Submission to the Commerce Commission on 'Process and issues paper – Review of 2015/16 base milk price calculation,'18 December 2015

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Glossary

2013 Final Report	Commerce Commission, Final Report on the Review of Fonterra's 2012/13 base milk price calculation, 16 September 2013, http://comcom.govt.nz/regulated-industries/dairy-industry/review-of-fonterra-s-farm-gate-milk-price-and-manual/statutory-review-of-milk-price-calculation-2/review-of-milk-price-calculation-201213-season/
2015 Final Report	Commerce Commission, Final Report on the Review of Fonterra's 2014/15 base milk price calculation, 15 September 2015, http://comcom.govt.nz/regulated-industries/dairy-industry/review-of-fonterra-s-farm-gate-milk-price-and-manual/statutory-review-of-milk-price-calculation-2/review-of-milk-price-calculation-201415-season/
DIRA	Dairy Industry Restructuring Act 2001.
kgMS	Kilogram of milksolids.
Miraka Submission	Miraka Limited, Miraka Submission to the Commerce Commission: Commerce Commission Process and Issues Paper – Review of 2015/16 Base Milk Price Calculation, 4 February 2016, http://comcom.govt.nz/regulated-industries/dairy-industry/review-of-fonterra-s-farm-gate-milk-price-and-manual/statutory-review-of-milk-price-calculation-2/review-of-milk-price-calculation-201516-season/
MT	Metric tonne.
NMPB	Notional Milk Price Business, comprising the notional milk powder manufacturing business implied by Fonterra’s Farmgate Milk Price Manual.
OCD Submission	Open Country Dairy, Submission on the Commerce Commission’s Process and Issues Paper – Review of 2015/16 Base Milk Price Calculation, 5 February 2016, http://comcom.govt.nz/regulated-industries/dairy-industry/review-of-fonterra-s-farm-gate-milk-price-and-manual/statutory-review-of-milk-price-calculation-2/review-of-milk-price-calculation-201516-season/
RCP	Reference commodity product, comprising WMP, SMP, BMP, Butter and AMF.
WACC	Weighted average cost of capital.

1 Introduction

This paper sets out Fonterra's cross submission on submissions provided in response to the Commission's *Process and issues paper – review of 2015/16 base milk price calculation*, dated 18 December 2015. Our cross submission is confined to certain matters presented in the OCD and Miraka submissions.

2 Miraka's submission

We comment below on Miraka's submissions on the following matters:

- Asset beta
- Production yields
- Reliability of GDT prices
- Selling costs.

Asset beta

In paragraph 2.3 of its submission, Miraka notes the "concerns [raised in its 5 November 2015 submission] about a specific 'framing issue' … used by Fonterra to justify a reduction in the Asset Beta …"

Miraka describes the 'framing issue' as follows:

> 4.1 The analytical framework laid out in [Dr Marsden's] Report is unclear and inadequately defined. Of some concern, it posits (yet more) notional business concepts:
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> - 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.
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> 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.
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> 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:
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> - 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 test3. 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.
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> 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:
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> "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.

We accept there is scope for clarification of the framework relating to the definition and concept of the 'notional business' which Fonterra instructed Dr Marsden to assume as a basis for his review of the asset beta.

We first note that both the Milk Price Manual and subpart 5A of DIRA contemplate a 'notional' business:

- The notional business contemplated under the Milk Price Manual is a manufacturer of RCPs of Fonterra's scale. Such a business clearly faces a different set of earnings risks than the actual Fonterra business, due to very significant differences in both the scope of its activities and in its product range.
- Similarly, subpart 5A of DIRA also assumes a notional manufacturer of RCPs and of Fonterra's scale.

The rationale for this approach is that:

- The business contemplated under the Manual and DIRA is clearly distinct from both Fonterra's overall business and its ingredients manufacturing business, from which it follows that it would not be appropriate to simply use an estimate of the beta for either of these businesses in the Milk Price calculation.
- A key principle underpinning both DIRA and the Manual is that the Milk Price, and the inputs into its calculation, should provide performance benchmarks for Fonterra. In particular, the asset beta for the NMPB should provide a reference point against which Fonterra can assess any incremental systematic risk of investments in downstream businesses or non-RCP commodity manufacturing assets.

