8 September 2016

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Miraka Submission to the Commerce Commission: Review of the 2016/17 Farmgate Milk Price Manual

1.0 **Introduction and Summary**

1.1 Fonterra has submitted the 2016/17 Farmgate Milk Price Manual (the Manual) and Reasons Paper in support of the Manual. In anticipation of its statutory review of the Manual, the Commission has invited comments on the Manual and the Reasons paper.

1.2 In summary, Miraka submits that:

1.2.1 The provision for "Consistency over time" (Part A, section 2.6 of the Manual) does not meet the "practically feasible" requirement of Section 150A (2) of the Dairy Industry Restructuring Act (DIRA).

1.2.2 The Manual does not provide a coherent, complete or practically feasible framework to give effect to changes in the basket of Reference Commodity Products (RCPs).

1.2.3 The inclusion in 2016/17 of off-GDT sales to determine the Notional Producer prices for WMP, SMP and AMF is a fundamental change in policy which Fonterra has not properly disclosed or explained, is not consistent with Rules 5 and 8 of the Manual, and will undermine the credibility of the FGMP calculations. The change cannot be justified.

1.2.4 Fonterra's represents that changes in Sales Costs (Rule 17 of the Manual) are no more than a "minor technical and drafting matter". This demonstrates that Fonterra has not considered the changes that would be needed to the Notional Producer assumptions if prices of off-GDT sales of WMP, SMP and AMF are included in the milk price calculations.

2.0 **Consistency over time**

2.1 Miraka agrees it is necessary that inputs, assumptions and processes used to determine the milk price (i.e. the Notional Producer construct) must "evolve in a manner that could be achieved by a 'real world' dairy processor". This is prescribed in Section 2.6 of Part A of the Manual). This is a fundamental requirement to meet the practical feasibility requirement of Section 150A (2). Fonterra however qualifies Section 2.6 by the proviso that it does not apply in "exceptional circumstances" (i.e. in "exceptional circumstances", whatever those might be, the Notional Producer **is** permitted to evolve in a manner that could **not** be achieved by a real world dairy processor). Fonterra seems to consider this exception to practical feasibility is permitted because "consistency over time" is not a requirement of the overarching principles documented in the Manual and which are derived from the Fonterra constitution.

2.2 To comply with the DIRA, the Notional Producer must always be "practically feasible". "Exceptional circumstances" are part of the risks that any real world processor must manage and the Notional Producer cannot be excused from those risks and remain "practically feasible". The Fonterra constitution certainly does not provide an excuse to avoid applying the statutory test of practical feasibility.

2.3 Miraka submits that the proviso based on "exceptional circumstances" needs to be removed from Section 2.6 of Part A of the Manual.

3.0 **Changes to the basket of RCPs**

3.1 Fonterra has amended section 2.6 of Part A of the Manual to clarify the timing of disclosures consequent to changes in the Manual. The amendment is generic and applies to all changes in approach that result in "materially different" input values. The standard of materiality is not defined and this gives Fonterra undue discretion to determine what it will disclose. While the amendment is generic, Fonterra confirms it has been made in response to the Commission's report on the 2015/16 Milk Price Manual that "it would be necessary for [Fonterra] to publically explain the rationale and consequences of any change <u>in advance</u> of a change to the reference basket"[1]. The remainder of this Section 3.0 therefore addresses what this amendment means for disclosure of changes in the RCPs.

3.2 The amendment serves to highlight that the intended process for changes in the basket of RCPs would not meet the DIRA Section 150A (2) practical feasibility requirement. This is because:

a. it implies or assumes the Notional Producer will make retrospective changes to its production and sales of products; and

b. it implies a timeframe for changes to the basket of RCPs which is not practically feasible.

3.3 Section 2.6 of the Manual as amended states or implies that a change in the basket of RCPs could be <u>disclosed</u> within three possible timeframes:

a. at the time the Milk Price Manual for the Season is issued (i.e. in August of the relevant season).

[1] Commerce Commission Report on the 2015/16 Milk Price Manual paragraph 93.

b. at the time the Milk Price Statement for the previous season is issued (i.e. in September of the relevant season). This would presumably occur where a change in the RCP basket was approved <u>after</u> the Manual is issued.

c. given the proviso noted in section 2.0 above, Fonterra also considers a change in the basket of RCPs could be approved after the Milk Price Statement (b above) has been issued (i.e. under "exceptional circumstances"). The Manual leaves unsaid how such late change in the RCPs might be disclosed.

