24 August 2021

Miraka Submission to the Commerce Commission:

Commerce Commission invitation to submit "on the advice from our expert advisors, CEPA, on the appropriate asset beta and specific risk premium for a notional milk processor in the context of our 2020/21 Milk Price Calculation review" (Commission letter 27 July 2021)

By online submission: https://comcom.govt.nz/regulated-industries/dairy/milk-price-manual-and-calculation/milk-price-calculation/milk-price-calculation-202021-season

1 Miraka appreciates the opportunity to submit on the differing CEPA and Fonterra Milk Price Group (MPG) conclusions regarding the Notional Producer (NP) asset beta and specific risk premium (SRP). It is particularly appreciated that this opportunity was provided in advance of the Commission issuing its draft report on the 2020/21 Base Milk Price Calculations. Miraka is available and would welcome any opportunity to discuss this submission with the Commission.

2 Since issuing its letter of 27 July 2021, the Commission has also issued its draft report on its review of the 2020/21 Base Milk Price Calculations[1] (Commission Draft Report BMP 20/21). That report includes draft findings on the NP WACC for 2020/21. This submission also responds to those draft findings.

3 This submission identifies up to 8 c/kg MS equivalent understatement in the 2020/21 NP WACC across a range of issues. These are summarised in the table below. It is disappointing that after the extended period of focus on this issue, the NP WACC continues to be materially understated and results in a material overstatement of the Base Milk Price (BMP).

	Refer paras:	NP WACC	WACC Impact (c/kg MS equiv)
Fonterra WACC 2020/21		4.9%	
WACC Calculation Error	46 ff	5.17%	0.019
Fonterra 500 bp discount of calculated asset beta: not justified	36	5.50%	0.026
Independent assessment (CEPA) calculates asset beta 500 bp higher than Fonterra	35	5.87%	0.026
Exclude Fonterra from the NP comparator set	9 & 22	5.94%	0.005
SRP removed (0.15%) without justification while NZ industry environment suggests risk has increased	39 to 45	6.03%	0.007
			0.083

4 The Commission has obtained advice (the CEPA 2021 Paper) from Cambridge Economic Policy Associates Ltd on the NP asset beta and SRP recommended by the MPG and set by

[1] Commerce Commission "Review of Fonterra's 2020/21 base milk price calculation" – 16 August 2021

Fonterra for the 2020/21 Milk Price Calculations. Miraka is grateful that the Commission has obtained independent advice on this matter. Miraka considers there are special circumstances to the determination of the WACC that mean disinterested expert advice independent of the Fonterra Milk Price Principles is especially important to provide the necessary confidence that the WACC and underlying assumptions are practically feasible.

5 The asset beta and SRP are parameters used in the calculation of the NP weighted average cost of capital (WACC). Fonterra has made changes to these parameters for the 2020/21 milk price calculations. These changes include a response to an amendment to s 150C of the Dairy Industry Restructuring Act (new subsections 3 to 5). The amendment comes into effect from the 2021/22 Milk Price calculations but the Fonterra Board has chosen to explicitly comply with the amendment for the 2020/21 milk price calculations. The Commission advises that its review of the 2020/21 Milk Price Calculations will apply s 150C without the new amendment[2].

6 The change in the asset beta for the 2020/21 calculations should be considered in the light of the Commission's relevant previous conclusions, and especially, since the 2017/18 review of the Milk Price Calculations, the Commission has concluded that

> "On balance we consider that this asset beta estimate [0.38] is therefore unlikely to be practically feasible for an efficient processor… Accordingly our final conclusion is that we do not consider that this aspect of the base milk price calculation is consistent with the contestability dimension of the s 150A purpose"[3].

7 The amended s 150C codifies the framework that arguably should always have been used to confirm practical feasibility of the NP asset beta and WACC. To that extent the amendments to s 150C should carry weight in determining practical feasibility. The fact that the amendments are not legislatively enforceable for the 2020/21 BMP does not detract from the fact that the asset beta and WACC must be practically feasible, and the amended s 150C provides the appropriate basis for determining practical feasibility.

8 In considering the NP asset beta and WACC, Miraka viewpoint is informed by the following three issues:

- Multiple "feasible" outcomes for the asset beta
- Practical feasibility (DIRA s 150A)
- Role and priorities of the Fonterra MPG

<u>Multiple "feasible" outcomes for the asset beta</u>

9 Lining up the Fonterra MPG paper of 30 June 2021 (Asset beta and Specific Risk Premium)[4] with the CEPA 2021 Paper highlights the wide range of possible asset beta outcomes and the significance of judgement in determining an asset beta for the NP. This is for example reflected in:

- the criteria and process used for selection of comparators

[2] Commission letter, 27 July 2021
[3] Commerce Commission Review of Fonterra's 2019/20 base milk price calculation, para 2.4 (for example)
[4] Fonterra Reason Paper 2020/21 Milk Price Calculations, Attachment 6,

- the wide range of asset beta observations that comprise the final asset beta – in the MPG observation points these range from a low of 0.06 (Savencia, daily, 26/12/2019) to a high of 1.16 (Associated British Foods, four weekly, 31/12/20)
- the selection of time periods from which to average asset beta observations
- the judgement based attribution of systematic risk to comparators and the NP
- varying views over the relevance or alignment of comparator asset betas to the NP (eg the MPG justification for a "downward adjustment" to the comparator analysis)

10 The scope for selective judgement to skew the outcome of asset beta analysis is clear and an asset beta can readily reflect bias (deliberate or otherwise). Regardless of good intentions, the asset beta determined by an interested party will always be tainted by suspicion of a gerrymander. An asset beta determined by a fully disinterested party with the right credentials should be given more weight than an asset beta determined by an interested party.

