



Matthew Lewer, Regulation Development Manager

Commerce Commission  
44 The Terrace  
Wellington

1 September 2020

Dear Matthew,

### **Open Country Dairy Limited—Submission on Milk Price Calculation 2019/20 Season**

Thank you for the opportunity to make a submission on the Commerce Commission's Draft Report on its Review of Fonterra's 2019/20 base milk price calculation: Dairy Industry Restructuring Act 2001.

#### **Executive Summary**

The Commerce Commission (Commission) is again failing to properly scrutinise Fonterra's application of the milk price calculation. Fonterra's off-Global Dairy Trade (GDT) sales are again a "black box". The Commission is essentially taking Fonterra's word that the off-GDT sales are appropriately selected and represent reference commodity product (RCP) market prices, even though common sense and economic principles suggest off-GDT sales should not be higher than GDT sales for the RCPs.

As the Commission knows, Fonterra essentially sets the reference price for the industry when it sets its Base Milk Price. The effect of even small movements in the Base Milk Price have significant effects on the contestability of the dairy industry. Given Fonterra's underlying incentives, any areas where it has non-transparent discretion to select inputs into the calculation deserve heightened scrutiny.

Open Country Dairy requests that the Commission require Fonterra to improve the transparency on off-GDT sales. It requests at a minimum that the Commission should fully scrutinise the off-GDT sale prices and margins above GDT. Fonterra should be required to meet its commitment to publishing the quarterly cents per kilogram of milk solids (kgMS) impact of off-GDT sales on the base milk price. Without this information, the Commission cannot reach a finding on consistency with section 150A of the Dairy Industry Restructuring Act 2001 (Act).

#### **Fonterra's Underlying Incentives Matter**

The Commission should apply scrutiny to areas of the milk price calculation where Fonterra has discretion because of Fonterra's underlying incentives to use that discretion unfairly. The incentives have been revealed over many years now, in particular in respect of the asset beta debate.

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Fonterra's behaviour at the margin matters. Small changes in inputs to the milk price calculation can have a major impact on contestability in the wider dairy industry. The more areas where Fonterra has discretion, the less likely a fair Base Milk Price can be achieved. Where Fonterra has discretion, the Commission should seek the maximum amount of transparency to ensure fairness.

We have set out in a range of submissions since the commencement of the milk price monitoring regime that Fonterra has strong incentives at the margin to use the milk price calculation mechanism to set the Base Milk Price in a non-transparent way. We have outlined in previous submissions how Fonterra has strong incentives to use the milk price setting mechanism to make entry into the processing industry more difficult, which reduces the contestability in the milk processing industry.

Fonterra's incentives are revealed by its conduct over the asset beta. Fonterra has persisted with an unreasonably low asset beta (0.38) in the calculation (still being applied). This is in the face of repeated findings by independent experts, and the Commission itself, that a higher asset beta of 0.45-0.50 is correct. It has taken an Act of Parliament this year to get Fonterra's incorrect asset beta component of the milk price calculation changed. This follows many years of Fonterra's refusal to change, and the Commission procuring costly academic opinions, inviting independent processors to discuss the issue and ultimately taking no real action.

### **Off-GDT Sales Allow Non-Transparent Discretion to Fonterra Calculating the Base Milk Price**

Off-GDT sales add complexity to the calculation of the milk price. Although there are mechanisms to offset the change, this complexity gives additional discretion to Fonterra in its calculation of the base milk price. The lack of transparency around the off-GDT prices achieved means it is impossible to scrutinise the results.

GDT sales provide a simple, regular and transparent measure of the prices the Notional Producer could achieve in the international market.

#### ***GDT sales benchmark commodity prices***

In order to achieve the purpose of subpart 5A (Base Milk Price) of DIRA, section 150C requires that the revenues and costs for calculating the base milk price must be determined from the prices of a portfolio of 'Reference Commodity Products' (RCPs)<sup>1</sup>

A commodity is a standardised and fungible economic good—such that the market treats each unit of the good as interchangeable. GDT auctions provide an open, efficient market for a commodity price to be established, with large quantities of commodity product sold to many buyers, and they occur frequently (every two weeks).

Fonterra concedes that it treats GDT sale prices as a price floor for the RCPs. Fonterra's Peter Goss confirmed this in affidavit evidence in recent judicial review proceedings.

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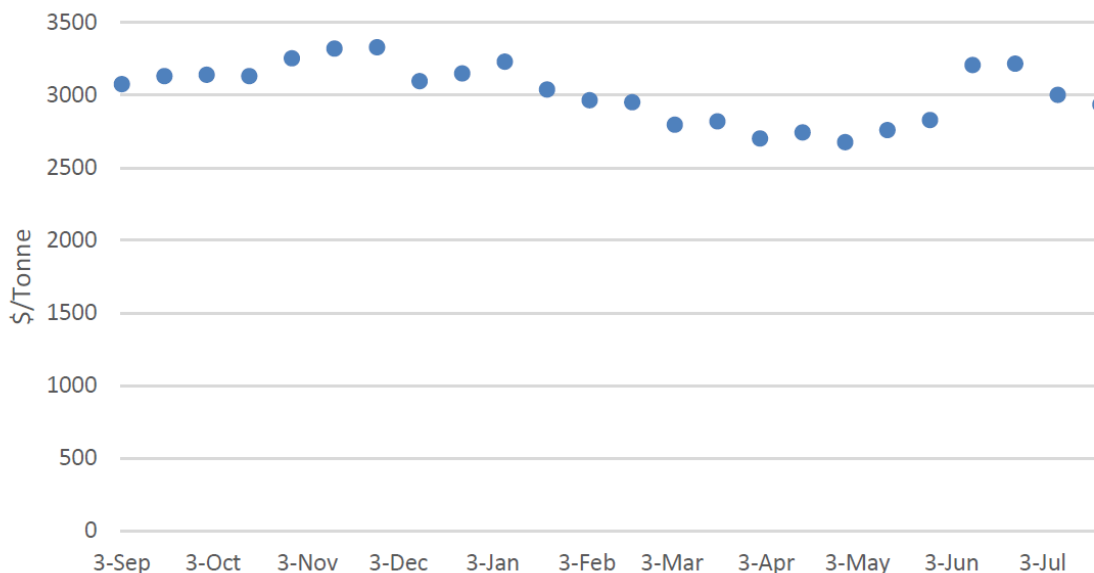
<sup>1</sup> [https://comcom.govt.nz/\\_data/assets/pdf\\_file/0026/63962/Our-approach-to-reviewing-Fonterras-Milk-Price-Manual-and-base-milk-price-calculation-15-September-2016.PDF](https://comcom.govt.nz/_data/assets/pdf_file/0026/63962/Our-approach-to-reviewing-Fonterras-Milk-Price-Manual-and-base-milk-price-calculation-15-September-2016.PDF)

