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Miraka Submission to the Commerce Commission:
Draft Report (15 October 2019): Review of Fonterra 2019/20 Milk Price Manual

Miraka appreciates the opportunity to submit in response to the Commission Draft Report on the 2019/20 Milk Price Manual. Miraka is available and would welcome any opportunity to discuss the contents of this submission with the Commission.

Abbreviations used in this submission:

- MPM Submission - Miraka Submission (16.11.18) on the review of the 2018/19 Milk Price Manual
- MPC Submission - Miraka Submission (2.09.19) on the review of the 2018/19 Milk Price Calculations
- MPC Final Report – Commerce Commission Final Report (12.09.19) on the 2018/19 Milk Price Calculations
- MPM Draft Report – Commerce Commission Draft Report (15.10.19) on the 2019/20 Milk Price Manual

Amended Definitions of Standard Plant" and "Standard Product Offering"

1 Fonterra states it has amended the 2019/20 Milk Price Manual definitions of "Standard Plant" and "Standard Product Offering" in accordance with a Commerce Commission endorsed Miraka proposal. If this is true, the change at best partially implements the Miraka recommendation and its effect is the opposite of the Miraka intention: it further embeds a lack of clarity and open-ended nature of the rules and principles by which Fonterra includes off-GDT sales in the calculation of the Notional Producer (NP) revenue. Perhaps this was not deliberate and perhaps Fonterra did not understand the intention of the Miraka proposal. But it is consistent with Fonterra failure to comply with the various commitments to transparency it has made to the Commission and to make opaque the inclusion of off-GDT sales in the milk price calculations.

2 It is also apt to point out that Fonterra continues to default on its commitment to release quarterly updates on the impact of off-GDT sales on the Base Milk Price. It is now over 5 months into the 2019/20 Season and Fonterra has still not provided any update for this season.

3 At section 1.6 of the MPM Submission, Miraka pointed out that the criteria for "qualifying material" was "open–ended and can readily be used to justify expanding the range of qualifying materials and therefore off-GDT sales that can be included in the selling price calculation". Miraka proposed the definition of "Standard Plant" be tightly defined as a means of limiting what can be included as "qualifying material".

4 At 1.6.2 Miraka explained that definitions for "Standard Product", "Standard Plant" and "Specialised Plant" were circular and had the effect of leaving undefined the range of products that could qualify as off-GDT sales in the milk price calculations. At 1.6.3 Miraka went on to explain the circular logic could be corrected by simply defining the "Standard Plant" as the [NP] plant designed *to produce the GDT product range*. Only product able to be made on the Standard Plant (without modification or additional plant or equipment) could be deemed to be "qualifying material". It is this proposal which the Commission endorsed but which Fonterra has not in fact implemented.

5 The revised definition of "Standard Plant" in the 2019/20 Milk Price Manual is contrary to both the substance and intent of the Miraka proposal: it leaves Standard Plant dependent on what comprises Standard Product and the definition of Standard Product remains open ended:

- A Standard Plant is now defined as "a plant for the manufacture of .... a Standard Product Offering"; and
- Standard Product Offerings comprise products sold on GDT **or** "generic product specifications"; and
- generic product specifications remain undefined; while broad criteria are provided these are hopelessly wide or are based on self-referencing definitions: for example generic products include those which "can be substituted for other Standard Product Offerings": thus "standard product offerings" include "generic products" which are ("can be substituted for") "standard product offerings"

6 The Miraka proposal was intended to establish a clear and unambiguous link between the definition of "Standard Plant" and "Standard Product" with the former defining and limiting the latter (i.e. Standard Product should be limited to what can be manufactured on Standard Plant).

7 Rule 25 in the Milk Price Manual is the defining rule for the scope of the NP product range, production efficiency and throughput, and the NP capital investment. That Rule remains unchanged in the 2019/20 Milk Price Manual.

8 The purpose of Rule 25 is to establish the "installation cost and specification" of the NP factories. A Standard Plant is described (and thus defined) as a plant "for the manufacture of each ***initial*** Reference Commodity Product". "Reference Commodity Products" are not individual products as such but refer to groups of products which have a range of compositions, functionality, and other characteristics. An "***initial*** Reference Commodity Product" however would seem to refer to a single product specification. These "initial" products are not defined elsewhere in the Milk Price Manual. The "incremental product cost" concept implies the "initial" products must in

fact be the Standard Specification Products and Miraka assumes that is the case until Fonterra advises otherwise. Thus the capital cost and characteristics of the Standard Plant are in fact for a plant that only manufactures the relevant and singular Standard Specification Product. That plant cannot even produce the limited range of products Fonterra sells on GDT let alone an expanded range included in "off-GDT sales". For example a plant specified to manufacture RWMP (the Standard Specification Product for the Whole Milk Powder group of products) cannot manufacture the other GDT products (IWMP and UHT WMP) although the additional plant and equipment and associated capital expenditure might not be substantial. It is unknown if it can similarly be claimed that the expanded range of products sold "off-GDT" can be readily manufactured on the "Standard Specification Product" plant for the simple reason that product range is not disclosed.

9 The "Incremental Product Cost" concept is included in the Part C definitions of Milk Price Revenue. Its purpose is not otherwise explained. It is however understood that Fonterra uses this concept to get around the problem of assuming the NP sells and earns premiums on products which it cannot manufacture. It does this by adjusting the selling prices for these products by the incremental product cost the NP might incur in the event it did produce those products. This is an abstract concept which bears no relationship to economic events in the real world. A real world dairy processor cannot simply "wish away" the fact that it cannot produce a product on which it would like to earn a price premium.

