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Milk Price Project Manager
Commerce Commission
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Dear Leighton

Submission on Draft Review of Fonterra's 2015/16 base milk price calculation

Poldrissick Farms is a shareholder in Fonterra, and receives the milk price paid by Fonterra, as such is an interested party in the Fonterra Milk Price Manual and Milk Price Calculation. We are pleased to offer a submission on your draft report.

Purpose of the base milk price calculation report

The Commerce Commission (CC) has determined that the purpose of the milk price monitoring regime is to provide an incentive to Fonterra to operate efficiently while providing for contestability in the market for the purchase of milk from farmers as required in the Dairy Industry Restructuring Act (Act) Section 150A.

When evaluating the Fonterra Milk Price Manual and Milk Price Calculation for compliance with the "Efficiency" and "Contestability" dimensions, on a number of occasions in the report, the CC has only determined whether a specific factor contributes to the Milk Price being lower than that of the notional efficient processor.

We submit that the Act also contains a responsibility on the regulator (CC) to consider the interests of parties that receive the Milk Price. When the formation of Fonterra was contemplated and the Act was constructed it was clear that due to scale Fonterra would be the Milk Price maker in the New Zealand market, and consequently there would not be an efficient and effective market place to determine farm gate Milk Price. It was deemed important that both competing milk processors and milk supplying farmers were protected from a Milk Price setting method that produced outcomes that were not appropriate.

A number of other milk processors base the Milk Price they pay to their supplying farmers off the Milk Price set by Fonterra. As a result, the milk supplying farmers that are interested parties to this process are not limited to Fonterra supplying farmers. Most of the other processors have a corporate ownership structure (e.g. they are not owned by their milk supplying farmers) so they have a strong commercial interest in encouraging a Milk Price that is lower as this lower Milk Price, all other things being equal, improves their profitability.

The structure of Fonterra separates the business into two parts, the Ingredients business (Global Operations & Global Ingredients – GOGI) and Consumer and Foodservice. From this, the returns from GOGI are predominantly expected to be Milk Price and Consumer and Foodservice deliver returns via Earnings and dividend. Table 4.1 indicates that there is a difference of \$0.44 / kgMS between the notional producer and GOGI. In the absence of any other specific data in your report, this suggests that

the Milk Price is potentially set \$0.44 / kgMS lower than it should be. Your report comments that several aspects of the Milk Price Calculation contribute to a Milk Price that is lower than the notional efficient processor, but does not state to what extent each factor would lower the Milk Price.

The CC only concerning itself whether the Milk Price is being set lower than that of the notional efficient processor means it is only ensuring the interests of milk processors competing with Fonterra are being protected (“contestability dimension”). This approach does not protect the interests of the parties that receive the Milk Price (milk supplying farmers), many of whom have limited technical capability to question Fonterra on the Milk Price Manual and Milk Price Calculation, or access an alternative milk processor if they are unhappy with the milk price Fonterra is offering. As stated above, it has always been clear that market competition alone would not protect the interests of milk supplying farmers so this monitoring regime was expected to also protect their interests too. This lack of ability for a Fonterra milk supplying farmer to access an alternative milk processor is why the CC has an obligation to ensure that the Fonterra Milk Price is not set materially lower than the notional efficient processor – in much the same way the CC has a responsibility to electricity consumers that don’t have ready access to alternative providers.

There is a natural tension between the needs of milk processors that compete with Fonterra, who would naturally prefer a lower milk price, and milk supplying farmers who would naturally prefer a higher milk price. The Act does not expect the CC to favour either interested party, but to independently inspect and confirm that the Milk Price is being set in a way that delivers an outcome that is materially similar to the notional efficient processor.

We submit that the approach adopted by the CC in this report of accepting methodology as long as it contributes to generating a milk price lower than the notional efficient processor is not consistent with the responsibility the CC has to supplying farmers as intended by the Act. To meet your obligations to all interested parties, the report needs to articulate for each item assessed in the Milk Price Calculation whether it approximates, is above, or below, and the amount of the variance from the notional efficient processor and then a summary that estimates what the CC believes is an appropriate Milk Price (or range) for the notional efficient processor.

Awareness and participation in the Milk Price Review processes

As stated above all milk supplying farmers in New Zealand are interested parties to this process. I note with interest that the majority of submitters to your process are competitor milk processors to Fonterra and very few milk supplying farmers have contributed. For the reasons stated above, it is not surprising to see the competitor milk processors to Fonterra consistently lobbying this process to see the Milk Price model changed in ways that would deliver a lower Milk Price. We submit that milk supplying farmers are interested parties and would provide useful balance to this process. To participate in this process, milk supplying farmers need to be aware the process occurs and the timeframes and processes by which to contribute. We would encourage the CC to actively communicate with and encourage milk supplying farmers to contribute.

Weighted Average Cost of Capital

This is one of the components identified as currently contributing a higher cost into the Milk Price Calculation than the notional efficient processor.

Section 4.62 outlines the approach used to determine the risk free rate, being a 5 year rolling average. The notional efficient processor would typically source debt capital on a range of tenures – short medium and long term bank facilities.

We submit that establishing the weighted average tenure of the debt facilities typically held by a milk processor would provide a useful guide to determining the appropriate number of years to use in calculating the rolling average risk free rate rather than just arbitrarily picking 5 years or 1 year.

Fixed Asset Assumptions and Repairs & maintenance and other capital costs assumptions

The analysis of the capital cost recovery methodology used (the tilted annuity method) gives a higher level of overall capital cost recoveries than alternative approaches. The repairs and maintenance costs are also significantly higher than the actual costs incurred by Fonterra.

Typically a higher total capital cost would be generated from a quicker replacement cycle and lead to an overall newer standard of plant, and with a newer standard of plant, it would normally be expected that repairs and maintenance costs would be lower. In this case both the total capital cost recovery and repairs and maintenance costs are higher and the combination of these two factors leads to a Milk Price that is inappropriately lower than it should be.

We submit that the CC should recommend an approach to capital cost recovery and repairs and maintenance that are aligned – either adopting a lower repairs and maintenance cost to better align with the higher capital cost recovery, or reduce the capital cost recovery to better align with the current repairs and maintenance cost.

Farmer support

We submit that Fonterra shareholders consider the farmer support package as a shareholder cost and it is expected that the cost involved with providing this support will come out of Earnings and consequently dividend. Given the impact on Milk Price is less than \$0.01 / kgMS the allocation of this item is not material to the Milk Price Calculation, there are other much more significant items to be addressed as outlined above.

Conclusion

We thank you for the opportunity to make this submission, and as we have outlined we believe the Commerce Commission has a responsibility to ensure that the interests of milk supplying farmers in New Zealand are protected, as well as the other interested parties that have and will continue to push their own interests which have a natural tension with our interests. We encourage you to ensure all interests are fairly treated and look forward to any opportunity to engage further with the Commerce Commission on what we as milk supplying farmers see as an important topic for the industry and New Zealand.

Regards,



Greg Mills

DIRECTOR – POLDRISSICK FARMS