3.4 It should be self-evident that the feasible range of products that the Notional Producer can manufacture must be established before the Season commences and milk is processed. However all of the disclosure timeframes above occur <u>after</u> the Season has commenced. The two latter timeframes further imply both the decision and disclosures for a change in RCPs would occur after milk processing has commenced. This necessarily means that to a varying extent, the Notional Producer would determine its production and sales retrospectively which is not practically feasible. Furthermore, none of the timeframes provide disclosures "in advance" as sought by the Commission.

3.5 Section 150C(i) of the DIRA requires the RCPs be those that "are likely to be the most profitable over a period not exceeding 5 years from the time <u>*when the portfolio is determined*</u>". Section 150C is a mandatory requirement. Section 150C must however be applied in accordance with Section 150A (2) – i.e. in a way that is "practically feasible for an efficient processor". Therefore the "time when the portfolio is determined" must be practically feasible in relation to the time when a change in production and sales is given effect by that determination.

3.6 For a "practically feasible" "efficient processor" any fundamental change in the range of products it will make (i.e. its "basket of RCPs") would be preceded by a substantial and strategic capital investment decision, the identification of suitable production site(s), compliance with planning requirements, construction and commissioning of the production facility, and development and implementation of a sales and marketing strategy. The timing would also typically be constrained by a requirement to align production to the start of a milk supply season. The lead time BEFORE production and sales can actually occur is therefore measured in years. The Manual seems to measure it in days.

3.7 Fonterra notes that "changes in the composition of the reference basket require the support of 75% of Fonterra independent directors"[2]. This would seem to establish the appropriate trigger point from which a practically feasible lead time can be established. The disclosure of that decision might be delayed (in line with commercial confidentiality of an "efficient processor") but the disclosure would again be measured in years rather than days in advance of the actual change to the Notional Producer RCPs.

3.8 In its draft report on the 2015/16 Milk Price Calculations, the Commission encouraged Fonterra to review the basket of RCPs on a regular basis and even annually (even

[2] Reasons Paper Note 3 pg. 6

though an efficient processor would be unlikely to make such strategic reviews with that regularity). Fonterra now indicates it is analysing if a change in the RCPs is warranted. Miraka however considers the Manual is grossly inadequate to deal with the implications of a change in the RCPs. As currently formulated, the Notional Producer is in effect able to respond to competitive risks arising from changing market demand and/or competitor behaviour seamlessly, at minimum to no disruption cost, and in a timeframe (even retrospectively) which is not feasible under any definition.

3.9 Miraka submits that before changes in the RCPs can be considered, the Manual must be revised to ensure a practically feasible framework is available to manage that change. It is irresponsible to consider changes in the RCPs before that framework is established. That framework would at least need to consider:

- the lead times between the decision to change the reference products, disclosure of that change, and the deemed production and sales resulting from that change
- an assessment of the impact on the availability and allocation of milk to the new processing facilities (including impact on milk aggregation, plant operating efficiency, and asset stranding)
- an assessment of the impact of disruption costs caused by the change in production facilities and sales portfolio
- a proper assessment of the impact on WACC of competitive risks arising from exposure to changes in market demand and/or competitor behaviour (i.e. which is implicit in the prospect of changes in the RCPs).

4.0 Off-GDT Sales of WMP, SMP and AMF

4.1 Fonterra has advised that for the 2016/17 Season it will include prices of “selected” off-GDT sales of its WMP, SMP and AMF sales to determine the prices achieved by the Notional Producer. This is a substantial change to Milk Price assumptions and represents a fundamental change in policy. The significance of this change is not properly represented by Fonterra in the Reasons Paper.

4.2 At page 7 of the Reasons Paper Fonterra explains that “the primary reason for making this change is that it has become increasingly clear in recent years that GDT sets the ‘base’ price for sales of RCPs, with sales undertaken off GDT almost invariably being transacted at higher prices”. Fonterra does not make clear what it means by ‘base’ price and Fonterra’s use of quotation marks (‘base’) suggests Fonterra itself is undecided on what it means. Fonterra does however confirm it will continue to use GDT prices to provide “a benchmark” to measure sales team performance[3]. Miraka considers this reconfirms that Fonterra considers GDT prices are appropriate benchmark prices for commodity products.

4.3 Fonterra further states (at page 7) that “the practical implication of this change is to align the approach … [for WMP, SMP and AMF] to the approach currently used for Butter and BMP”. This attempts to add weight to the change to include off-GDT sales for WMP, SMP, and AMF by indicating it is in line with current practice for butter and BMP. This misrepresents the situation: until now the policy intent has been to do the

[3] Reasons Paper page 8.

reverse (i.e. to progressively align the process for butter and BMP to the process for WMP, SMP, and AMF). The change for WMP, SMP and AMF is in fact as a result of a fundamental change in policy. The Fonterra Reasons Paper has skirted this change.