The table presented on pp.17-18 of Dr Marsden's report, which was prepared by Fonterra, does not distinguish as clearly as it could the characteristics of the business implied by the Milk Price Manual and the notional business for which Dr Marsden was instructed to prepare his estimate of the asset beta. We will look to have this matter addressed in Dr Marsden's supplementary report. We note, however, that:

- Dr Marsden's estimate is intended to be for a business that has the attributes of Fonterra's New Zealand-based RCP manufacturing business, as required under Rule 43 of the Milk Price Manual, which provides that "in calculating the Asset Beta, the Independent Reviewer is required to have regard to Fonterra's exposure to systematic earnings risk with respect to the portion of its business corresponding to the Farmgate Milk Price Business."
- Fonterra's NZ-based RCP business is exposed to incremental earnings risk relative to a business that conforms precisely with the Manual, and it is intended that this incremental risk be accounted for where relevant (i.e. where it is systematic) in the asset beta. The sources of incremental risk include variability in incremental revenue on sales of RCPs not included in the Milk Price calculation,[1] differences between actual and assumed operating costs, and differences between the capital costs associated with Fonterra's actual RCP plants and the standard plants assumed in the Milk Price calculation.
- To the extent that Fonterra (or another processor) could choose to more fully align its revenue and costs to the inputs assumed in the Milk Price calculation, a case can be made for disregarding the incremental sources of risk noted above when setting the asset beta. If some of this incremental risk is both systematic and the associated incremental returns co-vary positively with market returns (both of which conditions appear plausible), this alternative approach would imply a lower asset beta. We would therefore expect that our actual approach would be supported by other processors.

[1] For example, sales of WMP, SMP or AMF off GDT, and on-GDT sales for delivery in less than one month or more than 5 months after the GDT event.

Production yields

Miraka notes that both it and other independent processors "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" and claim that "this inconsistency between [the use of GDT prices] and yield assumptions has never been satisfactorily addressed."

We have addressed the point raised by Miraka and others on a number of occasions, and are surprised they still consider this an open issue. In brief:

1. The product compositions assumed in the Milk Price calculations are established by reference to (a) the relevant CODEX standards and (b) the actual composition of the relevant product manufactured by Fonterra, and not by reference to the 'typical composition' noted in the product bulletins published on the GDT website. We have explained this approach on a number of occasions, including in our 2015 Reasons Paper:

   > For the 2014/15 base milk price calculation, Fonterra has applied the following process to update the specification offset assumptions relative to the assumptions employed in the calculation of the 2013/14 base milk price:
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   > - The MPG engaged Tina Gandell as an independent expert to review the specification offsets employed in the calculation of the 2013/14 base milk price and to recommend any changes.
   > - In undertaking her analysis Ms Gandell undertook detailed analysis of the actual composition of base specification milk price products manufactured by Fonterra over a four year period, including data showing the variability of performance at the plant level. Given this data Ms Gandell derived values for composition offsets that would be consistent with the composition of the product manufactured by the NMPB comfortably exceeding the relevant CODEX standard.[2]

2. As noted in the extract, the assumed product composition derived using this approach is consistent with the actual composition of the product sold by Fonterra on GDT.
3. The 'typical' compositions noted on the product bulletins reported on the GlobalDairyTrade website are intended to provide an indication of the product composition, but are not intended to precisely depict the product's content.[3] Miraka and other processors will be aware that customers receive detailed test results showing the actual composition of product purchased by them, and Fonterra's experience is that it is this data that customers rely on.
4. The Commission has previously reviewed the raw data underpinning our composition assumptions,[4] and confirmed that the composition assumptions are consistent with this data. The data shows the actual composition of product sold by Fonterra on GDT. We will make available to the Commission in the course of this year's base milk price review detailed data showing the current composition of product sold on GDT.

Reliability of GDT prices

Miraka "submits that Fonterra should publish the equivalent GDT prices (quarterly and full season) to demonstrate the practical feasibility of the Notional Producer prices [and should] also need to explain material differences between the GDT and Notional Producer prices."

For SMP, WMP and AMF, the prices used in the base milk price calculation are derived solely from the prices achieved on GDT for all relevant NZ product manufactured in the relevant year, with the shipment month prices derived by weighting contract month GDT prices by the percentages of the RCP shipped in the month that were contracted in each of the preceding five months. We accept that external parties do not have visibility over the proportion of a month's sale volumes that were contracted in each of the prior five months, and that this information would be required to precisely replicate the monthly prices published in the Milk Price Statement.

We note, however, that:

- Both the Commerce Commission and PwC, as Fonterra's external auditor, are provided with and work through the detail of these calculations.

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[2] 2015 Reasons Paper, page 19.

[3] Fonterra reduced the 'typical' protein and fat content reported in the GDT product bulletin for Regular WMP (for example) in November 2014, but did not alter the targeted composition for product manufactured after that date.

[4] See for example pararagraph D22 of the 2013 Final Report.

