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Grant Weston
Manager - Compliance
Regulation Branch
Commerce Commission
PO Box 2351
Wellington 6140

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

<u>Miraka Submission to the Commerce Commission:</u>
<u>Draft Report (15 August 2018): Review of Fonterra's 2017/18 base milk price calculation</u>

Miraka appreciates the opportunity to submit in response to the Commission's Draft Report on the milk price calculations for 2017/18. Miraka is available and would welcome any opportunity to discuss the contents of this submission with the Commission.

1.0 <u>WACC/Asset Beta</u>

1.1 The first formal review of the base milk price calculations was performed by the Commerce Commission for the 2012/13 dairy season. Up until this latest review, the Commission had been unable to determine whether the WACC assumption in the calculations complied with the DIRA. This was despite substantial review and input from experts and interested parties.

1.2 While the WACC depends on a wide range of assumptions, more recently the Commission has refined its focus to the asset beta. Miraka and other interested parties had submitted that the asset beta was not practically feasible and was too low. This had resulted in an understated WACC and contributing to an inflated Base Milk Price. Because the BMP is the primary determinant of the competitive milk price in New Zealand, this had directly resulted in Fonterra, Miraka and other independent dairy companies paying higher milk prices than would have been the case with a compliant asset beta.

1.3 In its latest review, the Commission has confirmed it now has information[1] that:

> *"has provided sufficient insight … to enable us to assess whether Fonterra's estimate of the asset beta is practically feasible when taken together with the other available evidence"[2].*

Despite this the Commission has still been unable to provide an unqualified decision on the matter, finding only that:

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[1] The Commission draws on evidence provided by CEPA (its appointed expert) whose comparator based study concluded an asset beta range of 0.45 to 0.58; CEPA noted it had "not seen sufficient empirical support for an asset beta below the bottom end of that range", and retained that view after receiving feedback to the contrary from Fonterra and experts.

[2] Draft Report, 1.14

"the notional producer is <u>unlikely</u> to have an asset beta as low as Fonterra's estimate of 0.38, and on balance we consider that the beta estimate is therefore <u>unlikely</u> to be practically feasible"[3] - (emphasis not in the original).

This doubly qualified decision ("on balance" and "unlikely") leaves the door open for Fonterra to continue its campaign to justify the low asset beta, or to simply ignore the Commission on this matter.

1.4 Miraka submits the Notional Producer asset beta and WACC assumption should be assessed from the perspective of both the practical feasibility **<u>and</u>** efficiency limbs of S150A. Miraka offers the following for the Commission to consider.

1.4.1 The CEPA report which the Commission draws on to reach its conclusion on the asset beta is unaligned to any of the parties with vested interests; it found an absence of evidence to support the low asset beta of 0.38.

1.4.2 The Commission has concluded the asset beta and WACC meet the efficiency requirement of the DIRA[4]. It is unclear how the Commission has drawn this conclusion, and it would appear the Commission has not taken into account the wider efficiency of investment decisions of the stakeholders in the dairy industry (milk suppliers and investors). Miraka requests the Commission to particularly note:

1.4.2.1 CEPA considered that the risk profile and therefore asset beta presumed for the Notional Producer "is only achievable if the NP benefits from its position of market power and a lack of competition". CEPA considered it was difficult to align these points "to the requirement that the asset beta reflect that of a practically feasible efficient processor". The Commission added weight to this by repeating CEPAs view it in its Draft Report[5].

