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Miraka Submission to the Commerce Commission Draft Report (15 August 2016): Review of Fonterra's 2015/16 Base Milk Price Calculation

1.0 Introduction and Summary

Miraka addresses three areas in this submission.

a. Practical feasibility – the Commission's assessment of various elements of the milk price model does not apply a consistent standard of practical feasibility, and the Commission does not assess practical feasibility in manner consistent with the Dairy Industry Restructuring Act 2001 (DIRA).

b. WACC/Asset Beta – the Commission assessment of the asset beta is not consistent with the DIRA and the Commission has not addressed the central point in previous Miraka submissions on this issue.

c. Transparency – Miraka responds to the Commission on extra disclosures to improve transparency.

Miraka seeks specific responses from the Commission. These are <u>underlined</u> in the body of this submission.

2.0 Practical Feasibility

2.1 Under S150A (2), the contestability purpose of Subpart 5A is met if the notional costs, revenues or other assumptions are "practically feasible for an efficient processor". For purposes of managing efficiency, theoretical, technical and practical feasibility are all useful measures. The DIRA however prescribes the milk price must be based on "practically feasible" measures (S150A(2). At paragraph 4.47 of the Draft Report the Commission states that to meet the practical feasibility test it must be "reasonably possible for a business with the features of the notional producer to exist". To be "reasonably possible" must mean "reasonably possible in the real world" and goes beyond mere theoretical or technical feasibility. The "reasonably possible business" must also be consistent with the context of S150 (2) – i.e. the business must be "reasonably possible" within a contestable market for raw milk. In any event, the Commission does not consistently apply its own definition, let alone a definition that aligns to a business operating in a contestable market in the real world. The

Commission seems variously to rely on theoretical feasibility (WACC, and aggregate assessment of feasibility), technical feasibility (yields), contingent feasibility (selling costs), or mere "reasonableness" to conclude the Notional Producer is practically feasible under S 150A. In the case of the WACC, Miraka considers the issues remain muddled and practical feasibility has been determined by a misreading of the DIRA. This is addressed in 3.0 below. Other inconsistencies are described in Appendix A, <u>including responses sought from the Commission.</u>

2.2 The Commission has issued a supporting document to its Draft Report: "Our Approach to Reviewing Fonterra's Milk Price Manual and Base Milk Price Calculation – 15 Aug 2016". This includes the Commission's interpretation of the policy objectives of its reviews of the milk price. Paragraph 9 states that "the [review] regime monitors whether the base milk price set by Fonterra provides incentives for it to operate efficiently while ***not precluding*** efficient processors from ***potentially*** **competing**" [emphasis not in original]. Miraka considers this interpretation is not supported by S150A[1], and that it reflects a bias in the Commission's reviews (towards incentivising Fonterra efficiency over the contestability purpose). Miraka considers this bias has resulted in an incorrect assessment of practical feasibility and the Commission's assessment is not consistent with S150A.

2.3 <u>Miraka requests the Commission to explain its assessment of practical feasibility. This would need to include an expanded description of the standards it has used to determine practical feasibility in a way which aligns with the contestability purpose of S150A(2).</u>

2.4 At Paragraph X14 the Commission summarises its view on practical feasibility. The Commission states that alternative "practically feasible" options based on more "real world" scenarios would "likely result in a higher milk price". The Commission illustrates by reference to selling costs and fixed asset related costs. The report does not substantiate the expected "likely result". It is possible the Commission is relying on analysis in the Draft Report which "suggests that sole reliance on GDT for WMP, SMP and AMF may not be an appropriate basis" for determining Milk Price revenue [2]. The Commission notes that Fonterra has signalled it will include more off-GDT prices in the 2016/17 calculations and that this will increase the Milk Price. The Commission itself has not assessed that change and is therefore not in a position to rely on possible outcomes from that change. Despite this, the Commission concludes that the milk price "provides for more contestability than [would be the case if] a more "real world" approach" is adopted. <u>Miraka requests the Commission to substantiate the basis for this conclusion.</u>

2.5 The Commission notes on several occasions (e.g. at paragraph 3.8 of the Draft Report) that interested parties have not responded to invitations to provide data to assist the Commission determine practical feasibility of the Notional Producer. Miraka wishes to

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[1] S150A: the purpose of this subpart is to promote the setting of a base milk price that provides an incentive to [Fonterra] to operate efficiently *<u>while providing for contestability in the market</u>* for the purchase of milk from farmers" [Emphasis not in original].

