**16 November 2020**

**<u>Miraka Submission to the Commerce Commission:</u>**
**<u>Draft Report (15 October 2020): Review of Fonterra's 2020/21 Milk Price Manual</u>**

<u>By online submission: https://comcom.govt.nz/file-upload-form-folder/file-upload-form</u>

Miraka appreciates the opportunity to submit in response to the Commerce Commission Draft Report on the 2020/21 Milk Price Manual. Miraka is available and would welcome any opportunity to discuss the contents of this submission with the Commission.

## <u>Off-GDT Sales</u>

1. Off-GDT sales and their inclusion in the Notional Producer revenues was a focus area for the Commerce Commission review of the 2019/20 Milk Price Calculations. Major issues remain unaddressed following the Fonterra decision from the 2016/17 Season to change its policy concerning off-GDT sales. In submissions on the Commission Draft Report, 2019/20 Milk Price Calculations Miraka and others reflected our concerns with this matter. Despite these efforts, the latest iteration of the Manual has made no progress in clarifying, defining and normalising procedures for off-GDT sales. The inclusion of off-GDT sales in the Notional Producer revenues was a voluntary choice made by Fonterra. This has led to a vast increase in the complexity and opacity of the Farmgate Milk Price (FGMP) model and outputs. Addressing the issues is challenging. However Fonterra was not obliged to make the change in policy and the resulting complexity cannot therefore be an excuse for the Fonterra ongoing failure to address the issues raised.

2. In the Final Report, 2019/20 Milk Price Calculations the Commission responded to the submissions of Miraka and others to the Draft Report. The Commission response raises further issues with regard to off-GDT sales. It is timely they be addressed in this Miraka submission.

3. Unless indicated otherwise, the paragraph references below are to the Commerce Commission Final Report, 2019/20 Milk Price Calculations.

    i. Paragraph 2.21 – the Commission here repeats the Fonterra newly coined expression "sub Reference Commodity Products". The Commission also advises that Fonterra has explained "low heat SMP, medium heat SMP, and instant SMP" are examples of "sub Reference Commodity Products". In its submission on the Draft Report, Miraka explained that the new expression "sub Reference Commodity Products" adds no further meaning to the existing plethora of product descriptions and categories which have been made necessary by inclusion of off-GDT sales. The new expression in fact adds further complexity and ambiguity to the process. For example the list provided of so-called "sub Reference Commodity Products" includes medium heat SMP (MH SMP). This is however already defined in the Manual as the Standard Specification Product. What further meaning is added by also referring to it as a "sub Reference Commodity product"? It is already clear that the benchmark product for the SMP Reference Commodity Product is MH SMP, and that other SMP products would fall within the group of SMP Reference Commodity Products to the extent they are "qualifying materials". By introducing this new concept of a "sub Reference Commodity Product" Fonterra purpose seems to be to diminish the role of the Standard Specification Product (e.g. MH SMP) to be a benchmark for purposes of selecting qualifying materials and confirming qualifying reference sales. Rather than increase clarity, the "sub Reference Commodity Product" is a device which undermines the emergence of clear rules and procedures based around the Standard Specification Product as a benchmark, serving the assumed Fonterra objective of minimising limits on its discretion to classify products as qualifying materials.

In Miraka view, there should either be a clear explanation of how the "sub Reference Commodity Product" concept adds clarity to the off-GDT sales issue, or the Commission should reject it as unhelpful.

ii. Paragraph 2.39: "We do not consider that the additional processing required for ISMP means it does not constitute a Qualifying Material. We note that instant whole milk powder is a commodity product listed in GDT (and is therefore a standard specification product[1]) and Fonterra has confirmed that its standard plants are capable of agglomeration. The cost of the additional Lecithin plant required to manufacture instant products is insignificant and has been provided for in the incremental costs".

