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Stephen Bass
Compliance Manager, Regulation
Regulation Branch
Commerce Commission
PO Box 2351
Wellington 6140.

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

Miraka Submission to the Commerce Commission:
Draft Report (15 August 2019): Review of Fonterra's 2018/19 Milk base milk price calculation: Dairy Industry Restructuring Act 2001

Miraka appreciates the opportunity to submit in response to the Commission's Draft Report on the 2018/19 milk price calculations. Miraka would welcome any opportunity to discuss the contents of this submission with the Commission.

1.0 Draft Report Conclusions

1.1 The Commission's draft conclusions are summarised at paragraphs 2.3 and 2.4 of the Draft Report; these are aggregated below:

> With some noted exceptions[1] "our draft conclusion is that the assumptions adopted, and the inputs and process used by Fonterra in calculating the 2018/19 base milk price are consistent with the contestability and efficiency dimensions of the section 150A purpose [of the DIRA]".

1.2 These conclusions are consistent with previous Commission reviews of the Milk Price Manual and the milk price calculations. There are usually some areas for concern or for improvement but overall the Milk Price Manual and the milk price calculations are found to be compliant with the DIRA.

1.3 Miraka does not agree the milk price calculations are compliant with S150A of the DIRA and has conveyed this opinion in many previous submissions. Putting aside our differing opinion, even if the milk price calculations are compliant with Section 150A, this is not the same as concluding that the resulting milk price is an appropriate benchmark for a competitive environment and which supports economic efficiency and effectiveness in the New Zealand dairy industry. That is nevertheless the message that is taken by the wider business and political community from the Commissions largely favourable reviews of compliance with the Section 150A.

1.4 It is Miraka view that Fonterra exploits Sub-Part 5A of the DIRA to inflate the milk price: in particular it exploits the Section 150B "safe harbour" provisions, and it defaults to assumptions and processes that increase the milk price. This is for example reflected in:

- its use of the safe harbours (S 150 B) to obfuscate commercially unrealistic yield assumptions

[1] The noted exceptions are administration and overhead costs (efficiency) and the asset beta (contestability).

- its use of off-GDT sales to inflate sales revenue to a level inappropriate to the Notional Producer "business model"
- its ongoing battle to retain a commercially unrealistic WACC which in effect prioritises interests of its milk supplying members over its other investors

1.5 Accordingly even if the Commission's reviews conclude substantial compliance with Section 150A, Miraka considers it is misleading to leave the impression that the resultant milk price is appropriate to support economic efficiency and effectiveness. The Commission no doubt considers it is not its role to highlight this issue within the DIRA review processes and Miraka understands that position. That does not detract from the damage caused by the ongoing largely positive reviews of the base milk price provided by the Commission.

2.0 Compliance with S150A

2.1 Miraka has made many previous submissions addressing the failure of the base milk price to comply with the DIRA. It is not intended to repeat those submissions here, but Miraka primary concerns can be summarised as follows:

- the production drivers for determining the Notional Producer costs and efficiency are mismatched against revenue assumptions, causing margins to be inflated
- stretch targets and safe harbours further understate costs and overstate production efficiency, further inflating margins
- stretch targets are deemed practically feasible because Fonterra is assumed able (if efficient) to achieve them; this is regardless of whether Fonterra actually achieves the targets or its business model is able to achieve the targets
- safe harbours trump the practical feasibility test and thus sanction what are in effect only theoretically feasible cost and efficiency assumptions
- claimed or actual commercial sensitivity of key assumptions and metrics in the base milk price calculations renders opaque any proper assessment of practical feasibility by the wider industry

2.2 These concerns are for example reflected in:

2.2.1 Notional Producer Yields – while lacking transparency, the Notional Producer production yields are unlikely to be commercially feasible; Fonterra (and the Commission) rely on the safe harbours to sanction those unrealistic yields. Miraka considers that safe harbours were intended to safeguard the inclusion of Fonterra actual business advantages (including scale) in the milk price calculations; they were not intended to allow Fonterra to inflate those advantages beyond what Fonterra itself can actually achieve.