10 In the largely transparent world that existed when the NP revenues were based on GDT sales, that abstraction was perhaps not unreasonable. In the expanded and murky world that now prevails with the large volume of opaque off-GDT sales, that abstraction has now stretched far beyond the real world, adding yet more layers to the notional nature of the NP. This stretches to breaking point any remaining assertion of "feasibility", practical or otherwise.

11 This further validates Miraka long held concern that production yields are not practically feasible and are not internally consistent with revenue assumptions. The NP claims high production yields achieved by assuming very long production runs in factories which are configured to manufacture just one product specification. At the same time it takes credit for premiums from selling a (much?) larger range of made to order products. In reality, the production of those products would be disruptive to the yields that could theoretically be achieved by endless production runs of single products. The fact that yield assumptions are drawn from peak plants operating at full capacity (e.g. the update in effluent loss data based on Lichfield performance in November 2017) simply underlines that the NP losses are not based on a proper assessment of yields to reflect production across a seasonal milk curve and discontinuous production.

12 These issues and complexities arise because Fonterra chose to include an undisclosed new range of products sold off-GDT which now comprise over 40% of the sales basket used to determine the NP selling prices. Having made that fundamental change to the NP business model, it is incumbent on Fonterra to redefine and align the remainder of

the NP milk price model to this revised business model. Fonterra appears reluctant to do so.

13 Miraka requests the Commission revisit its view concerning the change Fonterra has made to the definition of "Standard Plants". With respect to the Miraka proposal in the MPM Submission, that should now be reconsidered with reference to the "initial" Reference Commodity Product (standing in place of the Miraka proposed GDT Product Range) of Rule 25. Fonterra needs to define that "initial" product, if not confirm it is the "Standard Specification Product". Miraka also still considers it would be appropriate and simplifying to define the "initial" Reference Commodity Product to comprise the Fonterra offerings on GDT.

14 More broadly Miraka requests the Commission review the practical feasibility of the NP product range of Qualifying Materials:

- Is it practically feasible for the NP plant <u>as configured</u> to manufacture the product range?
- Are the production efficiencies assumed for the NP consistent with the range and scheduling of production for the full sales portfolio?
- Is it practically feasible to attribute selling prices to the NP using the "Incremental Product Cost" adjustments for products the NP cannot in fact manufacture?

<u>Qualifying Outlier Sales</u>

15 Responding to a previous Miraka submission, the Commission has investigated and clarified processes and implications of "Qualifying Outlier Sales" (QOS). Miraka appreciates the Commission actions to investigate this matter.

16 The MPM Draft Report explains that QOS are sales which would:

- first be rejected as "qualifying reference sales" on the basis they do not pass the "prevailing prices" filter (prices are lower); and
- then reinstated for purposes of determining the NP average selling prices; because
- the relevant sale itself has the effect of keeping other selling prices higher than would otherwise have been the case

17 Fonterra offers some remarkable reasons why the QOS concept was included in the Milk Price Manual including that:

- It was a response to a time when "demand and prices were spiralling downwards, <u>*which are unlikely to be present today*</u>" (paragraph 42). International commodity prices are cyclical and the spiralling down (and up) of prices are not unlikely but are quite normal events. In any event, what happens "today" is not representative of what will happen "tomorrow" in global commodity markets
- The terms of the sale would remain confidential and the sale would thus "not send pricing signals that will encourage the downward spiral" in prices (paragraph 43). This explanation does not accord with transparency of price

expectations in international commodity markets which are primarily due to international supply and demand dynamics

18 The real reason for the QOS rule is discovered in the mechanics of the Milk Price Calculations themselves. It is Miraka view that the QOS was originally introduced to respond to the quite specific situation where discounted high volume off-GDT sales have the effect of reducing availability on GDT and thus have the direct impact (and even intent) of supporting GDT prices (i.e. the prices which were previously intended to exclusively inform the NP selling prices). In other words, had those sales not occurred GDT prices would have been lower, and the NP selling prices and Base Milk Price would accordingly have been similarly lower. Miraka believes that Fonterra now finds the QOS concept to be unhelpful (its effect is to reduce NP calculated selling prices). Fonterra has accordingly taken other steps to prevent the QOS process being triggered.

19 Fonterra is reported to have confirmed there were no QOS in 2018/19 (paragraph 39) nor have there been any QOS for a very long time (paragraph 45). The reasons for this are obvious:

- Fonterra did not apply any "prevailing prices" filter to QRS in 2018/19 (refer paragraph 27.1 below). Consequently there were no sales that were rejected on the basis of price and thus there was never any reason to consider any sales as QOS.
- More importantly, the decision tree for determining QRS sales separately excludes "tender and formulaic sales". Tender sales are in fact those which would most likely be brought back into the selling price calculations as QOS. They are conveniently excluded before they can be considered for that treatment.

20 Miraka has previously questioned why tender sales are excluded from the off-GDT sales and continues to challenge it. On the one hand Fonterra has included those off-GDT sales which increase the NP prices above GDT prices; on the other hand they seem to exclude those off-GDT sales which are likely to have the opposite effect.

21 "Tender and formulaic sales" are problematic because like so many aspects of the Milk Price Manual they remain undefined. It is not clear which sales are actually excluded. Definitions and illustrations would help: for example are tender sales to large commercial customers (e.g. tenders held by large Chinese customers) treated the same as tender sales to the Algerian Government – i.e. are they all "excluded" as "tenders"? Or perhaps Fonterra has a different understanding of "tenders" from Miraka? It is also unclear what "formulaic sales" might comprise and whether this results in the exclusion of sales which are typically higher or lower than prevailing (GDT) prices.