Practical feasibility

11 To meet the requirements of s 150A (2) of the DIRA, the asset beta must be "practically feasible for an efficient processor". Fonterra itself is typically the default benchmark for practical feasibility: if Fonterra itself COULD achieve an outcome (e.g. cost, yield, selling price) the Commission will consider that outcome is practically feasible. Regardless of whether that default is appropriate, it is clearly not the case for the NP asset beta. As CEPA points out "Fonterra's shares trade in a restricted market for cooperative members only, with arrangements for liquidity using related securities from non-members of the cooperative (which have been suspended in 2021)"[5]. In an earlier 2018 paper responding to submissions to the Commission on the asset beta, CEPA concluded Fonterra should not be included in the comparator set[6]. Miraka further points out that the supply and demand for Fonterra shares is substantially dependent on the Fonterra Share Standard[7] and therefore the appetite of Fonterra suppliers to increase or decrease milk production. Drivers for the Fonterra share price reflect the specific nature of Fonterra as a cooperative and are fundamentally different to those of typical "processors of dairy and other food products" operating in contestable markets. Fonterra itself is not a typical processor because the separation between the interests of investors and of milk suppliers is blurred. Fonterra itself cannot therefore provide a default benchmark for practical feasibility of the NP asset beta and WACC. For the same reasons Fonterra itself should not be included in the comparator group for the NP asset beta.

12 Miraka considers the NP asset beta would be practically feasible if it could be reasonably expected to be observed for an efficient processor paying a competitive price for milk in a contestable market. The observed asset beta of the NP would emerge from a balance of

[5] CEPA Supplementary information (the "PowerPoint" document) in support of the CEPA 2021 Paper, pg 17
[6] Cambridge Economic Policy Associates Pty Ltd in association with Freshagenda Pty Ltd (4 June 2018): "Dairy Notional Processor's Asset Beta – Response to Submissions [to the] New Zealand Commerce Commission" - pg 6
[7] The Fonterra Share Standard currently requires suppliers to hold 1 Fonterra share per kg milksolids supplied. The Share Standard is under review.

competing demands for an economic reward for milk (the purpose of the NP model) and an economic reward for capital.

13 The CEPA 2021 Paper concerns itself with the provisions of the amended s 150C and "this is regardless of whether the asset beta meets the efficiency and contestability dimensions [of s 150A]"[8] – i.e. CEPA explicitly excludes any assessment of or requirement that the asset beta be practically feasible. Miraka believes this is why the CEPA 2021 Paper draws conclusions based on asset beta ranges (in effect, what it considers statistically feasible ranges) rather than single point conclusions. This is also why CEPA concludes the Fonterra "asset beta of 0.45 could be justified"[9]. This conclusion is though unexplained because an asset beta of 0.45 falls below the ranges calculated by CEPA.

14 In its Draft Report BMP 20/21 the Commission also appears to conclude the NP asset beta is practically feasible on the grounds of statistical or arithmetic feasibility (i.e. the MPG asset beta of 0.45 might reasonably be observed within a range of possible outcomes from asset beta analysis). The Commission draws this conclusion not because it considers the MPG procedure for determining the asset beta is practically feasible (the Commission in fact suggests failings in the MPG approach[10]). Rather it is because the MPG asset beta coincidentally falls within a range which CEPA considers to be statistically feasible.

15 Miraka contends that the statutory test for practical feasibility cannot be so imprecise as to assume the asset beta may be selected from a wide range thus allowing for bias in the selection – i.e. it is not sufficient that the asset beta be merely statistically feasible. Rather, a practically feasible asset beta must be determined in accordance with the disciplines of risk evaluation in capital markets from which the asset beta concept emerges. This should be overlaid with a requirement that the statutory test cannot be so imprecise as to allow a wide discretion or bias.

16 In Miraka view, if the asset beta process is credible, the concluded asset beta cannot fall away from an average or middle value and remain practically feasible. This is because such asset beta would reflect judgement bias either in favour of a higher economic return on capital (an asset beta above the mathematical average) or in favour of a lower economic return on capital (an asset beta below the mathematical average). To be deemed practically feasible, the focus should then be on a credible analysis based on comparators; the resulting asset beta must reflect that analysis without favour and an outcome selected from a range cannot be practically feasible because it facilitates bias.

<u>Role and Priorities of the MPG</u>

17 Fonterra has previously based the NP asset beta on expert advice provided by third parties. This latest change in the asset beta is based on a review completed by the Fonterra MPG without further input.

