Submission to the Commerce Commission on its Draft Report on Fonterra’s 2021/22 Farmgate Milk Price Manual

15 November 2021

Fonterra Co-operative Group

Glossary

2020/21 Reasons Paper	Fonterra, Reasons Paper in support of Milk Price Manual for the 2020/21 season, 1 August 2020, https://comcom.govt.nz/__data/assets/pdf_file/0024/225249/Fonterras-Reasons-Paper-in-support-of-the-Milk-Price-Manual-for-the-2020-2021-season-1-August-2020.pdf
2021/22 Reasons Paper	Fonterra, Reasons Paper in support of Milk Price Manual for the 2021/22 season, 30 July 2021, https://comcom.govt.nz/__data/assets/pdf_file/0031/262867/Fonterra-Reasons-paper-in-support-of-FonterraE28099s-Base-Milk-Price-Manual-for-the-2021-22-season-30-July-2021.pdf
F21 Manual Review, Final Report	Commerce Commission, Review of Fonterra's 2020/21 Milk Price Manual, Final Report, 15 December 2020, https://comcom.govt.nz/__data/assets/pdf_file/0014/230270/Final-report-Review-of-Fonterras-Milk-Price-Manual-15-December-2020.pdf
F22 Manual Review, Draft Report	Commerce Commission, Review of Fonterra's 2021/22 Milk Price Manual, Draft Report, 15 October 2021, https://comcom.govt.nz/__data/assets/pdf_file/0022/268015/Draft-report-Review-of-Fonterra27s-2021-22-Milk-Price-Manual-15-October-2021.pdf
DIRA	Dairy Industry Restructuring Act 2001.
NMPB	Notional Milk Price Business, comprising the notional milk powder manufacturing business implied by Fonterra's Farmgate Milk Price Manual.
2021/22 Season	The period commencing on 1 June 2021 and ending on 31 May 2022.

1 Introduction

This paper sets out Fonterra's submissions on the Commerce Commission's draft report, dated 15 October 2021, on Fonterra's Milk Price Manual (the Manual) for the 2021/22 Season, prepared in accordance with section 150I of the Dairy Industry Restructuring Act 2001 (DIRA). This submission is intended to satisfy Fonterra's obligations under section 150M(2) of DIRA. The submission has been prepared under the oversight of the Milk Price Panel, and where relevant reflects the Panel's views.

We welcome the Commission's draft conclusion that our amendments to the Manual for the 2021/22 Season are consistent with the section 150A of DIRA.

Our substantive comments in this submission are confined to the Commission's draft conclusion that "Rule 42 of the 2021/22 Manual is inconsistent with the new requirements set out in s 150C and thus inconsistent with the statutory purpose set out in s 150A."

2 The Commission's draft conclusion on Rule 42

Rule 42 of the Manual, in the first bullet point, provides that in determining an asset beta, the MPG is required to have regard to "Fonterra's exposure to systematic earnings risk with respect to the portion of its business corresponding to the Farmgate Milk Price Business, as implied by the allocation of risks between Fonterra and suppliers under the Farmgate Milk Price Methodology." The intent of this provision is simply to recognise that the purpose of the asset beta is to capture the exposure to systematic risk of a real-world business with the same characteristics as the notional milk price business.

The Commission's draft position is that:

> 36. We consider that the first bullet point [in Rule 42] is not consistent with the new section 150C(4) of the DIRA requirements and should be deleted.
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> 37. Section 150C(4) states that the asset beta used in the calculation of the base milk price must be "consistent with the estimated asset betas of other processors of dairy and other food products…". We consider that the asset beta would not be "consistent with the estimated asset betas of other processors of dairy and other food products…" if the matters in the first bullet point were taken into account when calculating the asset beta.
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> 38. We note, for completeness, our view that section 150C(4) necessarily requires the adoption of the average asset beta from the comparator set.
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> 39. We also consider the statement "…the MPG will have regard to…" does not accurately reflect the legal obligation Fonterra has to comply with the s 150C(4) requirements. Fonterra must apply (not merely have regard to) the requirements for the calculation of asset beta in section 150C(4).
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> 40. We therefore recommend that the Manual clarifies that Fonterra is required to apply the section 150C(4) requirements for the calculation of asset beta. Alternatively, the Manual could remove this requirement from Rule 42 entirely as DIRA requires the application of section 150C(4) in any event.

