30 May 2023

IDP Joint submission to the Commerce Commission:
Cross Submission to submissions made regarding Commerce Commission papers:
- Update of "Our Approach to reviewing Fonterra's Milk Price Manual and base milk price calculation" (issued 30.3.23); and
- Proposed focus areas for our review of Fonterra's 2022/23 base milk price calculation (issued 30.3.23)

Submitted by email: *market.regulation@comcom.govt.nz*

Attention:	Louise Stephenson, Fuel and Dairy Manager, Market Regulation
Subject:	Cross-submission base milk price calculation and approach paper
Submitted by:	Miraka, Open Country Dairy, Synlait Milk and Westland Milk Products (Independent Dairy Processors (IDPs))

Abbreviations and other references

Draft Approaches Paper – 2023 draft update (issued 30.3.23) of the Commerce Commission paper "Our approach to reviewing Fonterra's milk price manual and base milk price calculation"
BMP - Base Milk Price
DIRA - Dairy Industry Restructuring Act 2001
DIRA Amendment Act 2022 - Dairy Industry Restructuring (Fonterra Capital Restructuring) Amendment Act 2022
IDPs – Independent Dairy Processors: Miraka, Open Country Dairy, Synlait Milk, Westland Milk Products

1. This submission is made in response to the Commerce Commission's offer to provide feedback (cross-submissions) on submissions the Commission has received on the Draft Approaches Paper and on the Commission's proposed focus areas for the review of the 2022/23 BMP calculations.

2. The IDPs made submissions to the Commission on both papers[1].

3. In its submission on the Draft Approaches Paper, the IDPs indicated a different understanding of the meaning of new section 150(B) (2) of the DIRA than appeared to be held by the Commission. To further assist the Commission in considering the IDPs view on that matter, we

[1] https://comcom.govt.nz/__data/assets/pdf_file/0028/315559/Miraka2C-Open-Country-Dairy2C-Synlait-Milk-and-Westland-Milk-Products-to-Commerce-Commission-Joint-submission-on-our-Approach-Paper-2023-Update-27-April-2023.pdf; and https://comcom.govt.nz/__data/assets/pdf_file/0025/315619/Miraka2C-Open-Country-Dairy2C-Synlait-Milk-and-Westland-Milk-Products-Joint-submission-on-Proposed-focus-areas-27-April-2023.pdf

have obtained independent legal advice on that new sub-section from David Blacktop of A&B Competition Lawyers. A copy of that advice is provided as an attachment to this submission.

4. The IDPs have nothing further to add to their submission on the proposed focus areas paper.

5. The remainder of this paper responds to certain points raised by Fonterra in its submission on the Draft Approaches Paper[2].

6. From the Fonterra submission (page 3):

Reference (numbering in revised draft unless otherwise stated)	Proposed Changes	Reason
Former [82] and [83]	<u>Fonterra has incentives to improve efficiency to maximise profits</u> <u>82. We consider that Fonterra has an incentive to maximise its overall payments to farmers and to shareholders, including unitholders in the publicly listed Fonterra Shareholders' Fund (FSF), which was created in 2012 as part of TAF.[45] Improvements in efficiency may be passed through into a higher base milk price benefitting farmer-shareholders or result in higher profits for Fonterra potentially benefiting outside investors in FSF through higher dividends.[46]</u> <u>83. We consider Fonterra's management has an incentive to maximise profits (which benefits both farmers and shareholders, including unit holders in the publicly listed FSF).[47] This incentive is reinforced by the transparency associated with the listing on the stock exchange of the non-voting units, and the importance to Fonterra of ensuring that its TAF regime works.[48]</u>	We recommend reinstating these paragraphs. No reason was provided for their removal. The paragraphs remain accurate, except footnote 46 which would need to be updated.

7. **IDP Comment**: The IDPs have always considered the paragraphs identified by Fonterra are not valid and not relevant to the calculation of the BMP. It may be correct that Fonterra is incentivised to be efficient to maximise <u>overall payments</u> to co-operative members (and therefore to supplier shareholders). Fonterra co-operative members are however at best indifferent to payments received from profits/dividends as against payments received from the milk price. In reality it is almost certainly the case that Fonterra members place greater priority on receiving payments from the milk price than those derived from profits. This is reflected by the Fonterra Constitution which explicitly requires the milk price be a maximum amount that Fonterra can pay. While that "maximum" is subject to caveats the Fonterra Constitution has no

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[2] https://comcom.govt.nz/__data/assets/pdf_file/0027/315558/Fonterra-Submission-on-our-Approach-to-reviewing-Fonterra27s-Milk-Price-Manual-and-Base-Milk-Price-Calculation-27-April-2023.pdf

equivalent requirement regarding profits. This is particularly instructive given the milk price and profits are mutually (and inversely) dependent for a supplier co-operative like Fonterra. The principle that Fonterra is motivated to improve efficiency to maximise profits is therefore bogus. It is however used to justify "stretch targets" being used in BMP assumptions which have the direct effect of increasing the BMP.