18 In its review of the 2020/21 Milk Price Manual the Commission concluded that the MPG (and the Milk Price Panel to which it reports) has a sufficient "degree of independence"

[8] CEPA Supplementary information (the "PowerPoint" document) in support of the CEPA 2021 Paper, pg 4
[9] CEPA 2021 Paper, pg 2
[10] Commission Draft Report BMP 2020/21, para 3.25 ff

from Fonterra so that reviews carried out by the MPG could stand in the place of independent reviews previously required by the Milk Price Manual[11]. It is nevertheless the case the role of the MPG includes the "day-to-day administration of the [Milk Price] Manual (note 11 below) and ensuring "the Farmgate Milk Price is calculated in accordance with the Manual"[12]. This includes the overarching Milk Price Principles set in the Fonterra Constitution and necessarily representing Fonterra priorities. The Principles are subsumed into Section 2 of the Milk Price Manual. They reflect a bias which favours maximising the milk price. The Principles require that:

> "the Farmgate Milk Price should reflect the ***benefits that arise from collective selling power*** of Shareholders as suppliers to Fonterra, and ***from scale and other economies Fonterra enjoys in production***" and "should be the ***maximum*** amount that Fonterra, reflecting its status as a properly managed and efficiently-run, sustainable ***co-operative***, could pay for the Milk supplied to it"[13] (emphasis not in original).

19 By contrast, in the case of a return to capital the Milk Price Principles only require that the milk price should provide that Fonterra can "earn a risk-adjusted return on the [NP] assets sufficient to warrant long-term investment in new and replacement assets"[14].

20 This lack of balance in the Milk Price Principles between prioritizing returns to cooperative members' supply of milk and returns to capital is neither surprising nor controversial. It is consistent with the fact that Fonterra is a co-operative. It is however unavoidably the case that the MPG advice regarding the asset beta and SRP must be considered in the light of the priorities set by the Milk Price Principles to which the MPG is required to adhere.

21 The remainder of this submission is divided into two parts:

- Miraka response to the questions raised by the Commission in paragraph 12 of its letter of 27 July 2021. The Miraka response is considered against the background of the issues raised above.
- Additional issues Miraka wishes to raise concerning the NP WACC:
  - Mathematical correctness of the Fonterra calculated WACC (4.9%) for 2020/21
  - Rounding protocol in the calculation of the WACC and its components

Miraka Response to the questions raised by the Commission

22 Paragraph 12.1 (Commission letter, 27 July 2021):

"Do you agree that the methodology used by MPG to identify the firms in the core and full comparator sets would satisfy the new DIRA s 150C (4) requirements (even though

[11] Miraka disagrees with this conclusion. Miraka notes that: the head of the MPG is appointed by the Fonterra Board; the MPG operates under a policy set by the Fonterra Board, reports to the Milk Price Panel and is tasked with the "day-to-day administration" of the Milk Price Manual (Manual 5.3 and 5.4). The Milk Price Panel currently comprises five members: three are Fonterra directors and two are nominated by the Fonterra Shareholders Council – i.e. all Panel members are selected from roles which necessarily priortise the interests of Fonterra cooperative suppliers (and therefore of Fonterra itself). The Milk Price Manual is subject to the "Milk Price Principals" contained in the Fonterra constitution (section 2 in the Milk Price Manual).

[12] Farmgate Milk Price Statement, for example Appendix 3 the 2019/20 Statement

[13] Milk Price Manual, Part A Section 2

[14] Milk Price Manual, Part A Section 2

Fonterra is not required to apply s 150C (4) for this review)? Please explain why or why not".

23 Miraka response: Miraka is not in a position to conclude if the comparator group would satisfy the amended DIRA s 150C provisions and at this time has not sought expert advice on the matter. Miraka however believes there is reason to doubt the MPG comparator group would satisfy the requirements of the amended s 150C. In drawing this conclusion Miraka leans heavily on the advice provided by CEPA.

24 In respect of the CEPA expert advice it is noted that:

- CEPA highlights "a ***crucial step*** in [the MPG] process is the individual review of the 286 firms in their long-list to produce the list of 19 firms" which comprise the MPG Primary Comparator Set. The importance of this "crucial step" is witnessed by the wide range of asset beta observations in the MPG analysis as noted in paragraph 9 above.

- CEPA did not "set out to construct our own comparator sample[15]". Presumably this was outside the scope of the advice sought by the Commission, although CEPA did construct its own comparator set in its earlier advice to the Commission for the 2017/18 milk price reviews[16].

- CEPA did "***not have access*** to the MPG long list of 286 firms…. [and] it is possible that MPG may have missed comparators which ***meet [the MPG] stated interpretation*** [of amended S 150C]"[17]. Note that CEPA itself does not provide an independent interpretation of the amended s 150C and does not express a view on the MPG interpretation.

- CEPA highlighted a further 5 firms which potentially meet the MPG interpretation of amended s 150C (and which may or may not have been included in the 286 firms considered by the MPG). Miraka agrees those five firms appear to be appropriate candidates for inclusion in the sample of comparators.

- As explained in paragraph 11 above, CEPA has concluded (and Miraka agrees) that Fonterra itself should not be included in the asset beta comparator group.

- CEPA has previously provided expert advice on the asset beta as part of the 2017/18 milk price reviews. In that advice CEPA determined a comparator group that it considered "was a good fit for a notional processor"[18]. In the latest 2021 advice CEPA has updated the analysis of that comparator group, deriving an asset beta of 0.56[19]. CEPA now concludes that earlier comparator group is "unlikely to meet the new S 150C requirements"[20].