[2] Table 4.1

remind the Commission it has previously offered to assist the Commission but the Commission has not responded to that invitation[3].

3.0 WACC Assumptions

Asset Beta

3.1 The Commission has now concluded the WACC calculation and underlying assumptions are practically feasible. This follows substantial input by Fonterra, submitters, and independent experts.

3.2 At paragraph 88 and 89 of its supporting document "Our approach to reviewing Fonterra's Milk Price Manual and Base Milk Price calculation" the Commission explains why the DIRA regulates the setting of the milk price. At 88 the Commission states "In a workably competitive farm gate milk market, the level of the farm gate milk price would be determined through …. processors competing in both the purchase of raw milk and its onward sale after processing". At 89 the Commission explains that "currently in New Zealand there is not a workably competitive market process to derive a farm gate milk price. Therefore, the Act requires Fonterra to determine it using an administrative methodology".

3.3 Miraka interprets paragraph 88 and 89 to mean the purpose of the "administrative methodology" is to calculate a milk price that would arise from a "workably competitive market process" and that workably competitive market includes "processors [which are] competing in both the purchase or raw milk and its onward sale after processing".

3.4 At paragraph 4.41 of the Draft Report the Commission concludes the notional producer is a "cost reimbursement operation akin to a tolling operation" and that the Notional Producer accordingly faces low risk. Paragraph 4.41 concludes "the milk payment represents about 80% of [the Notional Producer's] costs which results in a substantially lower asset beta than if [the Notional Producer] were not a cost reimbursement operation".

3.5 The Commission states that this "toll processor" assumption is a requirement of the DIRA itself: "The Act requires the milk price to be calculated using revenues less efficient costs (i.e. the milk price formula). This milk price formula effectively reduces … the Notional Producer to a cost reimbursement operation akin to a tolling operation" (paragraph 4.41). The Commission relies on this conclusion to explain and support the (low) asset beta that has been used by Fonterra to determine the Notional Producer WACC.

3.6 It is not clear how the DIRA can be interpreted in the manner described by the Commission. <u>Miraka requests the Commission to lay out the legal basis for this interpretation. Miraka further requests the Commission to explain how an asset beta for a company facing no price risk on its key input (milk) could be practically feasible in the context of S 150A (2) and the Commission's own statements noted in paragraph 3.2 above.</u>

[3] Refer for example to paragraph 2.12 of the Miraka Submission on the Commission's 2014/15 Process and Issues Paper (BMP calculations).

3.7 While it is the case that S150C requires the milk price to be based on "real world" selling prices, and efficient processor costs, the DIRA does not specify how costs are to be determined other than by the requirements in Section 150C (required) and Section 150B (permitted). It is Miraka's view that the Commission, and the experts Dr Marsden and Dr Lally have failed to draw a distinction between the mathematical procedures for determining the milk price revenues and costs as laid out in the Milk Price Manual (modelled revenue less modelled costs), and the practically feasible processor operating in contestable markets. It is self-evident and rational that an economic model used to determine a competitive milk price in an otherwise uncompetitive market would include modelling of revenues and costs, and that the competitive price might include a determination of surplus from those calculations. By contrast, it seems extraordinary to assume the WACC cost for a business in a contestable market is based on a business that faces no price risk for its key raw material input. For this reason, Miraka considers the asset beta is only theoretically possible in a market where processors face no milk price risk. Miraka considers this is contradictory and defeats the purpose of DIRA S4(f) and is not practically feasible in accordance with S150A.

