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Matthew Lewer
Regulation Development Manager
Regulation Branch
Commerce Commission
PO Box 2351
Wellington 6140.

By email: regulation.branch@comcom.govt.nz

Miraka Submission to the Commerce Commission:
Draft Report (17 August 2020): Review of Fonterra's 2019/20 base milk price calculation

Miraka appreciates the opportunity to submit in response to the Commerce Commission Draft Report on the 2019/20 Milk Price Calculations. Miraka is available and would welcome any opportunity to discuss the contents of this submission with the Commission.

This submission includes headings which contain paragraph numbers. The paragraph numbers refer to the Commerce Commission Draft Report on its review of the 2019/20 Base Milk Price Calculations.

Asset Beta: paragraph 2.3ff.

1 The Commission confirms for the second consecutive year that the asset beta is unlikely to be practically feasible and is likely understated. This results in an understatement of the WACC and thus inflates the Base Milk Price

2 It is frustrating that apart from pointing this out, the Commission cannot further sanction Fonterra for inflating the Base Milk Price. While the Commission first concluded the asset beta was "unlikely to be practically feasible" in 2017/18, the Commission has raised ongoing issues with the asset beta and other aspects of the WACC calculations since the inception of its milk price reviews for the 2012/13 Season. Seven years later the issues remain unresolved and the DIRA has been ineffective in preventing an unrealistically low WACC from inflating the milk price for that entire period[1]. This adds weight to Miraka long held view that Fonterra systematically chooses milk price processes which favour an increase in the milk price while avoiding processes which might reduce the milk price. The effect of this is to subsidise its milk supplying members at the expense of other investors in Fonterra. At the same time, and contrary to the purpose of the DIRA, it enables Fonterra to exert market dominance to set a milk price higher than would be the case in a properly competitive market, in a bid to damage competitor profits and sustainability.

[1] After seven years, only Parliament has been able to force compliance on Fonterra although it remains to be seen whether the August 2020 DIRA Amendment will achieve the required outcome.

Qualifying materials Paragraph 2.18 ff

Product definitions

3 Fonterra uses a plethora of terms to describe and define the products the Notional Producer is deemed to manufacture or sell. Thus we have:

- Primary Reference Commodity Product
- Reference Commodity Product
- Standard Specification Product
- Qualifying Material
- Qualifying Reference Sale

4 The resulting definitional complexity arises because on the one hand the Notional Producer is a simple highly efficient producer of just 5 commodities, while on the other hand it is deemed to be a sophisticated marketer of a wide range of products through multiple sales channels. The definitional complexity arises to justify pushing the square peg of the Notional Producer marketer (multiple products and multiple sales channels) into the round hole of the Notional Producer manufacturer (highly efficient factories manufacturing endlessly long runs of single products).

5 To the dizzying array of definitions it seems "sub Reference Commodity Product" must now be added (Draft Report paragraph 2.20). Fonterra appears to use this new category of product to further explain the nature of "qualifying materials" as "relatively undifferentiated commodity products".

6 The Commission states at paragraph 2.20 that Medium Heat Skimmilk Powder (MH SMP) is a "relatively undifferentiated commodity product". The Commission goes on to describe it as a "sub Reference Commodity Product" on the grounds that Dairy America also sells a product on GDT which has "essentially identical technical specifications". This argument is redundant and bewildering. MH SMP **IS** and has long been accepted to be the "standard specification product". By definition, it is therefore "representative of an undifferentiated [SMP] commodity product and which Fonterra manufactures in material quantities"[2]. As the "representative" product, it is of course a "qualifying material" – the "sub Reference Commodity Product" concept is accordingly unnecessary and adds no new understanding or meaning to "qualifying materials". On the other hand, the Standard Specification Product (MH SMP in the case on which the Commission focuses) is a meaningful concept which is fundamental to the design of the Notional Producer model. It is the benchmark against which to assess or set key assumptions in the model – i.e. the Standard Specification Products are the benchmark for:

- Defining and determining the capital and operating costs of the Notional Producer's standard plants
- Determining the plant throughput for purposes of sizing and/or determining the number of plants
- Measuring production efficiency and yield
- Determining selling price for the Notional Producer SMP
- <u>And should therefore be a benchmark for validating Qualifying Materials</u>

[2] Section 1.1 of Part C of the Milk Price Manual (meaning of Standard Specification Product). Should there be any remaining doubt about the nature of MH SMP, it is also the product selected by NZX to settle its SMP commodity futures contracts. In the 12 months to August 2020 for example, an equivalent of over 36,000 MT of futures contracts have been settled against Fonterra GDT prices for MH SMP.

7 Qualifying Materials are required to be "relatively undifferentiated commodity products". "Relatively" implies comparison: the qualifying material should not vary significantly from a recognized benchmark of an "undifferentiated commodity product". That "undifferentiated commodity product" is precisely how the Standard Specification Product is defined. The comparison for determining "relatively undifferentiated" should accordingly be based on a comparison (price, specification, manufacture, widespread availability, etc) of the qualifying material to the Standard Specification Product. It appears that comparison has not been considered. Rather the Commission has focused on confirming that a Standard Specification Product (MH SMP) is itself a Qualifying Material". This is in fact the only Qualifying Material for which it is unnecessary to be demonstrated to be "relatively undifferentiated commodity": it is already the accepted benchmark.