1.4.2.2 There is increasing concern in the wider investment community over the conflict of interests within Fonterra, and that this has resulted in a preference by Fonterra for its co-operative suppliers over investors. This is for example reflected in Fonterra's continued staunch support for an asset beta which has been shown to favour supplier over investor interests. Recent comments and actions in financial markets have included:

- Craigs Investment Partners has dropped the Fonterra Shareholders Fund from its New Zealand equities portfolio, noting that after six years the performance of the FSF does not meet the "quality threshold". In further explaining this decision, Craigs noted that Fonterra "faced differing incentives for farmers and unitholders". It also cited the Commissions "Emerging Views" paper that Fonterra had too low risk estimate when calculating the cost of financing milk processing operations, resulting in it paying a higher milk price to farmers. [6]
- A separate comment reported in the media from head of private research at Craigs was more specific, noting that one of Fonterra's problems is that it is "poorly structured and

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[3] Draft Report, 2.7

[4] Draft Report, 2.5 (unlike for practical feasibility in 2.4, there is no exclusion for asset beta in the Commission's conclusion that the milk price calculations meet the efficiency dimension of S150A)

[5] Draft Report, B111

[6] The decision of Craigs Investment Partners was reported widely in the media. For example refer (12.7.18): https://pro.newsroom.co.nz/articles/3551-6-fonterra-dropped-from-craigs-portfolio

poorly governed, giving preference to farmer suppliers-shareholders over investors in the fund"[7].

- A representative of First NZ Capital stated regarding Fonterra that "an inconsistency between the growth structure and capital structure make it hard to raise equity and led to a poor track record of adding value from investments"[8]
- An opinion piece posted on interest.co.nz by David Hargreaves[9] addresses the same conflict of interests: "the farmers' raison d'etre is to get top dollar for their milk. Ask a farmer what they would prefer – a good dividend from Fonterra or no dividend and absolute top dollar for the milk? Well I think that you know what the answer is". Hargreaves goes on to say "it's a frankly bizarre conflict that no "normal" business would contemplate"[10]. While this opinion piece is colourful and raw, such opinions are increasingly common in financial market commentaries. Miraka submits this is a development which should inform the Commission's views.

While these examples do not all speak directly to the asset beta, they reflect the growing uneasiness in financial markets that Fonterra's choices in setting the milk price are impacting adversely on the quality of investments in Fonterra. This adversely impacts investment efficiency in Fonterra and the wider dairy processing **<u>and</u>** milk production industries.

1.4.2.3 Fonterra has found the 2017/18 milk price determined by the Milk Price Manual to be unaffordable, and has discounted that price by $0.05. It is informative that had Fonterra based the asset beta on the mid-point of the range concluded by CEPA (0.515), the milk price calculated by the Milk Price Manual would have reduced by approximately $0.05[11]. It is also informative that in "sharing the pain", Fonterra chose to reduce the milk price by $0.05 while reducing the forecast dividend by up to $0.10.

1.5 In conclusion, while it might be difficult to determine with certainty an asset beta for the Notional Producer, taking DIRA Section 150A purpose <u>in its totality</u>, Miraka submits that all evidence now confirms the asset beta (and resulting WACC) used by Fonterra since the 2014/15 Season does not comply with the S150A purpose and that it is not necessary to qualify this conclusion.

1.6 **Miraka requests the Commission reconsider its decision on the asset beta.**

2.0 <u>Practical Feasibility</u>

2.1 Miraka and others have long contested that the Commission's assessment of practical feasibility is flawed. It is overly influenced by the Commission's approach to the efficiency limb of S150A of DIRA. That results in milk price assumptions set at levels which are stretch targets for Fonterra, and which are still deemed practically feasible because the Commission considers they remain feasible

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[7] Newsroom 10 August 2018: https://pro.newsroom.co.nz/articles/3881-fonterra-fund-units-drop-to-3-year-low-as-investors-grow-dark-on-capital-structure

[8] *ibid*

[9] The biographical note on Interest.Co.NZ states David Hargreaves is "a senior journalist and news editor with interest.co.nz" who "has covered financial markets and economics for 35 years both in New Zealand and Britain".

[10] https://www.interest.co.nz/opinion/95368/david-hargreaves-argues-government-needs-concede-creation-fonterra-was-wrong-thing-do (17 August 2018)

[11] Draft Report, 2.17

for Fonterra. Thus not only do Fonterra natural advantages (scale) become subsumed in the milk price, these are then inflated by the application of stretch targets.