2.2.2 Off-GDT sales included in the Notional Producer revenues: In summary, Miraka primary concerns are:

- the dissembling manner in which the expanded use of off-GDT sales were introduced (undermining confidence as to intentions)
- lack of transparency in the process and impact of including off-GDT sales (undermining confidence in outcomes)
- lack of alignment between the Notional Producer "business model" (mass commodity producer of precisely five products) and the Fonterra real world business model which produces premiums from off-GDT sales (Fonterra's multi-product customer focussed business model); i.e. the stripped down business model assumed by the Notional Producer (and associated long production runs, low costs and high production efficiencies) cannot realistically assume achievement of the premiums Fonterra makes from off-GDT sales.

- At the same time as reaping premiums from selected off-GDT sales, the milk price calculations suppress prices from tender sales where prices are likely to be below GDT; this is despite the fact that the Notional Producer's much larger commodity production means it would resort to tender type discounted sales to a far greater extent than is the case for Fonterra. The suppression of discounted sales at the same time as the promotion of premium earning sales is a useful metaphor for the Orwellian world the Notional Producer inhabits.

2.2.3 Stretch targets: The Commission argues that Fonterra is motivated by profit and that stretch targets are thus necessary to comply with the Section 150A requirement that the base milk price incentivise Fonterra to operate efficiently. Miraka considers stretch targets have the opposite effect because under its Constitution Fonterra is obliged to maximise the milk price (not profits); stretch targets make it easier for Fonterra to meet that objective which rather than encouraging efficiency would be much more likely to discourage efficiency.

2.3 Miraka has raised these and related issues in its various submissions across many years. Miraka remains concerned that the issues raised are not adequately addressed. In some cases the Commission even appears to misinterpret the Miraka submission. Miraka wishes to draw the Commission's attention to the latest example:

2.3.1 Paragraph 22 of the Commission's final report on the 2018/19 Milk Price Manual (14 December 2018) noted:

> "Miraka provided its analysis of the effect of inclusion of off-GDT sales on the milk price. The premium calculated by Fonterra for its off-GDT sales relative to GDT reference sales does not look unreasonable to us overall".

2.3.2 The Commission thus (incorrectly) implies the Miraka analysis asserted the premium for off-GDT sales was unreasonable; the Commission responded that it disagrees and so presumably considers it has addressed the issue raised.

2.3.3 The Miraka submission however makes it clear that the point of the analysis was in fact to seek an explanation for the lack of consistent outcome from off-GDT sales between consecutive years, specifically when both the Commission and Fonterra claimed the outcomes were "similar" when available evidence suggested otherwise[2]. The Miraka analysis attempted to understand why the Commission had concluded the off-GDT margins were "similar" when available evidence suggested otherwise. Miraka concern was with possible inconsistency in process between the two years (Miraka has previously raised concerns that the process was so poorly defined that outcomes could be impacted by changing the way the processes are applied). In this case, the concerns of Miraka were heightened when both Fonterra and the Commissions claimed that the outcomes were "similar" between the two years when the evidence suggested to the contrary. The Commission has not responded to that issue, and has closed down the matter by responding to an entirely different issue.

2.4 This is not an isolated example. The Commission actively encourages parties to engage with it and submit on its reviews. But this is too often followed a failure to seriously respond to issues raised in submissions. This is a frustrating outcome for submitters, and underlines why Miraka considers the Commission has not adequately shown how it continues to conclude the milk price (manual and calculations) are substantially compliant with the DIRA.

3.0 Specific Issues Raised in the Draft Report

[2] Miraka submission on draft report on review of Fonterra's 2018/19 Milk Price Manual – 16 Nov 2018 – Sections 1.4 and 1.5.

3.1 Materiality

3.1.1 For some time Miraka has sought objective and transparent materiality standards to be used for reviewing the milk price manual and calculations. Most recently in its submission on the 2018/19 Milk Price Manual, Miraka requested that the issue of materiality be addressed before completing the review of the 2018/19 milk price calculations and be reflected in the assessment of those calculations. Unfortunately this has not occurred; the Commission had signalled that materiality would be a focus area for the current review including consultation with stakeholders. In the event it appears the Commission has only consulted with Fonterra, and in the Draft Report simply described the status quo application of materiality principles (paragraphs 2.61 ff). At 2.81 it seeks feedback on limited matters concerning materiality and indicates it will take this into account when it next reviews its framework paper (described as occurring in "the near future").

