
# Submission:

# Review of Fonterra’s 2018/19 Milk Price Manual:

# Dairy Industry Restructuring Act 2001[1]

November 16, 2018

## Summary

This report responds to the Commerce Commission’s (ComCom’s) draft conclusions on its review of Fonterra’s 2018/19 Milk Price Manual (MPM) – specifically with respect to the draft conclusions on stranded assets and mothballing. It also raises the question of yield, that is, kgMS used to produce tonnes of product, from a practical feasibility perspective.

ComCom has suggested that there should be more transparency with respect to Fonterra’s fx assumptions. We think that Fonterra’s fx disclosures should be more precise and therefore less misleading.

We agree with ComCom’s conclusions with respect to the impact of Fonterra’s amendments on consistency with the s 150A purpose.

We agree with ComCom’s conclusions on efficiency and contestability with respect to the rules on asset stranding.

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## Foreign exchange

ComCom has suggested that there should be more transparency with respect to Fonterra’s fx assumptions. We think that Fonterra’s fx disclosures should be more precise and therefore less misleading. For example, in the 2018 Farmgate Milk Price Statement, Fonterra disclosed that its average foreign exchange conversion rate for the year was USD:NZD 0.7074, that is, an exchange rate reported to four decimal places as is standard practice in fx markets. However, Fonterra then disclosed that “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 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.”

This statement lacks precision in two areas: “approximately 73%” could be anything between 72.50% and 73.49% and “70 cents” could be anything between USD:NZD 0.6950 and USD:NZD 0.7049. For IPs trying to match Fonterra’s average conversion rate, the FGMP-equivalent impact of an average conversion rate of USD:NZD 0.7174, that is, 1 US cent worse that Fonterra’s, in the 2018 season was 17 cents. We think that that is material.

## Asset stranding

Lower than expected milk volumes over the last two seasons raise the possibility that milk volumes may be stabilising and/or could experience decline. It seems to be generally accepted within the industry that “peak-cow” has been reached in New Zealand with tightening environmental management requirements probably leading to less intensive farming practises being adopted across the country in the very near future. That doesn't necessarily mean that New Zealand has also reached “peak-milk” but it would probably be a surprise to everyone if there was much additional material investment in dairy conversions that were based on traditional New Zealand pasture-based dairying.

There are four scenarios that potentially lead to assets being stranded:

1. Lower milk volumes across the industry;
2. Accelerating defections from Fonterra to the Independent Processors (IPs);
3. A change in the reference commodity products (RCP); and
4. Inefficient investment

There are three rules in the MPM relevant to the consideration of asset stranding:

- Rule 32 - Adjustments for amendments to the RCP;
- Rule 33 - Surplus capacity; and
- Rule 43 - Specific risk premium.

Rule 32 allows that the cost of writing off an asset that has become stranded as a consequence of there being a change in the RCP should be borne by suppliers. It would be reasonably argued that suppliers should bear the cost because they will benefit from a resultant FGMP that presumably is higher than it otherwise would be. And, presumably, if the FGMP is higher than it otherwise would be, the earnings of the business will be less than they otherwise would be. Therefore, it would seem inequitable to burden Fonterra with the cost of writing off the stranded asset and lower earnings.

Rule 32 also says that the oldest "*relevant*" plant should be written off. We think that that is reasonable from an efficiency perspective.

Rule 33 allows that the cost of writing off a plant that becomes permanently stranded due to a decrease in the supply of milk to Fonterra in that region should be borne by Fonterra's shareholders. That seems reasonable given a permanent decrease in milk supply is most likely to be the consequence of suppliers exiting Fonterra to supply a competitor. That being the case, it would be inequitable to charge the remaining suppliers for that lost supply.

Rule 33 also says that the oldest plant in the region where milk supply has been reduced – that is, where the asset has actually been stranded – should be written off. We think that that is reasonable from an efficiency perspective.

ComCom has questioned whether or not rules 32 and 33 are consistent with the contestability dimensions of the Act as the cost of asset stranding for an IP are likely to be significantly higher than they are for Fonterra essentially because the IP's stranded asset is its only processing asset or one of only a few processing assets compared to Fonterra's processing footprint.

Our response to that question is that IPs make the decision to invest in this market with their eyes open. That is, milk supply is their biggest risk. They invest thinking that they can effectively manage that risk. It would be inappropriate to require Fonterra to be burdened with a higher asset stranding cost just because it costs IPs more.

Rule 43 provides for a specific risk premium to compensate investors in the Farmgate Milk Price Commodity Business for risks that are not otherwise provided for in the Farmgate Milk Price calculation methodology, and which investors would rationally seek compensation for. In recent seasons, Fonterra has set a specific risk premium of 0.15% per annum. That cost of equity adjustment makes little sense to us given the cost of equity is estimated by comparing similar commodity businesses – all of which presumably risk asset stranding. Adding a specific risk premium in that case seems to be double counting.

## Mothballing

A number of years ago Fonterra announced that it would be investing in additional processing capacity to give it optionality at the peak of the season. In other words, more capacity to give it more choice around its product mix in order to maximise the FGMP. On the one hand, this optionality is similar to a permanent supply decrease given, by definition, it implies that Fonterra always has excess capacity. However, on the other hand, it is similar to a temporary decrease because the it is unlikely that the same assets will be mothballed each year.

Given the objective of optionality is the benefit of the suppliers, it is reasonable that suppliers bear the cost of this annual excess capacity.

Given the scale efficiencies required to effectively compete in the commodity markets, we think it unlikely that IPs would similarly invest for optionality and therefore question whether or not such investment is consistent with the contestability dimension of the Act.

We think that the cost of optionality should be a cost to suppliers and be included in the MPM if it isn’t already.

## Practical feasibility - yield

The Farm Gate Milk Price Statement 2018 states that the NP produced 2.886 million tonnes of product from 1.505 billion kgMS. In other words, on average, each tonne of product used 521 kgMS .

The product specifications of the RCP together with the NP’s stated product mix imply that the production of 2.886 million tonnes of product would have required 1.514 billion kgMS.

The difference suggests that the FGMP was overstated by 4 cents and that assumes a yield of 100%. If yield was 98% for example, the NP would have required 1.545 billion kgMS to produce 2.886 million tonnes of product. That difference suggests that the FGMP was overstated by 18 cents.

From a practical feasibility perspective, these calculations suggest that the NP produced an extraordinary amount of product given the milk supply.

## Conclusions

1. We think that the asset stranding rules in the MPM meet the efficiency and contestability dimensions of the Act.

2. We think that Fonterra’s foreign exchange disclosures need to be more precise in order to not be unintentionally misleading.

3. From a contestability perspective, it is not clear to us that the cost of optionality is included in the FGMP. We think that the cost of optionality should be a cost to be carried by suppliers and be included in the calculation of the FGMP.

4. From a practical feasibility perspective, we question the yield that Fonterra apparently achieved in the 2017/18 season.

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