8 At paragraph 2.20 the Commission indicates that Fonterra also considers Instantised SMP (ISMP) is a "sub Reference Commodity Product" and it has thus been classified as a Qualifying Material. Had the Commission focused on ISMP instead of MH SMP as a "relatively undifferentiated product", the Commission might have drawn some different conclusions. In its discussion of MH SMP the Commission seems to have focused on product composition to confirm "uniform technical specifications". Technical specifications however go well beyond the composition of the product. While composition of ISMP is for example the same as MH SMP, the product itself is significantly different because of its functional properties – i.e. its solubility in water. This is achieved through differentiated manufacturing practice, requires manufacturing knowledge and expertise beyond the benchmark commodity SMP, is difficult to manufacture (many suppliers of SMP cannot or will not make it), and it would typically require specialized plant (plant not required in the manufacture of the benchmark product – MH SMP)[3]. As a result of these factors, ISMP is in short supply, and commands a substantial price premium above MH SMP. ISMP is therefore NOT a "relatively undifferentiated product" and is not in fact a "commodity".

9 As the only Qualifying Material now disclosed apart from the Fonterra GDT sales, ISMP will be repeatedly referred to throughout the remainder of this submission to question the draft conclusions the Commission has made from its review of the off-GDT sales included in the milk price calculations.

ISMP and other criteria for qualifying materials

10 In reviewing the definition of "Qualifying Material" the Commission appears to have focused on the requirement that they comprise "relatively undifferentiated commodity products". It has further narrowed that to whether the product is "characterized by uniform technical specifications" and has again narrowed that to an assessment of product composition. The Commission seems then not to have assessed other requirements that the product:

- Would "transact at a comparable price to other products"
- Be a "standard product offering"
- Be manufactured without the use of "specialised plant"

11 In addition to failing the "relatively undifferentiated commodity" test, ISMP would also not meet the above further tests:

[3] In the absence of specialized plant, the operation of a standard SMP plant would decline and/or product quality would be impaired.

- Price – price for ISMP reflects its limited supply and strong demand; it sells for significant price premiums over the benchmark commodity product (MH SMP) and as such cannot be considered to be "a comparable price to other products"
- Standard Product Offering – a "standard product offering" is defined as being either a product that is:
  - sold on GDT; or is
  - a generic product specification

  ISMP is not sold on GDT. To be a standard product offering (and a "qualifying material") it must therefore be classifiable as a "generic product". The Milk Price Manual definition of "generic product" is so wide as to be largely meaningless with the exception that a generic product must be able to be "substituted for other Standard Product Offerings". There can be no question that "other product offerings" (other SMP products) cannot be substituted for ISMP for the simple reason they are not "Instantised". ISMP could also not be substituted for other standard SMP products because that substitution would never be commercially justified (price).
- Specialised Plant – For efficient plant operation, ISMP requires specialized equipment which is not required for standard commodity SMPs.

Full list of Qualifying Materials

12 ISMP is the first new "qualifying material" identified by the Commission or by Fonterra since Fonterra expanded the revenues of the Notional Producer to include off-GDT sales of WMP, SMP and AMF. It is then particularly disturbing that this single disclosure turns out to be a product that should not have been classified as a qualifying material. Rather than allay concerns, the Commission explanation of qualifying materials as discussed above heightens those concerns. The need for Fonterra to provide full disclosure on the actual products included as qualifying materials is now urgent. Given these products are supposedly "generic product specifications" there can be no commercial reason for failing to make this disclosure.

Open-ended Definitions

13 At paragraph 2.25 of the Draft Report, the Commission states that a concern of Miraka with regard to qualifying materials is the "open-ended nature of the definition of Standard Product Offerings". The Commission seems to have addressed this "open nature" not by considering the actual Qualifying Materials but by assessing the number of products classified as Qualifying Materials. At 2.30 the Commission concludes there "has been only a slight increase in the net number of products added" as qualifying materials. On this basis the Commission concludes there has been "no systematic inflation of off-GDT prices by simply increasing the range of Qualifying Materials". Without further evidence, at 2.32 the Commission then concludes it is satisfied that "the range of products assumed to have been sold off GDT constitute Reference Commodity Products". It is unclear why the number of product specifications included as "qualifying materials" is relevant to concluding the products should be classified as qualifying materials. It is also unclear why the number of products (changing or otherwise) provides assurance that the open ended nature of the definition of qualifying materials has not been exploited by Fonterra. The only actual example provided for a qualifying material introduced as a result of the inclusion of off-GDT sales (ISMP) provides evidence to the contrary.