3.1.2 The draft paper outlines the materiality status quo as applied by Fonterra, Fonterra auditors (PwC) who also audit the farmgate milk price, and the Commission in accordance with its framework paper[3]. The Commission does not propose any changes to these status quo positions.

Fonterra:

3.1.3 At 2.65 of the Draft Report the Commission identifies how Fonterra determines materiality in determining the milk price; at 2.66 the Commission indicates it supports the Fonterra approach:

> "2.65 For inputs derived from actual and notional transactions, Fonterra has advised that it does not apply a materiality threshold, as the objective is to directly input the actual value into the base milk price calculation. However, for notional inputs, there are ranges prescribed by the Manual that Fonterra maintains are supportable."
>
> "2.66 We consider that this approach is appropriate for the preparation of the base milk price calculation."

3.1.4 The Commission is requested to expand on the explanation at 2.65.

- It is unclear why Fonterra's input of "actual values" for "notional transactions" obviates the need for materiality thresholds. For example notional sales transactions are valued in accordance with Fonterra actual sales prices. This first requires the identification of Qualifying Reference Sales (QRS); these must "reasonably be regarded" as being transacted "at a price that reflects prices that could be achieved by the FGMP Commodity Business"[4]. It is assumed that GDT prices are the relevant prices for making this assessment. In any event a materiality threshold must necessarily be applied to determine that a specific price meets the definition of a QRS (e.g. falls within a prescribed or material range around the relevant reference price). Fonterra has confirmed the selection process for QRSs is fully automated[5]. This adds weight to the expectation that the test for QRSs must rely on an algorithm that explicitly includes a materiality threshold.
- 2.65 further states that "notional inputs" depend on "ranges prescribed by the Manual". The Manual makes many references to judgements based on materiality but a quick review of the Manual does not unearth any "ranges" which are relevant to determining materiality. The Commission is requested to provide the Manual references to which Fonterra refers.

[3] Commerce Commission document: "Our approach to reviewing Fonterra's Farmgate Milk Price Manual and base milk price calculation (15 August 2017)"
[4] Milk Price Manual: Definitions.
[5] Draft Report paragraph 2.99

Fonterra auditors (PwC)

3.1.5 PwC audits are performed against the principles methodologies and rules in the Milk Price Manual. While not inappropriate, it is important to note that PwC does not perform its audit or form an opinion of the milk price based on the DIRA Subpart 5A requirements.

3.1.6 At 2.69 the Commission advises that PwC uses an "overall" materiality threshold of 1% of the forecast farmgate milk price – for 2018/19 that threshold is presumably 6.35 cents/kg MS. PwC will have disaggregated thresholds as relevant for assessing materiality of specific or groups of items but those thresholds will be informed by the "overall" threshold. The relevance of a materiality threshold needs to be considered relative to the potential economic impact on relevant stakeholders. Noting that the base milk price sets the reference milk price for all raw milk sold to New Zealand processors, the primary parties impacted by the Fonterra milk price are milk producers other than Fonterra member suppliers[6], and dairy processors including Fonterra (including Fonterra investors other than Fonterra member suppliers). It should be noted these are NOT necessarily the target stakeholders for purposes of the PwC audit, but they ARE key stakeholders for the Commission reports on compliance with the DIRA.

3.1.7 The 6.35 c/kg MS threshold appears high relative to the target stakeholders. In the case of dairy processors, that threshold would be assessed against measures of profit. The Notional Producer EBIT provides a relevant reference measure of profit. Although the Notional Producer itself is immune to the materiality measure, Notional Producer EBIT nevertheless is represented to be the EBIT of a practically feasible entity and is therefore a relevant benchmark to assess the PwC materiality threshold. In that regard:

- A 1% materiality threshold for the 2017/18 Season equates to 18% of Notional Producer EBIT[7]. This is well outside an appropriate threshold for the identified stakeholders having the potential to severely undermine profits of either milk suppliers or dairy processors, or returns to non-member Fonterra investors. A 5% to 10% "overall threshold" would be more consistent with general practice, although a threshold of that level would more typically be applied with reference to a before tax measure of profit rather than an EBIT measure (i.e. a 5% to 10% materiality threshold for NPBT would be lower again as a percentage of the forecast farmgate milk price).