3.8 At paragraph 4.42, the Commission notes that "other processors operate a cost reimbursement model". The Commission is thus suggesting that other processors also have no exposure to milk price risk. This is simply wrong. To the extent that the independent processors set their final milk price after year end, this is because they are waiting for the Fonterra milk price to be finalised. This is to ensure their milk price remains competitive with Fonterra. In some cases, the final adjustment will also be due to contractual commitments where the milk price is based on the Fonterra milk price. This is certainly not a "cost reimbursement model"[4]. Indeed the interest of the Independent Processors in the Commissions reviews of the Milk Price manual and calculations illustrate the very real concern they have for their exposure to milk price risk.

3.9 Miraka has addressed the WACC assumptions (asset beta and specific risk premium) in detail in its last 3 submissions to the Commission (5 November 2015, 4 February 2016, and 17 June 2016). Miraka position was summed up in the final paragraph of the most recent submission:

> "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

[4] As co-operatives, Westland and Tatua return actual surpluses (determined after year close) to members. This is central to the co-operative framework. It is also not a "cost reimbursement model"; rather the co-operatives return all surpluses after deducting retentions for balance sheet/investment management purposes.

that is largely immunized from a normal competitive environment, and takes far too literally the environment assumed to the FGMP Notional Producer".

3.10 Despite its assurance that submissions would be considered, neither the Commission nor the two independent experts have addressed this fundamental issue. Miraka submits this issue must now be addressed in full as part of the final report on the 2015/16 Milk Price calculations.

Specific Risk Premium/Asset Stranding

3.11 The Commission considers the 0.15% specific risk premium is "consistent with the contestability dimension" (paragraph 4.52). This is not based on an assessment of practical feasibility but rather that "there is no clear evidence that the 0.15% [specific risk premium] increment to the cost of equity is unreasonable" (paragraph 4.53). It appears the Commission puts aside confirming practical feasibly on the grounds the item is not material (paragraph 4.53). This is despite the fact the Commission has specifically rejected the use of a materiality standard in assessing the milk price calculations.

3.12 The specific risk premium includes provision for the risk of asset stranding. Asset stranding could occur either because of a reduction in milk supply available to the Notional Producer, or to a change in the Reference Commodity Price (RCP) basket.

3.12.1 Miraka dos not accept the Commission's view laid out in paragraph 4.55 that the oldest plants would be assumed displaced first in the event of a decline in milk supply. The plant displacement should rather reflect the efficient reallocation of milk to plants following the reduction of supply, including as a result of regional competition.

3.12.2 In the case of changes to the RCP basket, the Commission refers to the analysis of Dr Marsden (independent expert appointed by Fonterra) which concludes the "risk of any significant changes to the RCPs is relatively low" (paragraph 4.58 including note 55). It is then somewhat contradictory that the Commission is now actively encouraging Fonterra to review the RCP basket more frequently and even annually (paragraph 6.8). Miraka is concerned that the framework to effect a change in the RCP basket is primitive. As currently formulated, the Notional producer would seem able to respond to competitive risks arising from changing market demand quickly, seamlessly, and at lowest theoretical cost. This framework needs to be scrutinised properly to determine practical feasibility in a contestable market before the RCP basket itself can be changed. Miraka will address this further in a submission on the 2016/17 update of the Milk Price Manual.

4.0 Transparency

4.1 Notional Producer Prices

4.1.1 At paragraph 6.25, the Commission seeks feedback on expanded disclosures proposed by Fonterra to increase transparency for the Notional Producer selling prices. This disclosure address concerns raised previously by Miraka. Miraka appreciates Fonterra's willingness to address the issue. In the Annual Milk Price Statement, Fonterra discloses average prices by shipment period (quarters) and for the full season (Attachment 4 in the 2014/15 Milk Price Statement). This Table is based on Notional Producer phasing. Miraka concerns would be addressed if Fonterra replicated (or provide a means for replicating) this Table with quarterly and annual prices based on the GDT sales programme from which the Notional Producer prices were derived. The GDT table (the new Table) would demonstrate actual average GDT prices achieved for the comparable Notional Producer period. Comparison to the Notional Producer Table (the existing Table) would then provide greater confidence in the practical feasibility of the Notional Producer prices.

