15 November 2021

Miraka Submission to the Commerce Commission -
Commerce Commission Draft Report (15 October 2021): Review of Fonterra's 2021/22 Milk Price Manual

Submitted by email:

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Subject: Milk Price Manual 2021/22

Introduction

1. The Commerce Commission has issued a draft report following its annual statutory review of the Milk Price Manual (Section 150I of the Dairy Industry Restructuring Act 2001 (DIRA)). The Commission has invited submissions by 15 November 2021 on the draft report.

2. The Commission is not required to seek submissions from interested parties apart from Fonterra itself. The Commission however actively seeks input from other interested parties. Miraka places importance on supporting the Commission in the milk price reviews to help ensure the Fonterra processes are consistent with the purposes of Section 150A of the DIRA:

   "*to promote the setting of a base milk price that provides an incentive to new co-op* [Fonterra] *to operate efficiently while providing for contestability in the market for the purchase of milk from farmers".*

3. Miraka would welcome any opportunity to assist the Commission in its scrutiny of this submission.

Draft Conclusion

4. The Commission summarises its draft conclusions in paragraphs 31 and 32 of the draft report as follows:

   - "*the amendments* [to the latest version of the Milk Price Manual] *are consistent with s 150A of the DIRA*"; and
   - [with the exception of Rule 42 – asset beta] "*all other rules of the 2021/22 Manual are consistent with the s 150A purpose of the DIRA*"

5. Miraka agrees with the Commission that Rule 42 is not consistent with the amended s 150C and therefore does not meet the s 150A purpose of the DIRA. In this submission Miraka also raises further issues with aspects of the 2021/22 Milk Price Manual.

Asset Beta

6. Rule 42 of the Milk Price Manual concerns the determination of the asset beta used in the milk price calculations. Rule 42 has not been amended in the 2021/22 Manual. An amendment to the DIRA (s 150C (3) and (4)) which came into force for the 2021/22 milk price calculations specifies how the asset beta must be determined. Fonterra seeks to retain discretion in determining the asset beta (the first limb of Rule 42). The Commission considers that would not be consistent with the amended s 150C. Miraka agrees with the Commission. Miraka has long submitted that the asset beta should be determined from an objective assessment of the asset betas of comparable commercial entities. Miraka has for example previously objected to the discretionary adjustments Fonterra has chosen to make to the asset beta (for example, the 500 bp "downward adjustment" to the observed asset beta of the comparator group used for setting the 2020/21 asset beta)[1].

7. Miraka agrees the Milk Price Manual should be amended to remove the explicit discretion for Fonterra to adjust the asset beta. This will not in itself however stop Fonterra from applying discretion in setting the asset beta. The procedure for determining comparables from which an asset beta is determined is itself subjective, requiring judgement and lending itself to game playing. This for example could be reflected in the Milk Price Group decision to include Fonterra itself in the comparable companies for setting the 2020/21 asset beta. Fonterra has a lower observed asset beta than the average of other comparables.[2]

8. In the CEPA report to the Commission reviewing the 2020/21 asset beta[3] CEPA noted:

    "a crucial step in [the Fonterra Milk Price Group] *process is the individual review of the 286 firms in their long-list to produce the list of 19 firms".*

    The step is "crucial" because the decision to include or exclude a comparable company has a direct impact on the final outcome of an asset beta analysis. In its review of the Notional Processor asset beta, CEPA did not have access to the full 286 firms included in the Fonterra "long-list", so was unable to definitively assess if the long list was suitable.

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[1] Miraka Submission (24.8.21) regarding CEPA advice on asset beta and specific risk premium (21.7.21).

[2] CEPA "Response to submissions – Asset Beta and Specific Risk Premium – 13.9.21. At page 4, CEPA reiterated previous advice from 2019 where it explained why the Fonterra Shareholder Fund (and by implication the FCG shares) do not provide an appropriate comparable for the NP asset beta. CEPA view is in line with frequent Miraka submissions on the matter of Fonterra economic drivers and is repeated here in full:

> *"The* [Fonterra] *share structure has been designed in the interests of farmer shareholders by allowing third-parties to provide liquidity to farmers but without giving those third parties any opportunity to control the company or to influence it.* ***Fonterra does not have pressure from third party shareholders to maximise returns to the processing activity, with its stated "number one priority is and always has been to maximise the total payout to our farmers". The total payout includes the sum of all benefits to farmers including but not limited to the dividends from Fonterra shares. Further, trading in Fonterra shares is driven by farmer shareholder decisions. These factors point to share trading and thus beta that is unrelated to the economics of the business, and in particular one that would not reflect the beta for a competitor processor****".* [Emphasis not in original]

At paragraph 3.48.4 of the Commission Review of the 2020/21 Base Milk Price Calculations the Commission summarises and thus appears to endorse this view of CEPA.