2.2 The Commission considers stretch targets incentivise Fonterra efficiency because profit is a key performance measure for Fonterra. Stretch targets thus demand increasing efficiency by Fonterra for it to deliver profits. Miraka has long argued that the milk price itself is the primary performance measure and target for Fonterra and the overwhelming majority of its shareholders (as evidenced for example by the disproportionate "sharing the pain" with the latest reduction in the 2017/18 Fonterra milk price - refer 1.4.2.3 above). Setting stretch targets by way of the milk price calculation is thus perverse: it results in Fonterra's key performance KPI being inflated and is therefore more likely to encourage operational <u>inefficiency</u>. It also provides a screen for Fonterra to exert market power through price competition for milk supply. That is enabled by Fonterra's co-operative framework which places priority on maximising the milk price and tilts towards a preference for surpluses distributed through the milk price rather than profits and dividends (i.e. through subsidising the milk price from profits).

2.3 A more detailed submission from Miraka on this issue was provided in its submission (1 September 2016) to the Commission on its Draft Report 2015/16 Milk Price Calculations.

2.4 While the Commission considers it has addressed these issues previously, recent actions and comments from investment markets (section 1.4 above) add independent weight to the Miraka position. **It is then timely to raise this again and to request the Commission consider recent developments in financial markets and their effect on the approach to interpreting S150A of the DIRA.**

3.0 <u>Off-GDT Sales</u>

3.1 In its Reasons Paper for the 2017/18 Milk Price calculations, Fonterra noted that 45% of "price informing" sales were sourced from off-GDT sales. Fonterra confirmed that this was similar to the proportion for the 2016/17 Milk Price calculations[12]. In the Draft Report, the Commission confirms this conclusion and adds that the price differential for off-GDT sales is similar to last year[13].

3.2 Fonterra had not previously disclosed the proportion of off-GDT sales that were included in the milk price calculations for 2016/17 (at least not that Miraka has detected)[14]. 2016/17 was the first year to include the change in policy regarding off-GDT sales. In previous years, a small (but undisclosed) portion of off-GDT sales had been used to determine milk price revenue for butter and buttermilk powder. The failure to disclose the change from a negligible[15] to 45% share of total

[12] Fonterra Reasons Paper_2017/18 Milk Price Calculations – Pg 25
[13] Draft Paper, 2.31
[14] In its draft report on the 2016/17 Milk Price Calculation the Commission noted (para 2.103) an earlier submission from Independent Processors including Miraka that had assessed off-GDT sales represent as much as 23% of price informing sales. It is now apparent that in 2016/17 off-GDT sales comprised 45% (or similar) of those sales. Fonterra chose not to correct the IP assessment; that tends to acknowledges Fonterra's perception of the sensitivity of the information in the first year of the policy change, and suggests Fonterra's commitment to transparency was hollow. It is unclear why the Commission did not at least indicate that the IP assessment was wrong.
[15] The proportion of off-GDT sales that had previously been included to determine the prices for butter and BMP had been justified by a lack of depth in GDT sales for those categories. While they may have been material to determining the butter and BMP revenues, the impact on the milk price revenue will have been

sales sourced from off-GDT is extraordinary. The new revelation substantially transforms the understanding and interpretation of the revenue and selling cost assumptions in the milk price calculations.

- The source of milk price revenues has been transformed from public record selling prices (GDT auctions) to an almost 50% dilution of data based on selection criteria which continue to appear arbitrary and ambiguous. The independence and reliability of milk price revenue has been severely undermined, as has the predictability of the annual milk price.
- The magnitude of change in off-GDT sales completely changes the interpretation of the Notional Producer selling costs. Previously these had been largely based on the GDT regressive commission rates, with commercially infeasible gross sales volumes and therefore attracting a similarly infeasible low marginal commission rate. An allowance to selling costs was added for assumed 10% of sales made through off-GDT channels. Despite the now disclosed massive increase in off-GDT sales, Notional Producer selling costs remained largely unchanged in 16/17 (and presumably 17/18). In the Commission's opinion selling costs in 2016/17 and 2017/18 remain practically feasible. Miraka considers this is not credible. Given the fundamental change in sales infrastructure which must now be assumed to have occurred for the Notional Processor, and the reduced volume of product attracting the low marginal GDT commission rate, the selling costs should have moved substantially. Also, the Notional Producers has been able to move seamlessly from a low cost auction based business model to a direct marketing and sales model. In reality such change would involve enormous disruption and setup costs. Yet again, the Notional Producer has been able to reap large benefits (possibly valued at up to $0.12/kg MS – refer 3.4 below) from a simple change in assumptions without facing the costs that a real world processor would incur. **Miraka requests the Commission revisits this issue.**