4.1.2 The Commission's report and the Fonterra reasons paper suggest that submitters do not have confidence in the use of GDT prices themselves. Miraka wishes to clarify its position which has remained unchanged across all its submissions on the Milk Price. Miraka believes that GDT itself provides a defensible and objective basis for determining the Notional Producer prices. Miraka agrees with Fonterra that governance of GDT ensures GDT prices are independent of Fonterra influence (other than the influence of normal commercial processes and decisions). Miraka thus agrees with Fonterra that GDT prices "represent an unbiased estimate of the prices achievable for standard specification commodity product"[5]. Miraka concern is limited to confirming the process of converting GDT prices to the Notional Producer prices does not undermine the practical feasibility of the prices.

4.2 Notional Producer Conversion Rate

4.2.1 The Commission and Fonterra consider the Notional Producer conversion rate is sheltered by the safe harbour provision in S150B(c). That cannot be correct nor is reliance on that section necessary. While based on the Fonterra actual USD/NZD conversion rates, as Fonterra confirms[6] the Notional Producer conversion rate is different to the Fonterra rate both in terms of the rate itself and the quantum of underlying gains and losses. This is therefore not consistent with Section 150B(c). It is indeed difficult to consider how that section might be properly applied. It is also difficult to determine whether this is a significant issue due to a lack of transparency in the information available.

4.2.2 Miraka agrees it is impractical to establish a notional foreign currency risk management program to determine a conversion rate for the Notional Producer. Miraka also agrees that Fonterra actual currency risk management programme would be practically feasible for the Notional Producer. However, the process for using Fonterra actual conversion rates to determine the Notional producer conversion rate is flawed and does not produce a conversion rate which is feasible (practically or

[5] Fonterra Reasons Paper, BMP Calculations 2015/16, Pg 23.
[6] Ibid Pg 16 and Pg 25

otherwise). This is because the Fonterra conversion rate depends on spot rates relevant to Fonterra's cash stream (both at the time of conversion, and at the time risk management instruments are put in place). Notional Producer "exposure" to spot rates is different because the phasing of its cash receipts is different. The correct practically feasible measurement of Fonterra currency risk management is the difference between the conversion rate achieved and the spot rate that would have prevailed in the absence of a currency risk management programme. The Notional Producer conversion rate should simply reflect that same "delta" – i.e. the Notional producer average weighted average spot rate applicable to Notional Producer receipts should simply be discounted/inflated by the same delta as achieved in the comparable Fonterra US$ currency risk management programme.

4.2.3 Miraka requests the Commission reassess the practical feasibility of the Notional Producer Conversion rate noting the above. To provide confidence in the conversion rate used by the Notional Producer (and assuming no change is made to the calculation process for the 2015/16 season) Miraka also requests that a conversion rate calculated as above be included in expanded disclosures by Fonterra. Miraka suggests that Fonterra change its calculation process going forward.

4.3 Yields and losses

4.3.1 The Commission has encouraged Fonterra to release more information on yield and loss assumptions (paragraph 4.82). Miraka agrees and appreciates the Commission's support for increased transparency. The key missing information is the average composition of the Notional Producer products. There should be no reason to withhold these since Notional Producer compositions are not the same as Fonterra actual achieved product compositions. Disclosure of this information will provide a basis for interested parties to gain confidence in the practical feasibility of yields and losses.

Richard Wyeth
Chief Executive Officer

Appendix A: Milk Price Calculations, Assumptions and Measures: Items which are not practically feasible.

