



## Emerging Views on Asset Beta Submission of Open Country Dairy

Open Country Dairy Limited appreciates the opportunity to provide a submission on the Commerce Commission's emerging views on Fonterra's approach to estimating the notional processor's asset beta.

### **1. CEPA report and Commission's emerging views paper**

We agree with the Commission's emerging view that an asset beta of 0.38 as used by Fonterra is unlikely to be practically feasible. Indeed, Fonterra's asset beta estimate is so implausible on the face of the available evidence that the Commission's conclusion ought to be even more plainly stated. Fonterra's asset beta estimate of 0.38 is not practically feasible. This must be the Commission's conclusion in its final report.

The CEPA report has further confirmed what was already apparent. Fonterra has consistently used an asset beta which is demonstrably too low to be practically feasible. The impact of this erroneous approach has added around \$0.06 per KgMS to the base milk price for the 2016/17 season and has resulted in approximately \$440 million being misallocated to farmers at the expense of Fonterra shareholders in the five years since independent processors first raised the issue with the Commission.

This is a remarkable transfer of value away from contestable market outcomes. These figures are not hypothetical. They represent real misalignment of incentives and misplaced investment by Fonterra. The size of the figures suggest that Fonterra's incentives are seriously misaligned with DIRA's efficiency and contestability objectives. The Commission now needs to address this misalignment by confirming unequivocally that Fonterra's approach is not consistent with DIRA's purpose.

We note that neither CEPA nor the Commission have addressed the limitations of CEPA's analysis that we pointed out in our previous submission (including that CEPA appears to have erred in its finding that any short-term systematic risks faced by the notional processor are sufficiently comparable to that of a regulated utility, and there is no rationale and certainly no reliable information for selecting anything other than the midpoint of the estimated range). Failing to correct their position to better align with the best evidence means that CEPA's range is, if anything, conservatively low. The real extent of Fonterra's misplaced incentives is likely to be even greater. While our preference is for the asset beta estimate to be as accurate as possible, the conservative nature of CEPA's analysis means that any conclusion of a lack of consistency with DIRA's purpose can be expressed by the Commission with a very high degree of confidence.

## 2. Fonterra's position

Fonterra's response to the CEPA analysis has not added anything new or relevant to debate, and the Commission is right to reject its views. We support the Commission's analysis in this regard.

That said, there are three aspects of Fonterra's position that are so erroneous that they must be addressed in the strongest possible terms.

First, we absolutely reject Fonterra's apparent position that the Commission is not entitled to reach a view on the contestability of Fonterra's asset beta estimate.<sup>1</sup> That is precisely the Commission's statutory role, and it must be discharged.

Fonterra appears to argue that the Commission should defer to Fonterra's own views of efficiency and market contestability because its incentives to determine a milk price that is either too high or too low are "balanced".<sup>2</sup> This is an egregious misrepresentation of the reality of Fonterra's incentives. We acknowledge that Fonterra is subject to conflicting incentives. The most important of these are its short-term incentives to raise the milk price (to secure supply), and its long-term incentives to lower the price (to lower input costs and invest in high-value processing). But whether those conflicting incentives are "balanced" is an empirical question – it cannot simply be assumed. Incentives pointing in one direction or the other may well dominate. Indeed, the Commission's entire function of the DIRA price monitoring regime is to determine whether those incentives are in fact appropriately balanced and point out when they are not.

What the CEPA report has further confirmed is the extent to which Fonterra's conflicting incentives are unbalanced. Fonterra has meaningfully and consistently raised the milk price above contestable market levels. Its short-term incentives are dominant. This is exactly the situation in which the Commission is statutorily required to unequivocally state its view on the contestability of Fonterra's asset beta estimate.

Second, Fonterra argues that the asset beta estimate cannot be found to be inconsistent with DIRA because its nature as an estimate means that experts can legitimately have different and equally credible views on the best estimate of asset beta.<sup>3</sup> At a high level of abstraction, the claim that experts can reasonably disagree about the asset beta is certainly true (and this is why a range of values rather than a single point is often presented). However, in this case, Fonterra is so far outside the plausible range that its estimate lacks any semblance of credibility. The empirical analysis of dairy and commodity-exposed companies' asset beta undertaken by both CEPA and Dr Marsden has generated estimates of asset beta that, even when expressed in a range, are significantly above the point estimate of 0.38 adopted by Fonterra.

The debate about Fonterra's asset beta estimate is not occurring at the margins. Fonterra's position on the asset beta estimate is implausible, and the question of whether

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1 Fonterra *Submission on Independent Report on Dairy Notional Processors' Asset Beta*, paragraph 33.

2 Fonterra *Submission on Independent Report on Dairy Notional Processors' Asset Beta*, paragraph 26.

3 Fonterra *Submission on Independent Report on Dairy Notional Processors' Asset Beta*, paragraph 13.

Fonterra has met its DIRA obligation to determine a contestable base milk price has been answered. Further expert views do not alter that reality.

Finally, Fonterra suggests that specific examples of investment by independent processors occurring under current market conditions is evidence that the market is contestable.<sup>4</sup> The evidence actually suggests the opposite. The examples referred to underscore that investment only occurs in limited pockets where independent processors still believe they can earn a viable return. There are a number of geographic regions where Fonterra still holds an effective monopoly, and the prospect of entry and expansion by competitors is remote. A contestable market would have seen these regional monopolies eliminated or at least significantly eroded over DIRA's lifespan. Instead, the incumbent still holds a market share in excess of 80% nationally. The vast majority of farmer-suppliers do not have an alternative buyer for their milk and will not realistically have one in the foreseeable future. These are not features that describe a contestable market.

### 3. Conclusion

In our previous submission we noted that there was never any real doubt on the basis of the available evidence that Fonterra's use of asset beta of 0.38 for the 2016/17 base milk price calculation was not practically feasible for an efficient notional processor. If Fonterra continues to apply the same methodology for the 2017/18 base milk price calculation, the Commission must state unequivocally that the asset beta estimate is not practically feasible.

We look forward to this issue finally being put to rest.

Best regards



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<sup>4</sup> Fonterra *Submission on Independent Report on Dairy Notional Processors' Asset Beta*, paragraph 30.