3.1.8 The PwC audit of the milk price calculations is a "reasonable assurance" audit performed in accordance with ISAE (NZ) 3000[8]. The audit is prepared "at the request of the Directors [of Fonterra] and for no other purpose"[9].

3.1.9 Under ISAE (NZ) 3000, "materiality is a matter of professional judgement, and is affected by the assurance practitioner's perception of the common information of intended users"[10] - in this case Fonterra Directors and therefore Fonterra executive. Measures of materiality will also be influenced by "Criteria" established in the "reasonable assurance" audit engagement. "Criteria" is a technical term within ISAE (NZ) 3000 and is subject to detailed prescription throughout the standard. At A51. the standard notes that "Criteria need to be available to intended users to allow them to understand how the underlying subject matter has been measured or evaluated".

[6] Fonterra member suppliers are relatively unaffected by materiality variations in the milk price arising from material differences in the milk price calculations: an understatement in the milk price is compensated by dividends/changes in share price and vice versa.
[7] 6.7 c/kg MS compared to 36.9 c/kg MS.
[8] ISAE (NZ) 3000: Assurance engagements other than audits or reviews of historical financial Information.
[9] Refer the PwC audit report in the Fonterra Milk Price Statements.
[10] ISAE (NZ) 3000 at A94.

3.1.10 The Commission has not sought comment on the PwC materiality threshold explaining “that is a matter for its [PwC] professional judgement”. At the same time however, at 2.67 the Commission explains that it places reliance on the PwC audit processes “to verify reliability of the numbers used to calculate the milk price components”. While it makes sense to depend on the independent audit performed by PwC, that audit is not performed for purposes of the Commissions requirements and as noted above the materiality benchmark would seem inappropriate to those requirements (compliance with the DIRA). Presumably Fonterra’s “Criteria” for the PwC audit engagement would provide some explanation for the apparently high materiality threshold but those “Criteria” are not available. The Commission is requested to review those “Criteria” to assess relevance of the PwC audit for the Commission’s purposes. In any event it appears that dependence on the PwC audit is not sufficient to replace the Commissions own processes to determine materiality of items and issues under review.

<u>Commerce Commission Framework Document</u>

3.1.11 The Commission lays out its approach to materiality commencing at paragraph 2.74. While the Commission does not “audit” the milk price calculations as such, ISAE (NZ) 3000 provides a useful framework for considering the Commission approach to materiality. At A95. ff it describes that materiality is considered in the context of both qualitative and quantitative factors. The Commission approach broadly fits within the “qualitative factors” described in ISAE (NZ) 3000. Miraka is generally comfortable with that aspect of the Commission approach to materiality.

3.1.12 The Commission does not however include any “quantitative factors” which ISAE (NZ) 3000 describes as being “expressed numerically” and are “related to numerical values" (A97.) The Commission’s description of information it takes into account in determining key focus areas includes (2.76.6) “sensitivity of components to the milk price (sic)”. This is presumably intended to mean <u>*sensitivity of the milk price to components in the milk price calculations*</u>. It is specifically in this area that Miraka would expect to see “quantitative factors” (numeric materiality thresholds) for assessing the sensitivity that is referred to.

3.1.13 The Commission does not propose any quantitative thresholds for materiality even though the Commission can be inferred to be frequently using either implied or actual thresholds. The Commission’s reports are peppered with judgements based on an assessment of materiality and which must have been made by applying a quantitative threshold. In the latest Draft Report for example paragraph 2.83 is laden with judgement based on what must have included a numeric assessment of materiality:

> “2.83 With the exception of fixed energy costs, we did not identify any material inconsistencies with previous milk price calculations. We therefore confirm our reliance on the conclusions from previous years’ reviews for those aspects of the base milk price calculation that have not materially changed.”