1.0 Aggregate Practical Feasibility

1.1 To assess the aggregate feasibility of the Notional Producer, a comparison has been made between the Notional Producer and a presumably desktop analysis of part of Fonterra's ingredient business. This is on the basis that this part of Fonterra's business is "a real world operation that closely replicated the Notional Producer" (paragraph 4.5). Fonterra's ingredient business cannot in fact replicate the Notional Producer. While Fonterra processes a similar quantity of milk, its production mix and sales and marketing strategies are quite different. Miraka submits that the Commission confuses theoretical feasibility with practical feasibility in comparing performance to Fonterra. The Notional Producer in aggregate cannot be shown to be practically feasible because it relies on a product mix which cannot produce the revenue stream attributed to it. The Notional Producer is at best only theoretically feasible and relies on the Safe Harbour provisions of S150B(d) to overcome the fact that it is not practically feasible. The Safe Harbour provisions are discretionary. Fonterra is permitted but not required to rely on them to meet the Purpose of Subpart 5A. Reliance on the safe harbour provisions does not make the Notional Producer practically feasible. This failure of the Commission to properly assess the Notional Producer is a source of frustration for submitters, and is a barrier to progressing beyond this fundamental issue.

1.2 A comparison has nevertheless been made between the Notional Producer and part of Fonterra's ingredient business. The analysis is based on Fonterra's 2014/15 Financial Results. It has been prepared by Fonterra and there is no indication it has been independently validated. At best, the analysis compares the Notional Producer to a materially smaller business: only 75% of Fonterra's NZ based production in 2014/15 was of reference products, and less than 40% of that volume was sold on GDT. By contrast, the Notional Producer is some 33% larger than Fonterra's production of reference products, and almost all the Notional Producer volume is sold on GDT (i.e. the Notional Producer sells over 4 times more product on GDT than does Fonterra). It is therefore not possible to conclude that this Fonterra analysis is a "real world operation that closely replicates the Notional Producer".

1.3 The analysis calculates that the Fonterra business incurred non milk costs some $0.18/kg MS higher than the Notional Producer. Miraka would expect a bigger number, and notes the number would depend on the way the overall Fonterra costs have been attributed in the analysis. While the Commission concludes the cost differences are "as expected" it does not assess the relevance or scale of differences. The Commission nevertheless then concludes the analysis shows the Notional Producer (costs) are practically feasible. This seems simply because they are lower than Fonterra costs.

1.4 The Commission also seems to conclude the revenues are practically feasible simply because the Fonterra revenues are higher than the Notional Producer. This is despite the fact that the Fonterra analysis includes off-GDT sales, intercompany sales, and sales through value add channels (consumer and food service) and so are not comparable. In this respect, it should be noted the Commission has yet to consider whether the signalled inclusion of off-GDT sales (of WMP, SMP and AMF) in the milk price calculation would meet the requirements of Subpart 5A. Miraka does not accept it is reasonable to conclude the analysis shows either Notional Producer costs or revenues are practically feasible, and it cannot show that the Notional Producer is practically feasible in aggregate.

1.4 Recognising the Notional Producer as currently defined is itself not practically feasible, Miraka considers an aggregate assessment needs to focus more carefully on consistency across the various assumptions. In this respect, Miraka draws the Commission's attention to sections 3.0 and 4.0 below which illustrate inconsistencies across assumptions which need to be addressed.

2.0 Product yields

2.1 The Commission has appointed Greg Winter as an independent consultant to assess the practical feasibly of production yields. Mr Winter has concluded that losses in the milk price model "represent actual and achievable yields for Fonterra" and are therefore "practically feasible for the model".

2.2 Miraka seeks further clarification of the yield analysis and the conclusion the losses and yields are practically feasible. Mr Winter confirms the yields are based on "actual production data". This must however only be a selection of data, and Mr Winter confirms (at paragraph 4.74 of the Draft Report) that "Fonterra was unable to provide data on actual losses during the beginning, shoulders and end of the season for an efficient plant comparable to the milk price operation", and that "very few Fonterra plants match the requirements of the milk price standard plants". Mr Winter has also confirmed the data has been cleansed of "outliers due to low production volumes, technology changes and outlier results". He continues that "this is well founded and this method has been used by many people who have modelled losses in the past". Mr Winter also concludes the yields are "challenging". Furthermore, losses are based on the assumption that the Notional Producer plants operate at an average of 85% to 90% of full capacity. All of this suggests the yields have at best been assessed against a technical (and possibly only theoretical) rather than a practical feasibility standard. All real world businesses, including efficient businesses, reflect sub-optimised performance and this will mean practical feasibility is a lower standard than technical feasibility.

