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Miraka Comments to the Commerce Commission in advance of the 2016/17 Milk Price Calculations Review

1.0 Introduction and Purpose

1.1 This paper provides comments to the Commerce Commission on the Fonterra Reasons Paper (2016/17 Milk Price Calculations), and on a paper issued by the Commerce Commission "Concerns on practical feasibility and transparency" dated 19 July 2017. The Fonterra Reason paper was issued as part of the annual review required by the DIRA of the Fonterra milk price calculations. The Commission's paper was issued in response to issues raised by Independent Processors (IPs) at the Milk Price Workshop of 23 May 2017.

1.2 The Commission has also sought comments on two attachments to the Fonterra Reasons paper addressing the asset beta assumption in the Fonterra milk price assumptions, and the Commission's paper "Emerging views on asset beta" dated 20 July 2017. Miraka endorses the Open Country Submission on those papers, and does not otherwise comment in this submission.

1.3 Miraka appreciates the opportunity to provide comments to the Commission on these papers.

1.4 All page references referred in brackets in the below comments are to the Fonterra Reasons paper.

Fonterra Reasons Paper (2016/17 Milk Price Calculations)

2.0 Off-GDT sales

2.1 Notional Producer selling price transparency:

2.1.1 Despite signaling to the Commission that it would provide quarterly reporting on the impact on Notional Producer selling prices from off-GDT sales, Fonterra has failed to provide any reporting. In the Reasons paper, Fonterra remains silent on this failure, and on its future intentions regarding transparency of this change in policy. IPs strongly object that in making the policy change more palatable Fonterra committed to address the underlying transparency issues, when it now appears Fonterra had no intention to do so.

2.1.2 The introduction in mid-2016 of a fee for accessing GDT selling price data was a further instance where the transparency of the Notional Producer selling prices was undermined. Despite the Commission's view expressed in its report on the 2016/17 Milk Price Manual that GDT auction outcomes should be freely accessible, the fee for this data remains in place. While Fonterra owns and could readily waive the fee for this service offering of GDT, its failure to do so further illustrates its reluctance to address a declining transparency in the milk price.

2.1.3 The reduced transparency of the Notional Producer selling prices reduces the predictability of the milk price, and increases margin and liquidity risk for the IPs. It also undermines investment confidence that the milk price is a fair representation of competitive pricing. For publicly listed processors, it also further undermines their ability to provide reliable profit forecasts to NZX.

2.1.4 IPs seek the support of the Commission to ensure Fonterra is accountable for its failure to meet the reporting obligations it made when changing the policy for off-GDT sales. The Commission is further requested to apply its fullest authority in an attempt to change Fonterra's behaviour in this matter.

2.2 Criteria for selecting off GDT sales

2.2.1 Fonterra advises that GDT prices are a "key reference point" (Pg 24) for selecting off-GDT sales. It is disturbingly unclear what this means; for example:

- Are off-GDT sales selected on the basis they fall within a pre-determined price range of GDT prices; if so what is that range; or are GDT prices merely a subjective and therefore flexible "guide", thus rendering the selection of relevant sales subject to manipulation?
- Is there a bias in applying the "key reference point" criteria – e.g. towards prices above GDT prices and against prices below GDT prices?
- If on the other hand included off-GDT sales are very similar to the prices achieved on GDT, what is the purpose of including off-GDT sales?
- Failure to address the precise role of GDT prices in selecting off-GDT sales undermines credibility that the Notional Producer's selling prices have been determined on an objective basis. The IPs seek the support of the Commission to clarify this matter.

2.2.2 Attachment 5 of the Reasons paper expands on "decision criteria" for determining inclusion of off-GDT sales. This delivers little further detail than previously provided. The criteria provide limited clarity, are not self-explanatory, and do not assure an objective approach to the selection of relevant sales. Criteria for included products are undefined and potentially very broad:

- "standard material" is generic and not defined
- "specialised plant or technical resources" are not defined
- "standard product offerings" are not defined
- "standard packaging" is not defined

- "general trade" is not defined (for example, is it limited to products which can directly cascade, without further cost, to existing GDT product specifications)
- Tenders are explicitly excluded for no clear reason; tender sales might for example be excluded on the basis of price, but then they would similarly be excluded under the "key reference price" criteria. Fonterra needs to explain why tenders are explicitly singled out for exclusion.

2.2.3 In summary, the Reasons paper does not properly explain the basis for determining included off-GDT sales. It therefore does not provide assurance that the selection is objective or consistent with the product the Notional Producer is able or resourced to produce, or other aspects of the Notional Producer model.

