



2 September 2019

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Regulation Branch

Email to: Regulation.branch@comcom.govt.nz

Dear Stephen,

We would like to thank you for giving Synlait Milk Limited the opportunity to make a submission on the draft report on the review of the 2018/19 milk price calculation.

Asset Beta

We once again agree with the Commerce Commission's conclusion that an asset beta of 0.38 is not likely to be practically feasible for an efficient processor.

Having reviewed the additional material published on your website on June 7th and August 12th by Graham Partington and Stephen Satchell, on behalf of Fonterra, as well as CEPA's response published on July 12th we agree with the Commission's view that no new material points have been introduced through this process.

While we acknowledge that the asset beta for the notional producer is inherently difficult to estimate, we believe that a decision has been made by the Commerce Commission that an asset beta of 0.38 is not compliant.

In our view, it is now time for Fonterra to be compliant by increasing the asset beta estimate used in the calculation as recommended by the Commerce Commission.

We acknowledge that the Dairy Industry Restructuring Amendment Bill (**DIRA Bill**), introduced to Parliament on August 22nd, proposes adding some certainty into the legislation around asset beta. The amendment will require that the asset beta used in the application of the capital asset pricing model be consistent with the estimated asset betas of other dairy and commodity processors.¹

We do not believe that this proposed DIRA amendment reduces the importance of concluding on this issue under the current legislation.

FX conversion

The Commerce Commission acknowledge the submission from TBD Advisory to the 2018/19 milk price manual relating to FX in their draft report. In its submission, TBD Advisory outline two areas where the transparency around FX could be improved, with reference to Fonterra's Farmgate Milk Price Statement:

...as at 31 July, Fonterra had foreign exchange contracts in place for approximately 73% of the USD-equivalent cash flow exposure expected to impact on the Farmgate Milk Price for the 2019

¹ For DIRA amendment bill, see:

https://www.parliament.nz/en/pb/bills-and-laws/bills-proposed-laws/document/BILL_91054/dairy-industry-restructuring-amendment-bill-no-3



Season. If the balance was hedged based on a spot exchange rate of 0.6821, the average USD:NZD conversion rate would be 70 cents.²

The more meaningful number in this statement is the average conversion rate of 70 cents, which is informed by the level of hedging (73%). Fonterra's point, as referenced in the draft decision, is true that changes in commodity prices and full season milk collections will move their stated FX position.³ The reason further detail remains relevant is that external parties are able to monitor the changes in these variables through the GDT platform (commodity prices) and Fonterra's monthly collection updates (volumes) and are therefore able to understand the movement in the FX position throughout the season.

Outside of commodity prices, FX is the variable that has the greatest effect on the milk price each season. We agree with TDB's materiality assessment that a 1 cent movement in the FX rate (difference between 69.50 and 70.49) has around a 17c effect on the current milk price making the potential full cent variance in Fonterra's reporting hugely material. It becomes very difficult to run an accurate internal notional producer model when there is an inherent difference of up to 17c at the start of the season due to the lack of transparency in FX. As noted by TDB, four decimal places is the standard measure to express FX rates.

Asset utilisation

This section looks at Fonterra's permanent assets assumed in the 2018/19 calculation and Fonterra's temporary mothballing of plants in the season.

Mothballing

In Fonterra's paper supporting the 2018/19 milk price calculation Fonterra noted that:

We have assumed that the NMPB would have continued to 'mothball' the four plants originally mothballed in F17, with commensurate savings in associated direct labour and other overhead costs.⁴

In their draft report Commerce Commission note that:

We note that the 2018/19 milk volume forecast is greater than the 2017/18 total volume, so there are no additional short-term plant mothballing issues we consider we need to address in this year's review of the Calculation.⁵

Our reading of this explanation by the Commerce Commission is that as volumes have increased in 2018/19 relative to the previous season additional mothballing was not considered however the previously accepted assumptions around mothballing plants in 2016/17 and 2017/18 were rolled over and accepted in 2018/19.

Mothballing decisions should be assessed each season on the conditions at the time. Fonterra collected 1523kgMS in the 2018/19 milk season, higher than the 1505kgMS collected in 2017/18 and marginally less than the 1526kgMS collected in 2016/17. When assessing a processors ability to mothball plants for a full season however it is not the final collection volumes that are the most relevant but the expected

² TDB Advisory "Submission: Review of Fonterra's 2018/19 Milk Price Manual" (November 16 2018), page 2.

³ Commerce Commission "Draft report – Review of Fonterra's 2018-19 base milk price calculation (15 August 2019), para 2.114.

⁴ Fonterra "Reasons paper on review of 2018-19 base milk price calculation" (26 June 2019), page 26.

⁵ Commerce Commission "Draft report – Review of Fonterra's 2018-19 base milk price calculation (15 August 2019), para 2.105.



volumes through the peak milk supply months. Mothballing decisions need to be made in advance of these peak months.

The Commerce Commission acknowledge this point in their final report on the 2017/18 calculation review:

We consider that lower volumes in August and September due to poor weather would have given the notional producer sufficient information to modify its forecasts and temporarily mothball plants accordingly. Although October and November volumes were up on the previous years, they were still well down on recent historic levels. This is an area we intend to focus on in the 2018/19 Manual and calculation reviews, dependent on the extent of any material reduction in volume.⁶

This season Fonterra were predicting strong milk supply growth and it wasn't until February 28th that they reduced their forecast collection volume for the season from 1550kgMS to 1530kgMS.^{7,8} 1550kgMS would represent their strongest milk season since 2015/16. It is hard to reconcile how four plants were mothballed when Fonterra were forecasting significant volume growth until well past the peak months.

Permanent assets

In attachment 3 of Fonterra's paper in support of the 2018/19 Milk Price Fonterra outline the manufacturing plants assumed in the base milk price calculation. The information in the table below is taken from the last three annual Fonterra reasons papers.

Number of plants by type	2016/17 reasons paper	2017/18 reasons paper	2018/19 reasons paper
WMP	30	30	28
SMP	20	20	18
BMP	4	4	4
Butter	6	6	6
AMF	4	4	4

Volume of milk collected (kgMS)	1526	1505	1523
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The reduction in the number of powder plants is offset to a small degree by an improvement in powder plant reliability from 'greater than 95% On Product Time' in the 2017/18 reasons paper to 'greater than 96% On Product Time' in the 2018/19 reasons paper but this would obviously not equate to a reduction of four plants.^{9,10}

The Commerce Commission draft report makes no reference to this reduction in permanent plants, so we are interested in their view as to whether they believe this reduced number of plants is realistic in the face of increased milk volumes and four mothballed plants.

⁶ Commerce Commission "Final report – Review of Fonterra's 2017/18 base milk price calculation" (14 September 2018), page 11.

⁷ Fonterra's announcement can be found here: <https://www.fonterra.com/nz/en/our-stories/media/fonterra-increases-201819-forecast-farmgate-milk-price-and-reduces-earning-guidance.html>

⁸ Fonterra later reduced their forecast further to 1510kgMS, ultimately finishing the season at 1523kgMS.

⁹ Fonterra "Reasons paper on review of 2017-18 base milk price calculation" (2 July 2018), page 53.

¹⁰ Fonterra "Reasons paper on review of 2018-19 base milk price calculation" (26 June 2019), page 43.



Yours faithfully,

Nigel Greenwood

Chief Financial Officer