The Commission appears here to conflate IWMP with ISMP, including a suggestion that ISMP is manufactured through a similar process to IWMP (by the addition of lecithin). This is incorrect. Unlike IWMP where the "Instantised" characteristic is achieved through the addition of lecithin ingredient, ISMP (or "agglomerated" SMP) requires a specialised manufacturing process. It is surprising that Fonterra has not pointed this out to the Commission. The Commission correctly states that I**W**MP is sold by Fonterra on GDT. This is though irrelevant to the status of I**S**MP which notably Fonterra does not sell on GDT. Indeed this is because I**S**MP is more correctly a specialty product: it is difficult to make, it is in short supply, and it commands considerable premiums. Miraka remains of the view that I**S**MP (the only off-GDT product Fonterra has actually disclosed as being included in Notional Producer revenue calculations) cannot be attributed to the Notional Producer.

iii. It is surprising that the Commission has concluded that ISMP selling prices are similar to the Standard Specification Product "after adjusting for any costs that are normally recoverable from purchasers of the product" (paragraph 2.40). This is presumably a reference to the "Incremental Product Costs" for ISMP and provides no comfort. It simply raises questions about the costing principles Fonterra is using to determine incremental product costs because an incremental product cost should not in and of itself materially erode the premium obtained from ISMP.

The Fonterra costing system is outside the scope of the Manual and remains opaque. Costing system policies vary substantially depending on the purpose to which they are put.

[1] IWMP is not in fact a Standard Specification Product. The Standard Specification Product for the WMP Reference Commodity Product is Regular WMP.

Fonterra has provided a high level description of the system. This is not sufficient evidence to confirm it is "fit for purpose" for the quite specific purpose of adjusting arms- length pricing of specific products to achieve an equivalence with a related but different set of products so as to determine a competitive milk price. The suggestion that ISMP incremental product costs would neutralise the nominal premium on ISMP compared to MH SMP provides reason to doubt the costing system is fit for purpose.

iv. Paragraph 2.44: "We therefore conclude that products with these *features*[2] are a practically feasible commodity for an efficient processor, as the product specifications are identical to the standard GDT Medium Heat SMP and Regular WMP products".

The Commission seems to be taking one aspect of a commodity product (composition) and concluding that all products with the same composition must also therefore be commodities. This fails to acknowledge the full range of requirements that make up the product specification – in this case that the products are required to have an enhanced solubility in water ("instantised"). It is simply not possible to equate ISMP with MH SMP; it is certainly the case that a customer purchasing ISMP will not accept MH SMP as a replacement because the products have quite different functional properties.

v. Paragraph 2.52 "We confirm that we are satisfied the manufacture of Qualifying Material does not require ***significant*** plant modifications and does not have a ***significant*** impact on the production efficiencies that are assumed" [emphasis not in original].

These conclusions of the Commission were made in the context of the requirement that qualifying materials can be manufactured on the Notional Producer Standard Plants. According to the Manual, for a product to be a qualifying material its manufacture would "not require the use of Specialised Plant". This rule is clear and unequivocal. Unfortunately, and repeating the manner of its conclusions in the Draft Report, the Commission does not actually address compliance with the requirement concerning Specialised Plant. Rather, it simply restates that "plant" would not require "significant modification" to produce the qualifying materials. Miraka had requested the Commission clarify its conclusions in the context of the rules in the Manual and in particular concerning Specialised Plant. The Commission chose not to make that further clarification. It accordingly remains unclear if the Commission has in fact satisfied itself that qualifying material can be manufactured on Standard Plant without the use of Specialised Plant.

In its submission on the Draft Report, 2019/20 Milk Price Calculations, Miraka observed that in the case of ISMP, manufacture on Standard Plant configured for efficient production of MH SMP (the Standard Specification Product) would either require specialised plant, or would suffer from reduced operating efficiency and an increase in downgrade product. The Commission however simply confirmed that the manufacture of qualifying materials "does not have a ***significant*** impact on the production efficiencies that are assumed".

Miraka has long submitted that Notional Producer yields based on theoretically long production runs of just five individual products would be materially and adversely impacted by the expansion of product range to include the "qualifying reference sales". The

[2] "features" presumably refers to the "instantised" nature of the products

Commission has now confirmed that the qualifying materials would impact Notional Producer yields but that impact would not be "significant". This is both a welcome and worrying conclusion. Welcome because the Commission now confirms it will have an impact on yields; worrying because the Commission has assessed that impact to be not "significant" without confirming how "significance" is determined. Miraka has previously raised the need for a materiality standard to assess whether a departure from or failure to comply with rules and procedures in the Manual causes the measurement of an outcome to be impaired - in this case, whether the yields determined from the manufacture of just one SMP product (MH SMP) on Standard Plant designed to produce MH SMP as efficiently as possible would be impaired if the plant actually produced a range of SMP products. At least in the case of the production of ISMP produced on a MH SMP dedicated and configured plant this could be expected to be the case.

