16 November 2018

Matt Lewer
Manager – Regulation Development,
Regulation Branch
Commerce Commission
PO Box 2351
Wellington 6140

By email: regulation.branch@comcom.govt.nz

<u>Miraka Submission to the Commerce Commission:</u>
<u>Draft Report (15 October 2018): Review of Fonterra's 2018/19 Milk Price Manual</u>

Miraka appreciates the opportunity to submit in response to the Commission's Draft Report on the 2018/19 milk price manual. Miraka is available and would welcome any opportunity to discuss the contents of this submission with the Commission.

1.0. **<u>Off-GDT Sales/Definitions for "Qualifying Material"</u>**

1.1 Information on the effect of the policy change to include off-GDT sales in the Notional Producer (NP) revenue continues to emerge at a slow rate. This is despite the fact the policy change has now been in effect for over 2 seasons, and has had a large impact on the Farm Gate Milk Price (FGMP).

1.2 Since the last opportunity to submit to the Commission on this issue, Fonterra has:

- for the first time disclosed the impact of off-GDT sales on NP selling prices (2017/18 FGMP Statement)
- provided further though inadequate definitions of "qualifying material" (of relevance to determine which off-GDT sales can be considered for inclusion in the milk price calculations)

1.3 In its 2017/18 report on the milk price calculations, the Commission concluded (para 2.41) that it had "seen a similar proportion of the milk price revenues coming from the off-GDT sales, as well as a similar price differential with GDT sales prices in this year's calculation relative to last year. This is in line with what Fonterra describes in its reasons paper supporting the 2017/18 milk price." Subsequent evidence indicate the Commission and Fonterra need to elaborate on how they came to those conclusions.

1.4 <u>Price Differential; GDT versus off-GDT sales</u>

1.4.1 In the 2017/18 FGMP Statement, Fonterra disclosed the Notional Producer selling prices for both 2016/17 and 2017/18, and (their assessment of) comparable GDT prices. The difference between the two price sets is due to off-GDT selling prices. Fonterra did not actually disclose the off-GDT prices so we are forced to estimate what they might have been and what might have caused Fonterra and the Commission to conclude price differentials were similar between the two years.

1.4.2 An assessment of the off-GDT prices is shown in Table 1 below. As is generally the case with analysing the milk price calculations it relies on incomplete information: in this case, Fonterra has advised off-GDT sales comprised 45% of the basket of sales included in the 17/18 milk price calculations, and that this was "similar" to the previous year. The proportion of sales by product type has not been provided. The below analysis is therefore forced to assume that the 45% proportion of off-GDT sales applies all product types and both seasons.

Table 1 – Estimated off-GDT Selling Prices: 2016/17 and 2017/18

2016/17: Derived priced for off-GDT Sales		WMP	SMP	Butter	AMF	BMP	Total
Notional Producer Selling Price	US$/MT	2,855	2,216	4,221	5,076	2,210	2,942
GDT Selling Price	US$/MT	2,837	2,188	4,184	4,977	2,172	2,916
Price Margin Attributed to Off-GDT Sales	**US$/MT**	**18**	**28**	**37**	**99**	**38**	**26**
What if: Off GDT Portion of total sales	% of MT	45%	45%	45%	45%	45%	45%
Implied off-GDT Selling Price	US$/MT	2,876	2,249	4,267	5,197	2,258	2,974
Implied Margin: Off-GDT Prices vs GDT Prices	**US$/MT**	**39**	**61**	**83**	**220**	**86**	**58**

2017/18: Derived priced for off-GDT Sales		WMP	SMP	Butter	AMF	BMP	Total
Notional Producer Selling Price	US$/MT	3,091	1,968	5,575	6,474	2,057	3,227
GDT Selling Price	US$/MT	3,056	1,951	5,464	6,422	2,038	3,188
Price Margin Attributed to Off-GDT Sales	**US$/MT**	**35**	**17**	**111**	**52**	**19**	**39**
What if: Off GDT Portion of total sales	% of MT	45%	45%	45%	45%	45%	45%
Implied off-GDT Selling Price	US$/MT	3,134	1,988	5,711	6,538	2,081	3,274
Implied Margin: Off-GDT Prices vs GDT Prices	**US$/MT**	**78**	**37**	**247**	**116**	**43**	**86**

1.4.3 Table 1 suggests the impact of off-GDT sales between 2016/17 and 2017/18 is highly unlikely to have been "consistent" and thus appears to contradict the conclusions made by Fonterra and the Commission. Both might argue the overall price difference is "similar" (US$58 compared to US$86). To be assessed "consistent" at the total sales level, the difference between them must have been judged to be not material. In the absence of a measure of materiality that judgement can only be considered to be subjective and still require justification. But as noted in 1.5 below, that difference causes an increase in the FGMP in 2017/18 compared to 2016/17 of 3.3 c/kg MS which would almost certainly meet any reasonable and objective materiality measure. That is not to say the price difference is necessarily unreasonable, but it is certainly NOT consistent and therefore requires explanation. Miraka is concerned the Commission might not have sought an explanation because it judges the prices "consistent".