2.3 The Commission has confirmed the GDT products meet the "minimum GDT specifications and Codex minimum standards". Miraka has completed a mass balance to compare input dairy solids against the Notional Producer production/sales volumes assuming GDT minimum dairy solids specifications. This shows fat and protein losses of some 1.3% against minimum standard specifications. This might be comparable with the Notional Producer overall losses (including specification offsets) of 1.1%[7]. However, when the mass balance is expanded to include total dairy solids including ingredient lactose, the overall losses fall to just 0.6%. This is not practically feasible and it suggests notional fat and protein losses are substantially lower than 1.3%. The situation is worse if input dairy solids are compared against Notional Producer production/sales volumes assuming the Fonterra's GDT "typical compositions". The "typical composition" specifications are not even theoretically feasible as there is a shortfall in available fat and protein solids of 1.5%

[7] Fonterra Reasons Paper, 2015/16 BMP Calculations Pg 21

(before <u>any</u> losses). This analysis suggests the yields might be technically feasible but are not practically feasible[8].

2.4 The Commission considers the Fonterra "typical specifications" are not relevant because "customers do not expect to receive products that meet the typical GDT specifications". This seems extraordinary. Not only Fonterra and the Commission, but Fonterra customers are apparently indifferent to what appear to be knowingly false representations in GDT product specifications. Miraka does not accept this explanation, and it undermines the credibility of the Notional Producer mass balance. Fonterra needs to explain why it describes composition specifications as "typical" when marketing GDT products, while those compositions are not even theoretically feasible for the volumes assumed produced by the Notional Producer.

2.5 <u>Miraka requests that Mr Winter confirms his assessment of yields and losses are based on an appropriate standard of practical feasibility approved by the Commission and confirms that this is distinct from a standard of technical feasibility.</u>

3.0 Selling Costs

3.1 Miraka has submitted several times that the Notional Producer selling costs are not practically feasible. This is because the Notional Producer assumes a total volume of sales which itself is not practically feasible and so the volume through GDT cannot be practically feasible. Miraka has submitted that to be ***practically feasible***, selling costs and all costs need to be based on a scale of business which is itself practically feasible.

3.2 The Commission has previously considered selling costs are practically feasible. The Commission has now changed its view and considers the selling costs might not be practically feasible because it might not be practically feasible to sell all Notional Producer product through GDT (Note: this is different to Miraka's view that the Notional producer could not sell the volume of product, through any channel, at the selling prices which are attribute to the Notional Producer). The Commission then concludes it is more "consistent overall with the contestability dimension" that the selling costs are set according to the volume based discounts listed for GDT sellers[9]. This is on the assumption that if sales volume through GDT is not practically feasible, the Notional producer would then sell volumes off-GDT at higher prices. The Commission accordingly departs from the S150A test of practical feasibility, and introduces a new test ("consistent overall with the contestability dimension") on the basis that the effect of two practically infeasible assumptions (selling costs and volumes sold through GDT) are deemed to cancel each other out.

3.2 The Commission notes that for the 2016/17 Season, Fonterra has signalled it will include a portion of presumed higher price off-GDT sales to determine the Notional Producer

[8] This analysis is necessarily imprecise due to limited available data and roundings. Miraka is happy to share the analysis with the Commission, but separate analysis by Miraka would not be necessary if Fonterra disclosed the average specifications assumed in the milk price calculations. Given these specifications are different to Fonterra actual average outcomes, there seems no good reason to withhold this information.

[9] No seller on GDT (including Fonterra) actually achieves those heavily discounted rates to the extent assumed for the Notional Producer and the ability to obtain that overall rate is no more than hypothetical.

prices for WMP, SMP and AMF[10]. The Commission also notes that it will consider whether that change complies with Section 150A in the course of its reviews for 2016/17. The Commission therefore seems to conclude the practical feasibility of selling costs is contingent on conclusions drawn from a review it is yet to perform with regard to the prices of off-GDT sales. The DIRA does not provide for a "contingent" assessment of practical feasibility. Miraka requests the Commission reconsider its assessment of this matter.