25 While CEPA considers the selection of comparators is a "crucial step" in the process of arriving at the Notional Producer asset beta, CEPA is not in a position to conclude

[15] CEPA 2021 Paper – pg 2
[16] Cambridge Economic Policy Associates Pty Ltd in association with Freshagenda Pty Ltd: "Dairy Notional Processors' Asset Beta New Zealand Commerce Commission (28 March 2018)"
[17] CEPA 2021 Paper – pg 2
[18] ibid
[19] ibid
[20] ibid

whether that "crucial step" has been performed reliably or thoroughly. CEPA also has not considered whether the MPG selection of firms meets the requirements of the amended S 150C although CEPA does seem to conclude (with the exception of Fonterra itself) that the firms actually selected by MPG are reasonable when assessed against the ***MPG interpretation*** of the amended S 150C.

26 More particularly, CEPA has not "set out to construct" a comparator set on the basis of the amended Section 150C[21]. There would be merit, given its independent status, if it could do so. It is however notable that the CEPA updated analysis of its 2018 comparator group produces an asset beta of 0.56[22] which is close to the CEPA calculated asset beta of 0.55 for the MPG comparator group. While CEPA now considers (unfortunately without explanation) that its 2018 comparator group is "unlikely to meet the new s 150C requirements" it is perhaps reasonable to conclude that even if CEPA independently determined a comparator group consistent with its interpretation of the amended s 150C, the outcome might anyway not be materially different to an asset beta of 0.55. Miraka would therefore be comfortable with an asset beta of 0.55 (or 0.56 after removing Fonterra from the comparator set) for the 2020/21 milk price calculations.

27 Moving forward, Miraka considers that an independent assessment of the comparator group and associated asset beta is important for providing a firm base from which to maintain and update a practically feasible asset beta for future years.

28 Paragraph 12.2 (Commission letter, 27 July 2021)

> *"Do you consider that an asset beta estimate for the notional processor of between 0.45 (MPG's estimate) and 0.53 (CEPA's core comparator set estimate) would meet the requirements of DIRA? In particular, is a downward adjustment of the asset beta from the comparator set estimate justified? Please explain why or why not. "*

29 Miraka does not agree that an asset beta of 0.45 to 0.53 is most likely to meet the requirements of the DIRA. Miraka does not agree a downward adjustment in the asset beta is justified. Miraka considers an asset beta of 0.55 or 0.56 is more likely to be practically feasible.

30 Table 1 of the Commission letter 27 July 2021 summarises and compares the Commission's assessment of the asset beta estimates of the MPG and of CEPA. Miraka notes that:

- Consistent with MPG, the Commission's comparative assessment settles on single point asset betas which represent mathematical averages of asset beta observations. This contrasts with the CEPA report which concludes asset beta ranges and which the Commission has averaged in its Table 1. Miraka supports this approach. As explained in paragraph 11 to 16 above, an unadjusted average is more likely to deliver an outcome which can be considered to be practically feasible.

- It is unclear why the Commission in Table 1 ultimately summarises the comparable views of the MPG and of CEPA by way of an asset beta of 0.45 in the case of the MPG, which is derived from the "full set" of comparators, and 0.53 in the case of CEPA, which is based on a "core set" of comparators. MPG having concluded the "full set" of comparators is more suitable than the "core set" and Miraka sees no reason

[21] ibid
[22] ibid

why the CEPA comparison to the MPG asset beta should be based on the smaller comparator set. Miraka considers the comparable views of MPG and CEPA is therefore more correctly described as 0.45 (MPG) and 0.55 (CEPA).

31 At various places in its draft report on the 2020/21 BMP Calculations, the Commission cites the CEPA conclusion that an asset beta of 0.45 "could be justified on the range of revised estimates"[23]. The Commission appears to give weight to this conclusion. It is however unclear how CEPA drew this conclusion. None of its summarised data points falls below 0.47. In its assessment of MPG's core comparator set, CEPA calculates an asset beta range of 0.47 to 0.57 (data set average 0.53). The CEPA calculated range for the full comparator set is 0.50 to 0.60 (data set average 0.55)[24]. Presumably CEPA is not referring to the lower level array of data by individual company which, in similar fashion the MPG data set, encompasses a wide range (from 0.06 to 1.36)[25] and from which no conclusions can be drawn in isolation.

32 The Commission is experienced in analysing asset betas for regulated industries (e.g. energy, telecommunications and airports). The Commission is presumably well-placed to contrast the tendency of regulated industries to want a higher than a lower asset beta and WACC, with the tendency of Fonterra to pursue a lower than a higher asset beta and WACC for the NP. The contrast reflects the milk price priorities of Fonterra as laid out in the Milk Price Principles. On the other hand, those other regulated industries seek to embed the highest justifiable return to capital in their controlled selling prices. In the case of the NP this has resulted in an asset beta and WACC which the Commission has not previously been able to satisfy itself is practically feasible. In the last three reviews of the Milk Price Calculations the Commission has gone further and concluded the NP asset beta did not meet the contestability dimension of s 150A of the DIRA (paragraph 6 above).

33 In this latest round of expert evidence, the asset beta adopted by the Fonterra Board (and recommended by the MPG) of 0.45 is again lower than the comparable asset beta of 0.55 derived by independent experts CEPA from the ***same*** comparator set. The difference of 1000 bp (equivalent to 5 c/kg MS) comprises two elements: CEPA calculates the asset beta for the MPG comparator group is 500 bp higher than the MPG calculations (0.55 vs. 0.50 respectively), and the MPG recommended a further discount of 500 bp from its already lower asset beta (the "downward adjustment").