22 The Commission is requested to consider the wider implications of the failure to apply the QOS rule, whether the treatment of tender and formulaic sales is consistent, and if they are appropriately excluded from QOS. Miraka also requests

the Commission seek meaningful definitions for "tender and formulaic" sales be included in the Milk Price Manual.

Miraka Submission on the 2018/19 Milk Price Calculations Review

23 In the MPC Final Report the Commission responded to various issues raised in the Miraka MPC Submission. Miraka further responds below to the MPC Final Report. These responses are relevant to an assessment of the latest Milk Price Manual and are also intended to assist the Commission in developing its work programme for the 2019/20 Milk Price Calculations review.

24 Mothballed Plants/Asset Stranding

24.1 *2019/20 Assumptions - Mothballed Plants*

24.1.1 In the MPC Final Report the Commission noted it was "pleased with Fonterra's commitment to provide further transparency and agree the milk price statement, published each September, would be an appropriate place to deliver this information". The referred Fonterra commitment was made in its 15 November 2018 submission to the Commission: "consistent with real world timing, [NP] mothballing decisions are made prior to plants being started up for a season, and disclosure of any mothballing decisions in the Milk Price Statement ... would therefore be timely".

24.1.2 There is no such statement in the 2018/19 Milk Price Statement issued in September 2019. It is now necessarily the case therefore that the NP plant configuration for 2019/20 must be identical to 2018/19 (including mothballed plants). In the spirit of the new reporting commitment it might have been expected that Fonterra would have made this clear by providing a "null report". It did not do so.

24.2 *Granularity of NP Capacity Planning Assumptions*

24.2.1 In its Submission, Miraka sought clarification of how regional milk flow increases and decreases were matched against the geographic location of plants including mothballed plants. Miraka considers this is central to determining practical feasibility of cost consequences of milk flow changes and peak milk processing risks and costs.

24.2.2 In the MPC Final Report, the Commission confirmed (Table 5) that "capacity is matched on a North Island/South Island basis to peak supply". This finally confirms Miraka suspicion that the NP treats installed manufacturing capacity as geographically unanchored. It is thus assumed an infinitely flexible resource is available to process any milk supplied anywhere in each relevant Island. While this might be a convenient simplification it cannot be practically feasible.

24.2.3 Milk flows rise and fall on the basis of catchment areas (a much lower level of granularity). The rise and fall of milk flows relative to installed capacity has a direct impact on milk transport costs, peak processing risks, and any real world decisions to mothball any specific plant. In the NP world however, it is unnecessary to balance a decision to mothball an underutilised plant in say the upper North Island against the risk of milk flow increases in that same zone because the NP only needs to balance production capacity across the entire North Island.

24.2.4 Miraka submits that a real world processor of the scale of the NP (e.g. Fonterra) would retain more redundant capacity than for the "unanchored" plants assumed for the NP. A consequence of the NP assumption that it processes the same amount of milk as Fonterra (a non-mandatory assumption available under the safe harbours) requires that the NP faces the same choices as Fonterra and would hold the same amount of redundant capacity as Fonterra. If the NP is not prepared or able to properly "manage" production facilities at a catchment zone level of granularity, the only practically feasible assumption that remains is that the NP would only mothball a plant in the event Fonterra itself has actually mothballed a plant of equivalent scale and location. The NP would then face the same peak capacity risks and costs.

24.3 *2018/19 Shortfall in NP Processing Capacity*

In the MPC Final Report the Commission noted the NP did in fact face a shortfall of peak processing capacity in 2018/19. As a result it "reduced lactose standardising to cope with the capacity shortfall during peak, particularly in the South Island". Miraka can detect no discernible material effect of this assumption in reviewing the 2018/19 Milk Price Calculations Excel file. Miraka notes that had the matching of milk supply to production capacity been at the practically feasible catchment zone level, the shortfall in capacity would likely have been higher either resulting in increased milk transport costs, or increased manufacture of unstandardised milk powders. Miraka has no way of assessing whether this would result in a "material" impact on the Base Milk Price. But core assumptions are clearly wrong (peak capacity shortfall cannot simply be assessed at the total "Island" level) and contribute to inflating the milk price.

24.4 *Costs of maintaining mothballed plants*

At paragraph 3.3.1 of the MPC Submission Miraka sought assurance that "costs of plants that remain mothballed are properly accounted for by the NP. The Commission did not address this issue in the MPC Final Report. Miraka requests this be addressed in the review of the 2019/20 Milk Price Calculations.

24.5 *Asset stranding*

In its notification of priority areas for the 2018/19 Milk Price calculations review, the Commission advised it would "include the long-term issue of asset stranding in our review of the 2019/20 Manual". Miraka seeks clarification of this signalled review as it does not appear to have been carried out.

25 Milk Collection Costs

25.1 At 2.107 of the MPC Final Report, the Commission notes that the NP milk collection costs simply mimic Fonterra actual costs. It concludes that the Fonterra costs are likely higher than the NP on the basis that Fonterra would move more shoulder milk between plants than would be the case for the NP. This conclusion is attributed to

Fonterra's requirement to meet its non-RCP production requirements. Miraka does not agree that conclusion can be drawn without detailed analysis.