The Commission's explanation for its position that s 150C(4) necessarily requires the adoption of the average comparator asset beta was set out in the Final 2020/21 Base Milk Price Report, and reads (in full) as follows:

3.26 We note that s 150C(4) necessarily requires an adoption of the average asset beta from the comparator set. Although that section does not prescribe that an average must be used, it recognises that the asset betas of multiple firms must be used. Without averaging, there is no practicable way to derive a single figure which can be used as the asset beta for DIRA purposes.

Our understanding of the Commission's position is that we will not be in compliance with DIRA if we apply the six-step framework generally applied by the Commission in its regulatory work in estimating the asset beta for Milk Price purposes. If our understanding is correct, it is possible that the Commission's interpretation of s 150C(4) is inconsistent with Parliament's intention in enacting s 150C(4). In particular:

- Our understanding of Parliament's intent is that s 150C(4) was designed to "embed the Commerce Commission's approach to the setting of the asset beta as a mandatory assumption that Fonterra must use in the base milk price calculation."[1,2]
- The Ministry of Primary Industries (MPI) advised the Primary Production Select Committee that it would "be testing draft [asset beta-related] provisions with other government agencies and in particular the Commerce Commission as the monitoring agency."[3] We understand this consultation occurred, and to date have inferred that the Commission was satisfied that the new s 150C(4) achieved its intended purpose of mandating the use of the Commission's approach to setting asset beta.
- MPI also advised Ministers that "[given] the Commerce Commission's extensive consideration of the issue … [MPI] considers that the risk of regulatory error in the proposed correction is low,"[4] implying that MPI believed the new provision mandated the application of the Commission's standard approach to estimating asset beta.

More generally, we note that it is necessary to read the new s 150C(4) in conjunction with the new s 150C(3) and s 150C(5), with the new provisions in their entirety reading:

(3) For the purposes of subsection (1)(b), any estimate of the return on capital must be made applying the capital asset pricing model.

(4) For the purposes of subsection (3), the asset beta used in the application of the capital asset pricing model must be consistent with the estimated asset betas of other processors of dairy and other food products that are—
(a) traded in significant quantities in globally contested markets; and
(b) characterised by uniform technical specifications.

(5) In subsection (4), **asset beta** means a measurement of a firm's exposure to systematic risk where systematic risk measures the extent to which the returns on a company fluctuate relative to the equity returns in the stock market as a whole.

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[1] The Ministry of Primary Industries Departmental Report to the Primary Production Select Committee, November 2019, paragraph 187, p.29. https://www.parliament.nz/resource/en-NZ/52SCPP_ADV_91054_PP3326/172110f0f102fc29687b4294748c49dc5283b186

[2] Similarly, the relevant Cabinet Paper explained that "The Minister of Agriculture therefore proposes that the Commission's approach to the asset beta assumption be specifically referenced in the DIRA as a mandatory assumption which Fonterra must take into account in calculating its benchmark milk price," Appendix 5 of https://www.mpi.govt.nz/dmsdocument/34779-MO-redactions-DIRA-cab-paper-Watermarked-Redacted (mpi.govt.nz).

[3] See page 32 of the Modifying Fonterra's obligations under the Dairy Industry Restructuring Act 2001 regulatory regime, Regulatory Impact Assessment material, Ministry for Primary Industries, May 2019, https://www.mpi.govt.nz/dmsdocument34782-MO-redactions-FOR-PUBLIC-RELEASE-Regulatory-Impact-Assessements-Watermarked-Redacted (mpi.govt.nz).