The Commission has recommended that Fonterra include a definition of "material change" when considering changes to the Manual (which Fonterra has rejected)[3]. Miraka considers that recommendation should be expanded to include a standard of materiality from which to assess whether measured outcomes are impaired as a result of faulty measurement procedures (in this case, yields based on single product plants where the assumed sales programme requires the plant to produce multiple products).

vi. Paragraph 2.60: The Commission states "Miraka asserts that, to be approved, prices are also required to achieve a "target margin" presumably above the "current market price". "Approval" and "prices" here refer to Fonterra delegated authorities for approving selling prices for off-GDT sales. At 2.61 the Commission goes on to state "We do not read Fonterra's reference to a target margin to mean a margin above the market spot price". In so doing the Commission indirectly responds to and rejects the Miraka interpretation of "target margin". The Commission does not offer an alternative explanation of the Fonterra reference to a "target margin".

Miraka points out that it is Fonterra not Miraka that described an internal control procedure for approving prices for off-GDT sales that included the requirement that prices be referred to senior management where "prices … do not achieve the target margin". By implication then, lower levels of Fonterra management can approve prices provided they **<u>DO</u>** achieve "the target margin". It is not unreasonable for Miraka to question what this might mean and it is equally not unreasonable to interpret it as referring to price achievement at a margin above a benchmark (such as GDT prices). Given the context was Fonterra's explanation for how it assesses price performance against "prevailing prices", it is again not unreasonable to expect the "target margin" referred to was a margin in relation to the (as yet still undefined) "prevailing prices" or "current market price". This is important because the sale of a "qualifying material" can only be included as a qualifying reference sale if the sale "can reasonably be regarded as being … at a price that reflects ***<u>prevailing prices</u>***"[4]. Miraka contends that the "prevailing price" benchmark remains a meaningless

[3] Table A1, Commerce Commission Draft Report on the 2020/21 Milk Price Manual
[4] 2020/21 Milk Price Manual Part C section 1.2

and unenforceable requirement for the selection of qualifying reference sales because "prevailing prices" remains an unexplained and undefined concept.

At paragraph 37.3 of the Draft Report, 2020/21 Milk Price Manual the Commission recommends that Fonterra provide a definition for the term "prevailing" as it is used in the Manual. Miraka supports this recommendation. In Table A1 however the Commission states its understanding that Fonterra means "relevant market spot price" when it is referring to "prevailing prices". The Commission seems to consider that is an adequate definition of "prevailing price". The Commission goes on to state that a "prevailing price benchmark" should not necessarily be limited to GDT standard specification products". The Commission possible objection to GDT as the price benchmark seems to be on the grounds that higher prices might justifiably be achieved off-GDT. The Commission does not however provide any alternative benchmark for the "relevant market spot price". It is unclear why GDT prices would not be an appropriate benchmark simply because an off-GDT price is higher. The whole point of a benchmark is to provide a basis for comparison – and by definition actual achieved prices will vary from the benchmark; that does not render the benchmark ineffective but rather reflects the correct function of a benchmark – e.g. to test the extent to which a price might be different to the prevailing market price and to establish prescribed tolerance levels of acceptable price differences for qualifying reference sales (including because of a different sales channel).

It is not a coincidence that ALL the Standard Specification Products are sold on GDT. These products clearly provide benchmarks for the FGMP model – for example in determining the plant and equipment required for the Standard Plants, and providing the benchmark against which to determine incremental product costs. It is then difficult to understand why the prices achieved for these same products on the transparent and independent GDT auction site could be anything other than the appropriate benchmark of "prevailing prices" for assessment of off-GDT prices of New Zealand sourced product. If not that, then what? Notably when Fonterra introduced its policy for expanded use of off-GDT sales to inform the Notional Producer prices, it indicated that GDT prices would remain the benchmark for assessing selling price performance and this would be a benchmark for inclusion of off-GDT sales[5]. Miraka questions why that intention has not been acted on.

