement capex, even if the accounting rate of depreciation used is higher than the actual economic rate of depreciation (i.e. even if GIO's assumed asset lives for accounting purposes are shorter than the plants' economic lives and therefore plants are not immediately replaced when they are fully depreciated);

v. the depreciation charge in the milk price model in 2014/15 is $263 million. GIO's total depreciation charge in 2014/15 was $321 million, or an estimated $293 million in relation to GIO's New Zealand assets which comprise 91% of GIO's total non-current assets. Based on this information, the milk price model's depreciation charge does not appear to be too high; and

vi. as discussed above, our concern is in fact the opposite – that the model's depreciation charge is too low relative to the assumption of a fully modern portfolio of high yield, low operating cost plants. Internal consistency requires the depreciation charge to be increased by either of the approaches outlined in paragraph 12.

19. If the model is to be corrected using approach (i) in paragraph 12 (adding the necessary upgrade and repairs and maintenance costs to older plants), then a further requirement is that the Commission should confirm whether in fact old plants can be made to match modern performance levels, and confirm the true upgrade costs required to achieve this. In this regard, paragraph 6.106 suggests that Fonterra may argue all plants from 1990 onwards could operate from new at close to modern performance levels. If that is Fonterra's position, then the Commission should request information from Fonterra on the yields and operating costs achieved on one of Fonterra's upgraded 25 year old plants, for comparison with the data it has provided from its new Darfield plant.

20. We are disappointed that the Commission appears only now to be focussing on the model's capital cost/performance inconsistency, and that it has accepted Fonterra's flawed rationalisations of the approach taken. Why would the Commission not allow the time and devote the resources to address the four matters in paragraph 5 that it is deferring until next year, yet accept without further enquiry (or opportunity for third party input) the dubious position put forward by Fonterra regarding the model's capital cost assumptions?

Commission's approach to assessing aggregate feasibility

21. I will not repeat here arguments Synlait has previously made regarding the Commission's interpretation of the "practically feasible" test in Section 150A(2) of DIRA, other than to make the following two points regarding the Commission's final report.

22. Firstly, the Commission's report does not appear to address the point made in paragraph 45 of our submission dated 1 September 2015. In paragraph X24 of the Commission's report, the phrase "practically feasible for a notional producer" is a contradiction in terms, other than if the notional producer is defined as an entity that could have evolved in practice.

23. Secondly, the report places considerable focus on obtaining further information on cash costs to assist in the Commission's assessment of aggregate feasibility. Our concern is that this suggests the Commission is broadly comfortable in other areas. However, as noted in paragraph 46 of our recent submission, it is the combined impact of many assumptions that makes the notional producer infeasible. That is also why investigating the performance gap between the notional producer and GIO is important, particularly at the EBIT per kgMS level.

Conclusion

24. I would be grateful for your views on the concerns I have raised in this letter.

25. Also, Synlait would like to continue to engage with the Commission regarding the milk price. If appropriate, we would welcome a further opportunity to meet with you and/or your team to discuss the key issues.

Yours sincerely

John Penno
Managing Director and Chief Executive Officer
Synlait Milk Limited