25.2 The NP production programme is fundamentally different to Fonterra. For example the NP consolidates milk at specific production sites for purposes of maximising shoulder production. This in itself creates higher transport costs than would be the case of milk processed at the closest plant in the relevant catchment area. On the other hand, the fact that Fonterra allocates milk to non-RCP production does not in itself mean Fonterra incurs additional production costs. After all in the real world Fonterra non-RCP plants are simply part of the overall production configuration that has been built to align as economically as possible to its milk supply. The distinction between RCP and non-RCP plants is an abstraction relevant only to the NP. It is not relevant to Fonterra commercial decisions to locate plants, which are based on economically efficient production of **ALL** its milk supply.

25.3 To confirm practical feasibility of the NP milk collection and transport costs requires in the first instance a comparison of Fonterra actual milk processing by factory location and across the season, with the assumed NP milk processing at the same level of granularity. That would confirm whether it is feasible to rely on Fonterra actual milk transport costs (i.e. if milk processing volumes were substantially the same across the season at the catchment area level of granularity).

25.4 The assumption that the NP processes the same volume of milk as Fonterra relies on the DIRA safe harbours. It is not mandatory that Fonterra make that assumption. Having done so however, it is mandatory that the business model for the NP reflect the complexities that arise. Fonterra takes credit for the advantages the assumption delivers (e.g. yield) but refrains from developing the milk price model to reflect the full impact of that assumption. If it finds it inconvenient or difficult to do so, Fonterra option is to simplify the NP business model so that it is internally consistent and meaningful. Miraka has long considered the assumption that the NP processes the same volume of milk as Fonterra is unnecessarily complex and unhelpful; it results in inconsistencies which in Miraka opinion Fonterra exploits as a shield behind which it is able to inflate the milk price.

25.5 Miraka requests the Commission reassess the practical feasibility of assuming the NP milk collection and transport costs can be based on the entirely different Fonterra business model.

26 Notional Producer Selling costs

26.1 At 2.97 of the MPC Final Report, the Commission notes off-GDT sales comprise 42% of the total NP sales for WMP, SMP and AMF and that Fonterra has "included the necessary costs for the NP as a result of including sales for WMP, SMP and AMF". Miraka does not agree there is evidence to support this conclusion. The Commission also seems previously to have supported evidence to the contrary.

26.2 In its review of the 2015/16 Milk Price Calculations, the Commission completed a comparison of the NP with Fonterra's 2014/15 "Global Ingredients and Operations Businesses". At that time the NP was not including off-GDT sales to determine WMP, SMP and AMF selling prices. The NP selling costs were $0.08/kg MS while the Fonterra "Global Ingredients and Operations Businesses" selling costs were double that at $0.16/kg MS. In explaining that difference the Commission stated that "Fonterra incurs significantly higher costs from selling products to a wider global market and to achieve significantly higher revenues off-GDT"[1].

26.3 Since that time the NP business model has expanded to include over 40% of its sales activity depending on off-GDT sources. It is reasonable then to assume the Commission might now expect the NP selling costs to have increased towards the Fonterra costs reported as $0.16/kg MS in 2014/15. In the 2018/19 Base Milk Price, the selling costs have in fact fallen to $0.07/kg MS.

26.4 The Commission is requested to revisit its conclusion regarding the practical feasibility of NP selling costs in its review of the 2019/20 Milk Price Calculations.

27 Materiality

[The Commission has addressed certain materiality issues in both the MPC Final Report and the MPM Draft Report. The below section addresses issues raised from both those reports].

27.1 *"Prevailing Prices" Criteria for "Qualifying Reference Sales"*

27.1.1 In the MPC Submission Miraka noted (3.1.4) that automated criteria for selection of "Qualifying Reference Sales" (QRS) implied the use of materiality guidelines. For a "Standard Product Offering" to "qualify" as a "QRS" amongst other things it must have a selling price that "reflects prevailing prices". By definition that would seem to require an appropriate materiality threshold i.e. prices must fall within a material range around a given reference price.

27.1.2 At 2.95 of the MPC Final Report the Commission states in fact that the automated process for selecting QRSs is solely based on product descriptions ("qualifying material descriptions"). It goes on to state that the "prevailing prices" filter depends on a "discretionary decision" but then states there was no "commercial judgement" in the selection of QRSs in the 2018/19 Milk Price Calculations. This implied that the "prevailing prices" criteria had not in fact been applied in selecting QRSs in 2018/19.

27.1.3 The MPM Draft Report sought to clarify this issue further in a discussion on "Qualifying Outlier Sales". At paragraph 38 the Commission again confirms that the automated process does not incorporate any "prevailing prices" filter. The Commission also suggests that "non-automated review processes" provide the filter for the "prevailing prices" criteria. The description of those non-automated processes suggests they are ad-hoc.

27.1.4 Paragraph 39 of the MPM Draft Report however states that "the calculation (presumably of prices from QRSs) solely reflected the application of automated pricing". It then states "**thus** there were no RCP sales excluded on the basis of any review of prevailing prices". Miraka interprets this to confirm that for the 2018/19

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[1] Commerce Commission Final Report on 2015/16 Season Base Milk Price Calculations, Table 4.1

Base Milk Price calculations, the selection of QRSs did not include any validation against the "prevailing prices" criteria. It also confirms the "non-automated processes" referred above are indeed "ad-hoc" and that none were performed in the selection of QRSs for 2018/19.

27.1.5 At paragraph 41 of the MPM Draft Report, having seemingly stated that QRSs are not filtered against the "prevailing prices" criteria, the Draft Report than states "Fonterra has confirmed that it always includes a sale in the milk price calculation where it satisfies the inclusion criteria" - one of which of course is the "prevailing prices" criteria.