2.3 Weighting of GDT vs. off-GDT Sales Prices

2.3.1 Fonterra alludes to a process to determine "the proportion of its sales assumed to be undertaken on GDT" (pg 29). The process itself is not explained but would have a material impact on:

- the impact of non-disclosed price data (off-GDT sales) on the Notional Producer prices
- the sales effort (and feasibility of associated costs) needed to support the Notional Producer's new off-GDT sales channel

2.3.2 The Reasons paper needs to be expanded to explain the process for determining the proportion of the Notional Producer's GDT and off-GDT sales.

2.4 GDT – Adjustments to Other Assumptions

2.4.1 In its submission on the Commission's draft report on the 2016/17 Milk Price Manual Fonterra committed to "provide in our reasons paper in respect of the 2016/17 base milk price details of adjustments to other assumptions, including sales costs, which result from the inclusion of additional off-GDT sales".

2.4.2 This latest Reasons paper in fact provides few further details, other than to indicate in the case of selling costs it includes the cost of "maintaining 8 in-market hubs for customer service" (pg 27). No details are provided for the basis for this assumption, or its impact on selling costs.

2.4.3 No further details of adjustments to other assumptions are provided. This is despite introducing a fundamentally different sales channel which would be expected to involve substantial changes in cost. Most significantly, off-GDT sales offerings imply greater flexibility and responsiveness to specific customer requirements. This would directly impact production planning and scheduling, and would reduce plant efficiency relative to the status quo Notional Producer manufacturing endlessly long runs in single product factories. The introduction of the off-GDT sales channel [1] requires a reassessment of manufacturing efficiency. This issue is further considered in 3.2 below.

[1] While Fonterra has previously included off-GDT sales to determine the selling prices for BMP and Butter, the impact has been very small and has therefore evaded scrutiny and proper consideration. The introduction of off-GDT sales for powders and AMF has now fundamentally changed the nature and scope of the off-GDT sales platform. It is now necessary to properly scrutinise the ability of the Notional Producer assumptions to sustain that platform.

3.0 Production Losses/specification offsets/plant operating efficiency

3.1 Fonterra continues to take an unnecessarily opaque approach with regard to losses and yields. At page 21 overall loss levels and specification offsets are redacted. Fonterra points out that those loss and offset levels are not the same as Fonterra actual outcomes. The Notional Producer losses are therefore neither commercially sensitive nor confidential, including because they are at a fully aggregated level. The redaction therefore seems cynical and Miraka concludes Fonterra is unable or uncomfortable with defending the practical feasibility of the losses and offsets.

3.2 The Notional Producer achieves extremely high production efficiency and yield performance on the basis of its assumed single product factories. This results in assumed very long production runs of a scale which cannot be achieved by any real world processors in New Zealand. The Reasons paper confirms in Attachment 4 that Fonterra itself has higher losses and lower production efficiency as a result of shorter production runs. This reflects Fonterra's "real world" product mix and production complexity. While the Notional Producer enjoys the substantial production efficiency gains of its single product factories, at the same time its selling prices have always incorporated some revenue uplift from a wider range of products than actually produced[2]. The inclusion of off-GDT sales looks set to further expand that revenue uplift. That uplift reflects the higher earnings Fonterra achieves as a result of product differentiation and the marketing advantage it enjoys from offering a wide range of product and service offerings. With the further encroachment (off-GDT sales) of a revenue base not supported by the Notional Producer production assumptions, it is increasingly unsupportable that the efficiency gains from long production runs would remain practically feasible and consistent with revenue assumptions. This requires closer scrutiny in the milk price review this year.

4.0 Reduction in peak milk

4.1 The Notional producer has "mothballed" five plants on the basis of a decline in peak milk in the 16/17 Season (pg 34). For purposes of the Notional Producer, Fonterra is assuming that peak milk supply will continue down over the medium term. No explanation is provided. It will have resulted in a material and ongoing reduction in plant operating costs. It is unclear how or if the Notional Producer has addressed capital cost write-offs that should also be associated with redundant capacity.

4.2 While Fonterra is assuming the Notional Producer has a medium term decline in peak milk, at the same time it is projecting a 3.2% increase in its actual milk volume in 2017/18. The projected reduction in peak milk must therefore be due to a flattening in the Notional Producer's seasonal milk curve. There is no obvious reason for this assumption. Fonterra needs to justify why the notional producer milk curve has flattened thus allowing a reduction in peak processing capacity (and costs).

[2] These concerns are not alleviated by the fact that observed selling prices for non-standard specification product are adjusted to reflect cost differences. This is because the principles for determining cost adjustments (e.g. treatment of variable costs, and fixed and overhead cost allocations) are not transparent, let alone the quantum of the adjustments themselves.