3.3 Fonterra failure to disclose the magnitude of change in source data "price include" sales as a result of the change to include off-GDT sales is deeply cynical. This is especially when compared to Fonterra's claimed commitment to transparency at the time it introduced the policy change for off-GDT sales. In its draft and final reports on the 2016/17 Milk Price calculations, the Commission provided extensive criticism and recommendations concerning Fonterra's failure to meet its commitment to transparency in this matter[16]. In its submission of 1 September 2017, Fonterra responded that it would[17]:

a. Disclose the cents per kgMS impact of including off-GDT sales in the Annual Milk Price Statement

b. Disclose the average full season GDT selling prices for each RCP in the Annual Milk Price Statement

c. In the Milk Price Manual, provide definitions of criteria used to determine "price include" off-GDT sales

d. On a quarterly basis, include its current forecast impact (cents per kgMS) of off-GDT sales in its Global Dairy Updates.

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negligible (product mix). The inclusion of off-GDT sales for WMP, SMP and butter were not justified on the grounds of a lack of depth in GDT, and are not negligible in effect.

[16] For example, pages 33 and 34, Draft Report on the 2016/17 Milk Price Calculations (and similar material in the final report).

[17] Confirmed in the Final Report on the 2016/17 Milk Price Calculations, Table 2.3 and para 2.138

3.4 Despite these commitments falling well short of previous commitments and of a minimum needed to provide confidence in the milk price, Fonterra has again largely failed to meet them:

a. Reporting cents per kgMS impact: This is the only commitment that has been completed as signalled.

b. Disclosure of full season GDT selling prices: No disclosure was made in the 16/17 Milk Price Statement; no explanation has been provided for this failure, and it remains unclear if Fonterra will honour the commitment going forward.

c. Definitions and selection criteria for off-GDT sales: Definitions were not included in the 2017/18 Milk Price Manual and remain unpublished. The Commission has stated the updated 2018/19 Manual includes definitions but that Manual is not yet publically available. It is possible that Attachment 5 to the Fonterra Reasons Paper (2017/18 Milk Price Calculations) might be intended to provide the necessary disclosures. Published on 10 August 2018[18], this does not provide any more meaningful criteria and definitions. The concepts of standard products, standard offerings, standard packaging, standard plant and standard technical resources remain in effect undefined. It remains impossible to understand how Fonterra is selecting “price include” sales which are appropriate and without subjective overlay.

   The inability or refusal of Fonterra to produce meaningful criteria and selection processes undermines the integrity of the milk price revenue and the milk price. These were not issues when milk price revenues were sourced from public record GDT products and prices. By changing the basis for determining milk price revenue without addressing this core issue, Fonterra has undermined perception of integrity of the milk price and risks bringing it into disrepute. This is bad for Fonterra and the wider dairy industry.

d. Quarterly forecast updates of the impact of off-GDT sales: During the 2017/18 Season, Fonterra has only once reported on the impact of off-GDT sales in the Global Dairy Update. Even that single report did not comply with Fonterra’s commitment. The January 2018 GDU noted:

   > *“Off-GDT sales contributed 3 cents per Kg/MS to this [$6.40] forecast Farmgate Milk Price for the season to date in the first quarter”.*

   This lone report on GDU appears deliberately obscure and ambiguous. On the face of it, it meant that $0.03 of the $6.40 came from the “first quarter” actual results (whatever that means, given the Milk Price revenue is drawn from 15 months of sales). It was left unclear why a report in January 2018 was based on a financial outcome (probably) as at October 2017 and why the intervening months were ignored. More important, it remained unclear how much of the forecast $6.40 resulted from off-GDT sales. By extrapolation, the full year impact might have been $0.12 (or even $0.15). Given the explanation was so muddied, it might possibly just have been $0.03.