14 The Commission is requested to reconsider its findings in this matter.

Standard Plant – paragraph 2.33 ff

15 In this section of the Draft Report the Commission poses and responds to the question "Is it practically feasible to manufacture all Qualifying Materials on Standard Plant". At 2.34, the Commission concludes that because the range of qualifying materials is in fact manufactured by Fonterra on plants that are equivalent to the Notional Producer Standard Plants, "the production efficiencies assumed are consistent with the actual production of the portfolio". Providing no further evidence, at 2.37 the Commission concludes that "the qualifying materials can be manufactured on Standard Plant without significant modifications and therefore their inclusion in the base milk price is practically feasible". It is difficult to unpack what the Commission is saying here. Miraka suggests the following interpretation and requests the Commission confirm if it is correct:

- The Commission has concluded that the manufacture of any and all qualifying materials do not require "specialized plant" and that the Standard Plants are therefore configured and include all capital and operating costs required to manufacture the qualifying materials
- The Commission concludes that the manufacture of qualifying materials has no adverse impact on the manufacturing costs and efficiencies (including yield efficiency) attributed to the Notional Producer long production runs of the standard specification products.

16 In the absence of clarity, the above is a Miraka interpretation of what the Commission has concluded and Miraka requests the Commission to respond to this interpretation.

17 Miraka nevertheless notes that at least in the case of ISMP, the product either requires specialised plant or will result in reduced plant operating efficiency and increased downgrade product. At least in that case, the Commission conclusions (as interpreted by Miraka) do not appear to be correct.

18 The Commission is requested to reconsider its findings in this matter.

Selling price criteria for Qualifying Materials and for Qualifying Reference Sales - paragraph 2.39 ff.

19 Qualifying materials are expected to "transact at a comparable price to other products within the same Reference Commodity Product[4]". Further, "qualifying reference sales" are sales of qualifying materials that "can reasonably be regarded as being at arm's length terms at a price that reflect prevailing prices[5]".

20 At paragraph 2.42, the Commission describes the information it has sought and received from Fonterra to assess whether qualifying reference sales comply with these requirements. Included are:

- "circumstances in which a sale is considered not to have been conducted at prevailing prices"
- "criteria by which sales constitute tender sales" and "formulaic sales"

Prevailing Prices

21 It is unclear why the Commission formulated the first question above in the negative ("…not to have been conducted…"). This has allowed Fonterra to avoid explaining or defining

[4] Section 1.2 of Part C of the Manual (meaning of Qualifying Material)
[5] Section 1.2 Part C of the Manual (meaning or Qualifying Reference Sales)

"prevailing prices". The Draft Report thus remains silent on what "prevailing prices" might mean or how they are determined[6].

22 It would be appropriate that a prevailing price benchmark would be set by reference to arms-length prices for the acknowledged and representative undifferentiated commodity product for each product group (i.e. the standard specification product sold on GDT). It is however apparent that "prevailing prices" means anything Fonterra decides it means at any particular point in time. This appears to be accepted by the Commission. At paragraph 2.43, the Commission describes that Fonterra concludes a sale is at a "prevailing price" if it conforms to a Fonterra internal control process for approving selling prices for sales made off GDT. A sale of any qualifying material will be deemed to be "at prevailing prices" if the sale is priced "by reference to the relevant "current market price". "Current market price" is undefined but by context it is the price that Fonterra sets from time to time as part of its internal control process for managing contract pricing. Any "current market price" might or might not be linked to an external arms-length price and it might or might not be set systematically and consistently over time. We simply don't know and the Commission does not appear to have enquired. To be approved, prices are also required to achieve a "target margin" presumably above the "current market price". Senior management can "agree to proceed with at [sic] prices that do not achieve the target margin" although these are a "small subset of sales".

23 In summary, Fonterra includes any sales (other than tender or formulaic sales) of qualifying material as "qualifying reference sales" provided they meet a target margin <u>above</u> an undefined "current market price". Off-GDT selling prices included in the milk price calculations therefore will typically have selling prices that are higher than "current market price". Depending on how Fonterra sets "current market price" it appears that prices will also be "higher than prevailing prices". In any event, and contrary to the Milk Price Manual, there is no demonstrated process that assesses off-GDT sales for inclusion in the milk price calculations on the basis they "can reasonably be regarded as being at arm's length terms at a price that reflects prevailing prices".

24 Because ISMP is incorrectly included as a "qualifying material", sales of ISMP will also be included as qualifying reference sales. ISMP prices will of course meet the Fonterra internal control process (prices will be materially higher than any measure of "current market price" for standard SMP commodities). There is therefore no filter that identifies and assess higher selling prices to consider the reasons for that higher price. Had there been a filtering and review process, ISMP would have been removed from qualifying materials.

25 The Commission is requested to explain how it has concluded that the process for determining qualifying materials and qualifying reference sales "does give rise to pricing that could be achieved by the Notional Processor selling Reference Commodity Products at arms-length in freely contestable markets", including how the Base Milk Price calculations provide assurance that included off-GDT sales are transacted at "prevailing prices". As part of this, the Commission is asked to seek an explanation from Fonterra as to how it determines "current market prices", why Fonterra considers this process reflects "prevailing prices", and why (as seems the case) the benchmark Standard Specification Products would not be used as the benchmark for determining "prevailing prices".