8. It is however clear why the Commission has only now chosen to remove the paragraphs which Fonterra wishes to reinstate. It requires some effort to take seriously Fonterra's assertion that the Commission has provided no reason for their removal. The reason is obvious to all and surely to Fonterra: changes which it has made to TAF mean that Fonterra is no longer incentivised to maximise profits to ensure "that its TAF regime works". Indeed it is questionable that was ever the case. In this respect, and in the light of Fonterra's search for an explanation for the removal of the relevant paragraphs, it is instructive to quote widely from statements attributed to John Shewan in a "Business Desk" article published in November 2022[3]. John Shewan was the inaugural chair (2012) of the Fonterra Shareholders Fund Management Company. On his departure from that role, amongst other things he is reported to have said at the November 2022 annual meeting of the Fund:

- *"I want to apologise for the fact that, for most unit holders, the investment returns from the fund over the decade since its formation have been dismal. I find that outcome both unacceptable and deeply disappointing"*.
- "*The fund and the associated trading among farmers arrangements created a stable capital base"* for Fonterra, but it had not created value for unit holders: "*It's fair to say that Fonterra's track record on paying a respectable return on capital over time has not met expectations. In the context of a 45% loss over a decade where the market has delivered a 175% gain, I consider that to be an understatement of truly remarkable proportions"*.
- And in an apparent summation: "*To borrow a well-known Australian colloquialism, Fonterra, I put it to you that unit holders have not had a fair suck of the sav".* [4]

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[3] https://businessdesk.co.nz/article/finance/outgoing-fonterra-fund-chair-unitholders-havent-had-a-fair-suck-of-the-sav

[4] Relevant background to these comments is the frustration Shewan had expressed at the 2021 annual meeting of the Fund that Fonterra had not bought out the Fund at a fair price before it started consultation on its latest capital restructure. Announcement (and ultimate execution) of the restructure had the effect of a predictable decline in the value of the units in the fund. The restructure was carried out for the benefit of Fonterra supplier shareholders (who voted by a considerable majority in its favour). By contrast the unit holders suffered only loss as a result of the restructure and had no voting rights in the matter. Shewan repeated his frustration with this matter along with the above reported comments at the November 2022 meeting of the Fund – refer for example https://www.stuff.co.nz/business/farming/agribusiness/127263688/fonterra-shareholders-fund-should-have-been-wound-up-chairman-says.)

9. In considering these comments, it must be remembered that in setting its milk price each year, Fonterra also directly sets its own profit. Fonterra also holds all the strings in determining the regulatory BMP. Fonterra would appear to have exploited procedural flexibility sanctioned by the DIRA to increase the BMP (for example, inclusion of off-GDT sales, using safe harbour assumptions to assume theoretical super-efficiencies, and the long running saga of the undervalued WACC). These choices made by Fonterra have had the effect of increasing the BMP (and the Fonterra Farmgate Milk Price) and eroding Fonterra profits. There is no evidence that Fonterra has balanced its approach to the BMP and the FGMP against shareholder and unit holder expectations for returns on investment.

10. Shewan's comments may be contextualised against this reality and must be read in the light of Fonterra's constitutional emphasis on milk price over profits. None of this should be surprising or even criticised given Fonterra is a supplier co-operative. What is surprising is the continued assumption that Fonterra is incentivised to deliver profits and that BMP assumptions should include stretch targets on the unfounded basis that these will incentivise Fonterra efficiency.

11. Rather than reinstate the relevant paragraphs sought by Fonterra, the IDPs have requested the Commission reconsider its view that stretch targets included in the base milk price will incentivise Fonterra efficiency (as a means of meeting the DIRA s 150A purpose)[5]. The IDPs consider the stretch targets are more likely to have the opposite effect (inflating Fonterra efficiency and potentially hiding Fonterra inefficiency). The direct consequence of these "stretch target" is to increase the milk price, reduce Fonterra profits, and thus helping to entrench the poor returns to shareholders and unit holders illustrated by Mr Shewan.

12. From the Fonterra Submission (page 3):

Reference (numbering in revised draft unless otherwise stated)	Proposed Changes	Reason
[56]	... While Fonterra is able to use these assumptions~~,~~ and s 150B provides a conclusive presumption that the assumptions it contains do not detract from the purpose set out in s 150A (including the contestability purpose), we are able to review the way the assumptions have been used in setting the base milk price.[26]	It is not clear why the wording underlined has been removed.

13. IDP Comment: Contrary to Fonterra view, it is clear why the words have been removed by the Commission. New section 150(B) (2) specifically excludes the use of the assumptions ("the way in which new co-op uses the assumptions") from the presumption in subsection (1) that they do not detract from the achievement of the s 150A purpose. It would therefore be incorrect to reinstate the words as proposed by Fonterra.

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[5] IDP Joint Submission (27.4.23) on the Commerce Commission paper: "Our Approach to reviewing Fonterra's Milk Price Manual and base milk price calculation (issued 30.3.23)", paragraphs 34 to 44.

14. From the Fonterra submission (page 3):

Reference (numbering in revised draft unless otherwise stated)	Proposed Changes	Reason
[75] Fnt 38	The Commission may also direct Fonterra to publish any information requested by or provided to the Commission as part of its reviews, <u>except if the information is reasonably considered to be commercially sensitive, subject to legal privilege or personal information.</u> Remove Footnote 38	The point originally in the footnote is important. It detracts from clarity of and expectations created by the "our approach" guidelines to relegate it to a footnote.

15. IDP Comment: In their submission on the Draft Approaches Paper, the IDPs pointed out that note 38 is not the legal standard the Commission must apply when it directs Fonterra to publish information[6]. Regardless of whether the footnote is moved to the body of the paper or remains a footnote, the correct legal standard needs to be recorded.

Authorisation

This submission is authorised by:

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[6] Ibid, paragraphs 31 to 33.