In our submission on the Draft Report, 2019/20 Milk Price Calculations, Miraka concluded (paragraph 23) and continues to conclude there is no demonstrated process or procedure which assures prices for qualifying reference sales are in fact selected on the basis they are transacted at "prevailing market prices". The inclusion of ISMP as a qualifying reference sales was the only evidence offered for this conclusion for the simple reason ISMP is the only off-GDT product that Fonterra has confirmed is a qualifying reference sale. At paragraph 37.1 of the Draft Report, 2020/21 Milk Price Manual the Commission recommends that Fonterra publish the list of all products that constitute "Generic Product Specifications". This list would provide the full range of products that could be included as

[5] Fonterra Reasons Paper 2016/17 Milk Price Manual: "While we will be extending the range of actual sales taken into account in the Farmgate Milk Price calculation, we will continue to exclude a material proportion of sales of RCPs and all sales of non-RCPs. As now, the price achieved on GDT will continue to be used as a benchmark against which to measure sales team performance with respect to off-GDT sales."

"qualifying Reference Sales". Miraka considers this a minimum disclosure required to provide assurance that the process of including off-GDT sales remains consistent with the S150A purposes and is not being exploited to inflate the Notional Producer revenues.

Paragraph 29 of the Miraka submission on the Draft Report, 2019/20 Milk Price Calculations summarised our assessment of the impact of including off GDT sales in the milk price calculations. For reasons described above the Miraka assessment remains unchanged and is copied in full below.

"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."

4. The policy change in 2016/17 to include off-GDT sales has had a profound effect on the FGMP process and calculations, and for example increasing the FGMP in 2019/20 by 11 c/kg MS[6]. The Manual fails to provide a proper framework for assuring that increase in the FGMP is supported by proper process and evidence. The Commission is requested to review this issue again when considering adequacy of the 2020/21 Milk Price Manual for the measurement of the Notional Producer revenues prior to completing its Final Report. The Commission is further requested to consider the points raised in this Miraka submission and the Miraka submission on the Draft Report, 2019/20 milk price calculations, when planning its review for the 2020/21 milk price calculations.

## Independent Review

5. Previous Milk Price Manuals have variously required inputs to the milk price calculations to be subject to "independent review", "independent verification" or to be determined by an "independent reviewer". In the 2020/21 Milk Price Manual Fonterra has removed this explicit requirement for independent review. Fonterra explains that the Milk Price Group is responsible for the milk price calculations (including inputs to calculations). Fonterra asserts that because the Milk Price Group is independent from Fonterra, it can and does act as an "independent reviewer". Fonterra has thus concluded it is unnecessary to specifically require "independent review" in the Milk Price Manual. Fonterra seems to still accept that independent review is a necessary process. Miraka therefore wonders why Fonterra has considered it necessary to excise all explicit requirements for independent review in the Manual itself.

6. Miraka considers the removal of the explicit requirement for "independent review" is dangerous and at the very least risks a derogation from application of independence principles. Miraka considers the explicit requirement for "independent review" should remain in the Manual so as to reinforce that any party providing input to the milk price calculations must remain independent of direct influence from Fonterra. The explicit inclusion of a requirement for independent review or independent verification ensures an ongoing assessment of whether

[6] 2019/20 Farmgate Milk Price Statement

the governance structure for the milk price manual and milk price calculations is in fact independent.

7. At paragraph 51 of the Draft Report, 2020/21 Milk Price Manual, the Commission concurs with the Fonterra claim of independence in the governance of the Milk Price Manual and Calculations:

   > "Given the degree of independence that exists between Fonterra and the MPP and MPG, we do not consider that the absence of any additional independence provided by the independent reviews detracts from the s 150A purpose. The verification of the input of external reviewers will continue to be overseen by the MPP".

