Vannessa Turner

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Commerce Commission

Dear Vannessa

Submission on the Commerce Commission's Draft Report – Review of 2015/16 Base Milk Price Calculation

Open Country Dairy (Open Country) is pleased to make this submission on the Commerce Commission's (Commission) Draft Report (Draft Report) on the 2015/16 base milk price calculation.

We note from the outset our strong belief that this submission is made in the context of a regulatory regime that is demonstrably not working. The Dairy Industry Restructuring Act (DIRA) regime is intended to provide a degree of integrity to the market by promoting transparency and objectivity in how Fonterra sets the base milk price. As it stands, however, the Commission's Draft Report demonstrates that Fonterra is effectively free of regulatory discipline and is able to prioritise its own objectives over the development of an efficient and contestable market.

We recognise that neither the DIRA milk price regime nor the Commission's Draft Report are solely responsible for the current state of the New Zealand dairy sector. However, these are important aspects of a wider regulatory regime that could be performing much better.

Against that background, in this submission we make the following comments on the Draft Report:

- The Commission's interpretation of DIRA's section 150A purpose statement could be refined to better promote DIRA's objectives.
- The asset beta should be set at the level of market comparators and not doing so sets a milk price that is not practically feasible and fails to satisfy the purpose of the DIRA.
- Fonterra's proposal to change how the notional processor's revenues are set is another example of the wide discretion Fonterra has in setting the milk price and underscores the volatility in the notional processor's earnings (and therefore the asset beta).
- The Commission's aggregate assessment demonstrates a milk price that fails to satisfy contestability. We are very concerned that the Commission accepts a 21 cent per kgMS difference between the notional processor and Fonterra with no evidence for it.
- We continue to push for greater transparency in the milk price, particularly full disclosure of the milk price model with the exception of information that is genuinely commercially sensitive and do not understand why there has been no development on this.
- To satisfy practical feasibility, the reference commodity products (RCPs) should be set based on what is expected to be profitable over the next five years.

- We consider that the Commission's approach to discharging its statutory obligations could be much more robust. For example, the Commission has provided little information on how it reached its conclusion on asset beta and does not appear to have engaged sufficiently with the substance of submissions by stakeholders.

In the sections below we provide our comments on these issues and before doing so, we provide some context for our submission.

We have also engaged Castalia to comment on the asset beta and the appropriate data to use to estimate the notional processor's revenues, and Castalia's report is attached to this submission.

1 Context for Open Country's Submission

The Commission's consultation on its Draft Report comes at a pivotal time for the New Zealand dairy industry. There are a number of very current indicators that the sector is not performing as it should.

- Returns to farmer suppliers are at historic lows, creating stress on the sector.
- The Commission has undertaken its review of the state of competition and found that, despite 15 years of DIRA, Fonterra still has a dominant market positon.
- The Ministry for Primary Industries (MPI) is now reforming the DIRA, and our hope is that this reform process leads to a more practically feasible milk price—and in turn, a more efficient transition pathway to deregulation.

In our view, this context is telling. It reveals categorically that DIRA is not functioning in the way it was intended. Within DIRA, the milk price regime is intended to provide a degree of integrity to the market by promoting transparency and objectivity in respect of Fonterra's setting of the base milk price. This integrity is increasingly vital because the base milk price has now become one of the most important price signals in the New Zealand economy. For example:

- Financial markets require consistency in the setting of the milk price over time. Both Trading Among Farmers and the milk price futures market rely on Fonterra not having the incentives or the ability to simply change its approach to the calculation of the base milk price to suit its own ends and without discussion or warning.
- Farmer suppliers to Fonterra need independent assurance that they are receiving a fair price for their milk. This is especially important in seasons with low dairy payouts, as the base milk price could determine whether dairy farming remains viable in some cases.
- Investors across the dairy supply chain need the confidence of a milk price that is calculated in a stable and predictable way to invest in capital assets for the long term. Regulatory scrutiny should be able to provide this confidence.

If DIRA was workably effective in terms of providing objectivity and transparency, then by now we would expect to see a widely traded futures market, high levels of trust from farmers in times of uncertainty, and long-term capital expenditure commitments in the whole New Zealand dairy supply chain (other than from Fonterra). As yet, those indicators of a well-functioning market have not emerged.