[3] Comparator selection (pg 1): CEPA report Asset Beta and Specific Risk Premium (21.7.21)

This similarly means CEPA was unable to definitively conclude if the Fonterra selected "shortlist" provided the best or most complete match for assessing the NP asset beta.

9. In its final report on the 2020/21 Milk Price Calculations, the Commission stated:

   "we agree with CEPA's view that the method used to select comparators would be consistent with s 150C(4) when it comes into force"[4].

   In Miraka view the Commission has misstated the CEPA conclusion. CEPA concluded that the MPG comparator selection process <u>based on the MPG interpretation of s 150C</u> was "reasonable"[5]. This is not a ringing endorsement and it is certainly not an endorsement of consistency with s 150C. CEPA was careful to avoid providing an interpretation of s 150C, and neither endorses nor disagrees with the MPG interpretation of that section. The Commission similarly does not endorse the MPG interpretation of s 150C. It is unsurprising that CEPA was reluctant to fully endorse the process given it did not have access to the 286 firms in the MPG selected "long list" of comparables. It has not been explained why CEPA did not have access to the Fonterra "long list"; an explanation would go some way to placing CEPA advice in context.

10. The Commission also appears to retain some doubts about the comparator selection process, and went on to say it

    "will consider reviewing the full list of comparators for next seasons' calculation review".

    Miraka strongly encourages the Commission to follow through with this intention in its review of the 2021/22 Milk Price Calculations.

11. Rule 42 also states that the asset beta will only be updated in a "review year". In the case of the asset beta the next "review year" is described as 2024/25[6]. Section 150C does not however include any provisos limiting compliance to a "review year" and the asset beta must be shown to be consistent with s 150C in all years. In any event, given the new requirements that come into effect from the 2021/22 season, Fonterra is obliged to review and reset the asset beta for the 2021/22 Season.

12. In its review of the 2020/21 milk price calculations, the Commission assessed that a number of aspects of the 2020/21 asset beta were not consistent with the amended s 150C (adding weight to the requirement the asset beta be reassessed for 2021/22). For example,

    - at paragraph 3.40 (and reiterated at 3.49) the Commission alluded to a different measure of materiality that could apply once s 150C was in force:

      "*We further note that while the difference between our preferred estimate* [0.48] *and MPGs estimate of 0.45 might not be material for this year's calculation deviating from the average estimate based on the core comparator set places into question the practical feasibility of the asset beta estimate used in the base milk price calculation. The larger the deviation from the original estimate the less likely it is that the asset beta estimate will be practically feasible"*.

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[4] Paragraph 3.56: Commerce Commission Review of Fonterra's 2020/21 base milk price calculation (15.9.21)
[5] Comparator selection (pg 1): CEPA report Asset Beta and Specific Risk Premium (21.7.21)
[6] Glossary, 2021/22 Milk Price Manual

- at paragraph 3.61 the Commission was more explicit with regard to the "downward adjustment" of 500 bp Fonterra applied to the 2020/21 observed average asset beta stating that:

  "*an adjustment away from the average asset beta estimated using a set of comparators that meet the requirements of s 150C(4) (a) and (b) will not be consistent with the provisions of s 150C (4) once they come into force*"

- at paragraph 3.62 the Commission encourages

  "*Fonterra to consider our comments on their methodology when estimating the asset beta for the 2021/22 base milk price calculation, when the new s 150C(4) requirements will be in effect*".

13. In summary, it seems clear that the Commission anticipates Fonterra will review the asset beta again in the 2021/22 Season. Miraka requests the Commission explicitly clarify this in its final report reviewing the 2021/22 Milk Price Manual.