In the absence of a quantitative threshold of materiality, we are left to understand that in 2018/19 there <u>are</u> inconsistencies with previous milk price calculations but we do not know how significant they might be. The judgement that they are not material was presumably made on the basis that the difference with the prior year is not assessed material, or that the potential impact on the overall base milk price is not assessed material. These judgements would or should include numerically based assessments. Miraka considers that a failure to formalise the numeric thresholds that are being applied raises doubts about the consistency of approaches to materiality, and whether appropriate thresholds are being applied. The Commission for example appears to consider the PwC materiality threshold for its “assurance audit” is fit for purpose for the Commissions review of compliance with the DIRA. Miraka does not share that view.

3.1.14 At 2.81 the Commission seeks stakeholders' views:

"2.81.1 whether materiality should play a role in setting the scope of our calculation reviews;

2.81.2 how materiality should play a role in setting the scope of our calculation reviews, including whether materiality should play a role in the ways set out above, or whether materiality should play a role in some alternative way."

3.1.15 Miraka agrees that materiality is important to setting the scope of reviews of the both the Manual and of the milk price calculations. Materiality must however go beyond the scoping exercise and should pervade the review process by guiding responses to findings from the reviews.

3.1.16 In relation to scoping, as noted above Miraka is comfortable with the qualitative factors the Commission uses with one exception: Miraka considers the Commission places excessive reliance on previous review work. Miraka considers the historical body of work needs to be assessed on a rolling basis to assure that previous conclusions remain valid. This will especially be the case when the Commission codifies the way in which it applies materiality to the reviews. Rolling reviews would be prioritised on the basis of the ability of alternative measurement processes to materially affect the milk price (i.e. within a defined numeric measure of material movements in the milk price). Relevant examples would include:

- Off-GDT sales
- Product yields
- Internal consistency in the Notional Producer "business" model (alignment of revenue assumptions and cost assumptions)
- WACC (on which the Commission has especially focussed over several years)
- Rationale for stretch targets

3.1.17 In the absence of intimate knowledge of the Commission review processes and the data available to the Commission, it is difficult for Miraka to comment on specific numeric thresholds that should be used in assessing materiality. However in Miraka view, the over-arching numeric threshold which should inform the assessment of materiality should be set with reference to Notional Producer profit measures. In that respect a threshold of 3 c/kg MS (some 8% of Notional Producer EBIT) might be a useful starting place. That threshold would be used in assessing the overall materiality of issues identified in the review processes. For specific or singular review issues, materiality triggers would also include the extent to which an item changes year to year after normalising for external factors (e.g. commodity price changes or changes in milk volume processed). A movement of 5% might be an appropriate trigger for further explanation and review but that would be tempered by the extent to which the relevant item or groups of items could influence the measured base milk price (i.e. the overarching materiality threshold of say 3 c/kg MS). Miraka offers to assist the Commission to further refine these numeric thresholds.

3.1.18 At 2.63 the Commission states that "materiality is not a matter that we are required to reach a conclusion on in terms of section 150A". It is unclear why the Commission has highlighted this point. While Section 150A makes no reference to materiality as such, it is necessarily the case that the entire process to determine the base milk price involves judgement and measurement processes which are subjective. An assessment of compliance with Section 150A is unavoidably based on judgements of materiality. Miraka considers that codifying the principles used in assessing materiality is thus an essential component to ensure confidence in the Fonterra milk price setting process and in the Commission reviews.

3.2 Administration and Other Overhead Costs

3.2.1 Fonterra has added $45 million in costs to the 2018/19 Season and signals a further $45M will be added to the 2019/20 Season. The Commission has not yet had time to assess the practical feasibility of those costs but will do so in time for its final report. The Commission indicates that a substantial portion (almost 50%) of the increased costs relates to cost reductions introduced since the 2015/16 milk price calculations as part of the Velocity programme; these reductions are now apparently being reversed because the target savings have not been delivered[11].