   To date Miraka has detected only two further (but conflicting) clues to the impact of off-GDT sales in the 2017/18 milk price calculations:

[18] The Reasons Paper is dated 2 July 2018, but was only made publically available on 10 August 2018 when it was published on the Commission’s web site.

- In its half year results, Fonterra stated "the 2016 Manual change has added six cents per kgMS to milk price for the 2017/18 season-to-date". This was interpreted to refer to the change in policy regarding off-GDT sales although Fonterra again chose to obscure this. Fonterra again failed to clarify what portion of the full year forecast milk price was attributed to off-GDT sales, and so the full year impact had to be interpreted to be as much as $0.12. This added weight to the $0.12 extrapolation of the "first quarter" outcome of $0.03. ANZ made the pointed observation that $0.12 was quite different to the $0.04 to $0.05/kg MS which Fonterra had signalled when it announced the change to include off-GDT sales[19].
- As noted above, the Commission advised that both the proportion and price differential for off-GDT sales in 2017/18 was similar to 2016/17. This would mean that the impact of off-GDT sales in 2017/18 should be similar to the impact on 2016/17, which was $0.06. This does not align to Fonterra disclosures to date, unless prices for off-GDT sales in the second half of 2016/17 were the same as GDT sales. That does not seem credible.

3.5 When it first advised that it would use off-GDT sales to determine WMP, SMP and AMF milk price revenues Fonterra acknowledged the change would "raise some concerns for the Commission and external stakeholders about a potential reduction in transparency" and made specific commitments to address that concern[20]. Since that time, and following concerns raised by the Commission and other parties, Fonterra has continued to acknowledge its commitment to transparency. By contrast its practice has been to obscure the processes and outcomes of this fundamental change in policy. As of the end of August 2018 for example, the industry remains in the dark about the presumably very material impact of off-GDT sales on the 2017/18 milk price compared to the previous status quo. This is despite the fact the dairy season ended 2 months ago and the financial year ended a month ago.

As already noted, in its report on the 2016/17 Milk Price calculations, the Commission was highly critical of Fonterra's failure to address the transparency issue. Since that time, there has been no progress with transparency. It is then surprising that in its Draft Report on the 2017/18 milk price calculations, the Commission now merely states:

> *"We continue to consider that there should be more transparency around how Fonterra has determined the off-GDT sales price for the Notional Producer".*[21]

As part of the milk price review processes, Fonterra made transparency and reporting commitments to the Commission. Failure to hold Fonterra accountable for its failure to address those commitments undermines the authority of the milk price review processes and confidence in its outcomes. **Miraka requests the Commission reconsider its response to this issue.**

4.0 Mothballed plants

4.1 Fonterra has assumed the Notional Producer would have continued to mothball 4 plants originally mothballed in the 2016/17 Season, with ongoing savings in costs. Fonterra states:

[19] NZ Dairy Update, "ANZ Research", 21.3.18
[20] Fonterra Reasons Paper in support of the 2016/17 Milk Price Manual
[21] Draft Report, 2.34

"Given the significant shortfall in F18 peak milk supply relative to the NMPBs capacity, we have assumed the NMPB would have continued to "mothball" four plants originally mothballed in F17, with commensurate savings in associated direct labour and other overhead costs."[22]

This can only mean the Notional Producer was assumed to decide to continue mothballing AFTER actual peak milk had occurred. By contrast, in the real world decisions regarding recommissioning of mothballed plants must be made BEFORE peak milk supply has occurred. Given the lead time to recommission a plant that decision would need to be made <u>in advance</u> of Season start-up. In the footnote to the above extract from the Fonterra Reasons Paper, Fonterra clarified that while five plants were mothballed in 2016/17 only four were assumed mothballed in 2017/18 – ie one must have been recommissioned well in advance of peak milk. This further highlights the absurdity of mothballing decisions being based on knowledge of actual milk volumes. It also begs the question what costs were included for the plant re-commissioning.