[6] At 2.41.4 the Commission explained that in its review of the 2019/20 Milk Price Manual, it concluded the further disclosure of "what prevailing prices means" … "would better promote the purpose of subpart 5A". This would indeed have been useful but the Commission now appears to have put that objective aside.

Tender sales and formulaic sales

26 At paragraph 2.43, the Commission reports Fonterra's clarification that tender sales comprise sales to "government purchasing agencies" and that these are excluded from qualifying reference sales because "government tenders … are not freely contested global markets". Fonterra has provided a range of reasons for this conclusion. Those reasons deflect from the fundamental commercial reason Fonterra participates in these sales.

27 Government tender sales are typically priced below "prevailing prices". Fonterra is not driven by altruistic principles to participate in these lower price sales. Fonterra participates because they provide an opportunity for large placement sales, removing significant volumes from general traded markets which would otherwise reduce Fonterra prices in those markets. This is a win/win and makes commercial sense: scale purchasing power meets scale production looking for placement sales. It is however a direct consequence of the Fonterra scale. While the Notional Producer matches the Fonterra scale and "banks" the cost and efficiency advantages of scale, by excluding tender sales it excludes the scale disadvantage of production of large volumes of commodities. Of course, the Notional Producer manufactures commodities at an even larger scale than Fonterra, and in the real world would participate in even more tender or placement sales than the real world Fonterra. The exclusion of tender sales from the Notional Producer revenues is further evidence that as modelled by Fonterra, the Notional Producer delivers revenues that are unsustainable by comparison with is scale and costs.

28 It is less clear that "formulaic" sales involve an element of discounted placement sales. Formulaic sales are though likely to include sales to large and key customers where the price formula will reflect preferential pricing by reference to an external arm's length price (e.g. GDT prices, or prices to other classes of customers). This is likely to mean that formulaic sales overall deliver selling prices that are lower than prices for qualifying reference sales ("current market price" plus a target margin).

29 In summary, the process of selecting qualifying material and qualifying reference sales weights the Notional producer selling prices towards the top end of Fonterra commodity selling prices. At the same time the process of excluding tender sales, and possibly formulaic sales, excludes that part of the Fonterra commodity portfolio sold at the lower end of the price range. There appears no new evidence to counter the Miraka view that Fonterra uses the process for including off-GDT sales to increase the Notional Producer revenue to a level that is unsustainable by comparison with the Notional Producer scale costs and operating efficiencies based on producing just five individual products.

30 Miraka requests the Commission reconsider its finding that the process for determining qualifying materials and qualifying reference sales "does give rise to pricing that could be achieved by the Notional Processor selling Reference Commodity Products at arms-length in freely contestable markets".

Transparency of off-GDT sales

31 At 2.47 the Commission seeks views on further disclosures regarding off-GDT sales which would facilitate meaningful stakeholder engagement.

32 Miraka has previously submitted on areas where increased transparency is required. In summary these are:

Quarterly disclosure of the impact of off-GDT sales

33 Fonterra currently provides informal and ambiguous reports on off-GDT sales in its monthly Global Dairy Updates. To date three updates have been provided in the 2019/20 Season:

- November 2019 GDU ("to 31 October 2019")
- In the March 2020 GDU ("to 31 January 2020")
- In the May GDU ("to 30 April 2020").
- A further full year update can be expected to be provided in Fonterra's Annual Farmgate Milk Price Statement in September.

34 By contrast, compliance with a formal quarterly update would at minimum require a reporting calendar as follows:

- November (reporting on three months to October for the current season)
- February (reporting on 6 months to January)
- May (reporting on 9 months to April)
- August (reporting on 12 months to July)
- Annual FGMP Statement (reporting on the 15 months sale period from which the Notional Producer selling prices are drawn).

Global Dairy Update

35 The GDU is not an appropriate place for reporting on off-GDT sales. It is not relevant to the purpose or the general users of the GDU. The off-GDT sales reports are for example currently provided in an informal manner, most recently as a note in the "Fonterra Milk Collection" section of the GDU. The reports have no relevance to Fonterra milk collections. Miraka has previously and continues to recommend that the off-GDT reports should be included as a formal and separate section within the Farmgate Milk Price page on the Fonterra web-site. The reports should be issued in accordance with a fixed and pre-circulated calendar (as described above).

Ambiguity

36 The off-GDT reports currently provided by Fonterra are ambiguous. This needs to be corrected. By way of illustration, the most recent update states:

"The inclusion of off-GDT sales contributed 11 cents per kgMS to the Milk Price for the season to 30 April 2020."

