Dear Leighton

Submission on asset beta and specific risk premium reports

Open Country is pleased to make this submission on the two reports (the Reports) released by the Commission on the asset beta and specific risk premium for asset stranding used in the milk price model:

- The updated report by Dr Alasdair Marsden (the Marsden Update)
- The report by Dr Martin Lally (the Lally Report).

The asset beta assumed for the notional processor is a major driver of whether the milk price is both efficient and contestable. As the Commission has noted in the past—asset beta is a highly sensitive input. Open Country firmly believes the asset beta used in the milk price model is too low and that it is a primary driver of the milk price not being practically feasible. Our main comments on the Reports are that:

- They misconceive of the notional processor as having attributes of Fonterra that would not be expected to exist for an efficient and practically feasible notional processor
- Electricity lines businesses (ELBs) are an inappropriate starting point for estimating the notional processor's asset beta because of the significant differences between the industries and the firms
- Market comparators are the most appropriate starting point for estimating the asset beta for the notional processor.

Set out below are our comments on the first of these three points and our concerns on the process of the asset beta review. We have engaged Castalia to provide an opinion on the second and third points, and that opinion is attached to this submission.

The Reports do not take into account the full operating environment and risks for a practically feasible notional processor

Stepping back, a 5.9 percent weighted average cost of capital (WACC) (used by Fonterra in the 2015/16 season) is not practically feasible and an equity investor in the notional processor would expect significantly greater than this. The Reports paint the picture of a business that is either only as risky as an ELB or even lower risk. Dr Lally concludes that the only risk facing equity investors in **the notional processor** is the risk of deviations between the notional processor's non-milk costs and the allowances in the milk price.

The Dairy Industry Restructuring Act 2001 (DIRA) requires that the business in question is an efficient and practically feasible notional processor. While that business has operating characteristics assumed on the basis of Fonterra's (for example asset footprint), DIRA does not require that the risk allocations or regulatory environment of Fonterra are mechanically assumed to be so for the notional processor. DIRA effectively asks us (and the Commission) to leave aside what Fonterra looks like, and envision what an efficient dairy processing business would look like (although subject to the permitted assumptions within DIRA). Open Country's firm belief is that the best approximation of such an efficient business is the market comparators actually operating because:

- **They are subject to the same regulatory environment**—the notional processor under DIRA is subject to general competition law and not any form of further regulation by the Commission
- **The ownership structures may be the same**—the ownership structure of Fonterra as a co-operative is not necessarily the ownership structure of the notional processor
- **The risk allocations are likely to be the same**—based on Castalia's advice, a processing business being close to riskless is an inefficient risk allocation that does not provide Fonterra's management with incentives to be efficient—so it should not be assumed to be so for the notional processor.

Framing the question: 'what risks would an efficient processor be exposed to within the permitted assumptions of DIRA?' underpins our belief that market comparators are a much more appropriate starting point for estimating the notional processor's asset beta. Particularly for ELBs which operate in an entirely different sector and face very different risks.

For the reasons set out in this submission, Castalia's report and our previous submissions, we urge the Commission to consider carefully what efficient risk allocations would be expected to prevail for the efficient and practically feasible notional processor. That should lead to an asset beta better approximated by market comparators than a price-capped ELB operating under Part 4 of the Commerce Act. From there, the Commission's focus should turn to what discount is justifiable on the asset betas of market comparators in estimating the asset beta of the notional processor.

Improvements in the process for the review of asset beta

Open Country is concerned that the improvements in the transparency and robustness of the Commission's review processes do not appear to have carried through to the way asset beta has been assessed by Dr Lally and Dr Marsden. Dr Lally's report seems to have only been focused on peer reviewing Dr Marsden's original report and the Marsden Update. We specifically requested that part of the terms of Dr Lally's engagement include reviewing the wider body of literature on the milk price manual and the asset beta within that context. These calls appear to have gone unanswered, as there is no reference or mention of this work in the Lally Report. The milk price manual is complex. Over time, industry stakeholders have built understanding on what it represents. Since our comments largely stem from what we see as an incomplete understanding of the operating environment for the notional processor, the shortcomings of the Reports could have been at least partially addressed through a more robust process. As part of moving forward on this matter, we welcome the opportunity to meet with the Commission to discuss the contents of this submission and the Castalia report.

Open Country is particularly concerned that Fonterra appears to have had the opportunity to engage with Dr Lally in a way not offered to other industry participants. Dr Marsden's report includes reference to questions Dr Lally submitted to Fonterra. We do not know what the nature of those discussions was, but Open Country requested equal opportunity to engage in the process on the basis of procedural propriety. To move forward on this matter, we request the Commission immediately release the terms of reference for Dr Lally's review, and any communications between Fonterra and Dr Lally.

Conclusion

Thank you for the opportunity to make this submission, and we look forward to engaging further with the Commission on this important topic. It is our hope that better engagement will help to highlight the clear concerns for practical feasibility of any decision to follow the advice in the Reports.

Best regards,

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Chief Executive Officer

Open Country Dairy Ltd