As a result, the Commission's Draft Report stands as evidence that the current DIRA regulatory regime is not working in the interests of market participants or the New Zealand economy. The incentives on Fonterra are simply not sharp enough to promote the development of an efficient, contestable market.

We recognise that the Commission is not responsible for the sole operation of the entire DIRA regulatory regime. That said, the Commission does play a crucial role. Its economic expertise helps it to analyse and communicate market impacts, and its independence allows it to examine Fonterra's approach objectively. These features mean that the Commission is uniquely placed within the DIRA regime to provide the type of robust scrutiny that enables efficient and contestable market forces to develop and take hold.

In this submission we note a number of specific points where a broader view of the market context suggests that changes to the nature and implementation of the Commission's framework are required. We have been careful to demonstrate that these changes are consistent with the statutory scheme set out in DIRA. In some cases, we consider that DIRA in fact requires such an approach. We respect that the Commission has its own views on some of these matters, and will have its own interpretation of the relevant statutory framework. If the Commission feels that it is unable to adopt an approach that will make a real difference to the development of contestable, efficient dairy markets, then that is a clear signal that the regulatory regime needs to change.

We also challenge the apparent view that the DIRA regime is entering a 'business as usual' phase.[1] Based on our experience of the market, we do not understand how an objective observer could have reached this conclusion. In fact as the base milk price develops a more critical role in the New Zealand economy it is becoming more important that there be transparency and objectivity regarding its calculation. There is still much important work to be done in respect of the development of robust assessment criteria and a consideration process that treats Fonterra's approach with an appropriate degree of skepticism. Until these features are embedded in the DIRA regime, the objectivity and transparency required to achieve real market outcomes will be frustrated.

Open Country Dairy has a direct interest in the success of the New Zealand dairy sector, but the concerns addressed in this submission have wider implications for the effective functioning of the market. Unchecked dominance has never delivered real, sustainable economic benefits, and it was never intended that it should form part of the DIRA regime. We trust that the Commission is open to working with us (as well as other interested parties) to better deliver the types of market outcomes contemplated by the DIRA regime in order to lift New Zealand's economic performance.

[1] Comments to that effect were made by Commissioner Sue Begg during the Commission's presentation on its draft decision.

2 Statutory Purpose

The Commission's interpretation of the statutory purpose in section 150A focuses on two key aspects:[2]

- the "efficiency dimension"; and
- the "contestability dimension".

We agree that these two elements are central to the Commission's assessment of Fonterra's calculation. However, framing these elements as "dimensions" can give the impression that they are discrete considerations. In our view, that approach risks narrowing the focus of the Commission's assessment in a way that fails to take into account the market effects of Fonterra's calculation.

Our concern is that the full market context can be overlooked if the statutory references to efficiency and contestability are understood as discrete, isolated considerations. Both the notional processor construct and the practically feasible standard contemplated by DIRA can promote a relatively superficial "check the box" approach to assessing Fonterra's calculation when a broader assessment is more appropriate. It is not our intention to challenge the need to undertake those assessments as such. Our point is that these elements are not ends in themselves, but are undertaken to further the underlying objects of the statutory regime. The Commission's statutory obligation to assess Fonterra's calculation must be construed in light of this broader regulatory context.

At this point an example may be illustrative. The base milk price has important implications for the balance between productive and dynamic efficiency in the dairy sector. The notional processor standard provides a simple incentive for Fonterra to lower its costs relative to its revenues, which promotes productive efficiency. In contrast, the contestability requirement focuses more on dynamic efficiency through the potential for new entry and expansion. Where is the balance to be struck between these two efficiency considerations? Treating efficiency and contestability as isolated dimensions has the effect of avoiding this question, when answering it is in fact critical to the future development of the sector.

The point here is actually a very simple one. Fonterra's milk price calculation cannot be considered efficient or practically feasible if Fonterra sets the price in a way that prioritises its own interests over those of a functioning, contestable market. These are the central issues that the Commission is required to assess as part of the milk price monitoring regime, and they can only be appreciated if a sufficiently broad view of the market, and the role of the base milk price in the market, is taken.