This is ambiguous:

- Does the reported impact (11 c/kg MS) refer to season to date sales (shipments) as at 30 April, or does it refer to season to date sales contracts as at 30 April. It should refer to the latter, being the most up to date available information.
- Does the reported impact (11 c/kg MS) refer to the impact of <u>all</u> off-GDT sales to date, or is it only the impact of the change in policy which added off-GDT sales for the WMP, SMP and AMF product groups. It is presumably the former but there remains some ambiguity because the disclosures in these off-GDT reports were triggered by the policy to include off-GDT sales for WMP, SMP and AMF (off-GDT sales for Butter and BMP had already been included in the milk price calculations).
- In addition, the update should identify the full season impact of off-GDT sales that has been included in the latest forecast FGMP.

Annual reporting in the Farmgate Milk Price Statement

37 In the annual FGMP statement, for each product category Fonterra discloses both the weighted average GDT selling prices (presumably adjusted to the Notional Producer phasing[7]), and the overall Notional Producer selling prices (including off-GDT sales). Fonterra also discloses the overall proportion of off-GDT sales compared to GDT sales. For each product category, to enable a minimum transparency of the outcome of milk price revenue calculation processes, Fonterra should also disclose at least one of the following:

- For each product category, the weighted average off-GDT sales prices
- For each product category, the relative portion of GDT and off-GDT sales assumed made by the Notional Producer.

Neither of these are commercially sensitive and there is no reason why Fonterra should not disclose them.

Qualifying Materials

38 As already noted, disclosure of all products included as qualifying materials is required to provide a minimum confidence in the selection process for determining qualifying reference sales.

Incremental Product Costs – para 2.48 ff

39 At 2.48 the Commission confirms "that provision has been made for all of the costs specified in the definition of Incremental Product Cost in the Manual". This conclusion appears to be based simply on Fonterra assurance that this is the case. "Incremental Product Costs are extracted from Fonterra's costing system" (2.49) and "Fonterra considers that the Incremental Product Costs therefore capture the full range of costs incurred as part of the manufacturing process" (2.50). The Commission also appears to rely on the fact that "Fonterra's external auditors examine Fonterra's inventory" and "standard costs" (2.51).

40 Costing systems are infinitely variable and reflect multiple approaches and decisions especially with regard to allocation of indirect costs and overheads. Varying approaches and decisions are based on the purpose of the costing system. Any costing system must in the first instance therefore be assessed on the basis of its "fit for purpose".

41 There appears to be an assumption that the Fonterra costing system for statutory accounting purposes is "fit for the purpose" for determining "Incremental Product Costs". There is no demonstrated assessment of whether that is in fact the case.

42 The financial model which is constructed to determine the costs of the Notional Producer is based on the production of just five products (the Standard Specification Products). These five products are "stock keeping units" (SKUs) – i.e. they are individual products. Those 5 SKUs are assumed manufactured in four different types of factory which are assumed to be designed and run at maximum efficiency to produce just those five SKUs. This results in production and overhead costs that can only be achieved in that theoretical environment. Despite that very simple construct, the Notional Producer is also assumed to sell a wide range of products. The revenues from this wide range of products is not practically feasible for the Notional Producer (as designed and modelled) to produce. The purpose of the Incremental Product Cost then is

[7] The impact of phasing on the estimate of GDT average prices should also be disclosed. Phasing results in a different weighted average selling price than the weighted average selling prices actually achieved for GDT sales – that phasing impact is an important factor in assessing the reliability of Notional Producer selling price calculations.

to adjust revenues for those qualifying materials not actually manufactured by the Notional Producer (all Qualifying Materials which are not Standard Specification Products) by the costs that would be incurred if the Notional producer did in fact produce those products. While this is treated as an adjustment to revenue, it can equally be regarded as an adjustment to Notional Producer costs. In effect it is an attempt to reverse engineer the Notional Producer costs "after the event" based on a varying and apparently wide array of products. The Incremental Product Costs again reflect complexities in the Notional Producer model which are a consequence of forcing the square peg (flexible, versatile and responsive sales and marketing business) into the round hole of the highly streamlined five product manufacturing operation that the Notional Producer is represented to be.

43 The Incremental Product Costs have been based on the Fonterra (not Notional Producer) costing system. It is not feasible to simply assume the outputs of the Fonterra business costing system would be "fit for purpose" for determining Incremental Product Costs that the Notional Producer might incur for the production and sale of the qualifying materials. The delta "increment" in costs must first consider the cost attributed to the Notional Producer (fundamentally different to Fonterra actual cost) and then consider how those would change had the Notional Producer actually manufactured the qualifying material. As has been endlessly pointed out, this would at the very least require a fundamental reassessment of yields and production efficiency that is assumed by the "five SKU" highly streamlined Notional Producer manufacturing operation. This clearly has not been done.

44 Fonterra might argue that the Fonterra costing system provides an adequate adjustment to commercial revenues to neutralize that part of selling price which results from the variation between Qualifying Materials and Standard Specification Products. That would however confuses the incremental product cost (a costing function) with an attribution and apportionment of intrinsic market value of one product compared to another.

