

15 November 2018

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REVIEW OF FONTERRA'S 2018/19 MILK PRICE MANUAL

We set out in this letter Fonterra's response to the Commission's draft report on its review of Fonterra's 2018/19 Milk Price Manual, released on 15 October 2018 ("Draft Report").

We welcome the Commission's overall draft conclusion is that the Manual is largely consistent with the section 150A purpose statement. We have previously commented on the Commission's recommendations with respect to transparency and on the matters summarised in Attachment B of the Draft Report. We continue to hold the views on these matters stated in the Draft Report and therefore do not have any additional comments on these matters.

We have the following comments with respect to the Commission's commentary on stranding risk, the specific risk premium, and plant mothballing.

Stranding risk. We agree with the Commission's draft conclusion that the Manual's approach to asset stranding is reasonable. However, we do not agree with the Commission's argument that the notional processor (NP) necessarily faces lower stranding risk than independent processors: while the NP's scale, coupled with the assumption that the NP has assets of varying ages, means the NP is better able to align its actual capacity to different levels of milk supply than smaller processors, independent processors on the other hand can far more readily access new milk supply (i.e., Fonterra's supply), and therefore do not face anything like the same level of exposure to milk supply risk as Fonterra.

In paragraphs 28 – 29 the Commission has continued to support CEPA's assertions that (a) the oldest relevant assets will not necessarily be the lowest value assets to the notional producer, and (b) the requirement in the Manual that the oldest assets are to be written off first if assets become stranded due to a shortfall in milk supply or a change in the RCP basket is not necessarily consistent with what would happen in the real world. We continue to disagree with this view. As explained in our submission on the Commission's draft report on the 2017/18 base milk price "CEPA's argument overlooks the homogeneity of the NP's assets: because its material manufacturing assets are SMP and WMP plants, and because each SMP and WMP plant can manufacture the same products, it follows that the oldest plants (which are assumed both to have higher operating costs and which by definition have the shortest remaining useful lives) will also be the assets that are forecast to generate the least value." The Commission did not acknowledge our explanation in its final report on the 2017/18 base milk price, and it would therefore be helpful if it could respond to our explanation in its final report on the 2018/19 Manual.

Specific risk premium. The Commission notes that it has no new information to suggest our specific risk premium of 0.15% is no longer appropriate, but explains that because it has now been three seasons since the Commission last reviewed the premium it believes it is an appropriate time to consider whether the current allowance is still appropriate. We note that (a) Dr Alastair Marsden last reviewed the allowance for Fonterra in April 2016 and did not recommend any change, (b) under the Manual the next review is scheduled for 2020/21, and (c) our medium-term forecasts of milk supply do not imply any stranding risk over the relevant horizon.

Plant mothballing. The Commission proposes that we publicly disclose our assumption regarding the notional mothballing of plants in the Global Dairy Update (GDU). We acknowledge the Commission's request for additional disclosure, but consider the Milk Price Statement to be a better vehicle for disclosure – consistent with real world timing, our mothballing decisions are made prior to plants being started up for a season, and disclosure of any mothballing decisions in the Milk Price Statement, issued in September, would therefore be timely.

Please contact me if you have any questions or would like further information.

Yours sincerely

A handwritten signature in blue ink, appearing to be 'AC', written in a cursive style.

Andrew Cordner
Director Legal