27.1.6 Fonterra suggestion as reported at paragraph 46 is specious at best: "sales are deemed to be at prevailing prices as long as [Fonterra] internal approval processes and delegated authorities have been complied with". There is no need to "deem" prices as being at prevailing prices – they either are or are not by a comparison with an appropriate reference price; further, there can be many reasons why specific contracts can be approved above or below prevailing prices. Similarly noting the tenor of QRSs (contracts completed up to six months prior to shipment date – i.e. equivalent to GDT CP 5) a particular contract at a perceived prevailing price might easily be found later to be not so; the crucial point with assessing forward sales compliance with "prevailing prices" depends on the definition of "prevailing prices", which Fonterra has sidestepped.

27.1.7 The story painted here is disturbing. It seems to confirm the worst suspicion that the process for including off-GDT sales in the NP selling price calculations is uncontrolled and even out of control. The Commission is requested to urgently review this matter with Fonterra and obtain a clear, unambiguous statement of how or if the "prevailing prices" criteria is defined and determined, and how It Is applied as a filter for **all** qualifying reference sales. At the same time, Miraka notes it is extraordinary that the automated process does not simply include a validation check against "prevailing prices". This perhaps confirms Fonterra wants to avoid a codification of "prevailing prices". When off-GDT sales were first introduced, Fonterra made it clear that GDT prices would remain the reference prices for this purpose. It seems a simple step to check actual selling prices against relevant off-GDT sales including an appropriate materiality range. It is exasperating but informing that this has not occurred and that the door remains wide open for including any and every sale which Fonterra wishes as an off-GDT sale.

27.2 *Materiality standards should not be introduced because they would prevent Fonterra making voluntary disclosures?*

The MPM Draft Report includes (paragraph 49) the extraordinary statement that Fonterra does not agree materiality standards should be used in the Milk Price Manual because it would reduce its discretion to increase transparency through voluntary disclosures. This is contradictory in substance and difficult to reconcile with Fonterra actual track record with transparency. Miraka supports the Commission's dismissal of Fonterra's position when it states (paragraph 50): "As with financial reporting, various matters might be disclosed at the discretion of the Board that do not constitute material matters".

27.3 *"Re-inclusion of Off-GDT Sales"*

27.3.1 Paragraph 54 of the MPM Draft Report refers to the "re-inclusion of off-GDT sales of WMP, SMP and AMF ... [which Fonterra advises] was to better align the calculation of the milk price to the Milk Price Principles". This was somehow intended by Fonterra to illustrate why materiality standards are not required for managing changes in the Milk Price Manual.

27.3.2 Miraka reminds the Commission that prior to the re-write of the 2016/17 Milk Price Manual, and since the enactment of DIRA Sub-Part 5A in 2012, the Milk Price Manual prescribed that the NP selling price would be increasingly based on GDT sales. Rule 5 of the 2012/13 Milk Price Manual for example is replicated below:

> Once the Board determines that it is appropriate to place sole reliance on Benchmark Selling Prices achieved on GDT, the Farmgate Milk Price Commodity Business's selling prices will be determined solely by reference to prices achieved by Fonterra on the sale of product on GDT.
>
> In determining whether it is appropriate to place sole reliance on Benchmark Selling Prices achieved on GDT in respect of a particular Reference Commodity Product, the Board will have regard to:
>
> - The volume of the Reference Commodity Product traded on GDT relative to the total volume of the Reference Commodity Product sold by Fonterra.
> - Any factors relevant to determining whether the prices achieved on GDT can be considered to be materially representative of the prices Fonterra (and its competitors) should generally be able to achieve for standard specification Reference Commodity Product traded on terms comparable to those applying to sales on GDT.

27.3.3 By 2015/16, the Fonterra Board was sufficiently satisfied the above criteria were met that NP prices for WMP, SMP and AMF were exclusively based on GDT sales. Crucially the criteria included "the prices achieved on GDT can be considered to be materially representative of the prices Fonterra (and its competitors) should generally be able to achieve for standard specification Reference Commodity Product".

27.3.4 In its 2016/17 update of the Milk Price Manual Fonterra then simply deleted reference to its previous intention to move progressively to sole reliance on GDT sales. It provided no satisfactory explanation for this. It also failed to explain why prices previously considered "to be **materially** representative ..." were suddenly no longer the case. At the time Miraka pointed out these failures and that Fonterra had not addressed the issue of materiality inherent in the policy change. The absence of any materiality standards meant that Fonterra was not and still is not accountable for this travesty of major policy change without explanation or meaningful justification.

27.3.5 Miraka laid out its concerns about the way Fonterra changed the Milk Price Manual to provide for the use of off-GDT sales in its following submissions:

- Miraka Submission on the Fonterra 2016/17 Milk Price Manual, 8 September 2016 - Section 4.0 (given the substantial changes in that Manual, the Commission invited submissions prior to and in anticipation of its normal annual review of the Manual)
- Miraka Submission on the Commission Draft Report, 2016/17 Milk Price Manual, 15 November 2016 – Section 4.0

For convenience the above two sections of those submissions are replicated in Appendix A and Appendix B attached. These provide clear evidence of the need to introduce materiality standards to the management of the Milk Price Manual.

27.3.6 At paragraph 57 of the MPM Draft Report, the Commission concludes "that disclosure of what constitutes a material change [in the Milk Price Manual] ... will provide greater transparency". Miraka agrees with that conclusion. Miraka further states that absence of accountability against materiality principles has severely damaged the credibility of the Milk Price Manual and calculations. Introduction of a materiality measure at this time is important but does not remedy the damage that has already occurred. This is especially in the case of off-GDT sales. Miraka submits that this damage must be addressed by a full review of the ongoing practical feasibility and transparency of the way in which off-GDT sales and associated changes in the NP business model have been included in the Milk Price Calculations.