Considering these market effects is an essential part of the statutory assessment that the Commission is required to undertake, for two reasons:

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[2] Commerce Commission *Our Approach to Reviewing Fonterra's Milk Price Manual and Base Milk Price Calculation* (15 August 2016) at 3-5.

- The full wording of section 150A(1) expressly links the efficiency and contestability elements, requiring them to be considered together.
- The broader context of the DIRA milk price regime indicates that efficiency and contestability are not ends in themselves but intended to influence market dynamics.

The full wording of section 150A(1)

Section 150A(1) provides that the purpose of the Commission's assessment of Fonterra's calculation of the base milk price is to:

> … promote the setting of a base milk price that provides an incentive to new co-op to operate efficiently *while providing for* contestability in the market for the purchase of milk from farmers. (emphasis added)

In our view, the "while providing for" language is vital. It links the elements of efficiency and contestability together. In other words, the two "dimensions" identified by the Commission inform each other.

Expressly linking the efficiency and contestability dimensions in this way only makes sense if the intent of the legislation is that the Commission's assessment take into account the overall market effect of Fonterra's pricing. A number of factors support this interpretation:

- It is consistent with the overall scheme of DIRA, which is intended to check Fonterra's dominant market position.
- It is consistent with the Commission's role as an economic regulator, as it relies on expertise and the exercise of judgement.
- It is consistent with fostering a contestable dairy market in practice, and with real-world incentives for market participants to act efficiently.
- It gives effect to the express statutory wording in its entirety.

The broader context of the milk price regime

The broader context of the milk price regime within DIRA also supports this interpretation. We consider that two aspects of the regime in particular inform the proper interpretation of the underlying policy intent:

- the objectivity of an assessment undertaken by the Commission as an independent expert (who is in turn required to provide some justification for its assessment); and
- the transparency of a publicly reported assessment process.

These features indicate that the regime is clearly intended to promote a degree of integrity in the milk price for the benefit of the market as a whole. This promotion of integrity complements the express goals of efficiency and contestability, but all take effect in a particular market context. Understanding that market context is a part of any meaningful assessment of Fonterra's milk price under the DIRA regime.

This is not an esoteric issue. We emphasise again that the base milk price has real implications for a range of affected parties on all sides of the farm gate milk market: farmers, investors and independent processes. Taking the interests of all of these parties seriously is essential to the proper operation of the DIRA regime. It is required by section 150A that the Commission consider these issues as part of its assessment.

3 Asset Beta

The asset beta used by Fonterra in the base milk price calculation is too low, and the Commission should encourage Fonterra to adopt a more realistic asset beta. We are genuinely surprised by the Commission's acceptance of Fonterra's proposed asset beta because we cannot see how it satisfies DIRA's purpose statement.

As we have submitted previously, the asset beta must satisfy practical feasibility—and yet Dr Marsden, Dr Lally, and, it appears, the Commission all consider a processor that is close to riskless as satisfying practical feasibility. This view is based on a specific legal interpretation of sub-part 5A of DIRA that we can see little justification for. Crucially, Dr Lally states that:

> "Section 150C states that the milk price must be based upon the actual revenues that would have been earned from the sale of a particular mix of commodities produced using all of the milk supplied to it, ***net of costs***, with the mix of commodities chosen on the basis of Fonterra's physical manufacturing capacity and anticipated profitability rom possible mixes over a period of up to five years". [emphasis added]

Dr Lally appears to conclude that DIRA requires the base milk price to be set via an ex post adjustment at the end of each year. However, there is nothing in Section 150C that requires this type of ex post adjustment. Section 150C does require that the milk price be set based on revenues and costs estimated in certain ways, but nowhere is it stated that the calculation must include an annual ex post adjustment that passes on almost all commodity price risk to farmers.

Given the focus in the section 150A purpose statement on efficiency and contestability, Dr Lally's interpretation is open to question on the merits and we address this point in the following paragraph. But in any case, the Commission is required to give little weight to a specific legal interpretation of sub-part 5A based on a lay-person's views. Also of concern is that Dr Lally reaches conclusions on other legal points, such as the interpretation that practically feasible means "possible".[3] Dr Lally has been retained by the Commission as an economic expert, and with respect he is not in a position to provide credible legal advice to the Commission. As no independent justification for this interpretation has been presented by the Commission, Dr Lally's view is the only rationale for this specific interpretation. The interpretation must as a matter of principle be rejected on this basis.

