4 February 2016

Regulation Branch
New Zealand Commerce Commission
PO Box 2351
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Attention: Leighton Wong, Senior Analyst
By Email: regulation.branch@comcom.govt.nz

Miraka Submission to the Commerce Commission:

Commerce Commission Process and Issues Paper – Review of 2015/16 Base Milk Price Calculation (18 December 2015)

1.0 This submission addresses the following issues referenced in the Process and Issues Paper (the Paper):

1. Asset beta
2. Production yields
3. Reliability of GDT prices
4. Selling costs (identified in the paper as part of "Corporate Costs")

2.0 **Asset Beta**

2.1 The work plan for reviewing the asset beta and the WACC is outlined in paragraphs 19 to 22 of the Paper.

2.2 Miraka welcomes the Commission's confirmation that the WACC is a focus for its review of the 2015/16 milk price calculations. The Commission indicates (paragraph 22) it is planning to engage an independent expert to peer review the basis on which Fonterra sets the asset beta and specific risk premium parameters for the WACC. The Commission is not however committed to this peer review ("If we engage our own independent expert…" – paragraph 22). The Commission has not clarified its ambivalence towards this peer review. Miraka is concerned that the Commission is not committed to resolving the outstanding WACC issues during this latest review. Failure to resolve the long outstanding WACC issues has been the source of much concern to submitters, as most recently reflected in the Miraka submission on the Commission's draft report on the 2015/16 Milk Price Manual[1] and the Synlait letter of 13 October 2015 to the Commerce Commission[2]. Miraka requests that the Commission finalise its consideration of these WACC issues and provide a firm conclusion on practical feasibility in its report on the 2015/16 Milk Price calculations.

[1] Section 2.0 and 3.0 of "Miraka - Submission on Draft Report – Review of Fonterra's 2015/16 Milk Price Manual – 5 November 2015"
[2] The Commission published this letter as an attachment to the current Process and Issues Paper.

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2.3 At section 4 of the Miraka 5 November 2015 submission (see Appendix), Miraka raised concerns about a specific “framing issue” which had been used by Fonterra to justify a reduction in the Asset Beta and WACC in the 2014/15 Farm Gate Milk Price (FGMP) calculations. Miraka requested that framing issue be considered in the Commission’s final report on the 2015/16 Milk Price Manual. In that final report however, the Commission was silent on the issue raised by Miraka, providing no response to Miraka’s request that it be addressed. At paragraph 19 of this current Process and Issues Paper, the Commission notes that it has “collated our concerns and those of interested parties [concerning the WACC] and have requested Fonterra and its independent expert provide a response on how they propose to address those concerns”. The Commission has not published that collation of concerns, and Miraka remains unclear how or if the Commission will respond to the issues raised in its previously noted submission of 5 November 2015. Given this uncertainty, Miraka resubmits that “framing issue” as Appendix 1 of this submission, and again requests a response from the Commission on this issue.

3.0 **<u>Production Yields</u>**

3.1 The work plan for reviewing production yields is outlined in paragraphs 23 and 24 of the Paper.

3.2 The yield calculations and assumptions for the Notional Producer will be complex and have a material impact on the milk price calculation. Miraka thus agrees the Commission needs independent expert support to review the production yields (paragraph 24).

3.3 Miraka and others (most recently Synlait) have previously submitted the composition of product sold by the Notional Producer appears to be different to the typical composition claimed by Fonterra for the product it sells on GDT. Based on the limited data available, the milk solids in the Notional Producer product would be lower (i.e. yields are higher) than product sold on GDT. At the same time however, Fonterra uses GDT sales prices to determine the revenue of the Notional Producer. This inconsistency between revenue and yield assumptions has never been satisfactorily addressed. Rather there has been a focus on whether the yields in the milk price calculations are technically feasible and compliant with CODEX. While these are important, Fonterra also needs to provide an explanation for the apparent difference between the yields achieved for product sold on GDT, and the Notional Producer yields. If the yields are different, Fonterra also needs to explain why it nevertheless considers **<u>both</u>** revenue and yields are practically feasible. This lack of compatibility between assumptions would be an example where the Notional Producer could not be practically feasible at an aggregate level.

4.0 **<u>Reliability of GDT Prices</u>**

4.1 Paragraph 23.3 of the Paper expands the review of Production Yields to include a consideration of “the reliability of GDT prices as a basis for prices in the base milk price calculation”. The reliability of prices is noted as being required due to “the quantities sold by Fonterra off-GDT”. Miraka also considers a review of the reliability of GDT prices needs to consider wider issues of the practical feasibility of the GDT based selling prices and revenue of the Notional Producer. This needs to address transparency of the Notional

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Producer selling prices, and the calculations which convert the prices of GDT contracts into prices for the Notional Producer.

