Dear Leighton

Submission on the Commerce Commission's Process and Issues Paper – Review of 2015/16 Base Milk Price Calculation

Open Country Dairy (Open Country) is pleased to make this submission on the Commerce Commission's (Commission) Process and Issues Paper (Process Paper) for the review of the 2015/16 base milk price calculation.

Open Country supports the Commission's proposed approach

In summary, Open Country broadly supports the Commission's proposed approach and process for the upcoming review. We also suggest some additional areas of focus.

Open Country is pleased the Commission is engaging its own independent expert to peer review the Fonterra-commissioned report on the notional processor's asset beta and the specific risk premium for asset stranding (The Marsden Report). We reiterate that the asset beta is a key parameter, and Open Country is concerned that it is currently set too low. We look forward to this positive step in the maturity of the milk price monitoring regime, and added consistency with the Commission's practice for other regulated businesses.

We also appreciate the Commission consulting in January on the milk price calculation process. This provides stakeholders more time to contribute to the Commission's process. It will also provide the Commission with more time to carry out its review, and to engage independent experts to critically analyse information put forward by Fonterra. We hope this will also lead to more timely decisions on how to improve the practical feasibility of the milk price. In the past, Fonterra has not implemented the Commission's recommendations in the manual for the coming season—waiting until the following season to do so. This has effectively created a 2-year lag between an issue being identified and being resolved. Accordingly, we also see earlier consultation as an opportunity to push for shorter implementation timeframes.

We suggest additional areas of focus for the review

Set out in this submission we provide comments on the following issues as part of the Commission's review process:

- The scope and focus of the independent review of the notional processor's asset beta and specific risk premium for asset stranding
- The Commission's detailed review of Fonterra's performance compared with the notional processor
- The inclusion of winter milk premiums as a cost in the milk price model
- The inclusion of financing costs associated with farmer support in the milk price model
- The practical feasibility of capital and operating cost assumptions
- Further transparency in the milk price monitoring regime
- The Commission's proposed reliance on reports by the Milk Price Panel as part of the regulatory process.

The scope and focus of the independent review of the notional processor's asset beta and specific risk premium for asset stranding

Open Country is pleased that the Marsden Report will now be subject to external peer review by an expert engaged by the Commission. Open Country has consistently maintained that the WACC is too low—in particular the asset beta. Because of the dominance of capital costs in the cost profile of milk processing, this has been a major driver of the lack of practical feasibility in the milk price. Subjecting the Marsden Report to external peer review by a Commission-appointed expert is an important step forward in the maturity of the regime. To maximise the value of that review, the scope for the review should include:

- **Reviewing and commenting on the additional report Fonterra has engaged Dr. Marsden to prepare.** Given that Dr. Marsden is preparing a supplementary report, the peer reviewer should have the benefit of reviewing Dr. Marsden's response to points raised by the Commission and other stakeholders
- **Reviewing submissions by stakeholders on the milk price manual and calculation reviews over the last three seasons.** As an industry, we have built up significant expertise on how the manual works and its various shortcomings. Since estimating an asset beta requires a strong understanding of what the notional processor represents, simply responding to Dr. Marsden's reports would fail to benefit from all the work done by other stakeholders and by the Commission on the milk price manual and calculation. Accordingly reviewing that work should be an essential part of the review. It would have helped to avoid some of the queries that arose on the Marsden Report—for example an over-emphasis on notional inputs when they are or are derived from actual inputs. We are not suggesting that the peer reviewer must respond to all points made by stakeholders—simply that all submissions must be considered and taken into account in forming the expert's view.

To provide clarity on the scope of the review, we ask that the Commission release the terms of reference for the peer reviewer ahead of the reviewer being engaged. We also request that the supplementary report Fonterra has commissioned Dr. Marsden to prepare is also released at the earliest opportunity. This will provide stakeholders the time to review this report and help contribute to the Commission's process.

The Commission's detailed comparative review of Fonterra's business units and the notional processor

Open Country welcomes the Commission's detailed comparative review of Fonterra's performance with the notional milk processor. We believe this will help to highlight areas for improving the practical feasibility of the milk price calculation.

The Commission has suggested that its review process focus on EBITDA and depreciation separately. In addition, to analyse a comparable EBITDA, the Commission will seek to isolate the revenues and costs associated with Fonterra's production of the Reference Commodity Products (RCPs) from the rest of Fonterra's Global Ingredients and Global Operations units (formerly NZ Milk Products (NZMP)).

The overall goal of the Commission's review should be to determine the size of the performance gap between Fonterra's equivalent business and the notional processor. We agree that it will be useful to construct a Fonterra 'comparator' by adjusting Fonterra's NZMP business unit so its asset footprint and product lines approximate that of the notional processor. As the Commission notes, this process faces methodological challenges, including in relation to allocating common costs. In addition, the notional processor has the same asset footprint as NZMP does now. As a result, for any measure of absolute levels e.g. of EBITDA, the comparator's production levels would need to be scaled up to the notional processor's size for such comparisons to be made.

Open Country suggests that the Commission focus on the following key performance metrics:

- Yield of product output in weight and value in proportion to kgMS of supply
- Gross profit as a percentage of sales
- EBITDA/assets
- EBITDA/sales.

It is important to analyse EBITDA as a proportion of assets because it recognises that fixed costs dominate the milk processing business. Any significant divergence in capital costs should therefore show up as contributing to the notional processor having a higher EBITDA/assets ratio than Fonterra.