As Castalia discusses in its report, no processor actually operating is close to riskless and virtually every processor other than Fonterra shares in the systematic risk in the dairy sector. Fonterra even acknowledges this point. If no processor actually operating replicates this risk allocation, and

[3] Martin Lally *Assessment of the Asset Beta for Fonterra's Notional Business: further Analysis* at page 10.

Fonterra's own risk allocation is a product of its market dominance, we cannot see how the Commission could form the view that such a risk allocation satisfies practical feasibility.

While the Commission appears to have asked Dr Lally follow-up questions as a result of our submission, we are frustrated at the lack of engagement from the Commission with the substance of our submission. By accepting Dr Lally's evidence on these matters, the Commission risks failing to turn its own mind to the issues. We think a more critical reading of Dr Lally's evidence should be undertaken by the Commission before it is accepted. Understanding practical feasibility is really a question of legal interpretation, and yet the Commission's approach appears to be to ask Dr Lally as an economist to interpret DIRA on the Commission's behalf.

As a matter of the appropriate test, the Commission reaches the conclusion that using Fonterra's notional business to estimate the asset beta satisfies DIRA because it is "reasonable".[4] It then carries this analysis slightly further by concluding that this approach "does not produce an outcome that is inconsistent with section 150A". As we discuss in section 6 below, neither "reasonable" nor "not inconsistent with" are substitutes for the statutory test.

We are also frustrated by the Commission placing the onus on industry stakeholders to provide the figure for what the asset beta should be. The conclusion in the Draft Report appears to be that contrary evidence need not be considered because independent processors have not provided an alternative estimate of the asset beta.[5] As we explain in section 6 below, arguments provided during the submission process cannot be dismissed in this way. The obligation on the Commission is to take all arguments into account and weigh the relative merits before reaching its own view on the matter.

In any case, we now provide the Commission with further evidence, including a specific estimate of the asset beta, in the attached expert report from Castalia. Castalia explain in detail how they reach their conclusion that the asset betas of market comparators that operate in the dairy commodity sector are the appropriate data to use in estimating the notional processor's asset beta.

We urge the Commission to consider this submission and Castalia's report. The evidence is clear that Fonterra's proposed asset beta for the notional processor cannot satisfy the practical feasibility standard required by DIRA.

4 Using Off-GDT Sales in Estimating the Notional Processor's Revenues

Fonterra's proposal to use off-GDT sales to inform the notional processor's prices is unjustified and fails to appreciate the points raised in Castalia's report. Further, any such change will have major impacts on the transparency and predictability of the DIRA regime—impacting the dairy processing industry as well as financial markets.

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[4] Commerce Commission *Review of Fonterra's 2015/16 base milk price calculation: Dairy Industry Restructuring Act 2001 Draft Report* (15 August 2016) at para 4.49.

[5] Commerce Commission *Review of Fonterra's 2015/16 base milk price calculation: Dairy Industry Restructuring Act 2001 Draft Report* (15 August 2016) at para 4.36.

The Commission considers that the increase in the base milk price of between four to five cents per kgMS is inconsequential. This is far from inconsequential—it is a significant amount which impacts the contestability of the milk price. The impact on the market, and individual market participants, is significant and Open Country estimates this having an annual impact (over the industry) of $100 million.

The impact on affected parties should be a relevant factor in the Commission's decision. The efficiency and contestability criteria that the Commission and Fonterra are required to apply mean that a more qualitative assessment is appropriate.

