Synlait

Commerce Commission
44 The Terrace
Wellington

29 April 2021

Dear Hristina

Thank you for the opportunity to submit on the focus areas for the 2020/21 milk price calculation review. We support the focus areas selected and have provided some initial thoughts. We are happy to continue engagement on any matters raised in this submission as the Commission works through this season's calculation review. We also note one additional area where we would encourage further review, at the end of this submission.

Asset Beta

The Commerce Commission (ComCom) reached a conclusion in their review of the 2017/18 milk price calculation that the asset beta used in the calculation (0.38) was 'unlikely to be practically feasible'.[1]

This same conclusion was then carried forward into the 2018/19 and 2019/20 milk price calculation reviews with ComCom appearing to go a step further by stating that they 'do not consider that this aspect of the base milk price calculation is consistent with the contestability dimension of the Section 150A purpose'. [2,3]

During this same period, a review of the Dairy Industry Restructuring Act (DIRA) was carried out, concluding in 2020. One of the legislative changes made was in S35 which relates to asset beta. This change will come into effect from the start of the 2021/22 season, amendment below:[4]

(3) For the purposes of subsection (1)(b), any estimate of the return on capital must be made applying the capital asset pricing model.

(4) For the purposes of subsection (3), the asset beta used in the application of the capital asset pricing model must be consistent with the estimated asset betas of other processors of dairy and other food products that are—

> *(a) traded in significant quantities in globally contested markets; and*
>
> *(b) characterised by uniform technical specifications.*

[1] Commerce Commission "Final Report - Review of Fonterra's 2017/18 Milk Price Calculation" (14 September 2018), paragraph 2.5.
[2] Commerce Commission "Final Report - Review of Fonterra's 2018/19 Milk Price Calculation" (12 September 2019), paragraph 2.6.
[3] Commerce Commission "Final Report - Review of Fonterra's 2019/20 Milk Price Calculation" (15 September 2020), paragraph 2.4.
[4] Dairy Industry Restructuring Amendment Act 2020, S35

*(5) In subsection (4), **asset beta** means a measurement of a firm's exposure to systematic risk where systematic risk measures the extent to which the returns on a company fluctuate relative to the equity returns in the stock market as a whole.*

This amendment provides greater guidance around estimating asset beta in the milk price calculation. It makes it clear that a comparator set of dairy and food processors is to be used. This approach, using a comparator sample from within the sector, is consistent with how the Commerce Commission looks at asset beta in other regulated sectors.

Fonterra in turn acknowledged they intend to apply the amended legislation this season, ahead of it taking effect, in their 2019/20 milk price statement:

Fonterra has determined the revised DIRA methodology will be applied to the F21 season asset beta. At the time of preparing this Statement, Fonterra had not finalised the impact of this change on the F21 season WACC.[5]

We believe it makes sense for ComCom to make their assessment of asset beta against the amended legislation this season ahead of it taking effect. With Fonterra applying the amended legislation, identifying the appropriate comparator sample from within the sector and decomposing the asset beta of each selected entity is required.

While additional comparator sample analysis may be completed this season, the work carried out by CEPA and Freshagenda in 2017/18 remains relevant. The output of this work is in the table below (ignore bracketed figures).[6] There is no publicly available comparable sample analysis to the work carried out by CEPA and Freshagenda.

Table 2.1: Asset beta across samples excluding Fonterra, five-year period to 15 January 2018

Chosen sample	Daily		Weekly		4-weekly	
Full sample	0.58		0.50		0.56	
Dairy companies	0.58		0.53		0.59	
Commodity exposed	0.51	[0.53]	0.48	[0.49]	0.54	[0.52]
Cost pass-through	0.53	[0.55]	0.49	[0.51]	0.52	[0.54]
Regulated milk price	0.57		0.49		0.61	
Across all sub-samples	0.56		0.51		0.57	

Source: Bloomberg, CEPA analysis

While there may be additional sector comparators worth consideration, we believe this analysis remains fit for purpose and appropriate for the Commerce Commission to use as reference in their assessment of this season's asset beta estimate. Individual company beta's included in this sample are unlikely to have materially moved since this analysis was carried out.

Our expectation is therefore that the asset beta will fall within the range identified in CEPA's work carried out in 2017/18. The conclusion is summarised below, taken from their initial report published March 2018:

[5] Fonterra milk price statement 2019/20, page 6.

[6] CEPA & Freshagenda "Response to submissions" (14 June 2018), page 7

Our analysis indicates that dairy industry companies are a reasonable proxy for asset betas in the dairy industry in general, and the notional processor in particular. The betas for subsamples of industry comparators are similar, giving validity to the use of broader comparators. The full range of comparator estimates is 0.45 – 0.58, and we have not seen sufficient empirical support for an asset beta below the bottom end of this range.[7]

Specific risk premium & surplus capacity - Rules 33 & 43

We support these focus areas as part of this season's calculation review. Since the last review of these inputs in 2015/16 the national milk volumes have been materially static while Fonterra's share has decreased. There are also several factors that will put pressure on the national milk pool in future years. This submission focuses on milk volumes and provides guidance to ComCom on industry factors worth considering in their review of these inputs.