Materiality

14. In paragraph 12 above it was noted that in its review of the 2020/21 Milk Price Calculations, the Commission appears to conclude that an asset beta of 0.48 (rather than the asset beta of 0.45 used by Fonterra) would be more consistent with the amended s 150C. The Commission estimated the difference between an asset beta of 0.48 and 0.45 would be a reduction in the BMP of $0.02/kg MS. The Commission went on to say this difference (in the BMP) was not material. Miraka does not agree with this conclusion.

15. Miraka has long sought that the Commission establish an objective measure of materiality (in addition to subjective measures of materiality that are also relevant). The Commission appears to have responded to this request when it included a measurable metric for materiality in its most recent update of its paper outlining its approaches to reviewing the base milk price[7]. In its submission on the draft report on the 2020/21 Milk Price Calculations Miraka requested the Commission clarify this new materiality metric. Miraka indicated it considered a metric which set the benchmark for materiality at around $0.01/kg MS could be appropriate but was unable to interpret the Commission's metric[8]. The Commission included what Miraka considers is an incomplete response in its final report[9]. This included an interpretation of its materiality metric which equated to a benchmark of over 2.3 c/kg MS. The Commission indicated it could provide further clarification when it next updates it "Approaches" paper. This is unsatisfactory on two counts:

    - a materiality benchmark equivalent to 2.3 c/kg MS is close to 7.5% of the NP EBIT for the 2020/21 Season. That is well in excess of typical measures of materiality used for example in financial reporting

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[7] "Our approach to reviewing Fonterra's Milk Price Manual and base milk price calculation" – Commerce Commission 5 July 2021.
[8] paragraph 40 ff: Miraka Submission on the Review of the 2020/21 base milk price calculations (1.9.21)
[9] Appendix A, Commerce Commission Review of Fonterra's 2020/21 base milk price calculation (15.9.21)

- the penultimate update (Version 3) of the Commission's "Approaches" paper was 15 August 2017 suggesting the next update could be at least four years away. The schedule for updating the "Approaches" paper suggests the Commission considers there is no need for urgency to address this issue. This may not have been the Commission's intention but it nevertheless does not adequately respond to Miraka most recent and other submissions on the matter

16. Miraka requests the Commission provide a further and prompt opportunity for review of the materiality measure the Commission uses in its statutory reviews of the milk price.

17. At the same time Miraka supports the Commission in its ongoing recommendation that Fonterra include standards of materiality in the Milk Price Manual[10]. The Commission considers that materiality standards would provide greater transparency. Unfortunately the Commission does not consider the absence of standards is a serious matter which would render the Milk Price Manual or the Milk Price Calculations inconsistent with the s 150A purpose of the DIRA[11]. Miraka believes the Commission's grounds for this conclusion are not correct.

18. Sections 150L (d) and 150T (b) impose statutory obligations on Fonterra to certify to the Commission the extent to which the Milk Price Manual and the Milk Price Calculations respectively are consistent with s 150A of the DIRA. Year after year Fonterra certifies to the Commission that consistency is only "in all material respects"[12]. In Miraka view, Fonterra ongoing refusal to provide standards of materiality renders this certificate meaningless. Given Fonterra itself cannot properly certify the extent to which in this case the Milk Price Manual is consistent with s 150A, it must be concluded that the Commission can similarly not certify consistency with s 150A (although it signals it will do in paragraphs 31 and 33 of the Draft Report).

19. In Miraka view, the Commission should elevate the seriousness of Fonterra refusal to provide standards of materiality and clarify that consistency with s 150A cannot be confirmed until Fonterra rectify this matter.

Benchmark selling price for off-GDT sales

20. The Milk Price Manual definitions of "Benchmark Selling Price, "Qualifying Reference Sales", and "Qualifying Outlier Sales" are particularly relevant for providing some discipline and clarity to the otherwise opaque process Fonterra uses for including off-GDT sales in the NP selling prices. Prior to the latest milk price manual, "price" for these elements has been defined with reference to a benchmark of "prevailing prices".