45 In Miraka view the Fonterra costing system is unlikely to be "fit for purpose" to determine the Notional Producer incremental product costs. It is unavoidably the case that to be practically feasible, the Incremental Product Cost must adjust off-GDT selling prices on the basis of incremental costs that the Notional Producer would incur. Miraka acknowledges this would require a fundamental rethink of the Notional Producer model. However, it was Fonterra choice to expand the definition of qualifying materials to include off-GDT sales. Fonterra must equally be accountable for ensuring the full Notional Producer model remains practically feasible in the light of the choice it has voluntarily made. Miraka remains of the view that while Fonterra has adjusted the model in a way that increases Notional Producer selling prices, it has not adjusted the Notional Producer costs to take into account the full consequences of that change.

46 Miraka requests the Commission explain how it has assessed that the Fonterra costing system is fit for purpose for determining incremental product costs which are practically feasible for the Notional Producer.

<u>Selling costs – paragraph 2.54 ff</u>

47 In our submission on the 2019/20 Milk Price Manual, Miraka sought an explanation for the decline in Notional Producer selling costs from $0.08/kg MS for the 2015/16 FGMP to $0.07/kg MS by 2018/19. Miraka had expected selling costs to increase over that period, because following the 2015/16 Season Fonterra began including off-GDT sales for WMP, SMP and AMF. This was expected to increase selling costs given the relatively higher costs of the off-GDT sales channel. The inclusion of off-GDT sales was a fundamental change to the

Notional Producer business model. It resulted in a shift of over 40% of the Notional Producer business from a low cost GDT sales channel to the higher cost direct sales and marketing channel.

48 The Commission has provided an explanation for the reduction of selling costs. The explanation is difficult to understand. It is puzzling that the Commission bases its explanation on changes since the 2014/15 Season. Miraka had referred to the 2014/15 Season in its submission only because an analysis was completed for that year showing as expected that Fonterra selling costs were fundamentally higher than the Notional Producer at that time. This reflected the costs incurred by Fonterra as a result of its more sophisticated business model (including a large proportion of direct sales) compared to the almost exclusive reliance on GDT then assumed to the Notional Producer. The 2014/15 Season is otherwise irrelevant to the explanation sought by Miraka.

49 The Commission also refers to a "decrease in sales costs … in F15 and F16 was a result of a more detailed review of sales costs in the FY15/16 overhead reset[8]". This again is puzzling. The Miraka timeline <u>commences</u> with the 2015/16 Notional Producer selling costs (the last year before the Notional Producer was deemed to expand prices to include off-GDT sales) and seeks an explanation for the decrease in costs <u>from that time</u>. The fact that selling costs also reduced in the 2015/16 Season compared to 2014/15 seems irrelevant and certainly does not explain why selling costs continued to decline in the face of a fundamental change in the way the Notional Producer is assumed to sell product <u>after</u> 2015/16.

50 At 2.59 amongst other things the Commission notes that "GDT Commission costs reduced from F15 to F19. This should be self-evident (volume reduction of product sold through GDT) but is also not relevant. The issue is not the absolute amount of selling costs, but the <u>rate</u> of costs, which had decreased by $0.01/kg MS from the 2015/16 Season. In the case of GDT sales, if anything the <u>rate</u> should have increased because of the regressive commission rates charged by GDT (lower sales volumes incur higher commission rates).

51 The decrease in selling costs from the 2015/16 Season to the 2018/19 Season is counter-intuitive and remains unexplained. Miraka again requests that the Commission seek an explanation for the decline in the rate of selling costs.

<u>Administration and Overhead Costs – para 2.62 ff</u>

52 At 2.63 the Commission explains that a review of costs in 2018/19 identified that administration and overhead costs for the Notional Producer were understated by $90M. $45 million of this understatement was included in the 2018/19 Season milk price calculations. The full $90M has been included in the 2019/20 Milk price calculations. This suggests that the 2018/19 Season costs were knowingly understated by $45M or $0.03/kg MS. (i.e. only half of the understated costs were added back to the 2018/19 milk price calculations). The Commission nevertheless confirmed the administration and overhead costs for the 2018/19 FGMP were practically feasible. At the same time in its Reasons Paper for the 2018/19 Milk Price Calculations Fonterra certified to the Commerce Commission in accordance with DIRA Section 150T(b) that the "assumptions, inputs and processes" described in the Reasons Paper "are in all material respects consistent with the purpose of subpart 5A of the Act".

53 At 2.68, the Commission advises that $40M (equivalent to over 2.5 c/kg MS) of the $90M increase in costs was due to "the removal of Velocity and stretch savings". These "savings"

[8] The Commission is requested to standardize its nomenclature when referring to business years. It is not entirely clear what "F15", "F16", and FY15/16 refer to.

date back to the 2015/16 Season and it now appears those savings were merely targets which have in fact not been achieved. It is disturbing that Fonterra can cause a material portion of Notional Producer costs to "disappear" simply on the basis of internal efficiency targets set within Fonterra. It is especially disturbing that it has taken four years to determine those targeted savings have never in fact materialised and those costs are now being reinstated. In the meantime the Notional Producer costs have been understated (not practically feasible) and the FGMP has been overstated by over 2.5 c/kg MS for four seasons.