*“Prices realised in respect of production sold on the GDT platform represent a floor, and not a ceiling, for the price obtainable for Reference Commodity Products”<sup>2</sup>*

Since Fonterra concedes that GDT sale prices are a floor, the off-GDT sale prices used by Fonterra in the milk price calculation are by definition all above the GDT level. This is itself quite curious. Why are the only transparently reported sales prices conveniently also the lowest?

It is a foundational economic principle that one price exists for the same good on open markets—the law of one price. Any differences in the price of a commodity on competitive markets will be arbitrated away. Figure 1 shows the regularity of GDT auctions and price trends—it is implausible that the exact same ‘commodity product’ could achieve systematically higher prices off-GDT.

**Figure 1: GDT Auction Results for Whole Milk Powder (12 months to August 18 2020)**



Source: Fonterra. URL: <https://www.globaldairytrade.info/en/product-results/whole-milk-powder/>

There is no good economic reason why buyers should pay a premium for off-GDT product, unless the off-GDT product is different. Fonterra says the price difference is because:

<sup>2</sup> Affidavit Peter Goss 25 June 2019.



*“some customers because of the quantity of product they are purchasing, their participation on GDT may cause the GDT price for the relevant products to shift. Other customers are prepared to pay a premium for certainty of supply (noting that volumes offered on GDT may decrease, for example because of a reduction in milk supply due to adverse climatic conditions) or for additional services, such as flexibility around shipment dates.”<sup>3</sup>*

These reasons appear to represent additional services Fonterra are providing incorporated into the price, rather than the actual commodity RCPs. Fonterra is actually selling the commodities bundled together with futures contracts and/or special delivery terms. Put in plain terms, the buyer is paying for commodity milk and Fonterra’s risk of ensuring delivery to meet the buyer’s particular needs.

The logical explanation is that the GDT auction results best represent the actual commodity prices. Therefore, we must question what problem off-GDT sales are supposed to be solving.

***Compensating adjustments for off-GDT sales increase Fonterra’s discretion and reduce transparency***

Fonterra’s Milk Price Calculation process attempts to adjust for the departure from the GDT sales by including ‘fixes’ such as corresponding higher selling costs and a decision tree for transactions to include only those the notional producer could make into competitive markets.

This ultimately just adds to the complexity of the price-setting process and generates more areas where Fonterra can make judgement calls. This has led to disputes regarding Fonterra’s application of these fixes—the onus is on Independent Producers (unless the Commerce Commission does so in its monitoring role) to point out when the prices achieved or selling costs are unrealistic. However, Independent Processors are at a fundamental disadvantage because of the lack of transparency surrounding off-GDT prices.

***No transparency from Fonterra on how off-GDT prices impact the base milk price***

Fonterra asserts that off-GDT prices are reached in freely-contested markets, yet Independent Processors have no visibility of these prices, or the terms of sale for the products. The Commerce Commission is essentially “taking Fonterra’s word” that its list of sales and procedures reflects market commodity prices.

Fonterra has not provided the promised transparency on the price margins between the ‘public’ GDT market price achieved and the ‘commercially sensitive’ off-GDT market price. It has failed to consistently meet its own commitment to provide quarterly updates on the overall effect of off GDT sales on the base milk price<sup>4</sup>. We are unable to make an independent assessment of, for instance, if there is any bias in Fonterra’s decisions regarding off-GDT transactions. We must rely on the Commerce Commission to provide the appropriate rigour and scepticism.

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<sup>3</sup> Affidavit Peter Goss, 25 June 2019

<sup>4</sup> Made in Fonterra –Attachment 2 of Submission on Review of Fonterra’s 2016/17 Base Milk Price Calculation, 2017



## **Conclusion**

The Commerce Commission should acknowledge Fonterra's incentive regarding the base milk price, and support measures to reduce the flexibility and discretion Fonterra has in setting the price. This has been put beyond any doubt in the asset beta saga, which an Act of Parliament will resolve from next season.

The Commission should insist on greater transparency of off-GDT sales (or at least the margins above GDT) so that Independent Processors and the wider dairy sector can appropriately evaluate Fonterra's conduct. Fonterra should be required to publish on a quarterly basis the cents per kgMS impact from the inclusion of the additional off-GDT sales for the full year in the annual Milk Price Statement. This will provide confidence that Fonterra is not acting on its underlying incentives and is in fact fairly calculating the Base Milk Price.

Regards,

**Malikah Mitha**

Chief Financial Officer