34 CEPA suggests the MPG lower asset beta of 0.50 (before the "downward adjustment") might be a consequence of the MPG analysis deviating "from common regulatory approaches to estimating asset beta"; most significantly this seems because the "MPG have chosen 5 overlapping time periods and there does not appear to be justification for the time periods chosen"[26].

35 Miraka concludes the NP asset beta continues to reflect bias in favour of the milk price and causing the FGMP to be overstated by 5 c/kg MS. Despite the amendment to s 150C the Fonterra asset beta is still lower than determined by fully independent experts whose advice is not subject to the Fonterra (non-statutory) Milk Price Principles. As concluded in paragraph 10 above, the asset beta advised by a truly independent (or indifferent) expert

[23] Draft Report, eg para 3.25.3
[24] CEPA Supplementary information (the "PowerPoint" document) in support of the CEPA 2021 Paper, pg 33
[25] CEPA Dairy Asset beta estimates – spreadsheet – 10 Aug 2021
[26] CEPA 2021 Paper pg 2

will always be more credible than an asset beta that could be compromised by an interested party. On this basis, Miraka considers the CEPA asset beta of 0.55 (or 0.56 after excluding Fonterra from the comparator sample) has been determined in a fashion more likely to reach a practically feasible outcome while the MPG recommended asset beta of 0.50 (or 0.45 after the "downward adjustment") cannot be concluded to be practically feasible.

36 In relation to the "downward adjustment" of 500 bp to the observed asset beta of the comparator group, CEPA has concluded the MPG has not put forward a "strong justification" for the adjustment[27]. Miraka has nothing to add to that conclusion.

37 Paragraph 12.3 (Commission letter, 27 July 2021)

> *"Do you agree that any non-systematic stranding risk faced by the notional processor can be managed using the rules in Fonterra's Milk Price Manual and does not require upfront compensation at this stage (subject to an appropriate asset beta)?"*

38 Miraka understands the justification for "upfront compensation" such as an SRP is different depending on whether the risk of asset stranding is judged to be systematic or non-systematic. To the extent the risk is judged to be systematic, it follows that no separate "upfront compensation" would be required provided the NP asset beta is practically feasible. On the other hand, to the extent the asset stranding risk is non-systematic, "upfront compensation" for risk might be required. Miraka agrees that the Milk Price Manual provides mechanisms to capture the costs associated with risk. Miraka does not however agree that the MPG has put the case that an upfront compensation in the form of an SRP is not required. Also the Commission appears to conflate the selection of an appropriate (practically feasible) asset beta with compensation for "non-systematic" stranding risk. Miraka understands these are different issues. An inappropriate asset beta should be considered not practically feasible in its own right. That conclusion would not be mitigated by a separate SRP. On the other hand, an asset beta derived from a vigorous process might nevertheless be unable to capture the systematic risk specific to the New Zealand dairy industry. This could, as Miraka contends below, justify a separate SRP.

39 There is a remarkable symmetry in Fonterra choices in relation to the SRP. Fonterra introduced the SRP (0.15%) in the same year it ***reduced*** the asset beta ***from 0.45 to 0.38***. Fonterra is now removing the SRP in the same year it has ***increased*** the asset beta from ***0.38 back to 0.45***. It is tempting to conclude that Fonterra introduced the SRP on the grounds that it was compensation for systematic risk when the asset beta was reduced to an unrealistically low level; and that Fonterra now judges the SRP is no longer necessary because it now considers it has increased the asset beta (despite its downward adjustment) to an appropriate level. Elsewhere however Fonterra and the MPG argue that an SRP is no longer necessary because:

- Actual useful life of NP assets is greater than the economic life attributed to the assets for depreciation purposes and this difference can be deemed to provide compensation for any risk of asset stranding[28]. The MPG here seems to argue that selective "swings and roundabouts" are an excuse for failing to recognise a cost

[27] CEPA expands on that conclusion in pages 16 to 18 of its "supporting material" document published by the Commission alongside the CEPA 2021 Paper.
[28] Fonterra Reasons paper 2020/21 Milk Price Calculations Attachment 6, pg 38

required to be addressed by the Milk Price Manual. Miraka does not consider this an acceptable reason for failing to address the need for an SRP, or to justify removing the SRP in the 2020/21 WACC assumptions.

- Fonterra considers (and Miraka agrees) the most likely cause of asset stranding would be a loss of milk supply. Fonterra concludes that in this event the economic loss from stranding would not be material. Fonterra assumes that a reduction in required processing capacity due to reduced milk would simply result in a reduction in investment in replacement assets[29]. This remarkable assumption seems to extrapolate from simplifications in the NP model regarding asset obsolescence (a sort of FIFO approach to factory replacement). That simplification is not relevant to the real world prospect of asset stranding where the location of stranding is not predictable. There is then no reason why the location in which stranding occurs would align to the location of factories that are at the end of their economic life. It might be the case that a reconfiguration of milk processing planning could justify the decommissioning of an older plant in a location different to the incidence of stranding. That however is not an assumption that can be made in advance of the event in the case of a real world scenario.

- The Milk Price Manual (Rule 32) provides that in the case of a change in Reference Commodity Products resulting in the removal of reference assets from the NP asset base, an additional charge would be deducted when calculating the FGMP. That deduction would be in the form of a one-off charge or (presumably if the amount were judged to be too large) of a continuing charge reflecting any remaining value of the stranded asset. Rule 32 might be considered to remove the need for an SRP because the cost of stranding does not fall on investors. Crucially however Rule 32 provides that these charges to the FGMP can be waived in the event "this would result in the FGMP [being non-competitive by comparison to other processors]". In such circumstances, costs associated with asset stranding would in effect be borne by investors. In this case, Rule 32 is not an alternative to an SRP, and does not remove the need for an SRP.