5 The Commission's Aggregate Assessment Demonstrates a Milk Price That Fails to Satisfy Contestability

In the Commission's Draft Report, the Commission relies on and includes a comparison between the notional processor and Fonterra's global operations and global ingredients (GOGI) business. The comparison was used by the Commission expressly for the purposes of assessing whether the notional processors performance was practically feasible. The Commission's results reaffirm Open Country's position—the level of performance assumed for the notional processor is unrealistic despite the Commission regarding it as the 'best like for like comparison'. We cannot understand how the Commission could have faith in such an assessment when the Commission has been unable to 'pin down' the reasons for a 21 cents per kgMS difference between Fonterra's GOGI business and the notional processor. That is a hugely significant difference that has major implications for practical feasibility. It is unsatisfactory that the Commission's inquiry has not explained such a large proportion of the difference between the two businesses, and we urge the Commission to reconsider finding any comfort in this exercise until the reasons for such a large difference can be ascertained.

6 Transparency

We continue to push for greater transparency in the milk price regime. To date we have focused on increasing transparency in the information released by Fonterra, and this remains important. In this submission we add a push for greater transparency in the Commission's decision-making process.

We repeat below our earlier request that the Commission push for transparency on the following matters related to information released by Fonterra:

- The milk price model. Only information which is genuinely commercially sensitive should be withheld—and to date there has been no explanation or justification for the lack of further disclosure. We cannot understand how no progress has been made on this issue
- The sales phasing used in the model that, when matched with the prices on GlobalDairyTrade for each contract period, determine the notional processor's revenues
- The level of buffer capacity Fonterra assumes the notional processor maintains

- Fonterra's approach to scaling back its reported, publicly available costs to reach the costs of the notional processor.

We are frustrated that Fonterra' disclosure of a sanitized milk price model that, for the most part, restates the data already contained in the milk price statement, is being accepted by the Commission as sufficient transparency. Full disclosure of the model is required to ensure a fair consultation process:

- Interested parties must be given an opportunity to examine and comment on all information relevant to the Commission's decision. Doing so ensures that the information is properly tested.
- Interested parties must have sufficient information to understand and provide informed comment on the Commission's justification for the decisions in its Draft Report. This ensures that the Commission takes all relevant information into account.

We recognise that there may be genuine concerns regarding confidentially in respect of Fonterra's commercially sensitive information. However, these concerns need to be understood in context:

- The primary factor in this context is regulatory propriety rather than commercial sensitivity. The public interest favours transparency over secrecy.
- The model has been prepared by Fonterra as part of a regulatory proceeding. There must be a reasonable expectation in these circumstances that all information relevant to the Commission's decision is disclosed.
- Procedural fairness requires an opportunity for interested parties to comment on all relevant information, and the Commission's assessment of that information. A range of affected parties are disadvantaged if secrecy is maintained.
- As Fonterra has provided information directly to the Commission other than through a public consultation process, there is an added risk of bias. The best way to ensure that the Draft Report reflects the views of the Commission and not Fonterra is to lay all relevant information open to scrutiny.

In this case, procedural fairness requires disclosure unless there is a genuine commercial interest in the information not being disclosed. Only genuinely commercially sensitive information should be entitled to be withheld, and this should be interpreted in the context that commercial confidentiality is not the priority in this case—it is regulatory propriety. In that context, procedural fairness privileges transparency over commercial confidentiality.

We are aware that the DIRA regime does not expressly require that independent processors and other interested parties are consulted on the Draft Report. This is a failing of the DIRA regime that we hope will be amended as part of reforming DIRA. For that reason we fully support the Commission's decision to seek public consultation. In addition to assisting it in fulfilling its statutory obligations and retaining the requisite independence, it is the approach most likely to generate a better set of decisions. But regardless of the looseness of the statutory consultation obligation, once the decision to consult has been made, the consultation must be full and fair. That is what we are asking of the Commission in this case.

7 Changes to the Reference Commodity Products

Open Country is concerned that changes to the Reference Commodity Products (RCPs) must satisfy DIRA's purpose. The Commission has recommended in its draft report that Fonterra consider reviewing the RCP basket 'more frequently – possibly even annually'.[6] DIRA requires that the RCPs be the products likely to be the most profitable over a period not exceeding five years.[7] Beyond this requirement, changes to the RCPs must satisfy the purpose statement of DIRA. Both efficiency incentives and practical feasibility require that changes to the RCPs are only made where there are good reasons for doing so, and there is a robust case for change—and as a result we are very concerned about the Commission's recommendations. Real-world processors do not make investments based on expected profitability over a single year time horizon because processing assets:

- Have a significant lead time to install;
- Are, to a large extent, sunk; and
- Have long useful lives.