54 At 2.73 the Commission states "it is not possible to determine whether any part of the increase in costs reflects a failure to achieve Velocity efficiency targets". This appears to contradict the statement in 2.68 that $40M of the $90M increase in administration and overhead costs was due to "the removal of Velocity and stretch savings". The Commission is asked to explain this apparent contradiction and its consequences.

55 At 2.70 the Commission states "the application of Rule 19 to overhead and other admin costs is no longer an issue as the additional allowance previously provided for under Rule 19 (non-recurring costs) for the 2018/19 season have now been provided for under the provisions of the Manual relating to overhead costs (primarily Rule 18)". In the 2018/19 Season Fonterra apparently classified the then additional $45M as "non-recurring costs" under Rule 19. It subsequently represented $43 million of increased costs in the 2018/19 FGMP Milk Price Statement as "one-off". The Commission now seems to indicate the representation of that $45M of incremental costs as "non-recurring" or as "one-off" was incorrect. The Commission considers that is of no consequence because Fonterra has now reclassified the original $45M and the additional $45 (total $90 million) as ongoing costs. Miraka requests that the Commission reconsider this conclusion. The classification of incremental costs as either recurring or as one off is crucial for the understanding of subsequent season Notional Producer costs. In the interests of transparency it is important that Fonterra is held accountable for proper representation of milk price calculations and outputs. Miraka requests the Commission seek an explanation from Fonterra for representing costs as "one-off" in 2018/19 when they were apparently recurring.

56 The circumstances concerning the identification and treatment of the additional $90M costs is a fiasco. Costs have been systematically understated for an extended period of time and when this understatement has finally come to light they have been misreported and not brought to account immediately. The Commission is requested to more fully review how this came about and the changes that should be made to prevent a recurrence. In particular the Commission is requested to consider the practical feasibility of assuming the Notional Producer has made major cost savings simply on the grounds that Fonterra has targeted those savings to be achieved. In Miraka view such fundamental cost savings should only be brought to account when Fonterra has demonstrated they have actually been achieved, or when it is reasonable to assume they will be achieved in the very near term. The establishment of a project to achieve them does not in itself provide reasonable grounds they will be achieved.

<u>Asset Stranding – para 2.95 ff</u>

57 The Notional producer milk volume for 2019/20 was static. On this basis the Commission has concluded "there are no new asset stranding or mothballing issues to consider". In drawing this conclusion the Commission is perpetuating the view that it is practically feasible to consider mothballing of plants is an "after the event" decision. Miraka has previously explained that this is not practically feasible and does not represent what occurs in the real world: A plant previously mothballed cannot be assumed to be instantly available for milk processing should milk volumes rise; similarly a plant cannot be assumed to be mothballed from the start of the Season on the basis it was not used during the season. Miraka has

previously submitted that Fonterra should determine any changes to the Notional Producer plant configuration (plants, processing capacity, location) at the start of the Season (or indeed with a longer lead time in the case of new plant capacity). Like any other real world processor the Notional Producer would then be faced with the consequences of those decisions: i.e. costs associated with mothballed plants, underutilised capacity, and/or shortfall in capacity). The Commission saw merit in that proposal but it appears Fonterra has rejected it. While the static milk supply in 2019/20 might not have driven any change in asset stranding or plant mothballing expectations, it is clear that the issues on the table have not been resolved and are likely to become increasingly important in the future as pressures on sustainable milk supply grow. The Commission is requested to address this crucial issue in its review of the 2020/21 Milk Price Manual.

USD Conversion Rate – Draft Report Appendix A

58 In its submission to the Commission on focus areas for review of the 2019/20 Milk Price calculations, Miraka:

- explained its view that the calculation of the Notional Producer USD conversion rate does not comply with the DIRA section 150B safe harbour, that the safe harbour therefore does not apply, and that the Notional Producer conversion rate must therefore be shown to be practically feasible in accordance with Section 150A (2) of the DIRA.
- requested the Commission assess the methodology that Fonterra uses to determine the Notional Producer USD conversion rate.

59 The Commission has responded to the above first point of the Miraka submission in Appendix A of the Draft Report. The Commission disagrees with the Miraka interpretation of Section 150B. The Commission refers to its review of the 2012/13 milk price calculations. At that time (2012/13) the Commission noted there were differences between the Fonterra actual conversion rate and the rate used in the milk price calculations. The Commission "did not consider that these gave rise to significant differences". Since that time there has been an ongoing discussion over materiality and how the Commission determines "significance". That issue remains unresolved. In any event, whether the (undisclosed) difference at that time was or was not "significant" has not been assessed against an independent or agreed standard (or any standard), nor does it appear the comparison has been considered or made on an ongoing basis. Needless to say the ongoing differences have not been disclosed.