4.2 Fonterra's explanation for deciding to continue to mothball the plant is not feasible in any sense of the word. In the lead up to the Season, Fonterra actually expected milk supply to grow in the 2017/18 Season, and indeed **<u>peak</u>** milk production was higher in 2017/18 than in the previous year. This is confirmed in the below summary of data from Fonterra's Global Dairy Updates:

Milk Volume Reporting per Fonterra Global Dairy Updates					
			Fonterra Actual Milk Collection		
	Total 17/18 Ssn			Delta 16/17	
	F'cast	Delta 16/17	As at	Month	Ssn to Date
Jun-17	**1,575**	**103.2%**			
Jul-17	*no change*	103.2%	June	19.0%	19.0%
Aug-17	*no change*	103.2%	July	5.0%	10.0%
Sep-17 *(1)*	**1,575**	**103.2%**	Aug	-2.5%	0.3%
Oct-17	**1,540**	**100.9%**	Sept	-2.1%	-1.1%
Nov-17	*no change*	100.9%	Oct	2.3%	0.3%
	no change	100.9%	Peak vs LY		1.0%
Dec-17	**1,525**	**99.9%**	Nov	2.7%	1.0%
Jan-18	**1,480**	**97.0%**	Dec	-5.5%	0.4%
Feb-18	*no change*	97.0%	**Jan**	**-8.3%**	**-1.7%**
Mar-18	**1,480**	**97.0%**	Feb	-4.0%	-2.0%
Apr-18	**1,500**	**98.3%**	March	-3.0%	-2.1%
May-18	*no change*	98.3%	April	2.3%	-1.7%
Jun-18	**1,505**	**98.6%**	May	6.6%	-1.4%
Nth Island		**-2.6%**			
Sth Island		**0.5%**			

(1) Opening forecast reconfirmed.

4.3 The table shows:

- Fonterra milk collection did not fall significantly below 2016/17 until January 2018.
- Peak milk was 1% higher than 2016/17

[22] Fonterra Reason Paper 2017/18 Milk Price Calculations, Pg 34

- Fonterra full year forecast did not fall below 2016/17 until December 2017 (i.e. well after the crucial (for capacity planning) peak milk period
- South Island milk collection for the full year was higher than 2016/17

4.4 The table also illustrates the volatility in milk volumes and the difficulty in milk forecasting and why as a consequence dairy processors must retain substantial capacity "head-room" in their planning. The fact that South Island milk collection was in fact higher than 2016/17 further illustrates that a plant mothballing plan cannot be based on national milk collections[23].

4.5 There is no evidence to support the fact that a prudent and efficient processor would have risked facing a shortfall in processing capacity by (continuing to) mothball plants in the face of the reasonable expectation that milk supply was still growing. Indeed the original assumption that the plants were mothballed in 2016/17 remains highly questionable given the risks and costs associated with mothballing and re-commissioning plants, and the continued uncertainty of whether Fonterra (the Notional Producer) overall milk supply had in fact peaked and was now in decline.

4.6 The Commission has concluded that the assumption to continue to mothball the plants with associated cost savings is an appropriate "real world response"[24]. This conclusion is not supported by the evidence.