1.4.4 Whether or not the impact of off-GDT sales is "consistent" at the total sales level, it certainly is not consistent at the product level. This lack of consistency in outcomes provides insight into the "include" selection process for off-GDT sales, and therefore of the definitions for "qualifying materials". The differences between the two seasons for AMF and butter are extraordinary and the difference for WMP is at least material (scale) and requires explanation. The lack of consistency raises concern that the definitions for inclusion of off-GDT sales are not being applied consistently. This is not surprising given the open nature of the "definitions". In Miraka view, the Commission should not have considered the prices between the two seasons were consistent and should have considered the extent to which the process for determining off-GDT sales has been properly established and controlled.

1.4.5 The difference between GDT and off-GDT prices represent a premium. As Fonterra itself noted in its reasons paper for the 2017/18 milk price calculations (page 25), **<u>all</u>** price informing off-GDT sales "used the most recent relevant GDT price as a key reference point". In most if not all the relevant contracts then, the premium on GDT price will have been made explicit to customers and will have been explicitly attributed to product or service offerings additional to the standard GDT offerings. Given the very large premiums for off-GDT sales demonstrated in Table 1, Miraka recommends the Commission seek an explanation from Fonterra of the product and service offerings driving the premiums, and consider whether those product and service offerings are consistent with the assumptions and costs of the NP (i.e.is it practically feasible for the NP to achieve those premiums).

1.5 <u>Cents/kg MS impact: Off-GDT sales</u>

1.5.1 Off-GDT sales added 10.5 c/kg MS to the 2017/18 FGMP. That was a 46% or 3.3 c/kg MS increase over 2016/17 (7.2 c/kg MS). By comparison Fonterra reported that off-GDT sales for WMP, SMP and AMF added 8c/kg MS to the milk price. The comparable figure for 2016/17 was 6 c/kg MS. The impact of off-GDT sales has been muddied by these two different measurement sets – the former focussing on the impact of off-GDT sales and drawing focus to the process of including off-GDT sales in the milk price calculations, while the latter is a measure of the change in policy regarding off-GDT sales.

1.5.2 It should be clear that the impact of off-GDT sales in 2017/18 is not consistent with 2016/17. When the Commission concluded however that it was consistent, it may have been considering the smaller impact of the policy change (although this is arguably still material). Miraka requests the Commission clarify this. In any event, from the perspective of assessing the process of including off-GDT sales, it is again not possible to conclude the impact has been "consistent". The difference arising from the policy change and previous inclusion of off-GDT sales (and which has only now become more transparent) requires investigation and explanation. Miraka recommends the Commission complete a detailed assessment in the 2018/19 review of milk price calculations to determine whether the process of including off-GDT sales delivers selling prices that are practically feasible for the NP.

1.6 <u>Criteria for "Qualifying Material"</u>

1.6.1 In their documents on the 2017/18 Milk Price calculations, both Fonterra and the Commission signalled further clarification of the rules to determine qualifying materials which can be included in the NP price calculations. The actual changes were not disclosed until this latest review cycle. The further clarification now comprises new "definitions" for standard product offerings, standard packaging, and specialised plant. The Commission has welcomed the "increased clarity" these provide (e.g. paragraph X12); it has not provided an explicit opinion on their merit.

1.6.2 Miraka considers the new definitions contribute no further clarity. They remain open-ended and can readily be used to justify expanding the range of qualifying materials and therefore off-GDT sales that can be included in the selling price calculation. At worst they are meaningless – for example the definition of "standard product offerings" and of "specialised plant" are circular – i.e.

- plant is not standard plant if it is specialised plant;
- product is not standard product if it is required to be produced in specialised plants;
- a plant is "specialised" if the product it produces is not a standard product.