3.2.2 In reviewing the costs now reinstated in 2018/19 Miraka requests that the Commission also consider the impact of the now apparent understatement of Notional Producer costs since 2015/16, and to assess whether it is appropriate (practically feasible) to reduce Notional Producer costs on the basis of specific Fonterra strategic plans before underlying targeted cost savings have been demonstrated to be achievable.

3.3 Mothballed Plants/Factory Geographic Configuration

3.3.1 At 2.105 in the Draft Report, the Commission concludes plant mothballing does not need to be addressed for 2018/19 because the milk volume forecast is greater than 2017/18. It is not clear why milk growth means that mothballing issues do not need to be included in the 2018/19 review. The point of mothballing a plant (as opposed to retiring it) is that it might be recommissioned in the event of subsequent milk growth (i.e. as has occurred in 2018/19). At the same time there needs to be assurance that costs of plants that remain mothballed are properly accounted for by the Notional Producer.

3.3.2 Miraka raised this issue at 4.0 of its submission on the 2018/19 Milk Price Manual. It sought confirmation that costs of maintaining mothballed plants in a state of readiness for re-commissioning were properly accounted for by the Notional Producer; it further highlighted that the location of mothballed plants relative to increasing or declining milk supply needed to be taken into account for purposes of determining practical feasibility of those costs. This required that the geographic location of mothballed plants (at regional level) needs to be identified. The fact that milk volumes have now increased is not relevant to the need to address these issues.

3.3.3 Miraka notes the Commission is anticipating that Fonterra will signal mothballing decisions for the 2019/20 Season in the 2018/19 Milk Price Statement (due to be issued in September 2019) and that this will include a regional analysis (matching regional milk supply expectations with decisions to mothball or recommission plants)[12]. While this will be meaningful progress it does not address the practical feasibility of costs associated with mothballing, recommissioning, or new investment capacity in 2018/19. It is noted that in 2017/18 the reduction in milk supply occurred in the North Island; four plants were assumed to remain mothballed in that year and it might be assumed they were "located" in the North Island. In 2018/19, the growth in milk volume occurred in the South Island. In the absence of plants that can be deemed to have been mothballed in the South Island, the increase in milk supply might actually require the stock (and associated costs) of mothballed plants to remain unchanged while investment in processing capacity for South Island milk is increased. The Commission is requested to review and comment on how the Notional Producer plants were configured (mothballed and operating) in 2018/19, how this is demonstrated to be able to handle milk supply changes in 2018/19, and whether the configuration is practically feasible given the previously assumed situation in 2017/18 (specifically to demonstrate that

[11] Draft Report note 34 and paragraph 2.43.

[12] Paragraph 38, Commerce Commission Final Report on the 2018/19 Milk Price Manual (14 December 2018)

production capacity has not simply been assumed to be a flexible resource untethered from historically established physical locations).

3.3.3 Confounding the situation is the overall number of manufacturing plants attributed to the Notional Producer. According to Attachment 3 in the Fonterra Reason Paper (milk price calculations) the Notional Producer had 53 Powder plants in 2017/18 (presumably including the 4 plants that remained mothballed in that period). In 2018/19 that number had reduced to 50 - 5 older plants were deemed to be "retired" (possibly including previously mothballed plants?) and these were "replaced" by two new plants. The Commission is asked to seek clarification from Fonterra as to where or how the "mothballed" plants fit into that analysis.

3.3.4 At the same time, it is noted that the overall reduction in Notional Producer plant numbers has accelerated from net 1 reduction by 2017/18 (overall 4 "retired" replaced by 3 new plants) to a net reduction of 4 plants by 2018/19 (overall 9 "retired" replaced by 3 new plants). The Commission is asked to review and comment on:

- The geographic location of Notional Producer sites and processing capacity compared to Fonterra and how that impacts the cost of milk collection and diversion for consolidation of milk at full capacity processing sites (to achieve long production run yields and processing efficiencies). In particular, to confirm that the Notional Producer follows an appropriate production programming process including underlying costs to reflect the change in the geographic location of Notional Producer processing capacity compared to Fonterra.
- How the real world costs of retiring the 5 plants in 2018/19 are accounted for by the Notional Producer.

Richard Wyeth
Chief Executive Officer