60 Miraka remains of the view that a plain language interpretation of the Section 150B safe harbour indicates the process for determining the Notional Producer conversion rate does not comply with safe harbour.

61 The Commission has provided no response to the second point raised by Miraka. Miraka has provided detailed analysis and evidence of apparent inconsistencies in the calculation of the Notional Producer conversion rate. Regardless of whether Section 150B applies, the questions raised by Miraka require answers. Miraka again requests the Commission address the questions raised. The relevant part of the Miraka submission is attached as Appendices A and B.

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Richard Wyeth
Chief Executive Officer
Miraka Ltd

Appendix A

Extract: Miraka Submission to the Commerce Commission: Proposed focus areas for our review of Fonterra's 2019/20 base milk price calculation (22 April 2020)

6. The arcane nature of the process for converting a Fonterra conversion rate into the Notional Producer rate was reflected in two separate Fonterra perspectives on conversion rates provided firstly in the Fonterra 2018/19 Financial Statements (year end 31 July 2019), and then in the disclosures made in the Fonterra Farmgate Milk Price Statement for the 2018/19 Season.

   - At page 48 of Part 2 of the Fonterra Financial Statements is was noted that Fonterra held (**as at 31 July 2019)** USD cash flow hedges amounting to $9.3 billion (nominal NZD) with a weighted average rate of 0.6852 (refer Appendix B).
   - At the same time, in the 2018/19 Milk Price Statement (at Appendix 8), Fonterra explained that "**As at 31 July 2019**, Fonterra had hedged approximately 70% of the forecast cash flows related to the 2020 Season Farmgate Milk Price. If the remaining 30% of the forecast cash flows were to be hedged at the 31 July spot rate [0.6613[9]], the average NZD/USD conversion rate would be around 67 cents".

7. Regardless of what the 0.67 forecast conversion rate for the Notional Producer might have been to four decimal places (which Fonterra should reasonably disclose but chooses to round to 2 decimal places), it is not obvious how the Fonterra actual hedge book at 0.6852 translates to a Notional Producer forecast hedged conversion rate of 0.67. The Notional Producer's deemed 70% hedged position as at 31 July 2019 must have been subsumed within the then existing Fonterra hedge book. The Notional Producer's forecast conversion rate would therefore have included at most[10] an additional 30% of the Notional Producer forecast net cash flows hedged by instruments entered into in accordance with the forward points relevant to the 31 July 2019 spot rate of 0.6613. In these circumstances, it does not appear feasible for the forecast Notional Producer conversion rate to be 0.67. **Similar issues are assumed to arise between any actual Fonterra conversion rate (for a period matching the Notional Producer period) and the Notional Producer deemed conversion rate**. A translation process must be occurring.

8. The conversion rate is a crucial parameter in the base milk price calculations, second only to the selling prices and product mix attributable to the Notional Producer. Small basis point movements in the Notional Producer conversion rate have a highly material impact on the base milk price. Miraka requests that the Commission review the process whereby the Fonterra conversion rate is translated to the Notional Producer conversion rate for the purpose of confirming the practical feasibility of the Notional Producer conversion rate.

[9] Fonterra used a USD/NZD spot rate of 0.6613for evaluating relevant balance sheet items as at 31 July 2019.
[10] In the same way that Fonterra is unlikely to hedge 100% of its cashflows, the Notional Producer is unlikely to hedge 100% of its cashflows.

<u>Appendix B</u>

<u>Extract from Fonterra Financial Statements for the Year Ended 31 July 2019 (Part 2, page 48) – Notes to the Financial Statements – Foreign Exchange Risk</u>

	GROUP $ MILLION						
	AS AT 31 JULY 2019[1]					YEAR ENDED 31 JULY 2019[2]	
		CARRYING AMOUNT				HEDGE EFFECTIVENESS IN RESERVES	
HEDGING INSTRUMENT USED	NOMINAL AMOUNT[3]	DERIVATIVE ASSETS	DERIVATIVE LIABILITIES	ACCUMULATED COST OF HEDGING	CHANGE IN VALUE USED TO CALCULATE HEDGE EFFECTIVENESS	RECOGNISED IN OTHER COMPREHENSIVE INCOME	RECLASSIFIED TO THE INCOME STATEMENT[4]
Cash flow hedging							
Foreign currency forwards and options							
Maturity: 0-18 months Weighted average NZD:USD rate: 0.6852	9,267	37	(182)	(14)	(144)	(238)	309
Maturity: 0-11 months Weighted average USD:RMB rate: 6.9117	491	4	(1)	(1)	2	(2)	(7)
Maturity: 2-11 months Weighted average NZD:EUR rate: 0.5890	97	–	–	–	–	–	–
Total	9,855	41	(183)	(15)	(142)	(240)	302

1 Life-to-date amounts as at balance date.

2 Year-to-date amounts recognised during the year.

3 Nominal amount represents forecast foreign currency transactions in cash flow hedge relationships, translated into New Zealand Dollars using the exchange rate at balance date.

4 Recognised in revenue.