8. An analysis of the milk price governance structure does not support the above conclusion of the Commission. Neither the Milk Price Group (MPG) nor the Milk Price Panel (MPP) can be represented to be "independent" of Fonterra or of Fonterra interests for reasons reflected in the following:

   i. In the case of the MPG:
      - The head of the MPG is <u>appointed</u> by the Fonterra Board and <u>reports</u> to the MPP.
      - The MPG is responsible for ensuring any amendments to the Milk Price Manual "are in accordance with the Milk Price Principles in Fonterra's constitution" (and by implication that the Manual in its entirety is consistent with those principles in the Fonterra constitution). The Fonterra constitution includes principles which present a potential for conflict with the purposes of the DIRA. Those principles include:
        - "The Farmgate Milk Price for a Season should reflect the benefits that arise from the <u>*collective selling power of Shareholders as suppliers to Fonterra*</u>"
        - The Farmgate Milk Price should be <u>*the maximum amount*</u> which Fonterra, reflecting its status as a properly-managed and efficiently-run, sustainable co-operative, could pay for the Milk supplied to it…"

   ii. In the case of the MPP:
      - The composition of the Panel comprises 5 members the majority of which (three members) are Fonterra directors: two are "appointed" directors and one is a farmer elected director. Regardless of whether appointed or farmer elected, all directors are responsible for directing the co-operative and all its instruments (including the MPP and the MPG) in a manner consistent with Fonterra commercial objectives and the Fonterra constitution including the above mentioned requirement for "maximising the milk price".
      - The remaining two members are appointed by the Fonterra Shareholders Council. The entirety of the Shareholders Council is elected by Fonterra supplier shareholders. The Council (and its appointees) thus necessarily at least hold the same interest as Fonterra itself to maximise the milk price.

9. Miraka does not here suggest the MPG and the MPP act in an unprofessional manner. It is however wrong to state the MPG and the MPP are "independent" in a manner that provides <u>assurance</u> their priorities are not in conflict with the DIRA purposes. It is only necessary to consider the 8 year saga of the MPG, MPP and Fonterra Board resisting attempts to stop them from using an infeasibly low Weighted Average Cost of Capital in the milk price calculations. A properly independent assessment of WACC would require a neutral stance towards stakeholders. However, rather than striking an appropriate balance between the interests of non-supplier equity investors and Fonterra milk suppliers, the MPG and the MPP took a position

consistent with the Fonterra constitution of favouring parameters which assured an unnaturally low WACC. This delivers a higher milk price ("maximising the milk price" per the Fonterra constitution) while prejudicing the interests of non-supplier equity investors in Fonterra. Repeatedly throughout this period the MPG and the MPP have defended that biased position. It has taken an Act of Parliament to attempt to force a commercially feasible WACC to be recommended by the MPG and the MPP[7]. That is not a standard of behaviour that reflects or assures independence.

10. In summary, the issue of "independent verification and review" has two elements and Miraka considers they should be judged separately:
    - The requirement for independent review of inputs to milk price calculations and processes; and
    - Whether the MPG under the control of the MPP can provide assurance of independent review.

    In Miraka view
    - The requirement for independent verification and review must be retained as an explicit requirement in the Milk Price Manual; it is dangerous and risks derogating the requirement for independence if that requirement is merely implicit.
    - For reasons stated above Miraka considers that neither the MPG nor the MPP is independent of Fonterra and they cannot therefore provide assurance of independent review and verification of the inputs to the milk price calculations.

## Plant Capacity

11. At paragraph 27 of the Draft Report the Commission repeated its previous recommendation that "disclosure in the Manual of the capacity of both the primary and secondary plants would better promote the purpose in S 150A". At paragraph 30 the Commission states that they do not consider failure to disclose plant capacities as recommended "is sufficiently material to render this Season's Manual inconsistent with the S150A purpose as a whole".

12. Miraka supports the underlying intention of the Commission recommendation. Miraka however considers the disclosure should be made prior to the start of each season i.e. well in advance of the usual timeframe for making the annual update of the Milk Price Manual publically available (September)[8]. Miraka does not have a view on whether failure to make the disclosure invalidates the Manual itself. It is though notable and welcome that the Commission has now acknowledged that failure to make a recommended increase in disclosures for purposes of transparency can be judged to be  a failure to meet the S150A purposes.