Richard Wyeth
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Miraka Ltd

Appendix A **Extract: Miraka Submission on the Fonterra 2016/17 Milk Price Manual, 8 September 2016**

4.0 Off-GDT Sales of WMP, SMP and AMF

4.1 Fonterra has advised that for the 2016/17 Season it will include prices of "selected" off-GDT sales of its WMP, SMP and AMF sales to determine the prices achieved by the Notional Producer. This is a substantial change to Milk Price assumptions and represents a fundamental change in policy. The significance of this change is not properly represented by Fonterra in the Reasons Paper.

4.2 At page 7 of the Reasons Paper Fonterra explains that "the primary reason for making this change is that it has become increasingly clear in recent years that GDT sets the 'base' price for sales of RCPs, with sales undertaken off GDT almost invariably being transacted at higher prices". Fonterra does not make clear what it means by 'base' price and Fonterra's use of quotation marks ('base') suggests Fonterra itself is undecided on what it means. Fonterra does however confirm it will continue to use GDT prices to provide "a benchmark" to measure sales team performance[2]. Miraka considers this reconfirms that Fonterra considers GDT prices are appropriate benchmark prices for commodity products.

4.3 Fonterra further states (at page 7) that "the practical implication of this change is to align the approach ... [for WMP, SMP and AMF] to the approach currently used for Butter and BMP". This attempts to add weight to the change to include off-GDT sales for WMP, SMP, and AMF by indicating it is in line with current practice for butter and BMP. This misrepresents the situation: until now the policy intent has been to do the reverse (i.e. to progressively align the process for butter and BMP to the process for WMP, SMP, and AMF). The change for WMP, SMP and AMF is in fact as a result of a fundamental change in policy. The Fonterra Reasons Paper has skirted this change.

4.4 Consistent with Manuals for previous years, Section 4.3 (Overview of Methodology – Farmgate Milk Price Revenue) of the 2015/16 Manual stated:

> "Benchmark selling prices should:
>
> - Reflect actual prices realised by Fonterra on the sale of Reference Commodity Products across a range of contract terms which is consistent with prevailing market conditions.
> - Result in Fonterra facing strong incentives to optimise its product Mix.
> - Result in Fonterra facing strong incentives to maximise its Benchmark Selling Prices.
>
> *These objectives should eventually be fully achieved if Benchmark Selling Prices are based on prices achieved through Global Dairy Trade"* [highlighting not in original]

4.5 The highlighted section above has simply been deleted from the 2016/17 Manual. Thus whereas previously the policy intent was to "eventually" replace any remaining

[2] Reasons Paper page 8.

off-GDT selling price data with GDT data, it is no longer considered that GDT prices can achieve the objectives for the Benchmark Selling Prices. Fonterra would seem to have avoided active disclosure of this policy change and has not explained why it has been made.

4.6 Fonterra has explained the change to use off-GDT prices for WMP, SMP and AMF on the grounds that those prices are higher than GDT prices. This explains the effect of the change. It does not explain the reason (other than by a cynical interpretation). Taken at face value, this explanation for including off-GDT sales is not sanctioned by the Manual. The process for determining Notional Producer prices continues to default to GDT prices. Section 4.3 of Part A of the Manual (and mirrored in Rules 5 and 8 of Part B) prescribes the circumstances where GDT would be supplemented with off-GDT sales:

- where GDT "does not cover a sufficient volume of sales" to provide a reliable benchmark price"; or
- "where prices on GDT are not ... *materially representative* of the prices Fonterra and its competitors should generally be able to achieve for sales of the Reference Commodity Products"

4.7 The first of the above does not apply to WMP, SMP and AMF since those have previously been deemed to include "sufficient volumes". Fonterra hints but does not state that the second of the above has been triggered for WMP, SMP and AMF (page 7 and 8 of the Reasons Paper) but contradicts this further down on page 8 where it states "prices achieved on GDT will continue to be *materially representative* of the prices used in the FGMP calculation".

4.8 Fonterra indicates that had off-GDT prices been included in the milk price calculation between 2013 and 2016, prices would have been within USD20 of the GDT based prices actually used[3]. For the 4 Seasons ending 2014/15, a difference of US$20/MT would amount to less than 0.6% of the GDT based selling prices. Rather than trigger a need for including off-GDT sales in the milk price calculations, this outcome provides evidence the GDT prices ARE "materially representative" and there is no reason under Rules 5 and 8 for including off-GDT sales. It goes without saying that any approach Fonterra could use to select off-GDT prices could not match the advantage that GDT provides in assuring the Notional Producer prices are based on independent, transparent and neutral prices. Departures from the use of GDT prices on the basis they are not "materially representative" would demand a much higher hurdle than the 0.6% implied by Fonterra's analysis.

4.9 Miraka contends it is widely accepted (including by Fonterra) that GDT sets an international benchmark price for commodity dairy products. Where Fonterra achieves prices from commodity sales which are different to the benchmark price, this must necessarily be attributed to the differentiation that Fonterra itself offers. This includes its ability to offer a wide range of products (far wider than the Notional

[3] Fonterra Reasons Paper page 8.

producer can offer[4]) and services to customers, and Fonterra's investment in product and market development. All of these enable Fonterra to obtain prices which are differentiated from the benchmark commodity prices. The Notional Producer does not resemble these qualities which enables Fonterra to differentiate prices nor has any effort been made to realign the Notional Producer to the far more sophisticated Fonterra business model. It is therefore not practically feasible to consider the Notional Producer prices can include prices that Fonterra generates from it's more sophisticated business model.

