



Dear Keston

Submission on the Commerce Commission's Draft Report on the 2017/18 Milk Price Manual

Open Country Dairy (Open Country) is pleased to make this submission on the Commerce Commission's (Commission) draft report (Draft Report) on the 2017/18 milk price manual (Manual).

We are comfortable with the specific changes made by Fonterra because they do not make material amendments to the Manual. However, we remain troubled by the lack of transparency within the Manual and the impact this has on market contestability, and Fonterra's unwillingness to address previous recommendations made by the Commission.

We also reiterate our fundamental concern with the Commission's inability to conclude on the erroneous asset beta used by Fonterra in calculating the WACC (as documented in our responses to the Commission's 2016/17 Milk Price Calculation Review).

Lack of transparency damages market contestability

Within the DIRA regime, the Milk Price Manual contributes directly to market contestability by providing a relatively objective and predictable framework for the calculation of the milk price. It is intended to allow Fonterra and independent processors to make decisions during the season based on what the final milk price will be; lack of adequate disclosure materially undermines this market contestability.

Lack of adequate disclosure of Fonterra's process and inputs in the Manual creates risk that:

- The Commission is unable to properly scrutinise the Manual (and consequentially the final milk price) to perform its regulatory role effectively.
- Market contestability is threatened because competitors are put at a disadvantage. Lack of transparency provides Fonterra with discretion around key inputs and processes, which undermines milk price predictability.¹ This creates a regulatory risk to independent processors over and above the market risks that would exist in a properly contestable market.

Fonterra and the Commission ought to be working together to continuously improve transparency in the Manual, but the latest Manual shows that this is not happening.

The Manual lacks adequate disclosure and transparency

Multiple parts of the Manual allow Fonterra to make discretionary decisions on model inputs and calculations, without a disclosed process to inform such decisions. For example, Fonterra has the power to determine a 'material change' to a model input for the purposes of disclosing any changes in approach where more than one approach to applying a rule is available, but

¹ We are not suggesting that complete certainty over the final milk price is required, only that it should be reasonably predictable to independent processors and other market observers considering both the Manual and market circumstances as they emerge over the course of the season.



there is no definition of ‘material change’. This effectively gives Fonterra a degree of leverage over the market that independent processors do not have.

Where the Manual does specify processes to inform key decisions, the governance structure does not provide for independence or transparency. The Milk Price Panel oversees the governance of the Farmgate Milk Price and the Manual, but lacks independence: of its five directors, two are Fonterra-appointed, one is a Fonterra farmer-elected director, and two are nominated by the Fonterra Shareholders’ Council. The Panel relies heavily on an ‘external’ Milk Price Group for advice on proposed amendments to the Manual, yet the Group is not truly external: Fonterra established it, and it does not report to an independent body or directly to the Commission (it reports to the Milk Price Panel, which is made up of Fonterra representatives advising the Fonterra Board).

We understand that the Panel has a statutory role, but our concern remains that it does not achieve the objectivity and transparency necessary to promote contestability. Given these limitations, the Commission’s role in driving transparency is critical. Close, critical analysis by the Commission is the primary mechanism of addressing the potential shortcomings in the Manual.

Fonterra ought to respond to the Commission’s concerns

We are encouraged that the Commission has cited multiple problems around the Manual’s consistency with DIRA and Fonterra’s disclosure practices,² but remain concerned that Fonterra has either refused to accept that the issues fall with the scope of the Manual or, in the case of additional definitions for off-GDT sales, has simply not responded.

Fonterra refuse to include farmer support costs, despite the Commission concluding that this is not consistent with DIRA. The costs of farmer support are substantial (co-operative support loans came to \$383 million in 2016³), therefore we disagree with the Commission’s view this is not material to its overall conclusion on the Manual.

As we have signalled in previous submissions, we find it troubling that lack of transparency limits the Commission’s ability to perform its role effectively. If the Commission cannot see key Manual inputs and processes, or have full confidence of independent oversight over Manual processes, it cannot know that the Manual optimally encourages market contestability and Fonterra efficiency (as per the DIRA requirements).

Fonterra needs to deliver on their commitments for off-GDT sales disclosure

A lack of transparency creates significant risk for including off-GDT sales – independent processors have consistently raised this since the discussion first began during last year’s Manual review. Including off-GDT sales, without distorting market contestability, means being very clear about what the Manual assumes has been sold, and the costs associated with that. Providing this transparency is the only way the Commission can determine whether the assumptions are practically feasible, and therefore whether market contestability is assured both in respect of the Manual and the resultant milk price calculation.

² See paragraphs 28 and 29, page 10, and Table B1, page 15, of the Draft Review.

³ Fonterra Cash Flow Statement, page 88, Fonterra Annual Review 2017.



The Commission has previously allowed the inclusion of off-GDT sales under the clear expectation that Fonterra would disclose relevant information,⁴ yet Fonterra has not followed through with their disclosure commitments on off-GDT sales criteria.⁵ This undermines the DIRA regime. Without defined sales criteria and product specifications, we do not understand how the Commission can maintain a view that:

- the 'product specifications' of the off-GDT sales for the 2016/17 season are consistent with the commodity definition in the Act and standard specification commodity products (paragraph 2.113, 2016/17 Milk Price Calculation Review);
- there should be no material impact on manufacturing efficiency and costs, on the basis that Fonterra have only included off-GDT products that use 'standard material' in the calculation (paragraph 2.123, 2016/17 Milk Price Calculation Review);
- there is no effect on production planning and product mix management, on the basis that off-GDT 'product specifications' do not materially vary from GDT specifications (paragraph 2.125, 2016/17 Milk Price Calculation Review).

We expect Fonterra to deliver on their commitments before the Milk Price Manual Review has been completed: if they do not, it will create a significant threat to transparency and accountability, and market contestability.

Recommendations

The Commission must address the lack of transparency in the Manual if it is to properly serve the stated purposes of the DIRA regulatory regime. We urge the Commission to challenge Fonterra's reluctance to provide greater transparency, and to conclude that the Manual is not consistent with DIRA if that transparency is not provided.

Thank you for the opportunity to comment on the Manual.

Best regards,

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⁴ See paragraphs 2.130-2.143 of the Commission's Review of Fonterra's 2016/17 Milk Price Calculation.

⁵ See Table B.1, page 17 of the Draft Review.