5.0 Milk Collection Costs

5.1 The Notional Producer milk collection cost are not internally consistent. The Notional Producer is assumed (pg 15) to:

- have the same number, location, and total capacity as Fonterra; and
- annual milk volumes processed at the Notional Producer sites are materially aligned to milk volume at the "matched" Fonterra sites

5.2 The Notional Producer is also assumed to move milk between sites to maximise the time factories remain full (attachment 4). Given the time factories are full ("over 85-90%" of their operating days), it would appear these inter-site diversions of milk are much larger than actual Fonterra diversions.

5.3 By contrast, the Notional Producer milk collection costs are based on Fonterra actual costs <u>but exclude inter-factory diversion costs and inter-island transport costs</u> (pg. 31). Given the alignment of Notional Producer plants and milk volumes to the Fonterra actual network of plants, there is no reason to exclude Fonterra diversion/inter-island milk transport costs. Furthermore, given the assumption that the Notional Producer achieves an extraordinarily high plant utilisation during operating days as a result of inter-site transfer of milk, it would be expected the Notional Producer would incur <u>more</u> diversion costs than Fonterra.

5.4 The Commission has previously advised it is satisfied that the production efficiency is feasible based on an assumed ability to move milk between sites. The Commission has not however addressed the underlying impact that would have on milk collection costs, or even if the Notional Producer has the logistics capacity to move the necessary volume of milk.

6.0 Direct Labour

6.1 The Notional Producer uses "materially fewer plant labour FTEs than are actually engaged by Fonterra" (pg 34). Fonterra does not clarify or justify this assumption, other than that "consequently, any savings in unit costs by Fonterra will result in higher earnings, and therefore be incentivised to minimise unit labour costs". Taken on face value, and in the absence of a proper explanation, it must be concluded the FTEs have been artificially reduced for no other reason than to incentivise a reduction in Fonterra actual labour costs. The Commission is requested to review the practical feasibility of the Notional Producer FTEs.

7.0 Lactose Cost

7.1 The Notional Producer policy for determining lactose cost (pg 29) continues to be an "after the event" assessment based on the lower of cost alternatives. It therefore continues to be not practically feasible. The Commission noted this failing in its review of the 2015/16 Milk Price Calculations. Fonterra's footnoted further explanation (note 20) seems out of step with the policy leaving the Fonterra approach muddled at best.

<u>Commerce Commission Paper: Concerns on practical feasibility and transparency</u>

8.0 Practical Feasibility:

8.1 The Commerce Commission asserts that the IPs criticism of its approach to assessing practical feasibility is unfounded. It states that it is already assessing practical feasibility consistent with the framework that IPs had raised in the Milk Price Calculations workshop (23 May 2017). Miraka does not agree with the Commission. As outlined in the workshop, IPs had hoped to identify "common ground" in the approach to determining "practical feasibility" to:

- Establish a basis for participation of all parties (in the review process)
- Strengthen the milk price model
- Strengthen the monitoring process

The Commission's paper indicates the workshop was unable to make any progress on finding common ground. Miraka considers this significantly handicaps its participation in the DIRA annual milk price review processes.

8.2 At paragraph 11 of its paper, the Commission states "the IP's view is that there should be flexibility and discretion when applying the safe harbours" (found in Section 150B and S 150C). That misstates the IPs position. Rather, in relation to S150B, IPs pointed out the provisions in that section are not mandatory and so there IS flexibility and discretion available to Fonterra in applying those safe harbours. The fact that Fonterra chooses to exploit those provisions and which results in assumptions which are not commercially feasible undermines the credibility of a commercial or real world assessment of practical feasibility of the milk price assumptions and calculations. This failure also substantially limits the ability of the IPs to provide meaningful input to an assessment of commercial feasibility as any input is rejected because of the safe harbours. In relation to S 150C, these are clearly mandatory and IPs have never asserted they can be applied with discretion.

9.0 Transparency

9.1 IPs sought that the Commission take a more proactive position to include consideration of matters of transparency in its assessment of Fonterra's compliance with the DIRA. The Commission has concluded the DIRA does not permit it to consider transparency as a matter for determining compliance with the DIRA. Miraka does not agree with this position. In any event this confirms our concern that the Commission's role in reviewing the milk price is not able to assure compliance with the S150A purpose of the DIRA: "the setting of a milk price that provides….for contestability in the market for the purchase of milk from farmers". Proper standards of transparency are a prerequisite for achievement of that purpose.

Miraka would welcome an opportunity to discuss these comments with the Commission.

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