17 June 2016

Regulation Branch
New Zealand Commerce Commission
PO Box 2351
Wellington 6140
Attention: Vanessa Turner, Manager Market Assessment & Dairy
By Email: regulation.branch@comcom.govt.nz

Commerce Commission – Publication of milk price asset beta and specific risk premium reports

1.0 The Commission has sought comments on two papers which assess the "asset beta" used in the Farmgate Milk Price (FGMP) WACC:

- Marsden Update Paper (April 2016) – commissioned by Fonterra, Dr Alastair Marsden updates his earlier December 2014 paper which assessed an asset beta for what is described as the Fonterra Notional Business[1]. The earlier paper assessed the asset beta at 0.375. Fonterra used that asset beta to determine the FGMP WACC for 2014/15. In the Update Paper Marsden confirms his assessment of 0.375. Marsden also assesses a specific risk premium for asset stranding risk.
- Lally Paper (May 2016) – commissioned by the Commerce Commission, Dr Martin Lally peer reviews Marsden's Update Paper. Lally considers the asset beta for the Fonterra Notional Business should be 0.34 and bases this on the asset beta for Electricity Lines Businesses regulated in accordance with Part 4 of the Commerce Act.

1.1 The Marsden and Lally papers are a response to the Commission's report on the 2014/15 Farm Gate Milk Price (FGMP) calculations. That report concluded the "judgement exercised in arriving at the value for the asset beta and specific risk premium in the WACC component is not explicit, and this has not yet been sufficiently explained by Fonterra". As has been the case since it first commenced its reviews of the FGMP Milk Price, the Commission therefore remained unable to conclude on the practical feasibility of these assumptions for the 2014/15 FGMP calculations. The Marsden and Lally papers were intended to provide evidence so that practical feasibility of the asset beta and specific risk premium assumptions could finally be confirmed.

1.2 Miraka most recently noted its concerns about the practical feasibility of the asset beta assumptions in a submission to the Commerce Commission (4 February 2016) on the

[1] The Fonterra Notional Business was separately defined and described by Fonterra. Marsden was not required to consider whether the Fonterra Notional Business provided an appropriate framework for assessing the asset beta required in accordance with Rule 43 of the 2015/16 Milk Price Manual, or was practically feasible in accordance with Subpart 5A of the DIRA.

Commission's "Process and Issues Paper – Review of 2015/16 Base Milk Price Calculation". Miraka explained why it considered the notional business on which the asset beta was based (the "Fonterra Notional Business" in the Marsden paper) was not practically feasible within the terms of the DIRA. Miraka described this as a framing issue.

1.3 This framing issue raised by Miraka has not been addressed in the Asset Beta papers. This is confirmed in Marsden's update paper at paragraph 7.27: "the relevance of Fonterra's Notional Business to determining the FGMP WACC is a framing issue and is outside the scope of both our Prior report and this report".

1.4 At paragraph E.6 of his earlier (December 2014) paper, Marsden did however confirm that: "The pricing methodology to set the Farmgate milk price under the Milk Price Manual exposes the capital or business owners of Fonterra's Notional and Actual Businesses to significantly less risk compared to a normal business".

Marsden thus concludes the Fonterra Notional Business is not a "normal business". Its risk profile must be considered abnormally low. Unfortunately Marsden was not asked to consider whether this abnormally low risk profile was practically feasible for an efficient processor operating in a contestable market as envisaged by the DIRA.

1.5 Because Lally's paper is a peer review of the Marsden paper, Lally's paper is constrained by the scope of Marsden's paper: Lally also does not address the practical feasibility issue.

1.6 Miraka's issues with the practical feasibility of the asset beta have accordingly still not been addressed. Miraka considers that the asset beta and resulting WACC that was used in the 2014/15 FGMP, and will presumably be used in the 2015/16 FGMP, are lower than could reasonably be achieved by a commodity operator of scale in a competitive New Zealand market. The asset beta and WACC accordingly act as a disincentive for efficient investment in the dairy processing industry and serve to undermine the purpose of the DIRA.

2.0 Asset Beta Comparators

2.1 Marsden and Lally place considerable weight on the asset beta estimate for Electricity Lines Businesses (ELB). The ELB asset beta of 0.34 was estimated by the Commerce Commission for purposes of price controls imposed under Part 4 of the Commerce Act. Marsden considers the ELB asset beta is "a useful guide" while Lally goes further and concludes the FGMP asset beta should be the same as for the ELBs.

2.2 The ELBs are regulated under Part 4 of the Commerce Act. Section 52 of that Act states that organisations (such as the ELBs) are regulated because they operate "in markets where there is little or no competition and little or no likelihood of a substantial increase in competition". The regulation of the ELBs reduces profit volatility and uncertainty of profits. Profits are significantly assured by the regulated asset beta and WACC.