The relative levels of profitability of different commodities can also change rapidly. Against this context, even five years is a short period of time over which to make investment decisions in sunk processing assets. We urge the Commission to reconsider its recommendation that Fonterra should change the RCPs more frequently.

8 The Commission's Approach to Discharging its Statutory Obligations

We have two broad comments on the Commission's approach to discharging its statutory obligations in the Draft Report:

- The Commission's assessment for consistency with Section 150A; and
- The need for the Commission to give full consideration to all submissions.

Assessment for consistency with Section 150A

The Commission's statutory function is to assess Fonterra's base milk price calculation for compliance with the statutory criteria to be derived from Section 150A. Conceptually, this involves the Commission setting out its view of the statutory criteria, and then explaining the justification for its view as to whether Fonterra has satisfied this standard.

In a number of instances, however, the Commission appears to assess Fonterra's calculation against the standard of reasonableness, rather than against the statutory criteria of efficiency and contestability. This is a concern because:

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[6] Commerce Commission *Review of Fonterra's 2015/16 Base Milk Price Calculation: Draft Report* (15 August 2016) at para 6.8.3.

[7] Section 150C of the Dairy Industry Restructuring Act 2001.

- Reasonableness is not a standard that promotes a functioning, contestable market, and so it affords additional scope to Fonterra to manipulate the base milk price in ways that prioritise its own interests over those of the market;
- The Commission's reasoning is not justified in a sufficient level of detail for interested parties to respond to, as a conclusion of "reasonableness" is treated as self-justifying; and
- It is likely to amount to a mistake of law, with the Commission having misdirected itself as to the legal standard it is supposed to apply.

There are a number of examples where the Commission has determined that elements of Fonterra's calculation are reasonable rather than applying the statutory criteria of efficiency and contestability. For example:

- The Commission considers that the use of actual performance data in calculating the base milk price is "reasonable".[8]
- The Commission considers that Fonterra's estimate of the asset beta for the notional producer is "reasonable".[9]
- The Commission considers that Fonterra's assumptions around effluent losses are "reasonable".[10]
- The Commission considers that Fonterra's assumptions around stockfood losses are "reasonable".[11]
- The Commission considers that Fonterra's corporate cost reset is "reasonable".[12]
- The Commission considers that Fonterra's valuation of the notional producer's asset base is "reasonable".[13]

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[8] Commerce Commission *Review of Fonterra's 2015/16 base milk price calculation: Dairy Industry Restructuring Act 2001 Draft Report* (15 August 2016) at para 3.5.

[9] Commerce Commission *Review of Fonterra's 2015/16 base milk price calculation: Dairy Industry Restructuring Act 2001 Draft Report* (15 August 2016) at para 4.40 and 4.49.

[10] Commerce Commission *Review of Fonterra's 2015/16 base milk price calculation: Dairy Industry Restructuring Act 2001 Draft Report* (15 August 2016) at para 4.73.

[11] Commerce Commission *Review of Fonterra's 2015/16 base milk price calculation: Dairy Industry Restructuring Act 2001 Draft Report* (15 August 2016) at para 4.76.

[12] Commerce Commission *Review of Fonterra's 2015/16 base milk price calculation: Dairy Industry Restructuring Act 2001 Draft Report* (15 August 2016) at para 4.94.

[13] Commerce Commission *Review of Fonterra's 2015/16 base milk price calculation: Dairy Industry Restructuring Act 2001 Draft Report* (15 August 2016) at para 4.120.

Further, the Commission determines on at least one occasion that Fonterra's calculation is "not unreasonable":[14]

> We consider for the specific risk premium that there are good reasons for making an allowance for asset stranding risk. However, there is limited empirical information on which to base an estimate of the appropriate allowance for the notional producer. Fonterra has exercised its judgement and has chosen an increment to the cost of equity of 0.15%. Based on the information available to us, this does not appear unreasonable.

A finding that a decision is "not unreasonable" is, in effect, a statement that the reviewer is comfortable relying on the judgement of the party subject to review. This is of particular concern because it amounts to the Commission effectively delegating its role as objective regulator to Fonterra.