- By drawing a comparison to the telecommunications fibre sector the MPG also now suggests that to the extent asset stranding risk is not symmetric, it is not sufficiently material to warrant compensation by way of an SRP[30].

40 Fonterra's approach to the SRP is willy-nilly: it has not properly justified why the SRP should now be removed. Assertions are made about the extent to which the risk of asset stranding is or is not systematic, might or might not be consistent with the asset stranding risk of the comparator group, or is material in any way. In any event Fonterra argues that any residual risk of asset stranding is covered by "swings and roundabouts".

41 The SRP has been judged to be appropriate to the WACC calculations for the last six seasons. Miraka does not consider the arguments for now removing it provide any more clarity than when the SRP was introduced. At that time it was considered an SRP was necessary but its value was difficult to attribute. In the event the SRP was estimated on the basis of "the amount of compensation required for varying combinations of (a) the

[29] Ibid

[30] Fonterra Reasons paper 2020/21 Milk Price Calculations Attachment 6, pg 39

proportion of the asset base which might be fully stranded and (b) the probability of that proportion of the asset being stranded"[31].

42 In the Draft Report BMP 20/21, the Commission also concludes the SRP is no longer necessary[32]. Reasons include:

- "There is no conclusive evidence that the comparators [for the asset beta] … have a materially different asset stranding risk to that of the NP"[33]. Miraka responds that there appears to have been no effort to consider risk of asset stranding in the comparators, and no conclusion can therefore be drawn on the matter. Miraka further points out that asset stranding would most likely occur as a result of changing dynamics in the supply of milk in New Zealand. This reflects varying NZ specific issues including:
  - Environmental regulation
  - Alternative land use
  - Industry response to an extended period of milk growth followed by static (and potentially declining) milk volumes
  - Increasing competition for a now static milk supply

  Of the valid asset beta comparators (i.e. excluding Fonterra) in the MPG comparator set only Synlait could be considered to demonstrate an asset beta which might reflect systematic risk of dairy processing asset stranding in the context of the New Zealand dairy industry. It is therefore unreasonable to conclude without evidence that the comparator set would capture asset stranding risk similar to that of the New Zealand dairy industry.

- "Non-systematic asset stranding risk … is currently low"[34]. Miraka responds that however low it might currently be, it is certainly not lower and is most probably higher than was the case in previous years when an SRP was considered necessary.

- The Commission cites Fonterra short and long term milk supply forecasts as evidence that Fonterra (and the NP) plant capacity are in equilibrium and not at risk of becoming stranded[35]. Miraka responds that these are Fonterra "business as usual" estimates (and not independent estimates) and do not of themselves change the risk of asset stranding, as illustrated in paragraph 45 below.

- The Commission shares the Fonterra view that asset replacement policy provides flex so that the NP can respond to declining milk volumes without causing asset stranding[36]. As noted in paragraphs 39 above and 45 below this does not align to the real world. Stranding would occur in a specific geographic location and would require a specific response to processing capacity related to that location.

43 Miraka considers that if anything the risk of asset stranding is increasing and the more likely requirement is for an increase in the SRP rather than its elimination. In July of this year, comments by the Fonterra CFO that New Zealand had reached "peak milk" were

[31] Ibid.
[32] Draft Report BMP 20/21, para 3.45
[33] Ibid. para 3.45.1
[34] Draft Report BMP 20/21, para 3.45.2
[35] Ibid para 3.67 and 3.68
[36] Ibid. para 3.42

widely reported[37]. This coincided with a flurry of commentary predicting plant closures (within the industry) in the face of increased competition for milk[38]. Like all dairy processors, Miraka is aware of increasing pressure for securing milk supply.

44 Charts in Appendix I demonstrate that New Zealand effectively achieved peak milk several years ago. The industry is slowly responding to that new reality and the elevated risk of asset stranding it has created.

45 Presumably mirroring Fonterra, the NP has in fact already faced the cost of inflated milk supply expectations leading to (apparently) 5 plants being stranded. The Commission points out that the "plants assumed to be mothballed in FY 17 in response to the reduction in milk supply are now permanently closed"[39]. This is assumed to refer to the "approximately five plants"[40] Fonterra reported as mothballed in the 2016/17 season. The five mothballed plants are now more correctly described as "stranded". This link between mothballing and asset stranding has never been satisfactorily addressed. The process for determining mothballed plants again was based on the assumption that productive capacity provided by the NP asset base is unhinged from geography. Thus the simple calculation of total milk processed divided by plant capacity determines the number of plants required to process the milk. Any balance of "unnecessary plants" by number are simply assumed to be mothballed without being specifically identified. This process does not align to the real world and is therefore not practically feasible. Furthermore the underlying assumptions would be unnecessary if the NP framework included a plan at the level of operationally managed milk catchment zones, and which matches processing capacity, the simple NP production plan, and the geographic location of plants. That plan would not be difficult to produce. It would be the basis for a proper assessment of specific plants which would be mothballed (and potentially on the way to being stranded), and therefore determining the proper capital and operating costs associated with mothballing and stranding. It has also never been properly disclosed how the capital cost of the five mothballed (and now formally "stranded") plants has been addressed in the milk price calculations. Miraka requests the Commission consider these issues.