2.3 The purpose of the DIRA regulation of the FGMP is fundamentally different to Part 4 of the Commerce Act. While Part 4 regulates industries where there is little or no competition, the DIRA is intended to oversee and encourage the emergence of a properly contestable market. Further, the DIRA anticipates it will be dismantled once the dairy markets are sufficiently contestable. The FGMP is required to be based on assumptions and inputs that are practically feasible. To be consistent with the purpose of the DIRA, those assumptions must therefore be practically feasible in a contestable market. The ELBs would therefore seem of limited relevance to the asset beta for the FGMP.

2.4 Marsden also considers asset betas of actual comparator companies. However, he puts less or even little weight on them (and Lally seems to dismiss them outright). This appears to be because the comparator companies "do not have the ability to make ex-post adjustments to pass through variances between the forecast and the actual milk price" (Marsden: Paragraph E.7). Again, Marsden notes at paragraph 5.10 that Bega Cheese Ltd "is still exposed to competition for milk and must pay a market determined price". Marsden offers this as a reason why the Bega Cheese Ltd asset betas[2] are not a useful comparator for the Fonterra Notional Business. Miraka considers that the opposite is true. This goes to the heart of the "framing issue" that Miraka raised: to be practically feasible, the asset beta must assume a business which is "exposed to competition for milk and must pay a market determined price".

2.5 In summary, Miraka considers it is inconsistent with the DIRA to assume an asset beta based on companies (ELBs) operating in markets with little or no competition. Rather, the asset betas of comparator companies operating in contestable markets are more relevant for considering the asset beta of the FGMP. This is the reverse of the approach taken by Marsden (and Lally).

3.0 Specific Risk Premium – Asset Stranding

3.1 Asset stranding for the Notional Business could occur for a number of reasons including:

1. Milk supply declines so certain installed assets become surplus to requirements. Under Rule 34 of the Milk Price Manual, any associated cost is a charge against profit.
2. Demand for the relevant product declines or disappears. Under Rule 33 of the Milk Price Manual, any associated cost is a charge to the milk price and is borne by milk suppliers, <u>unless this would cause the FGMP to be uncompetitive compared to Fonterra's competitors (in which case it would be a charge to profit).</u>

3.2 Marsden only deals with the effect on WACC of the first above risk (asset stranding due to a decline in milk supply). He estimates a small adjustment to WACC could be required. However, in the absence of robust empirical evidence he suggests that no adjustment to WACC be made for this risk. He discusses how the relevant asset would be selected for write-off, but seems to accept Fonterra advice (paragraph 8.12) that it is appropriate to consider the oldest plant in the relevant island of New Zealand affected by the reduced milk supply should be written off. This seems contrary to what can be expected for a real world business with a network of plants across the entire country. The locale in which the diminished supply occurs would have a significant bearing on the actual plant to be written off.

3.3 Marsden does not deal with the second situation (asset stranding due to a change in product mix). This is because the default assumption in Rule 33 is that any cost of stranding would be a charge to the FGMP. However, for a practically feasible business, there is no reason to assume that competitors would face the same asset stranding due to changes in demand as would be the case for the Notional Producer. The default situation is therefore more likely. Overlaying the requirement for practical feasibility, it should therefore be assumed that costs associated with this asset stranding would also fall against profits, or there is a substantial risk that would be the case. WACC should reflect that risk. This is certainly the case for Fonterra's current real world competitors.

3.4 Miraka considers the Specific Risk Premium assessed by Marsden is flawed. In the case of a decline in milk supply, the asset stranding risk has not been assessed on a practically feasible

[2] Bega asset betas range from 0.48 to 0.70 (based on monthly data) - Refer the Ernst and Young analysis included in Appendix II of Marsden's paper.

basis. In the case of a change in product mix change, the asset stranding risk has simply been ignored.

4.0 Conclusion

4.1 When considering the approach to the WACC appropriate for the FGMP, a fundamental framing issue needs to be addressed. At the outset it is necessary to acknowledge the FGMP Notional Producer is merely a framework from which a competitive milk price emerges. However, to determine the practically feasible WACC requires a reimagining of the notional producer as a participant in the competitively priced market. This re-imagining has not occurred. On the contrary, the asset beta and specific risk premium have been determined on the assumption of a notional business that is largely immunized from a normal competitive environment, and takes far too literally the environment assumed to the FGMP Notional Producer. Miraka is concerned that again limited progress appears to have been made with this long outstanding issue. As noted, Miraka considers the current WACC is substantially lower than required to promote efficient investment. Miraka seeks for this issue now to be finalized as a matter of urgency in the Commission's report on the 2015/16 FGMP calculations.

Miraka would appreciate an opportunity to review the matters raised in this memorandum with the Commission.

Richard Wyeth
Chief Executive Officer
Miraka Ltd