4.4 Consistent with Manuals for previous years, Section 4.3 (Overview of Methodology – Farmgate Milk Price Revenue) of the 2015/16 Manual stated:

> "Benchmark selling prices should:
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> - Reflect actual prices realised by Fonterra on the sale of Reference Commodity Products across a range of contract terms which is consistent with prevailing market conditions.
> - Result in Fonterra facing strong incentives to optimise its product Mix.
> - Result in Fonterra facing strong incentives to maximise its Benchmark Selling Prices.
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> *These objectives should eventually be fully achieved if Benchmark Selling Prices are based on prices achieved through Global Dairy Trade"* [highlighting not in original]

4.5 The highlighted section above has simply been deleted from the 2016/17 Manual. Thus whereas previously the policy intent was to "eventually" replace any remaining off-GDT selling price data with GDT data, it is no longer considered that GDT prices can achieve the objectives for the Benchmark Selling Prices. Fonterra would seem to have avoided active disclosure of this policy change and has not explained why it has been made.

4.6 Fonterra has explained the change to use off-GDT prices for WMP, SMP and AMF on the grounds that those prices are higher than GDT prices. This explains the effect of the change. It does not explain the reason (other than by a cynical interpretation). Taken at face value, this explanation for including off-GDT sales is not sanctioned by the Manual. The process for determining Notional Producer prices continues to default to GDT prices. Section 4.3 of Part A of the Manual (and mirrored in Rules 5 and 8 of Part B) prescribes the circumstances where GDT would be supplemented with off-GDT sales:

- where GDT "does not cover a sufficient volume of sales" to provide a reliable benchmark price"; or
- "where prices on GDT are not … *materially representative* of the prices Fonterra and its competitors should generally be able to achieve for sales of the Reference Commodity Products"

4.7 The first of the above does not apply to WMP, SMP and AMF since those have previously been deemed to include "sufficient volumes". Fonterra hints but does not state that the second of the above has been triggered for WMP, SMP and AMF (page 7 and 8 of the Reasons Paper) but contradicts this further down on page 8 where it states "prices achieved on GDT will continue to be *materially representative* of the prices used in the FGMP calculation".

4.8 Fonterra indicates that had off-GDT prices been included in the milk price calculation between 2013 and 2016, prices would have been within USD20 of the GDT based prices actually used[4]. For the 4 Seasons ending 2014/15, a difference of US$20/MT would amount to less than 0.6% of the GDT based selling prices. Rather than trigger a need for including off-GDT sales in the milk price calculations, this outcome provides evidence the GDT prices ARE "materially representative" and there is no reason under Rules 5 and 8 for including off-GDT sales. It goes without saying that any approach Fonterra could use to select off-GDT prices could not match the advantage that GDT provides in assuring the Notional Producer prices are based on independent, transparent and neutral prices. Departures from the use of GDT prices on the basis they are not "materially representative" would demand a much higher hurdle than the 0.6% implied by Fonterra's analysis.

4.9 Miraka contends it is widely accepted (including by Fonterra) that GDT sets an international benchmark price for commodity dairy products. Where Fonterra achieves prices from commodity sales which are different to the benchmark price, this must necessarily be attributed to the differentiation that Fonterra itself offers. This includes its ability to offer a wide range of products (far wider than the Notional producer can offer[5]) and services to customers, and Fonterra's investment in product and market development. All of these enable Fonterra to obtain prices which are differentiated from the benchmark commodity prices. The Notional Producer does not resemble these qualities which enables Fonterra to differentiate prices nor has any effort been made to realign the Notional Producer to the far more sophisticated Fonterra business model. It is therefore not practically feasible to consider the Notional Producer prices can include prices that Fonterra generates from it's more sophisticated business model.

4.10 Fonterra however claims at page 8 of the Reasons Paper that the Notional Producer prices would remain practically feasible in aggregate because the prices would still be lower than Fonterra achieves on sales not included in Milk Price calculation. This is circular logic and must be dismissed. It also suggests a lack of coherent policy in the process Fonterra is using to select off-GDT sales for inclusion in the milk price calculations. The reason that Fonterra would exclude certain sales from the milk price calculations is because Fonterra would consider those sales are not practically feasible for the Notional producer. It is then circular logic to say the Notional Producer prices are practically feasible because they are lower than the prices for excluded sales.