4.10 Fonterra however claims at page 8 of the Reasons Paper that the Notional Producer prices would remain practically feasible in aggregate because the prices would still be lower than Fonterra achieves on sales not included in Milk Price calculation. This is circular logic and must be dismissed. It also suggests a lack of coherent policy in the process Fonterra is using to select off-GDT sales for inclusion in the milk price calculations. The reason that Fonterra would exclude certain sales from the milk price calculations is because Fonterra would consider those sales are not practically feasible for the Notional producer. It is then circular logic to say the Notional Producer prices are practically feasible because they are lower than the prices for excluded sales.

4.11 Fonterra indicates "a sample of prices"[5] from off-GDT sales will be included in the calculations of the Notional Producer prices. Fonterra provides no explanation of the parameters for selection of those prices, how that selection will be controlled, nor how off-GDT prices will be merged with GDT prices for purposes of calculating the Notional Producer prices. Fonterra advises that the inclusion of off-GDT prices from 2013 to 2016 would have resulted in an increase in selling prices of US$20/MT[6] and an increase in the FGMP by NZ$0.04 to NZ$0.05[7]. On the other hand separate analysis published by the Commission[8] indicates Fonterra "price achievement" for reference commodity products (and proxies) is $0.22/kg MS higher than the Notional Producer in 2014/15. A further difference of $0.21/kg MS in revenues of Fonterra reference commodity products above the GDT based Notional Producer prices is unable to be explained (or "pinned down"). This suggests that the change in policy to include off-GDT sales offers Fonterra considerable and unacceptable new flexibility to manage the level at which the FGMP is set.

4.12 The Commission is encouraged to consider the representations GDT itself makes with regard to sales through "GDT events". The preamble to the "Guiding Principles" of the Rules for GDT Events[9] state "the goal [of GDT] is to develop and manage a multi-seller Trading Platform for trading dairy products that embraces the objectives

[4] For example, Fonterra relationship with a customer extends well beyond that which is possible from the RCP product range. That ability to service a much wider range of customer needs will affect the price relationship Fonterra has with that customer including for products which might be classified as RCPs.
[5] Fonterra Reasons Paper page 8
[6] Fonterra Reasons Paper pg 8.
[7] Fonterra advice to financial markets of changes in the 2016/17 FGMP Manual.
[8] Addendum to the Commission's draft report: Review of Fonterra's 2015/16 base milk price calculation.
[9] Refer GDT website: https://www.globaldairytrade.info/en/gdt-events/governance/gdt-trading-event-rules/

of independence, neutrality, and transparency". Guiding principle 1 then states that "the Rules are intended to foster efficient and competitive markets which

- Encourage the discovery of prices for the products traded through the competitive interaction of buyers and sellers;
- Establish prices that clear the market

4.13 In its description of "what we do", GDT states[10]

- GDT "has proven to the market it provides credible reference prices for globally traded dairy ingredients"; and
- "GDT is owned by Fonterra Cooperative Group but is operationally and physically separate from Fonterra. GDT Events have clear governance structures. An independent Oversight Board oversees GDT Events' rules and structures so that they are monitored and developed in a neutral and transparent manner".

4.14 Fonterra owns (but necessarily does not control) GDT. It is also by far the largest seller on GDT and both GDT and Fonterra are mutually dependent. Fonterra must be presumed to support and agree to the principles, rules and statements of purpose of GDT.

4.15 In summary, by contrast to the "independence, neutrality, and transparency" of GDT, the standard reflected in the Fonterra Reasons paper for the change in policy to include off GDT prices is incoherent. It is disturbing that the standards of "independence, neutrality, and transparency" which are regarded as crucial for the commercial success of the GDT auction platform are being diluted for purposes of determining the FGMP. This is especially problematic given the crucial importance of the FGMP to the efficient and effective operation of the entire NZ dairy industry and the wider NZ economy. Given Fonterra has neither explained its change in policy, nor is inclusion of off-GDT sales justified by the Manual, Miraka submits that the prices for WMP, SMP and AMF must be based exclusively on GDT prices, and the policy intent to expand reliance on GDT prices for Butter and BMP should be reinstated[11].

[10] Ibid: https://www.globaldairytrade.info/en/about-us/

[11] Attention is drawn to section 4.1 of the Miraka submission on the Commission's draft report on the 2015/16 Milk price Calculations. Miraka considers GDT provides practically feasible prices. Further disclosures are however needed to demonstrate that the prices remain practically feasible following the transformation of the GDT prices through milk price calculation processes.

Appendix B **<u>Extract Miraka Submission on the Commerce Commission Draft Report, 2016/17 Milk Price Manual</u>**

4.0 Off-GDT Sales

As noted, Appendix A summarises the further responses Miraka requests from the Commission on issues it raised in its submission on the 2016/17 FGMP Manual. The remainder of this section concerns new material in the Commission's draft report.

4.1 Fonterra Explanation for Changes to the Manual

4.1.1 In Table 4.1 of the of the Draft Report, the Commission replicates the Fonterra explanation and reasons for those changes to the FGMP Manual concerning off-GDT sales. The Commission does not comment on the Fonterra explanations, and leaves the impression that it accepts the explanations as authoritative. In referring to the change in Part C page 62 of the Manual (expanding use of off-GDT for determining WMP, SMP and AMF revenues of the Notional Producer), Fonterra has justified this change on the grounds that "previous approaches are not consistent with the milk price principles". This explanation is glib and does not satisfy DIRA Section 150A.