4.0 Collection Costs/Plant operating efficiency

4.1 In accordance with the Fonterra Reasons Paper for the 2015/16 Milk Price Calculations the milk collection costs for the Notional producer are based on Fonterra actual milk collection costs "excluding actual inter-factory diversion costs and inter-island milk transport costs"[11]. A modelled transport cost is then added to account for "volumes of cream and buttermilk to be transported between sites" (given not every site has a cream and butter milk processing facilities). No other adjustments are noted. The Commission concludes this is practically feasible. At the same time however, Fonterra explains low processing losses of the Notional Producer is because factories "operate at peak capacity full [sic] for around 85%-90% of their total operating days"[12]. This would require substantial inter-factory diversions of milk, but no provision is noted in the Fonterra Reason paper for this additional cost. The milk collection cost calculations as described by Fonterra is therefore not practically feasible[13].

4.2 Miraka requests the Commission review its conclusions on the practical feasibility of the collection costs.

4.3 Miraka further requests the Commission to consider the practical feasibility of the very high percentage of time the Notional Producer factories are assumed to operate at peak capacity. Given the scale, it would seem likely that Fonterra calculations are based on technical feasibility and do not take into account real world uncertainties and variations of milk supply which would result in sub-optimal outcomes.

5.0 Ocean Freight Costs/Kotahi Dividend

5.1 In its Reasons Paper Fonterra explains it has applied notional rebate from Kotahi to reduce ocean freight costs. The Commission considers this is practically feasible. Kotahi is a cargo management company established by Fonterra and Silver Fern Farms. At its

[10] In the Draft Report, the Commission encouraged Fonterra to consider wider inclusion of off-GDT sales on the basis that data provided by Fonterra shows off-GDT sales generate higher prices. The basis, criteria and controls for determining how off-GDT WMP, SMP and AMF sales contracts might appropriately be selected for inclusion in the milk price calculations has not yet been presented by Fonterra or considered by the Commission.

[11] Fonterra Reasons Paper 2015/16 BMP Calculations, Pg 29

[12] Ibid Attachment 4.

[13] At the 15 August 2016 stakeholder briefing held by the Commission a representative of the Fonterra Milk Price Group indicated the Milk Collection costs do include costs of inter-factory milk transfers. That is however not consistent with the Fonterra reasons paper, and in any event it was not clear that there was a specific allocation of collection costs to allow for the consolidation of milk required to achieve the 85% to 90% capacity utilisation.

launch it was described as a ”sea change that will help Kiwi business be more competitive in global markets”. Fonterra has invested in this operation to improve shipping cost performance. Any profit arises from this investment cannot be attributed to the Notional Producer. It is also not credible to accept that an efficient and professional freight and logistics management business, which was established to offer price advantages to its customers, would not in fact charge customers on an arm’s length basis which includes the very benefits it was set up to deliver. **Miraka requests the Commission reassess the evidence that this notional rebate from Kotahi is practically feasible.**

5.2 It would also seem the notional rebate is not consistent with the efficiency objective of S150A. Under some circumstances the Commission accepts Fonterra actual costs are acceptable for the efficiency objective. In this case however, Fonterra not only uses actual (arm’s length) costs, it also reduces those actual costs by a notional rebate deemed to be obtained from an external entity.

6.0 Lactose

6.1 Fonterra and the Commission have both now concluded the lactose cost for the Notional producer is not practically feasible because it is set on lowest cost determined on a retrospective basis. The Commission however considers this is not a “practical issue” (para 6.20). Miraka disagrees. The cost of lactose should not be able to be determined retrospectively. Within the current cost formula, the cost is set on either Fonterra actual unit cost or on the unit cost paid by competitors whichever is lower. In the absence of any better measure, the basis for costing must be prescribed in the Milk Price Manual (i.e. determined in advance) specifying which <u>one</u> of these two cost bases will be used.