4.11 Fonterra indicates "a sample of prices"[6] from off-GDT sales will be included in the calculations of the Notional Producer prices. Fonterra provides no explanation of the parameters for selection of those prices, how that selection will be controlled, nor how off-GDT prices will be merged with GDT prices for purposes of calculating the Notional Producer prices. Fonterra advises that the inclusion of off-GDT prices from

[4] Fonterra Reasons Paper page 8.
[5] For example, Fonterra relationship with a customer extends well beyond that which is possible from the RCP product range. That ability to service a much wider range of customer needs will affect the price relationship Fonterra has with that customer including for products which might be classified as RCPs.
[6] Fonterra Reasons Paper page 8

2013 to 2016 would have resulted in an increase in selling prices of US$20/MT[7] and an increase in the FGMP by NZ$0.04 to NZ$0.05[8]. On the other hand separate analysis published by the Commission[9] indicates Fonterra "price achievement" for reference commodity products (and proxies) is $0.22/kg MS higher than the Notional Producer in 2014/15. A further difference of $0.21/kg MS in revenues of Fonterra reference commodity products above the GDT based Notional Producer prices is unable to be explained (or "pinned down"). This suggests that the change in policy to include off-GDT sales offers Fonterra considerable and unacceptable new flexibility to manage the level at which the FGMP is set.

4.12 The Commission is encouraged to consider the representations GDT itself makes with regard to sales through "GDT events". The preamble to the "Guiding Principles" of the Rules for GDT Events[10] state "the goal [of GDT] is to develop and manage a multi-seller Trading Platform for trading dairy products that embraces the objectives of independence, neutrality, and transparency". Guiding principle 1 then states that "the Rules are intended to foster efficient and competitive markets which

- Encourage the discovery of prices for the products traded through the competitive interaction of buyers and sellers;
- Establish prices that clear the market

4.13 In its description of "what we do", GDT states[11]

- GDT "has proven to the market it provides credible reference prices for globally traded dairy ingredients"; and
- "GDT is owned by Fonterra Cooperative Group but is operationally and physically separate from Fonterra. GDT Events have clear governance structures. An independent Oversight Board oversees GDT Events' rules and structures so that they are monitored and developed in a neutral and transparent manner".

4.14 Fonterra owns (but necessarily does not control) GDT. It is also by far the largest seller on GDT and both GDT and Fonterra are mutually dependent. Fonterra must be presumed to support and agree to the principles, rules and statements of purpose of GDT.

4.15 In summary, by contrast to the "independence, neutrality, and transparency" of GDT, the standard reflected in the Fonterra Reasons paper for the change in policy to include off GDT prices is incoherent. It is disturbing that the standards of "independence, neutrality, and transparency" which are regarded as crucial for the commercial success of the GDT auction platform are being diluted for purposes of determining the FGMP. This is especially problematic given the crucial importance of the FGMP to the efficient and effective operation of the entire NZ dairy industry and the wider NZ economy. Given Fonterra has neither explained its change in policy, nor is inclusion of off-GDT sales justified by the Manual, Miraka submits that the prices for

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[7] Fonterra Reasons Paper pg 8.
[8] Fonterra advice to financial markets of changes in the 2016/17 FGMP Manual.
[9] Addendum to the Commission's draft report: Review of Fonterra's 2015/16 base milk price calculation.
[10] Refer GDT website: https://www.globaldairytrade.info/en/gdt-events/governance/gdt-trading-event-rules/
[11] Ibid: https://www.globaldairytrade.info/en/about-us/

WMP, SMP and AMF must be based exclusively on GDT prices, and the policy intent to expand reliance on GDT prices for Butter and BMP should be reinstated[12].

5.0 **Sales Costs**

5.1 In Appendix 1 of the Reasons Paper, Fonterra lists amendments to the Manual which are "of a minor technical or drafting nature". This includes a change to Rule 17 (Sales Costs). It would appear Fonterra has failed to consider the holistic impact on the Notional Producer which would occur as a result of expanding the use of off-GDT sales in the Notional Producer price calculations. While Miraka considers there is no justification for including off-GDT sales, if Fonterra persists in that change in policy it must fully consider the selling cost and wider business model implications of doing so. As discussed in 4.9 above, the differentiation of Fonterra off-GDT prices reflects the differentiation of Fonterra itself from the basic commodity business model attributed to the Notional Producer. The resulting change in Sales Costs could therefore not simply be a change of a "minor technical or drafting nature".

Richard Wyeth
Chief Executive Officer

[12] Attention is drawn to section 4.1 of the Miraka submission on the Commission's draft report on the 2015/16 Milk price Calculations. Miraka considers GDT provides practically feasible prices. Further disclosures are however needed to demonstrate that the prices remain practically feasible following the transformation of the GDT prices through milk price calculation processes.