4.1.2 The "previous approaches" referred to are that WMP, SMP and AMF prices were set exclusively from GDT sales. The milk price principle referred to seems most likely to be Principle 2, or is possibly Principle 1 – we are left guessing. Turning to Principle 2, the second bullet point requires that revenue for the Notional Producer should be determined as if "Fonterra … processed that milk into commodity products which were sold on freely-contested global markets". GDT is however a "freely contested global market". Accordingly it cannot be said that the "previous approaches" were not consistent with Principle 2. Principle 1 is more broadly defined. It needs to be considered in full. It states:

"The Farmgate Milk price for a Season should reflect the benefits that arise from the *<u>collective selling power</u>* of *<u>Shareholders as suppliers</u>* from scale and other economies Fonterra enjoys in production and sales. The Principle reflects an important reason why Fonterra is a co-operative – *<u>to ensure that benefits arising from the collective selling power of farmers working together flow through into a higher farm-gate milk price</u>*". [Emphasis not in the original].

4.1.3 Principle 1 is a recognisable and understandable basic principle for a co-operative. It is not however compatible with the DIRA Section 150A. It mixes the role of supplier and shareholder; and it attributes the benefits of market power to the "shareholder as supplier" through a "higher farm-gate milk price". Miraka has previously submitted that Principle 1, which replicates the Fonterra constitution, is not compatible with the DIRA. Principle 1 also illustrates a much referenced issue by Miraka that Fonterra would not be reluctant to mingle shareholder returns with the milk price. Miraka also notes the Milk Price Principles contain nothing which matches the Section 150A contestability principle.

4.1.4 Miraka submits that where the Commission replicates Fonterra explanations, it needs to clarify its view on the adequacy of those explanations (do they comply with the DIRA?). Along with the submissions already made on the FGMP Manual (Appendix A), Miraka submits the above discussion is further evidence that there is no proper or DIRA compliant explanation for the change in policy to expand the use of off-GDT sales.

Fonterra seems to have taken a superficial and somewhat evasive approach to accounting for this change. Miraka requests the Commission consider this further in its final report.

4.2 Fonterra has provided further information on off-GDT sales

The Commission notes that Fonterra has confirmed certain further information concerning the inclusion of off-GDT sales. This further information raises more questions than answers:

4.2.1 SSP equivalent price/yield adjustments:

At paragraphs 53 to 55, the Commission questions the impact that off-GDT sales might have on yield assumptions where Reference Commodity Products (RCPs) differ from the Standard Specification Product (SSP). Previously at paragraph 46.1, the Commissions advises that Fonterra had confirmed "product specifications of off-GDT qualifying sales do not vary materially from GDT specifications". That seemingly responds to a comment in the Commission's final report on the 15/16 calculations questioning if there are any significant difference in specifications between products sold on and off GDT (paragraph 4.17.3).

4.2.2 The issue of price and yield adjustments for RCPs which differ from the SSP (SSP equivalent price/yield adjustments) should already have been fully transparent to the Commission. The issue already exists and most especially with IWMP sales in the WMP group. Given the WMP group is very large, and IWMP sales must be assumed to be similar to RWMP sales[12], the SSP equivalent adjustments for IWMP sales should be material, and transparent to the Commission. Miraka has always assumed these adjustments were a normal part of the price calculation process, that the Commission had reviewed them, and that the calculations were practically feasible. This now seems doubtful. Miraka requests the Commission review the SSP equivalent price/yield adjustments to assess practical feasibility. Miraka would expect that review to be part of the 2016/17 Milk Price Calculations review. Miraka also supports the Commissions comment (paragraph 55) that Fonterra should make available supporting information showing the method and effect of SSP equivalent adjustments.

4.3 Off-GDT sales do not impact GDT Auction Prices

Fonterra has advised the Commission that "using off-GDT sales ... allows larger customers to make substantial orders without impacting on the GDT auction prices"[13]. Without further explanation, this statement is disturbing. It is unclear whether this is providing a justification for including off-GDT sales in the milk price calculations (and if so what is that justification), or if this explains a selection criteria for including certain off-GDT sales. Most importantly, Fonterra needs to explain what "impact on GDT auction prices" is being avoided by these large sales to large customers. Miraka requests the Commission to clarify this in its final report.

4.4 Criteria for determining off-GDT Sales to Inform the Milk Price

The Commission has recommended that Fonterra provide explicit criteria for determining the inclusion of off-GDT sales (paragraph 47). At table 4.2 the Commission

[12] RWMP is the SSP for the WMP RCP. Unfortunately GDT does not make available the separate sales volume by each GDT seller, much less the sales of each product specification of each supplier. The GDT volume of each Fonterra product sold on GDT must therefore be deduced from product availability data and is therefore only an estimate.

[13] Draft report paragraph 46.2

provides the high level decision criteria that Fonterra has supplied in the interim. The criteria shed very light. This is symptomatic of Fonterra's lack of transparency with this major change in policy. Assuming Fonterra proceeds with this change in policy and in the absence of a substantial change in Fonterra approach to this matter, Miraka considers the credibility of the milk price will be materially damaged.

4.5 Independent Processor Information on RCP Prices

At paragraph 49 the Commission indicates it would "welcome information relating to RCP prices received by independent processors". This is to assist the Commission in the quantitative analysis it intends to perform to determine practical feasibility of including off-GDT prices in the milk price calculation. In its previous submission, Miraka has submitted that the use of off-GDT prices as proposed is not practically feasible (aggregate assessment), is not compliant with the FGMP Manual, and has not been shown to be compliant with the DIRA. Consistent with that position, Miraka does not consider it appropriate or necessary to provide selling price information to the Commission at this time.