1.6.3 In effect this leaves no clear definition to differentiate standard product (which can be included as qualifying material) from non-standard product. A prescriptive definition of at least one of the three items in the above is required as a circuit breaker to the circular logic. That circuit breaker is obvious and already exists in the NP model and it is informative that Fonterra has chosen not to rely on it. Standard plant should simply be defined as the NP plant which is designed to produce the GDT product range. Any product able to be made on this plant (not requiring other equipment) can be deemed to be standard product for purposes of determining "qualifying material".

1.7 The Milk Price Manual includes a definition for "Qualifying Outlier Sales" which is unclear. It seems to describe the situation relevant to some tender sales (which can remove large volumes of Fonterra product from the market and thus "result in a higher Farmgate milk price than would otherwise have been the case" by virtue of higher selling prices. However tender sales have been explicitly excluded from the NP revenues (for reason which are far from convincing). The Commission is requested to seek clarification of what "qualifying outlier sales" comprise or are likely to comprise, and whether they have had an impact on NP selling prices.

1.8 <u>Quarterly reporting on the impact of off-GDT sales</u>

In paragraph 26 of the final report on the 2017/18 Milk Price calculations, the Commission repeated its expectation that Fonterra would meet the commitments it had made regarding transparency of off GDT sales. It noted the ongoing failure of Fonterra to publish quarterly forecasts of the "cents per kgMS impact from the inclusion of off-GDT sales of WMP, SMP and AMF in the Milk Price Calculation". Fonterra had previously committed to publish this information in its Global Dairy Update. It has sporadically done so, though in a manner that makes it difficult to identify. In the over 5 months since the current season commenced Fonterra has again failed to provide any update in its monthly Global Dairy Updates.

1.9 In summary:

- The Commission (and Fonterra) are asked to explain why they consider the impact of off-GDT sales in 2017/18 was consistent with 2016/17
- Available evidence suggests the process for selecting off-GDT sales in the NP revenue is not consistent
- The definitions of qualifying materials are open ended rather than prescriptive, and especially in the case of specialised plant are circular. They do not provide a basis for the objective and consistent inclusion of off GDT sales in the NP revenues, and this evidenced by the outcomes identified for 2016/17 and 2017/18. Miraka does not consider the definitions are fit for purposes, and they cannot provide assurance the "include" process is objective.
- It is recommended the Commission seek an explanation from Fonterra of the underlying product and service offerings which deliver the premiums in off-GDT prices, and consider whether those product and service offerings are consistent with the assumptions and cost of the NP.

- The Commission is requested to seek clarification of "qualifying outlier sales" and of their impact (if any) on the milk price calculations to date.
- Despite repeated requests from the Commission, Fonterra is still not providing quarterly forecasts of the impact of off-GDT sales despite its previous commitment to the Commission to do so.

2.0 **<u>Stranded assets</u>**

2.1 Miraka has previously submitted its disagreement with the stranding rules (Milk Price Manual Rules 32 and 33). Neither of these rules reflect the most likely outcome for a real world processor.

2.2 In the case of Rule 32 (change on BCPs), it makes no commercial sense to select a stranded plant for disposal based on its economic life. The assumed stranded asset should be the lowest returning asset as a consequence of the change in portfolio. This would be the response of any astute commercial entity. Miraka does not consider it is reasonable to assume selecting stranded assets on the basis of the "oldest plant" is sheltered by safe harbour provisions. Fonterra itself, whose commercial decisions give substance to the safe harbour "network of facilities" would certainly not select assets for stranding on that basis so neither should its protégé the NP be assumed to do so.

2.3 In the case of Rule 33 which concerns stranded assets resulting from reducing milk supply, Miraka does not agree the default position is that the cost of the stranded asset should be borne by the NP "shareholders". That again would not be the case for a real world processor which would have to balance "ability to pay" with competitor milk prices. This is even more the case for the NP because Fonterra has <u>elected</u> to rely on the "network of facilities" safe harbour. It is important to note Fonterra is not obliged to do so. But having so elected, the NP must face ALL the consequences, not just those that are beneficial to the milk price calculations. The scope of the Fonterra "network of facilities" exists as a result of Fonterra's legacy co-operative mandate to process all milk offered to it, and its ongoing obligation to do so under DIRA free entry rules. As a result of electing the Fonterra "network of facilities", the NP has assumed major commercial benefits of economies of scale, and in particular has assumed opportunities to aggregate milk and increase "long production run" efficiencies. These are not available to any real world processor (including Fonterra) and would not be available to the NP if Fonterra did not elect to apply the "network of facilities" safe harbour. It has passed these benefits to its suppliers through the milk price; looking back to the reason for the establishment of the network of facilities (in effect to guarantee to purchase milk from all and any suppliers throughout the country) it is difficult then to argue that the cost of stranded assets should not be included as a charge in the milk price calculations. And this is especially because Fonterra elected (but was not obliged) to apply the safe harbour provision.

