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

5 February 2016

Glossary

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.
NMPB	Notional Milk Price Business, comprising the notional milk powder manufacturing business implied by Fonterra’s Farmgate Milk Price Manual.
R&M	Repairs and maintenance.
RCP	Reference commodity product, comprising WMP, SMP, BMP, Butter and AMF.
F15 Season	The period commencing on 1 June 2014 and ending on 31 May 2015.
WACC	Weighted average cost of capital.

1 Introduction

This paper sets out Fonterra's submission on the Commission's *Process and issues paper – review of 2015/16 base milk price calculation*, dated 18 December 2015.

Our comments in this submission are organised under the following headings:

- The Commission's proposed approach to its aggregate assessment of the notional producer, and
- Other focus areas.

2 Commission's proposed approach to aggregate assessment

The Commission explains that its proposed approach to assessing the aggregate practical feasibility of the notional producer in the base milk price calculation model as follows:

> 30. To determine whether there is a material performance gap between an efficient producer and the notional producer, we consider that the best way to carry out the aggregate assessment is to start at an Earnings Before Interest, Tax, Depreciation and Amortisation (EBITDA) level for Fonterra's New Zealand ingredients business (Global Ingredients and Global Operations 'GI & GO' businesses, formerly NZMP). We would then work out an equivalent 'actual' EBITDA to that for the notional producer based on this. This will help build understanding about the practical feasibility of the notional producer in aggregate.
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> 31. We consider that EBITDA, rather than EBIT, is the best starting point. The tilted annuity depreciation method makes an EBIT level comparison difficult. We will look at the depreciation method separately.
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> 32. Because GI & GO produces both reference commodity products (RCPs) and non-RCPs, it is necessary to separate the financial performance of each part of the operations to enable a more direct comparison of the RCP part with the RCP financial performance of the notional producer.
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> 33. We will seek to work with Fonterra to compare GI & GO's EBITDA with the notional producer's EBITDA by:
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> 33.1 removing the estimated EBITDA of the non-RCP part of the business, to leave an estimate of the EBITDA for the GI & GO RCP operation; and
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> 33.2 comparing some specific details of GI & GO RCP operations and the notional producer's revenue, foreign exchange and costs at a KgMS level.
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> 34. Because some of the analysis used in separating the financial performance of the RCP and non-RCP parts of the business will involve estimates and judgement calls (particularly where there are shared costs between the RCP and non-RCP production activities), key assumptions will be documented with our conclusions in our draft report on the base milk price calculation review in August 2016.
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> 35. As a cross-check, we will review the data we use in the analysis of the GI & GO EBITDA for consistency with information that is publicly available.
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> 36. We note that our approach to assessing the aggregate assessment of the notional producer is dependent on Fonterra providing the relevant information in a reasonable timeframe for us to complete our analysis.
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> 37. We will also use any comparable cost information received from interested parties to help us identify any cost components that are potentially 'over-optimised' in the base milk price calculation. We request that any data is provided to us **by the end of March 2016** to give us time to factor this into our conclusions.

We have the following comments on the Commission's proposed approach:

- A strong case can be made for placing primary (or at least equivalent) reliance on a detailed comparison of the notional milk price business to independent processors which are more comparable to the milk price business, such as Open County Dairy and Miraka. We acknowledge this approach is feasible only if the relevant independent processors make the requisite data available to the Commission.
- The Commission's proposed approach appears viable when applied retrospectively to a full financial year. However, we anticipate considerable difficulties in any attempt to apply it for the current year, particularly because of the practical issues involved in determining and reconciling to the full year forecast the cost of

milk in inventory, and in reconciling assumed costs, which would have to be sourced from Fonterra's product costing system, to as-yet undetermined actual full year costs.
- As the Commission notes, cost allocation issues mean the proposed approach will necessarily involve an element of approximation.
- Unlike the notional Milk Price business, a substantial portion of the added lactose used by Fonterra to standardise milk powder is sourced internally. It will be necessary to derive transfer prices for internal lactose purchases that are internally consistent with the prices assumed to be paid by the notional Milk Price business.
- While not directly relevant to the estimation and comparison of EBITDA per kgMS for a single year for Fonterra's and the NMPB's RCP production, we note that cross-year comparisons need to account for differences across years in the quantum of interest expense on outstanding 'supplier payables' balances that is bundled into the Milk Price.[1]

3 Other focus areas

In addition to its aggregate assessment of the notional producer the Commission has advised that its focus areas for this year's review are:
- Weighted average cost of capital, with emphasis on the asset beta and specific risk premium.
- Production yields
- Consistency of cost of capital assumptions
- Administration, plant labour, other supply chain costs, site overhead costs and selling costs.

The Commission has previously concluded it is satisfied with our approach to some of these matters (as summarised in the table below), and we note that we agree with the Commission's previous analysis and conclusions on these aspects. We also provide brief comments in the table below on the other outstanding matters the Commission has carried over from previous reviews, as summarised in paragraph 28 of the Process and Issues Paper.

Issue	Comment
Focus areas	
WACC	As requested we have provided the Commission with the Terms of Reference for the further work on the asset beta and specific risk premium we have commissioned from Dr Alastair Marsden, and will make Dr Marsden's report publicly available.
Production yields	We are comfortable with the Commission's proposal to engage an independent expert to reassess the practical feasibility of our assumed yields.
Consistency of capital cost assumptions	We are comfortable with the Commission's proposed approach to capital costs.
Fixed costs	We are comfortable with the Commission's proposed approach to capital costs.
Outstanding matters carried forward	
Treatment of winter milk premiums	As previously advised, we will consider how we can increase the transparency of our disclosures around our approach to winter milk premiums.
Treatment of 'support payments' to suppliers	As previously advised, we do not consider the funding costs associated with this season's support to payments to suppliers constitute consideration for milk. Putting this difference of opinion to one side, we would not in any case consider it appropriate to fund these costs from the aggregate amount payable for milk calculated under the Milk Price

[1] The Milk Price methodology results in suppliers being compensated for delays in payment for milk through a higher Milk Price. Other things being equal, this higher Milk Price will be offset by lower interest expense on the resultant lower seasonal debt. The allocation of seasonal financing requirements between supplier funding and external debt, and therefore in financing costs between milk price and interest expense, varies between years, resulting in between-year (and between processor) variances in EBITDA per kgMS even where underlying business performance is consistent over time.

	Manual, and therefore do not intend making any provision in the calculation of the base milk price.[2]
Practical effect of non-GDT sales on the base milk price	We are comfortable with the Commission's proposed approach to capital costs.
Repairs and maintenance (R&M) costs	We are comfortable with the Commission's proposed approach to capital costs.
Application of the 'asset stranding' rules	We do not anticipate any need to make any provision for asset stranding costs in the calculation of the 2015/16 base milk price.

Finally, we note and welcome the Commission's comments on ways it can reduce the level of its review. We will provide the information requested in subparagraphs 42.1 – 42.3 in the course of this year's review.

[2] If a provision was made in the base milk price calculation for the cost of funding the support payments, the practical effect would be to reduce the calculated base milk price by the average support payment funding cost per kgMS of milk supplied. The consequence would be that, in aggregate, Fonterra would not be providing any support to its suppliers (or, equivalently, that the support payments to the 76% of shareholders who have taken advantage of the payments were being funded, in part, through payment of a lower milk price to the 24% of shareholders who have not applied for support payments. This would clearly be counter to Fonterra's objective of supporting its shareholders in the current low milk price environment.