The inclusion of winter milk premiums as a cost in the milk price model

Open Country reiterates that Fonterra's current approach to winter milk premiums is not practically feasible. As noted in our submission on the 2014/15 milk price calculation, the failure of Fonterra to account for the cost of purchasing winter milk artificially inflates milk volumes by approximately 5%. Given DIRA permits Fonterra to assume that milk volumes collected by the notional processor are those of Fonterra, satisfying practical feasibility calls for the full cost associated with collecting winter milk to be included as an input cost in the model.

The inclusion of financing costs associated with farmer support in the milk price model

Open Country reiterates that the best way to support farmers is by also ensuring that support given by Fonterra is consistent with DIRA and competition law. Interest-free loans are a cost for Fonterra because Fonterra must pay financing costs to raise the capital to make the loans. These financing costs are material—and were cited as one of the reasons for Fitch Ratings downgrading Fonterra's credit rating in October last year.[1] The interest-free loans also pose potential risks for open exit of farmers from the cooperative.

We support the Commission's statements as part of the review of the milk price manual that the way Fonterra funds the support loans is irrelevant—they are a cost Fonterra bears and so must be incorporated into the milk price calculation.

We urge the Commission to push for the inclusion of these costs in the milk price model. While it is unclear at this stage how long the farmer support loans will be available for and what the aggregate size of the loans will be—that does not change the policy justification for including the costs in the model. In addition, Castalia provided a methodology for quantifying these costs that takes into account the changing loan pool over time in submissions as part of the 2014/15 milk price calculation.

The practical feasibility of capital and operating cost assumptions as part of the aggregate review

The Commission intends to carry out an aggregate review of how various components of the milk price calculation work together. As Open Country has noted in past submissions, practical feasibility is determined by how components function together as part of the notional processor's business. For example, whether the notional processor has enough 'buffer' capacity at each of its plants in a given season depends on various factors including milk supply, the types of plant it has and how much it spends on transport.

As Open Country has submitted in the past, we request that the Commission focus on the following component relationships of greatest concern (with the relevant components stated in brackets):

[1] Reuters 'Fitch Downgrades Fonterra to 'A'; Outlook Stable' 21 October 2015, accessible at this link.

- Whether the notional processor's costs reflect all the plant needed to process the assumed amount of milk it earns revenue on in the season (capital costs determined based on a forecast of milk supply, and revenues determined based on actual milk supply)[2]
- Whether the notional processor can always produce the profit-maximising product mix given its assumed fixed assets (phasing of milk supply, buffer capacity, plant type and specification, and transport costs)
- Whether the notional processor can allocate input milk to RCPs in the way it assumes (buffer capacity, plant type, and specification)[3]
- Whether the notional processor's assets are always in the right place when regional milk supply varies (assumed buffer capacity, plant location, and transport costs).

In forming Open Country's view on practical feasibility in the aggregate, Open Country has used two 'lenses' which might be helpful for the Commission:

- Looking at the notional processor as a functional business, working through what it could have produced (and what it would have cost to do so) in the relevant season, including taking into account seasonality, production constraints during peaks and prevailing commodity prices
- Identifying the risks the notional processor faced in the season, and reconciling each risk with how it has been treated in the milk price calculation (such as the risk of under or over supply of milk).

Further transparency in the milk price monitoring regime

Open Country supports the Commission's process and is pleased the Commission is moving toward greater transparency within its mandate under the Dairy Industry Restructuring Act 2001 (DIRA). Open Country considers that there are further opportunities to improve transparency—and we repeat below our earlier request that the Commission push for transparency on the following matters:[4]

- The sales phasing used in the model that, when matched with the prices on GlobalDairyTrade for each contract period, determine the notional processor's revenues
- The level of buffer capacity Fonterra assumes the notional processor maintains
- Fonterra's approach to scaling back its reported, publicly available costs to reach the costs of the notional processor.

The Commission's proposed reliance on reports by the Milk Price Panel as part of the regulatory process

The Commission has raised the prospect that in some way it might seek to rely on the views of or reports obtained by the Milk Price Panel in carrying out the Commission's regulatory function. Under Fonterra's constitution, the Milk Price Panel is simply a committee established by Fonterra's Board of Directors. Accordingly, the Milk Price Panel is not independent from Fonterra, and we caution that analysis undertaken

[2] See Castalia "Analysis of Fonterra's 2013/14 Milk Price Calculation: Report to Open Country Dairy" dated August 2014 at Section 2, acknowledged in Commerce Commission "Dairy Industry Restructuring Act 2001: Review of Fonterra's 2013/14 Base Milk Price Calculation – Final Report" dated 15 September 2014 at 2.5.2.

[3] See Open Country Dairy "Submission on the Commerce Commission's Draft Report – Review of Fonterra's 2014/15 Milk Price Manual" dated 18 November 2014, at page 7.

[4] First highlighted in: Open Country Dairy "Submission on the Commerce Commission's Draft Report – Review of Fonterra's 2014/15 Milk Price Manual" 18 November 2014.

by the Milk Price Panel cannot be considered a substitute for the Commission's own analysis and for the performance of its regulatory role under DIRA.

Conclusion

Open Country looks forward to reviewing the independent reviewer's report on the notional processor's asset beta and risk premium for asset stranding, and to continuing to engage in the review of the 2015/16 milk price calculation. The Commission's recent engagements with industry have been well-received, and Open Country would welcome further meetings with the Commission to discuss the issues outlined in this submission further.

Best regards,

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Chief Executive Officer

Open Country Dairy Ltd