21. Miraka has previously submitted that "prevailing prices" is a meaningless benchmark and sought a more meaningful definition. The Commission has also sought clarification for "prevailing" as variously used in the Milk Price Manual. Miraka has pointed out that the obvious price benchmark for including specific off-GDT sales is the comparable price

[10] For example at paragraph 44 ff of the Draft Report on the 2021/22 Milk Price Manual
[11] For example, paragraph 46 of the Draft Report on the 2021/22 Milk Price Manual
[12] For example, page ii, Reasons' Paper in Support of Fonterra's Milk Price Manual for the 2021/22 Season

achieved on GDT. In this context a GDT "benchmark" would have meant that off-GDT sales would be included or excluded depending on the degree to which they vary from GDT selling prices, while allowing for price enhancement reflecting the extent to which an off-GDT sale delivers expanded offerings (compared to GDT sales). Such sales still of course need to demonstrably qualify as "commodity products sold on freely contested global markets"[13] (i.e. expanded offerings cannot trespass outside a boundary which can reasonably be described as consistent with commodity products).

22. When Fonterra expanded the inclusion of off-GDT sales in the NP selling prices, it committed to using GDT prices as the price benchmark. Fonterra has failed to honour that commitment.

23. The 2021/22 Milk Price Manual includes amendments to the definitions of "Benchmark Selling Price, "Qualifying Reference Sales", and "Qualifying Outlier Sales". The previous reference to "prevailing prices" has been amended to refer to "prevailing *market* prices". In other cases, "prevailing" has been removed from definitions and has been replaced by "normal". Thus "prevailing market conditions", "prevailing market conventions" and "prevailing commercial terms" have been replaced by "normal market conditions", "normal market conventions" and "normal commercial terms".

24. At paragraph 42 in a "catch-all" draft response to these and other amendments to the Manual, the Commission states:

> "*we consider these changes provide greater transparency and are consistent with the efficiency and contestability dimensions of the s 150A purpose. In particular we consider … the amendment to the benchmark selling price and the clarification of the term prevailing are consistent with the contestability dimension of the s 150A purpose".*

The Commission does not explain how it draws these conclusions. It also appears to now consider any previous concerns with the use of the term "prevailing" have now been satisfactorily addressed (or at least it does not say otherwise).

25. By contrast, Miraka can find no nuance of new meaning in the amendments made by Fonterra with regard to the term "prevailing". Regarding the reference to "market" as in "prevailing market prices", it is incomprehensible that prices other than "market" prices could previously have been contemplated. Certainly, the reference to "market" prices adds no new information and thus no additional transparency. In relation to the replacement of "prevailing" with "normal" as in "normal market conditions" Miraka contends the two terms in this context are interchangeable. The change in definition is no more than a rearrangement of the deckchairs and again adds no new meaning. Perhaps Miraka has missed something and would appreciate the Commission advice of any further understanding it has taken from these amendments.

26. It is frustrating that these amendments to the Manual have contributed nothing to increase confidence in the processes Fonterra applies for including off-GDT sales in the

[13] On GDT sales are transparently consistent Principle 2 of the Milk Price Manual which requires the base milk price to be determined from "commodity products sold on freely contested global markets". While included off-GDT sales are completely opaque, they must of course still comply with Principle 2.

NP selling prices. On the contrary, these seemingly cynical amendments by Fonterra underline the fact that Fonterra has no intention of improving the transparency of processes and outcomes related to off-GDT sales. It adds further weight to the necessary conclusion Fonterra prefers an opaque and undefined process to provide it with flexible tools that can directly influence the outcome of the milk price calculations.

27. Separately at paragraph 55 the Commission has reconfirmed its intention (signalled in its review of the 2020/21 Milk Price Calculations) to

> "*examine how the Manual gives effect to the DIRA definition of "commodity" more closely" …* and that *"this will likely involve engaging an expert to review the list of the qualifying materials and incremental product cost adjustments made to account for differences in product specifications and manufacturing processes*".

28. Miraka welcomes this intention and it might go some way to alleviate the many concerns Miraka has with off-GDT sales processes. These concerns have been documented in previous Miraka submissions and are not repeated here[14]. The Commission has signalled this review would occur at earliest as part of the review of the 2022/23 Milk Price Manual. Miraka considers the requirement is more urgent and should be a priority for the review of the 2021/22 Milk Price Calculations. It is after all over five years since Fonterra changed its policy on the inclusion of off-GDT sales; that policy remains controversial, processes are opaque, and the change had a highly material impact on the base milk price ($0.10/kg MS for the 2020/21 Season).