Whether the outcome of Fonterra's judgement is consistent with the statutory purpose is a matter for the Commission, and not Fonterra, to determine. This delegation of the Commission's statutory function to Fonterra is a product of failing to apply the proper statutory test as well as being an abdication of discretion. In both cases the concern is that the Commission's determination is not being made lawfully.

When assessing Fonterra's calculation for consistency with the Section 150A purpose, the Commission is required to expressly turn its mind to whether the calculation provides Fonterra with incentives to be efficient and whether the calculation is practically feasible, in the context of the objectives of the DIRA regime. The "reasonableness" standard that the Commission has adopted at various points does not address either of those two dimensions.

The need to properly and fully consider submissions

When considering the views of interested parties in a consultation process, the approach required by standard public law principles is that the Commission consider the evidence, weigh its merits, and then factor that evidence into its considerations in an appropriate way. There are three reasons why this approach needs to be applied:

- It achieves fairness, with views from all sides being considered on their merits.
- It promotes stability, with conclusions being reached on the basis of a range of evidence.
- It ensures legality, as the Commission is required as a matter of public law to fully and fairly consider the arguments and evidence made to it.

Ultimately, the risk is that the Commission overlooks a strong or influential argument because it has not fully considered that argument on its merits.

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[14] Commerce Commission *Review of Fonterra's 2015/16 base milk price calculation: Dairy Industry Restructuring Act 2001 Draft Report* (15 August 2016) at para 4.31.

On the face of the Commission's Draft Report, we do not have confidence that this standard public law approach has been followed consistently. One key example the Commission's dismissal of the evidence provided by independent processors in respect to the estimation of the asset beta.

The Commission notes that it received submissions that market comparators should be used as the starting point for estimating the asset beta.[15] Rather than engaging with that submission on its own terms, the Commission simply notes that certain other evidence (the extent of any deduction for differences in risk) has not been provided.

With respect, it is an unusual approach to decline to engage with a particular line of argument because "better" evidence could (theoretically) have been provided. This approach does not afford full respect to the potential merits of the initial argument, which leaves open questions regarding whether the Commission's Draft Report has properly taken into account all available information.

One interpretation of the Commission's approach to assessing this evidence is that it declines to give meaningful weight to theoretical evidence, preferring to rely on empirical evidence if such evidence is available. We agree that empirical evidence is important, and often assists with the understanding the value to be placed on theoretical evidence in a specific context (although we note that the reverse is also true – theoretical evidence can qualify and contextualize empirical evidence). This desire for empirical evidence should not be corrupted so that it results in:

- An assumption that primacy is to be afforded to empirical evidence over theoretical evidence; or
- An approach that refuses to engage with theoretical evidence because empirical is either not available or has not yet been presented to the Commission by parties to the consultation process.

Each of these situations would result in manifest procedural impropriety. On the stated reasons given in the Draft Report, it is not clear that these impulses have been avoided.

We appreciate that there is no statutory obligation to consult non-Fonterra third parties, and we support the Commission's view that seeking input from a wide range of affected parties leads to a better overall decision. However, once the decision to consult has been made it must occur in accordance with proper process. If not, the benefits of the full range of views the Commission has received will have been lost in the process of finalizing the Draft Report.

We also note that the very high threshold set before third party evidence is accepted stands in contrast to the Commission's low "reasonableness" threshold in respect of evidence provided by Fonterra. Given that the very purpose of the DIRA regulatory framework is to promote objectivity and transparency in respect of Fonterra's decision-making, the preferential treatment Fonterra appears to have received in respect of its views is concerning. We would prefer to see evidence of an approach that ensures equal treatment of all views so that the best possible decision can be reached.

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[15] Commerce Commission *Review of Fonterra's 2015/16 base milk price calculation: Dairy Industry Restructuring Act 2001 Draft Report* (15 August 2016) at para 4.44.

9 Conclusion

Thank you for the opportunity to make this submission. Open Country looks forward to continuing to engage in the milk price monitoring regime.

Best regards,

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Chief Executive Officer

Open Country Dairy Ltd