4.7 **Miraka submits that the assumption is not feasible in any sense of the word and requests the Commission reconsiders its assessment for 2017/18.**

4.8 **Miraka also recommends that the Commission find that going forward, Fonterra should register its assumption regarding mothballing and recommissioning plants in advance of the start of the Season, and the Notional Producer must carry the consequences (as would Fonterra or any processor) of that decision. For 2018/19, that is now an urgent matter which Fonterra should respond to immediately.**

5.0 Yields and Losses

5.1 Miraka has previously submitted that production yields are not practically feasible. In particular, the related assumption that plants would operate at capacity for long periods of time depends on production volumes which are higher than is (demonstrably) commercially feasible and which would lead to selling prices and Milk Price Revenue which are lower than are used for the Notional Producer[25].

5.2 Even in the event the yields and losses might be technically feasible in themselves, it appears that Fonterra has maximised advantage from yields and losses without properly considering costs that would be incurred by keeping selected plants operating at full capacity for extended periods of time. For example, Fonterra does not appear to have processes in place to determine the milk

[23] This further highlights the bizarre assumption in the Milk Price Manual that plants would be decommissioned on the basis of their age rather than location.

[24] Draft Report, 2.23

[25] Other things being equal, the increase (above real world volumes) in commodity production and availability that must be attributed to the Notional Producer would result in lower commodity selling prices than is actually achieved by the "price include" sales. It needs to be noted that not only is the Notional Producer commodity volume inflated by the "reallocation" of milk from "price exclude" products of the same nature as the reference products (WMP etc), it is also inflated by "reallocation" of milk from cheese, protein and liquid milk products.

transport cost associated with the plant optimisation assumption. Miraka has raised examples of this previously but those and now a new example have not been addressed:

- Mothballed plants – Fonterra has assumed four plants would remain mothballed in 2017/18. In accordance with the Milk Price Manual, Fonterra will have assumed the oldest plants are mothballed. Given there is no necessary alignment between "oldest plants" and changes in milk collection catchments, the mothballed plants should have resulted in increased milk diversion costs to maintain the assumption of extended full capacity operations in selected plants. This does not appear to have been provided for in either 2016/17 or 2017/18.
- Interplant milk diversion costs – apart from cream and buttermilk transfers, Fonterra does not provide for any milk diversion costs required if milk were moved between plants on the basis of maximising full capacity operations (while other plants lie idle over the shoulder months). In this context, Fonterra simply assumes[26] that any such transfers "are not material". There is no basis for making that assumption, and this confirms Fonterra has not properly considered the costs associated with its assumption of selected plants operating at full capacity for extended periods.
- Inter-Island milk transport costs – Fonterra relies on an <u>assumption</u> that milk will not have been transported between the islands[27]. An assumption would not be required if there were proper capacity planning for the Notional Producer, including the implications of keeping selected plants at full capacity for extended periods. In the absence of proper planning models, Fonterra actual costs of transporting milk between the islands should at a minimum be provided for. This also further illustrates the failure to consider the changing volumes of milk across catchments, and the lack of any nexus with the selection of mothballed plants. This is exacerbated by the fact that South Island milk in 2017/18 increased while North Island milk decreased.

5.3 It is acknowledged that addressing these points might be difficult. However complex modelling of milk transport costs is only required because of Fonterra's continued insistence 0n basing yields and losses on technically optimised plant operations. This illuminates the wider tendency for Fonterra to optimise certain milk price assumptions which maximise the milk price, while having less regard for associated costs. The problem of determining the associated costs arises because the optimising assumptions are not aligned to real world experience, and cost implications are thus more difficult to discern. In these cases a pragmatic response is required and Miraka considers this would more correctly align to the S150A requirements. For example, yields including loss assessments should be based on real world evidence of operating conditions and costs for "price include" sales volume. More simply, it would reflect Fonterra actual yields. As noted in 2.0 above, the efficiency based objection to using actual yields is misplaced, and S150A efficiency purpose would be more likely promoted if actual yields are used.