2.4 It is also an increasingly moot point that by mothballing plants which are part of the Fonterra "network of facilities" but which Fonterra itself has not mothballed, the NP has already strayed from the safe harbour and so must face the normal perils of any other real world processor.

2.5 As noted in 2.2 above, in the case of assets stranded as a result of declining milk supply, a real world processor will have to balance "ability to pay" with competitor milk prices. The Rule 32 exceptions mirror this balancing of considerations of a real world processor and is sufficient to address all stranding circumstances. Miraka submits that Rule 33 is therefore neither required nor is practically feasible for a real world processor.

3.0 **Specific Risk Premium**

3.1 If the cost of stranding is to be borne by suppliers in all circumstances as recommended above, it might be argued a specific risk premium is not required. This would be the case if there were no exceptions to the asset stranding rule. However the first (and necessary) exception to Rule 32[1] means shareholders remain exposed to the risk of asset stranding. In the current environment of expected flattening and even declining milk supply, this risk is increasing and is likely to be higher than would have been perceived at the time the current specific risk premium was determined. Miraka therefore agrees with the Commission that the specific risk premium should be reviewed.

4.0 **Mothballed plants**

4.1 In its draft and final report on the 2017/18 milk price calculations, the Commission concluded that the assumption to continue to mothball plants, with associated cost savings was an appropriate "real world response"[2]. Miraka responded that this was not supported by available evidence and outlined that evidence.[3] Miraka now wishes to elaborate on its earlier response:

4.2 The ability of a mothballed plant to be recommissioned depends on:

- the state of readiness of that mothballed plant – has the NP committed the necessary resources to maintain a state of readiness, and has the NP accounted for associated costs?
- the proximity of that plant to a readily available workforce
  - a mothballed plant co-located with other plants might reasonably be assumed to have access for a short period (two weeks) to overtime of an existing co-located labour force. It might also be reasonable to assume this would be available at short notice.
  - It is not reasonable to make these same assumptions for a mothballed plant which is remote from other processing plant. In that case, a work-force would need to be planned well in advance, and associated labour costs will be locked in regardless of whether the plant is actually re-commissioned.
  - Has Fonterra identified the location of mothballed plants that are assumed to be available to flex with milk processing requirements, and has Fonterra identified how the labour requirements (and associated costs) for those plants has been provided in the NP costs?
- for any longer period of processing (more than two weeks) recommissioning of mothballed plants at any location cannot be assumed to occur at short notice. Borrowed staff will only be available for a short period of time; this otherwise places stress on other plants and on staff. It would also be unacceptable to unions where the workforce for a mothballed plant has been laid off, and then replaced by overtime payments for the remaining workforce. Ability to recommission mothballed plants for a period more than two weeks therefore requires longer term planning, with the consequences of those longer term plans being unavoidable once they have been put in place.

4.3 To demonstrate practical feasibility, processing capacity must be assured at the geographical level of the milk processing catchment area. It is not practically feasible to assess capacity at a national level. The same is the case for mothballed plants. This is illustrated by the marked difference in milk volume variations between the North and South Islands (although planning for catchment

---

[1] Cost of stranding would result in a reduction in the milk price unless "this would result in the Farmgate Milk Price being significantly less than the milk price Fonterra's competitors for milk in New Zealand are able to pay while still earning a reasonable risk-adjusted return on their invested capital".

[2] E.g. Commission Draft Report on the 2017/18 Milk Price Calculations, paragraph 2.23

[3] Section 4.0 of Miraka - Submission on review of Fonterra base milk calculation draft report – 31.8.18

areas would need to be at a lower level than that). For example, Fonterra is currently forecasting a 3% milk growth in the 2018/19 season compared to the 2017/18 season. The rates of growth between the North and South Islands are almost certainly going to be different. In its latest Global Dairy Update (October 2018) for example, as at the end of September 2018 total season milk supply in the North Island was 2% higher than 2017/18; South Island milk was up 10%. For the 2018/19 season then, what plans has Fonterra made for the NP regarding processing capacity, and in particular what plans have been made for the NP plants assumed mothballed in 2017/18 in the North Island and in the South Island. What disclosures will Fonterra be able to make to the Commission to demonstrate planning decisions for the NP had a lead time consistent with a real world processor?