13. Aside from disclosure itself, Miraka does though consider that Fonterra must at least demonstrate to the Commission it has established Notional Producer available capacity at a

[7] Even now it is unclear whether the MPG and the MPP will now strike a proper balance between the interests of various stakeholders as the MPG has not yet disclosed its choice of WACC parameters in response to new section 150C(2) to the DIRA (introduced by the DIRA Amendment Act 2020).

[8] Miraka considers a more appropriate place for this disclosure would be on the Fonterra website (Milk Price Methodology page) along with other specific technical reporting on the Farmgate Milk Price. This could include the quarterly report on the impact of off-GDT sales (which Fonterra actually discloses sporadically in its Global Dairy Updates), and the Commission recommendation for quarterly updates on the Notional Producer USD conversion rate.

geographic level prior to the start of any Season and that failure to do so would render certain milk price calculations unable to be found practically feasible.

14. Fonterra has not implemented the Commission recommendation stating that it already reports on standard plant capacity (at a much later date) in the Reasons Papers supporting the annual milk price calculations. In the 2019/20 Reasons Paper for example it explained the capacity it assumes for each type of Standard Plant. While these are important parameters alongside the size (capital cost) and operating costs of the Standard Plant, this does not address the core issue at stake here. Fonterra has in recent years been adjusting the number of Notional Producer plants and associated costs (e.g. mothballing of plants) on the basis of fluctuating milk volumes. Fonterra Reasons Papers have described adjusting plant numbers on an "after the event" basis (e.g. determining plants would have been mothballed from the start of the Season based on observed milk flows analysed at the end of the Season). Miraka has contended (and it is obvious) that a real world processor cannot adjust available processing capacity (e.g. assume a plant would have been mothballed) "after the event". It is therefore not practically feasible for the Notional Producer to apply an "after the event" procedure to determine costs associated with shortfall or surplus capacity. A practically feasible procedure <u>**requires**</u> that planned and available capacity be set at least <u>before</u> the start of the season, and that costs be assessed against that predetermined available capacity.

15. This then is the point of disclosing total capacity, by geographic location, prior to the start of the Season. Miraka would prefer the planned and available capacity be disclosed. However, regardless of whether it is disclosed, the Milk Price Calculations associated with a deficit or surplus of capacity must be made by reference to that pre-determined available capacity. If as appears to be the case Fonterra does not establish planned capacity, by geographic location prior to the start of the Season, any measurement of the costs associated with a deficit or surplus capacity must be rendered not practically feasible.

## <u>Disclosure of the Notional Producer USD conversion Rate</u>

16. At paragraph 33 of the Draft Report, the Commission repeats its previous recommendation that Fonterra should provide quarterly updates of the Notional Producer USD conversion rate. Miraka supports this recommendation. Fonterra has responded: "we routinely disclose the information suggested by the Commission".

17. While the Fonterra disclosures do follow a set timetable, they can hardly be described as routine. Disclosures occur just once a year in the annual Milk Price Statement. Two disclosures are made:
    - Actual conversion rates achieved for each quarter of the previous Season; these rates are always presented correct to four decimal places
    - A forecast for the current season; this forecast is always presented correct to two decimal places although it is or can undoubtedly be calculated correct to four decimal places

18. The forecast conversion rate is established as at July (two months into the start of the Season) but is only reported two months later in September. It is based on hedges in place as at the end of July and estimated hedging to be entered over the remaining 13 months of the Notional Producer sales period. Noting that a movement of plus or minus 50 b.p. translates to a difference for example in the 2019/20 FGMP of +/-7 c/kg MS (a total potential difference of 14 c/kg MS due to conversion rate rounding), disclosing a conversion rate correct to 2 decimal places falls well short of an acceptable standard of disclosure. There is no reason why Fonterra cannot disclose this forecast correct to four decimal places and there is equally no reason why Fonterra cannot update that forecast at regular intervals.

19. Miraka requests that the Commission refine its recommendation regarding the conversion rate updates to state that all reports of conversion rates should be correct to four decimal places, and that the forecast provided in the Annual Milk Price statement should be updated and reported as at the end of October, January, March and June as soon as possible after those respective month ends.

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