29. The Commission has requested interested parties provide questions and issues that could be considered by the independent expert. Miraka will submit those in due course. Miraka is also willing to work directly with the Commission if this can assist in setting the scope of the work programme for the expert.

Ex-ante disclosure of NP Plant Processing Capacity

30. Yet another longstanding issue has concerned the practical feasibility of the NP processing capacity. This followed evidence that Fonterra had established plant capacity and consequential costs on a "retrospective" basis after actual milk flows are confirmed (e.g. the retrospective determination of mothballed plants). Such retrospective establishment of processing capacity is of course not practically feasible.

31. The Commission had previously indicated Fonterra should disclose the capacity of primary and secondary plants in the Milk Price Manual and this would go some way to addressing the need for ex-ante disclosure. Fonterra has responded that it now provides ex-ante disclosure of plant capacity by July of each season through disclosures in its Reasons paper for the Milk Price Calculations of the previous season.

32. At paragraph 49 of the draft report the Commission has indicated it accepts the disclosures in the Reasons paper are ex-ante and this is an acceptable resolution of the issue.

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[14] Refer for example Miraka submission (29.4.21) on the Proposed Focus Areas for the Commerce Commission review of Fonterra's 2020/21 base milk price calculation

33. A closer review of the disclosures made by Fonterra in the Reasons paper shows that Fonterra has not in fact addressed the issue. Fonterra made two separate disclosures (at page 9 and in Attachment 3) regarding plant capacity in its Reasons Paper for the 2020/21 Milk Price Calculations.

34. At page 9, Fonterra states

    "*the average capacity assumed in the Farmgate Milk Price **for the 2020/21** year is **materially** consistent with Fonterra's current weighted average WMP and SMP processing capacity of circa 2.2 million litres per day*" (emphasis not in the original); and

    "*the average capacity assumed for BMP, Butter and AMF plants … comprising 800 ml per day for BMP plants and 500 ml of cream per day for the butter and AMF plants* [and will be maintained] *for the next four years*".

35. Neither statement provides ex-ante confirmation of NP processing capacity (which requires disclosure of the number of plants **and** processing capacity of each plant). Both statements address the capacity of individual (or "average") plants, but ex-ante disclosure for individual plants is only provided for the capacity of the secondary plants.

36. The statement with regard to primary plants (WMP and SMP) provides retrospective confirmation of the previous season capacity. It also only provides a "material approximation"[15] of capacity (by comparison with the secondary plants which are prescriptive). Any real world processor is able to provide precise measures of processing capacities for their plants. Miraka questions why the NP is not similarly able to do so for its primary plants. Miraka submits this failure adds to evidence that assumptions concerning plant capacity are unable to be shown to be practically feasible.

37. Attachment 3 of the Fonterra Reasons paper provides a more appropriate framework (with some modifications) for ex-ante disclosures of the NP processing capacity. It prescribes the number of plants and provides more detail on processing capacity. Attachment 3 however reports on the Season that has finished and again is not an ex-ante disclosure of available capacity for the forthcoming season.

38. To provide effective ex-ante disclosure, Attachment 3 in the Fonterra Reasons Paper would need to be expanded to explicitly associate unit processing capacities with the number of factory units available in the coming Season. It would also need to establish plant location by catchment areas. The current aggregation of plant numbers by North and South Island is not consistent with practically feasible management of milk. To the extent that milk can be moved between catchment areas, the confirmation of geographic location of plants is also needed to determine practical feasibility of the costs of milk transportation between sites. This is especially important given the substantial consolidation of milk the NP appears to assume for its "square curved" processing plants[16]. It is also pointed out that Appendix 3 has lost sight of mothballed

[15] Given Fonterra does not include a standard of materiality in the Milk Price Manual, a "material approximation" provides no confidence in the relevance of the capacity measure supplied.

[16] Square curving" of plants refers to plants which are able to operate at full capacity for extended periods of time as a result of consolidation of milk at specific factories over the season shoulders.

plants which presumably remain in the NP capital base and should remain transparent in disclosures of plant capacity.

39. Miraka requests the Commission reconsider its conclusion with regard to ex-ante disclosures of processing capacity.

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