Fonterra, and by default the notional producer, collected 1,566M kgMS in 2015/16, which was reduced from 1,614M kgMS in the 2014/15 season. Fonterra's average annual collection volumes across the following four seasons has been 1,518M kgMS. This is an average reduction of 48M kgMS on 2015/16.

	Fonterra volumes	National Milk Volume	Fonterra Share
2013/14	1584	1825	87%
2014/15	1614	1890	85%
2015/16	1566	1863	84%
2016/17	1526	1851	82%
2017/18	1505	1839	82%
2018/19	1523	1884	81%
2019/20	1517	1896	80%
Four year average	1518	1867	

There is also growing competition in the farmgate milk market with existing processors attempting to develop their milk supply as well as at least two new processing plants in development in the Waikato. This will only continue to increase the competition for milk in New Zealand and therefore increase the risk of asset stranding making a deeper assessment of this risk and Fonterra's asset footprint appropriate at this time.

There are several additional factors that are causing uncertainty in the dairy industry and look set to put pressure on the national milk pool in coming years. The specific risk premium is designed to compensate for risks that investors in the Farmgate Milk Price Commodity Business would seek compensation for, and which are not otherwise provided for in the Farmgate Milk Price calculation methodology. Rule 43 of the manual related to the specific risk premium reads:

The MPG will determine an updated Specific Risk Premium in a Review Year. In calculating the Specific Risk Premium, the MPG will have regard to:

- *Fonterra's exposure to earnings risk as a consequence of assets being removed from the Farmgate Milk Price Business asset base due either to a shortfall in milk supply or an adjustment to the Reference Basket;*
- *Any other factors which in the MPG's opinion would result in investors in the Farmgate Milk Price Commodity Business requiring additional compensation for risk; and*

[7] CEPA & Freshagenda "Dairy Notional Processors' Asset Beta – Final report" (14 June 2018), page 3

- *The extent to which compensation for such additional risk has otherwise been provided for in the Farmgate Milk Price calculation methodology.*[8]

These risks to the future New Zealand milk pool and investment include:

1. Opportunities to convert non-dairy land into dairy appear very limited. With Nitrogen fully allocated in many areas this makes conversion challenging and will reduce investment. Recent DIRA changes around dairy farm conversions also makes this entry option less attractive to anyone wanting to enter the industry.
2. Land use changes. There is an increasing trend of dairy being converted as returns on other agricultural sectors increase. This is particularly true in the Waikato and Bay of Plenty where high returning alternatives are available in kiwifruit and other horticulture. Land use zoning changes opening dairy land up for housing and commercial use also a risk.
3. The National Environmental Standards for Freshwater have recently been updated with Regional councils responsible for meeting this updated policy with plans required to be publicised by 2023. While the true impact on the dairy industry is not yet fully understood there is an expectation that changes made at regional levels will not support dairy growth and compliance will have an impact on costs for the industry. The uncertainty it is currently creating in the industry is also not supportive of investment.
4. There is uncertainty in the industry around future greenhouse gas management legislation. The intention is to bring dairy into the emissions trading scheme by 2025 at a 95% discount. It is also currently unknown when and how this discount will be wound back. This change will add immediate cost on farm but more importantly the uncertainty about the future will weigh on the industry and likely limit investment.
5. The Climate Change Commission's draft advice for consultation report released in January 2021 also outlined scenarios that would require significant on farm changes to meet targets.
6. Investment in dairying is also being impacted by the perceived elimination of capital gains on dairy farms. Where previously farms could manage on smaller operating surpluses as their assets increased due to the accumulating capital gains this is no longer the case. On top of this recent reserve bank changes to bank lending requirements have seen increasing pressure of dairy farms to pay back more principle as well as interest payments.
7. Additional on farm costs are increasing at an accelerating rate. These include employment, fertiliser, grazing and compliance. Like the legislative and banking changes above this adds additional cost to on farm operations, squeezing profitability and making investment less attractive.

All these factors, putting pressure on future milk volumes and investment in the industry have either intensified or are new since the last time the specific risk premium was reviewed in 2015/16. We encourage ComCom to consider the state of the broader national milk environment while reviewing this input as part of this season's calculation review.

<u>Other matters</u>

The final report on this season's milk price manual review signalled whether the inclusion of Instant Skim Milk Powder in notional producer revenues was appropriate was 'being considered for inclusion in the 2020/21 calculation review'.[9] We encourage the Commission to include this as part of their review along with a deeper assessment of the appropriateness of the 'sub reference commodity products' more generally.

[8] 2020/21 Milk Price Manual rule 43

[9] Commerce Commission "Review of Fonterra's 2020/21 Milk Price Manual" (15 December 2020), page 26.

Kind Regards

Leon Clement

CEO

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