4.2 Selected GDT prices are <u>input</u> to a calculation procedure the <u>output</u> of which is prices used to determine the Notional Producer revenue. These <u>output prices</u> are almost certainly different to the comparable input GDT prices. It is the <u>output prices</u> which must meet the "practical feasibility" requirement. Fonterra publishes these <u>output prices</u> in the annual Milk Price Statement (as quarterly and full season average prices). Fonterra asserts these prices are practically feasible because they are based on GDT prices (in the case of WMP, SMP and AMF), or at least partially based on GDT prices in the case of butter and BMP. Fonterra does not however publish the equivalent GDT prices (quarterly and full season) and those equivalent prices cannot be replicated from available public information[3]. Miraka submits that Fonterra should publish the equivalent GDT prices (quarterly and full season) to demonstrate the practical feasibility of the Notional Producer prices. Fonterra will then also need to explain material differences between the GDT and Notional Producer prices. This would go a long way to providing much needed transparency and confidence in the Notional Producer selling prices. If however the publication of these quarterly and seasonal GDT prices is considered commercially sensitive (however unlikely), Fonterra should at least provide this information to the Commission so the Commission can form its opinion on the practical feasibility of the Notional producer selling prices.

5.0 <u>**Selling Costs**</u>

5.1 The review of selling costs is explained in paragraph 28 of the Paper.

5.2 Notwithstanding the discussion in section 4 above, Miraka has previously submitted that GDT prices cannot be practically feasible because the Notional Producer is assumed to sell a much larger volume than Fonterra actually sells on GDT. Further, the Notional Producer sales can exceed the total volume Fonterra sells through all sales channels. It is unavoidable that the resulting increase in supply would adversely impact the Notional Producer prices by comparison to the actual prices on GDT. The Commission has responded that GDT prices are nevertheless practically feasible for an efficient incremental plant of the Notional Producer or of a competitor and are therefore practically feasible for purposes of the milk price calculations. Miraka accepts that this would be a pragmatic approach if the Notional Producer cost assumptions were also set in a consistent manner. However, rather than aligning cost assumptions to the underlying revenue assumption of an efficient incremental plant, costs reflect the advantages of scale that have been

[3] GDT average prices (quarterly and seasonal) cannot be replicated because of limitations in publically available GDT data. This includes:

- Lack of detailed volume reporting
- Suppression of certain GDT selling prices which GDT claims anti-trust legislation prevents it from reporting. This problem is exacerbated by the fact that reported average GDT prices can also be incorrect because these suppressed prices are also suppressed in the calculations of average prices.
- Fonterra selects GDT prices on the basis of the production season from which the relevant product was derived. In the August to October period for example, where GDT sales will be from two seasons, the GDT prices used are a subset of the prices for the Fonterra product reported on GDT for that period.

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attributed to the total volumes of the Notional Producer. On the one hand then, the price degradation that would exist in the event the Notional Producer actually sold the assumed volumes is ignored, while the scale advantages of the Notional Producer are taken into account. This is another example where incompatibility between assumptions means the Notional Producer could not be practically feasible at an aggregate level.

5.3 A significant example of this is found in the selling cost assumptions for the Notional Producer. In the 2014/15 Season, the Notional Producer assumed GDT commissions of just US$6.54/MT for the 90% of the Notional Producer volume assumed sold through GDT. This artificially low rate reflects the costs that would be charged to the Notional Producer based on the GDT scale of charges (which drops to US$5/MT after 250,000 MT p.a.). Neither Fonterra nor any other seller on GDT is actually able to achieve that low cost rate, since no trader sells near that volume on GDT. In 2014/15 for example, it is estimated that Fonterra sold a little over 700,000 MT[4] of the products relevant to the milk price calculation – that is just 25% of the volume assumed to have been sold by the Notional Producer.

5.4 Miraka submits that if the GDT selling prices are assumed to be practically feasible because they can be achieved by an efficient incremental plant, the cost rate of selling through GDT must similarly be based on the volume assumed to be produced by that efficient incremental plant. To do otherwise undermines the fragile assumptions for the Notional Producer selling prices. This would bring the selling costs more into line with the scale costs available to Fonterra competitors. Assuming the efficient incremental plant produces no more than 50,000 MT p.a., the GDT commission rate would be US$30/MT. In 2014/15, this would have increased selling costs by NZ$82M and reduced the milk price by over $0.05/kg MS.