4.4 In summary, it might be reasonable to assume that mothballed plants co-located with other operating plants can be re-commissioned for a short period of time and at short notice. It is **not** practically feasible to assume:

- a mothballed plant not co-located with other plants can be re-commissioned at short notice
- any mothballed plant can be recommissioned at short notice for an extended period of time

4.5 The practical feasibility of recommissioning mothballed plants will rely on pre-planning, and consequences will be locked in as a result of that planning. This is regardless of whether the mothballed plants are actually recommissioned e.g.

- committed labour costs for mothballed plant not actually recommissioned will be an NP cost for that year; and
- costs associated with unprocessed milk (insufficient pre-planned capacity)

These costs reflect the risk trade-off for all real world processor – i.e. the cost of surplus capacity versus the cost and associated risks of inability to process milk.

4.6 In Table B1 of Attachment B in the draft report (2018/19 Milk Price Manual) the Commission lays out amendments to the manual previously proposed to Fonterra but which Fonterra has rejected. This includes a recommendation that Fonterra disclose the capacity of primary and secondary plants in the Manual each season. Fonterra rejected this recommendation on the grounds that:

- it is not an appropriate use of the Manual (Miraka agrees, including because the situation is more dynamic than is appropriate for disclosing in the Manual)
- they had previously put the information in the public domain; and
- they would not revisit relevant assumptions until FY 20.

4.7 In Miraka view, that Commission recommendation should now be overlaid by the issue of mothballed plants. The Fonterra response will be found to be inadequate. For the past two seasons Fonterra has assumed varying numbers of mothballed plants for the NP, apparently assuming mothballed capacity is a flexible resource. That assumption cannot be made without addressing the issues and consequences raised above. Miraka considers that Fonterra needs to demonstrate that the assumptions regarding total available capacity including plans for mothballed plants are practically feasible. This requires disclosures of the capacity of plants not mothballed, and the capacity of mothballed plants which the NP includes in its capacity planning. These disclosures need to be made with a planning lead time consistent with a real world processor, with costs and processing capacity consequences then locked in in the same way as is the case for a real world processor.

4.8 All of this adds complexity to the milk price calculations. The complexity would not be required if Fonterra were to simply align NP mothballed plants with its own mothballed plants (or more fundamentally establish a real world scale for the NP rather than rely on the safe harbour). Such pragmatic response is taken in similar areas of complexity (milk transport costs) and Miraka considers it would not be unreasonable to take the same approach with the issue of mothballed plants.

4.9 <u>Vehicle for disclosure</u>

4.9.1 Miraka agrees with Fonterra that detail concerning plant capacity is not appropriate for the Milk Price Manual. In the case of the mothballed plants, the Commission has suggested (para 49) the information be provided in the Global Dairy Updates. Miraka considers that would also not be an appropriate vehicle – the disclosures are of a technical nature relating to notional plant and would be irrelevant to the target audience for the Global Dairy Update. As also noted in 1.8 above, Fonterra commitments to report information of this nature in the Global Dairy Updates cannot be relied on.

4.9.2 Disclosures concerning the NP are of interest to a narrow specialist group. Any disclosures made are as a result of commitments made by Fonterra to the Commission as a result of the annual review processes. It is Miraka view that agreed commitments to make such disclosures should become a technical reporting requirement of the annual review processes, and should be made directly to the Commission. They would then be published on the Commissions web-site including recognition of any non-compliance. Miraka considers this approach would add authority to compliance with the reporting commitments and Fonterra might then be more likely to comply with its commitments.

4.9.3 While above is the preferred Miraka reporting vehicle, an alternative and also appropriate location for reporting on matters of this nature including disclosures on off-GDT sales is the "Farmgate Milk Price" section of the Fonterra web-site. This would be tailored to the requirements of the special interest group rather than being buried in (and of little interest to the target audience of) the Global Dairy Updates.

5.0 <u>**Materiality**</u>

Materiality remains an overarching issue in judging the significance of items addressed in the various milk price reviews. In the Commission's latest draft report on the 2018/19 milk price manual there are 9 references to judgements based on materiality. This includes original content of the Commission and content attributed to Fonterra. It is unreasonable to attribute judgements to materiality when there are no objective or transparent measures of materiality. Attributing a judgement to undisclosed measures of "materiality" risks those judgements being considered a convenience or an attempt to dismiss an issue from further inspection without good reason. Miraka requests this issue be addressed before completing the review of the 2018/19 milk price calculations, with the aim of including objective materiality measures to the review processes.

Yours sincerely

Richard Wyeth
Chief Executive Officer