[4] See page 32 of the Modifying Fonterra's obligations under the Dairy Industry Restructuring Act 2001 regulatory regime, Regulatory Impact Assessment material, Ministry for Primary Industries, May 2019, https://www.mpi.govt.nz/dmsdocument34782-MO-redactions-FOR-PUBLIC-RELEASE-Regulatory-Impact-Assessements-Watermarked-Redacted (mpi.govt.nz).

We note:

- s 150C(3) provides that the cost of equity used in the base milk price calculation must be derived using the capital asset pricing model (CAPM), and that the purpose of the CAPM is to determine the rate of return required by providers of equity to a firm given their resulting exposure to systematic risk.
- s 150C(5) contains a standard text book-like definition of asset beta, as a measure of a firm's exposure to systematic risk.
- The concept of an asset beta is referenced explicitly in s 150C(4) and implicitly (via the requirement to apply the CAPM in estimating the cost of equity for the NMPB) in s 150C(3).
- We therefore believe that when read together, ss 150C(3) – (5) require that (a) the estimated asset beta used in the base milk price calculation should reasonably reflect the systematic risk attaching to the NMPB, but (b) must be estimated by reference to the asset betas of other processors of dairy and other commodity food products.
- The Commission's standard framework for estimating asset beta provides for both (a) and (b), by first requiring the calculation of the average asset beta for a set of comparator firms in the same industry, but then requiring consideration of whether an adjustment from the average is required to account for "regulatory differences or [differences in] systematic risk [between the subject firm and] the average asset beta for the sample."[5]
- In a number of documents issued from (at least) 2016 onwards, the Commission has emphasised that it considers it appropriate to apply its standard framework in its DIRA base milk price reviews, explaining (for example) in 2017 that "we consider that it is desirable to maintain cross-sectoral methodological consistency in how we estimate (or assess others' estimates) of WACC parameters [since] among other benefits, this promotes regulatory predictability and certainty."[6] In this instance, we would submit that the objective of promoting regulatory predictability and certainty requires that the Commission interpret ss 150C(3) – (5) as mandating the Commission's full six step framework.
- Application of the Commission's standard framework results in a point estimate of an asset beta which in most instances equates to the average of the comparator firms' asset betas, but sometimes does not. Importantly, however, the framework explicitly recognises that there can be a practicable way of deriving a single estimate of an asset beta which does not necessarily require adopting the average comparator asset beta.
- It appears reasonable to us to assume that had Parliament intended to mandate the use of the average of the comparator firms' asset betas it would have said so. Instead, it used the phrase "consistent with", which we consider can reasonably be interpreted as meaning no more than that we must be able to convincingly explain why our selected asset beta is reasonable relative to the average of the comparators', not that we must set it equal to the average.

In summary, the Commission's draft position appears to be that s 150C(4) requires that we adopt the average comparator asset beta and are not permitted to undertake any further inquiry into potential differences in systematic risk between the NMPB and the comparator firms, even though s 150C(4) does not expressly require the use of an average, simply on the basis that "without averaging there is no practicable way to derive a single figure which can be used as the asset beta for DIRA purposes." However, the Commission's framework specifically provides for the calculation of a single figure which is not the average of the comparators, and Parliament's intent in enacting the new ss 150C(3) – (5) was to mandate the use of the Commission's framework.

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[5] Commerce Commission, Fibre Input Methodologies Main Final Decisions Reasons Paper, October 2020, paragraph 6.416, p.420.

[6] Commerce Commission, 2016/17 base milk price review, final report, 15 September 2017. https://comcom.govt.nz/__data/assets/pdf_file/0038/59978/Final-report-Review-of-Fonterras-201617-base-milk-price-calculation-15-September-2017.PDF

3 Other matters

We note the Commission's comments in paragraphs 51 – 56 of the Draft Report, under the heading "How the Manual gives effect to the definition of commodity", and look forward to engaging with the Commission in its proposed review of the list of commodity materials and incremental product costs. We also confirm we will consider how we can best provide further information our 2021/22 base milk price reasons paper on the range of price-informing products in a manner which appropriately balances Fonterra's legitimate commercial interests with the Commission's desire for additional disclosure.