5.5 Fonterra provides for a further allocation of selling costs based on an assumption that 10% of the Notional Producer sales would be transacted directly to customers. The amount of this further cost allocation is not disclosed by Fonterra, but it is presumably part of the $102M of sales support costs that was provided in the 2014/15 Milk Price calculation. Fonterra does not explain the basis for the assumed 10% of product sold direct to customers. The assumption is however likely to have a material effect on selling costs. Miraka requests that the Commission seek an explanation for the basis of this assumption and why it provides a practically feasible mix of sales channels for the Notional Producer.

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[4] Based on an assessment of historical sales data available on the GDT website.

Appendix: Extract from Miraka Submission on the Commerce Commission Draft Report, Review of 2015/16 Milk Price Manual (submission dated 5 November 2016).

[This extract from the Miraka submission refers to "the Uniservices Report". That report dated 2 December 2014 was commissioned by Fonterra and was written by Dr Alastair Marsden of Uniservices. The report was titled "Asset Beta for Fonterra's New Zealand-based Commodity Manufacturing Business and Specific Risk Premium for Fonterra's Notional Business". It is assumed Fonterra commissioned this report in line with Rule 40 of the Milk Price Manual, and that Fonterra used this report to demonstrate the asset beta and specific risk premium in the 2014/15 WACC were "practically feasible"].

Extract from the Miraka submission:

4.0 **The Uniservices Report (the Report)**

4.1 The analytical framework laid out in the Report is unclear and inadequately defined. Of some concern, it posits (yet more) notional business concepts:

- The "Fonterra Notional Business", which is distinct from the "Notional Producer" business on which the FGMP is based; and
- The "Fonterra Actual Business" which is in fact not Fonterra's actual business, but a notional entity which comprises that part of Fonterra's New Zealand business which manufactures and sells dairy commodities.

4.2 The Report notes that Fonterra has commissioned an assessment of the WACC for these two notional businesses, but does not explain why they are relevant to the WACC for the FGMP. Given Fonterra has used the report to justify a change in the WACC for the FGMP, it must be assumed that Fonterra considers either or both these notional businesses to be relevant for the "practical feasibility" test. The Commission appears to accept this assumption, or more specifically does not contest the relevance of these new notional business concepts.

4.3 The new notional businesses are only broadly described in the Report. The limited descriptions that are provided suggest the concepts are not roundly developed. For example:

- At E.1 the Fonterra Notional Business is defined as marketing and selling Reference Commodity Products at GDT prices. Later however at E.4, the same business is described as facing pricing risk (but more correctly, margin risk) from off-GDT sales.
- In note 2 on page 5 of the report, the Fonterra Notional Business is described as being largely "Fonterra's milk powder business scaled up to process all milk supplied to Fonterra New Zealand (in other words, the same scale as the Notional Producer assumed in the FGMP calculations). At E.4, it then states the Fonterra Notional Business is exposed to product mix risk because it reflects "Fonterra's actual RCP's asset base". How such risk might be interpreted is unclear though unlikely to be large. An assessment of the risk could though require modelling as complex as for the FGMP itself.

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4.4 These new “notional business” concepts are not a welcome development. The notional businesses do not provide a basis for the practical feasibility test[5]. It cannot have been the intention of Section 150A (2) that the test of practical feasibility be determined by the notional performance of yet another notional entity. That would in fact be a test of theoretical feasibility. It could not be deemed a test of practical feasibility.

4.5 The reason it is not appropriate to use the Fonterra Notional Business to determine the FGMP WACC are in fact highlighted in Dr Marsden’s report. After describing the notional business risks for both the “Fonterra Notional Business” and the “Fonterra Actual Business”, he states in E.6:

> “The pricing methodology to set the Farmgate milk price under the Milk Price Manual exposes the [notional] capital or business owners of Fonterra’s Notional and Actual Businesses to significantly less risk compared to a normal business”.

4.6 In effect, the market dominance available to Fonterra to set the milk price at a level reflecting its own revenue streams is not just replicated in the Fonterra Notional Business and the Fonterra Actual Business, it is actually compounded by further diluting the margin risk actually faced by Fonterra. Compared to the margin risk faced by the “normal business” referred to by Dr Marsden, there is simply no comparison.

4.7 The Commission is asked to seek an explanation from Fonterra and from Dr Marsden of the relevance of the Fonterra Notional Business to determining the FGMP WACC. The Commission is then requested to consider whether the Fonterra Notional Business is in fact appropriate for determining the FGMP WACC or its practical feasibility in accordance with Section 150A of the DIRA.

4.8 These are framing issues and do not require a reassessment of the asset beta itself. To avoid yet another year being lost in finalising the WACC for the FGMP, the Commission is therefore requested to address these framing issues in the final report for the 2015/16 Milk Price Manual.

[5] Section 150A (2) of the DIRA requires that “costs, revenues, or other assumptions… are practically feasible for an efficient processor”.

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