- GlobalDairyTrade publish the relevant information for virtually all on-GDT sales.
- It is possible to infer the average contract tenor of the off-GDT sales included in the NMPB monthly price calculations from a combination of the contract tenor data provided in Attachment 5 of the Milk Price Statement and the data published by GDT. While Fonterra would be open to considering decomposing the data published in Attachment 5 into on and off-GDT average contract tenor, it is not clear to us that this would be of any particular value to external parties. Among other things, the relative proportions of product contracted on and off-GDT in each month inevitably vary considerably between months, and the historic data would therefore be of at best limited usefulness in forecasting future weighted average NMPB shipment prices.
- We are also open to, and will further consider, the possibility of including the relevant weighted average contract month prices (which will be more readily reconcilable to the associated GDT events) and the weighting methodology and weights used to convert these to shipment month prices in the version of the Milk Price Model that we publicly release alongside the Milk Price Statement for a year.

Selling costs

Miraka in effect argues that the NMPB would only be able to achieve the same prices as Fonterra for product sold on GDT if it did not sell any more product on GDT than Fonterra, and that it is therefore internally inconsistent to factor the scale advantage of assuming 90% of the NMPB's much larger production is sold on GDT into the Milk Price calculation.

We note:

- Miraka's calculation of the consequences of this assumption (in paragraph 5.4) significantly overstates its impact, since Miraka uses as a benchmark the average commission that would be paid on the assumed production of 50,000 MT from an incremental plant, rather than the average commission that would be paid by Fonterra on its actual volume. Given the basis for Miraka's argument (that the NMPB might not be able to achieve the same prices as Fonterra for volume sold on GDT in excess of Fonterra's volume), the latter is a more appropriate benchmark. If the NMPB had sold 700,000 MT on GDT in 2014/15, its average commission rate per MT would have been USD 11.07, rather than the USD 30 assumed by Miraka. The impact on overall selling costs of assuming this higher rate would have been NZD 15.8m, or approximately 1 cent per kgMS, rather than Miraka's assessed impact of in excess of 5 cent per kgMS.
- The assumption that the NMPB sells 90% of its product on GDT is a stylised simplifying assumption, and among other things is intended to provide a performance benchmark for Fonterra's off-GDT sales. We accept that it would be more realistic (and, as Miraka notes, practically feasible) to assume the NMPB sold a higher proportion of its product off GDT, and in the process incurred higher selling costs. Because Fonterra on average achieves materially higher prices for RCPs sold off GDT than for RCPs sold on GDT, and the incremental price achievement also materially exceeds the incremental selling costs, the net impact of adopting this approach would be a higher Milk Price.[5]

Miraka also queries our assumption that 10% of product is sold to government procurement customers, and notes that this "assumption is however likely to have a material effect on selling costs." We have provided the Commission with the basis for establishing our provision for these costs, and note that while we provide for additional costs, we nonetheless assume these sales are made at GDT-equivalent prices. Again, the data we routinely provide to the Commission demonstrate that this assumption is conservative.

3 Open County Dairy's submission

We comment in this section on the following matters raised by OCD in its submission:

- The Commission's comparative review of Fonterra's business units and the notional processor.
- Winter milk premiums.

[5] The detailed data supporting this assertion is routinely provided to, and reviewed by, the Commission in the course of the annual base milk price review.

Commission's comparative review

Our only comment under this heading is with respect to OCD's suggestion that "the overall goal of the Commission's review should be to determine the size of the performance gap between Fonterra's equivalent business and the notional processor."

Our view is that this proposal implies a misunderstanding of the Commission's role under subpart 5A of DIRA, and the reasons why the Commission is undertaking this review. As the Commission explained in the Process and Issues paper, its focus is on further understanding "the practical feasibility of the notional producer in aggregate." This focus is consistent with the Commission's role under DIRA, and an examination of the magnitude of any 'performance gap' between Fonterra and the NMPB is relevant only to the extent that it informs the Commission's stated purpose.

Winter milk premiums

OCD "reiterates [its view that] Fonterra's current approach to winter milk premiums is not practically feasible [given] … the failure of Fonterra to account for the cost of purchasing winter milk." We simply reiterate our previous comments on this matter: we do in fact provide for the cost of purchasing winter milk in the course of determining the portion of the aggregate amount available to pay for milk as calculated under the Manual that is available to pay for milk supplied on standard terms, and we will consider how to better communicate this approach in the annual Milk Price Statement. However, whereas OCD argues that "satisfying practical feasibility calls for the full cost associated with winter milk to be included as an input cost" we in practice exclude a portion of the cost (equating to around 1 cent per kgMS) that relates to additional premiums paid for milk for supply (primarily) to the NZ market for liquid milk. It would only be appropriate to include these additional costs if we also included the associated incremental revenue, relative to a GDT benchmark, the net impact of which would be a higher milk price.