46 In summary, Miraka considers the removal of the SRP from the 2020/21 milk price calculations is premature and has not been properly justified. Miraka considers the SRP should remain unchanged for the 2020/21 Season and be properly reviewed for the 2021/22 Season.

Mathematical correctness of the Fonterra calculated WACC (4.9%) for 2020/21

47 The formula for the NP WACC is laid out in the definitions section of the Milk Price Manual (1.4 of Part C) and in the Fonterra Reasons Paper for the 2020/21 Milk Price Calculations (page 34)[41]. Miraka is unable to reconcile the Fonterra calculated WACC of 4.9% to the WACC formula. Miraka estimates the WACC based on the formula in the Milk

[37] For example, https://www.rnz.co.nz/news/whoseatingnewzealand/446839/nz-has-reached-peak-milk-fonterra-cfo-warns

[38] For example, https://www.ruralnewsgroup.co.nz/rural-news/rural-general-news/peak-dairy-processing

[39] Draft Report BMP 20/21, para 3.65

[40] "Reasons Paper in support of Fonterra's base milk price for the 2016/17 Season (3 July)" pg 34 – it was then and remains unclear how a real world practically feasible processor could mothball "approximately" 5 plants.

[41] The Commission has also usefully laid out the WACC formula at page 14 of its Draft Report BMP 20/21 although that figure should be amended to reflect the restatement of the cost of debt to an after-tax basis.

Price Manual and the other parameters fixed by Fonterra is 5.2%[42]. Miraka estimates this difference of 30 bp is equivalent to 2 c/kg MS in the FGMP.

48 Miraka requests the Commission review the Fonterra calculations for the 4.9% WACC and confirm if it is consistent with the prescribed WACC formula and parameters. To remove all ambiguity from the calculations (e.g. to clarify what is included in the 35 bp adjustment for costs associated with debt issuance) Miraka also requests that Fonterra lays out its calculations for the WACC. Miraka notes there is nothing commercially sensitive in these calculations and in the spirit of transparency this detail should be disclosed.

Rounding protocol in the calculation of the WACC and its components

49 Fonterra sets the Notional Producer WACC correct to one decimal place. This contrasts with the provisions for costs of debt issuance (35 bp), the previously included SRP (15 bp), and the "raw" debt premium (defined as correct to 5 bp). These parameters are all set to a level correct to 4 decimal places (or a percentage correct to two decimal places). Miraka considers the WACC itself should not be set to a lower level of accuracy than the underlying parameters. The WACC, expressed as a percentage, should therefore be set correct to two decimal places.

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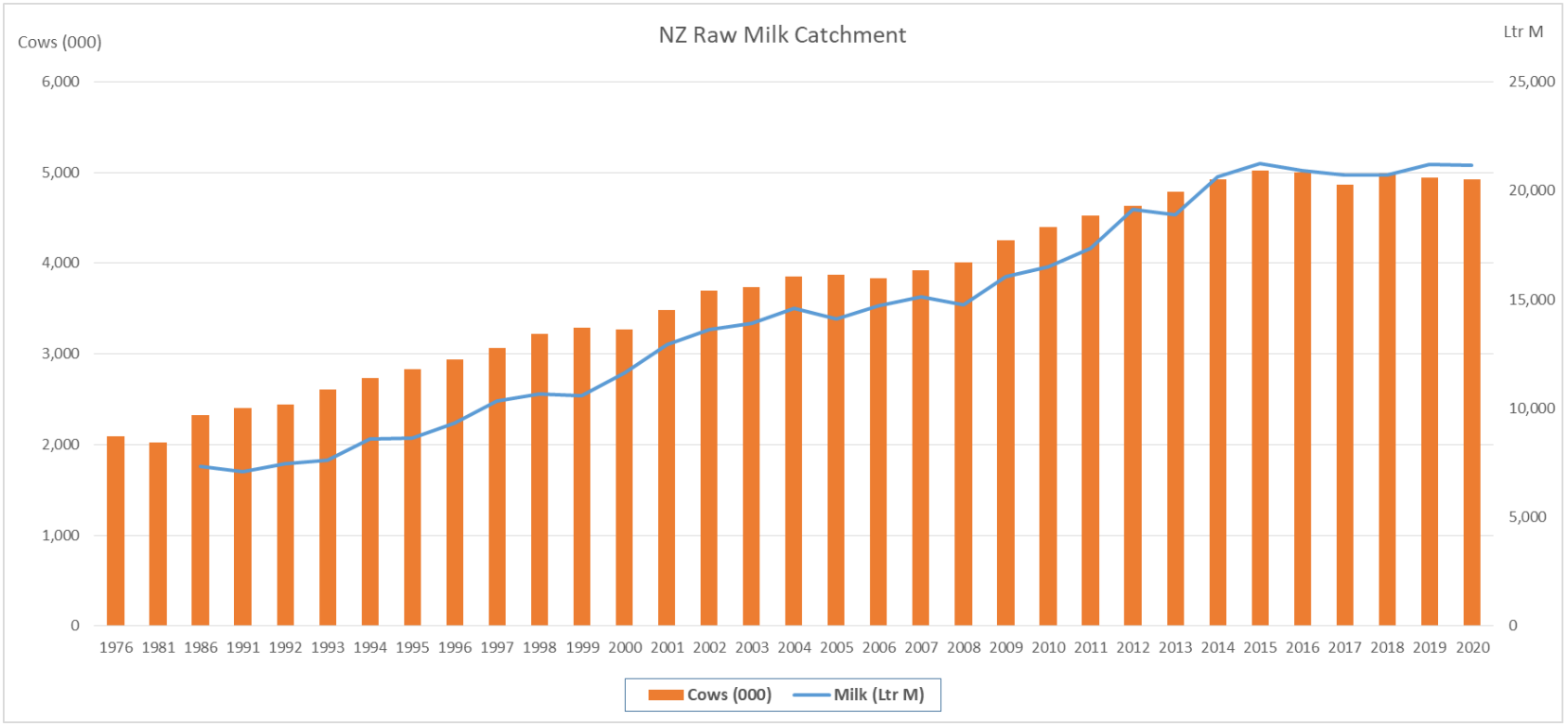
Grant Watson
Chief Executive Officer
Miraka Limited