5.4 **Miraka requests the Commission reconsider its view on the practical feasibility of the Notional Producer yields and losses, including the wider costs associated with optimisation.**

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[26] Fonterra Reasons Paper 2017/18 milk price calculations, pg 31
[27] *ibid*

6.0 Packaging Costs

6.1 The Commission notes that Notional Producer packaging costs have decreased by 3.4%, largely due to a reduction in AMF volume[28]. This does not appear to be credible. Since the 2011/12 Season, AMF has comprised on average 5.6% of the Notional Producer total production volume, with volume fluctuating within a narrow range (4.9% to 6.0%). If there has been a reduction in volume in 2017/18 it is not credible that it could have moved packaging costs by as much as 3.4%. Apart from the fact that the absolute volume of AMF is small, any reduction in AMF would be accompanied by a larger increase in butter volumes due to yield differences[29]. Alternatively, Fonterra (and therefore the Notional Producer) might have significantly increased its production of WMP and reduced the overall volume of fat available for butter and AMF. Again since 2012 the proportion of WMP to total production has remained relatively stable averaging 63% of total production Fonterra (and therefore the Notional Processor) has relatively limited scope to change that product mix. The highest proportion of WMP production since 2012 was in 2014 (67.2%). In that same year AMF production was 4.9% of total production (i.e. not substantially dissimilar to the 5.7% in 2016/17).

6.2 The proportion of AMF availability on GDT over 2017/18 has been largely the same as for 2016/17. Assuming GDT availability is an indicator of changes in Fonterra product mix, it would be concluded there has not been a significant change in the volume of AMF.

6.3 On the available information, it is not credible that a reduction in packaging costs of 3.4% can be attributed to a reduction in AMF volume**. Miraka requests the Commission investigate this further.**

7.0 Sales Phasing

7.1 At page 24 of the Fonterra Reasons Paper 2017/18 milk price calculations, Fonterra notes in relation to sales phasing that it is <u>assumed</u> “Fonterra’s overall contract profile for arm’s length commodity sales, rather than just the “price include” contract file, is <u>appropriate</u>”. This assumption is unchanged from previous years and is relied on to justify the average price for the Notional Producer sales being derived from a smaller (“price include”) portfolio of sales with different phasing (and different product mix). This results in the Notional Producer overall selling prices are different to the overall selling prices of the “price include” sales portfolio. The difference is something of a lottery. Fonterra does not explain why this difference in selling prices is practically feasible. In a different context Fonterra does however provide evidence why the assumption is <u>not</u> feasible.

7.2 In Attachment 2 of its submission to the Commission on the Draft Report on the 2016/17 Milk Price Calculations, Fonterra responded to issues raised by the Commission relating to the transparency of off-GDT sales. Independent Processors had submitted that Fonterra should provide monthly actual phasing of GDT, price include, and Notional Producer sales. This was to help IPs interpret the impact of the off-GDT policy change, and to gain assurance that the now multiple phasing differences did not seriously distort the Notional Producer prices. In its attachment 2 Fonterra rejected this request explaining that phasing was commercially sensitive because:

[28] Draft Report, Table 2.1

[29] It is acknowledged that AMF packing costs are relatively higher than butter; however the impact of any change in production volumes (between AMF and butter) would be partly offset by the yield difference.

"The phasing of sales is a tactical decision made by Fonterra to maximise value".

7.3 In other words, the prices achieved from a portfolio of sales is directly affected by the phasing of those sales. This is the same argument Miraka has previously put to the Commission when contesting the practical feasibility of applying the price series derived from one portfolio of sales to a completely different portfolio. The resulting different weighted average price cannot be demonstrated to be practically feasible and the assessment thus relies on the extent to which the phasing differences drive a difference in overall prices.

7.4 **The Commission is requested to revisit this issue in the light of the view presented by Fonterra noted above. Ideally Fonterra would provide the phasing information as requested. Failing that, the Commission is requested to assess how and why the Fonterra assumption on phasing remains practically feasible. At a minimum, in addition to the disclosure of the Notional Producer prices for each of the RCPs, Miraka submits this would require disclosure, again for each of the RCPs, of the total weighted average prices (actual phasing) for each of the GDT and off-GDT "price include" categories.**

Yours sincerely

Richard Wyeth
Chief Executive Officer