[42] By way of clarification, Miraka assumes (but the Fonterra Reasons paper does not make clear) the 35 bp added to the "raw" debt premium as an "allowance for annualised debt issuance and other debt related costs" does not include the costs associated with swapping the US denominated spread into NZD. The Miraka estimate of WACC reduces to 5.1% if the swapping costs are included in the 35 bp provision but if that were the case the 35 bp provision has been set too low.

Appendix I - NZ Raw Milk Catchment Statistics

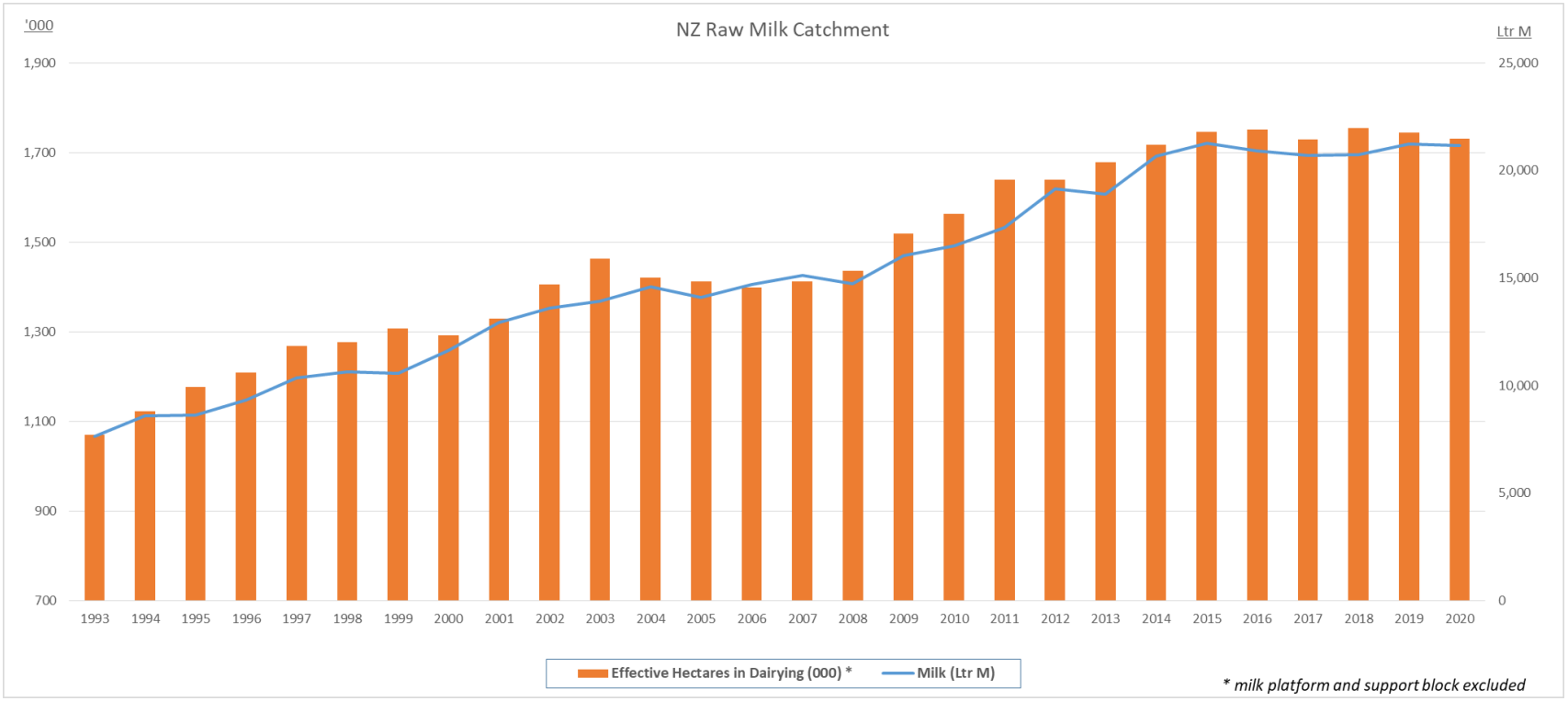
A. Cows in Milk/Milk Produced



[Source: New Zealand Dairy Statistics 2019-20]

B. Land in Dairying/Milk Produced

[Note that the primary vertical axis below has been set to “minimum 700” to more clearly demonstrate trend alignment.]



[Source: New Zealand Dairy Statistics 2019-20]