Submission to the Commerce Commission on its Draft Report on Fonterra's 2013/14 Farmgate Milk Price Manual

15 November 2013

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Glossary

DIRA	Dairy Industry Restructuring Act 2001.
MPG	Milk Price Group, the independent group responsible for calculating the base milk price.
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.
Season	The period commencing on 1 June 2013 and ending on 31 May 2014.

Executive Summary

This paper sets out Fonterra's submissions on the Commerce Commission's draft report, dated 15 October 2013, on Fonterra's Farmgate Milk Price Manual for the 2013/14 dairy season.

Fonterra welcomes the Commission's draft conclusion that the Manual is largely consistent with the purpose of subpart 5A of the Dairy Industry Restructuring Act 2001, which contains the milk price oversight regime.

The Commission raises the following matters in its draft report, and we address these in our submission.

First, the Commission expresses a "general concern" about the flexibility of interpretation of the Manual, noting that the Commission considers a lack of prescription in some parts of the Manual may undermine the efficiency objective of the oversight regime and create a risk that the Commission may not be able to determine whether some rules are 'practically feasible' until the Commission undertakes its review of the base milk price for 2013/14.

We do not consider the lack of prescription in certain rules noted by the Commission materially undermines the efficiency objective, because Fonterra management generally refer to sources other than the Milk Price Manual for information on relevant benchmarks. We also do not consider the effectiveness of the oversight regime is compromised if the Commission confines its assessment in this review to determining whether a rule is 'consistent with', or 'does not preclude', the establishment of practically feasible inputs. The Commission can then defer expressing an opinion on whether the actual inputs calculated under the rule are practically feasible until it prepares its report on the base milk price. And we emphasise the strong incentives on Fonterra to apply the Manual consistently over time, noting both Fonterra and the Commission will inform stakeholders if Fonterra makes material changes to the methodology used to calculate the base milk price.

Secondly, the Commission explains that it is unable to conclude on the extent to which three rules in the Manual are practically feasible, either for Fonterra or another efficient processor. The relevant rules are those relating to the treatment of stranded assets, repairs and maintenance costs, and overhead costs:

- We have previously explained why we apply different approaches to assets stranded due to a shortfall in milk supply and assets stranded due to a change in the mix of products used to calculate the milk price, and continue to consider the difference in approach is both supportable and appropriate – indeed, we do not consider a materially different approach would be viable.
- With respect to repairs and maintenance costs, we agree the Commission will not be able to determine whether our specific application of the revised rule results in an input that is both practically feasible and incentivises efficiency until it reviews the base milk for 2013/14. However, we are committed to ensuring the amended approach satisfies both tests. We are considering amendments to this rule for 2014/15 that will address the Commission's concerns.
- The Commission notes that during the 2012/13 base milk price review we indicated we would be changing the approach used to calculate overhead costs. The Commission has consequently decided it can no longer conclude on the extent to which the rule is 'practically feasible' for 2013/14. However, our proposed methodological changes will not be implemented until 2014/15, so should not impinge on the Commission's conclusions for 2013/14.

Thirdly, the Commission queries both the implications of amendments to the approach to setting working capital inputs, and whether the assumption of Fonterra's Advance Rate Schedule, governing the timing of payments for milk, constitutes a unique feature not replicable by another processor. The amended working capital provision enables a

better alignment to be achieved between the selling prices and costs assumed in the milk price revenue calculation and the trade terms attaching to the actual sales and costs used to determine the milk price inputs, providing additional assurance around the practical feasibility of these inputs. Fonterra's Advance Rate Schedule is publicly available, and other processors take a similar approach to Fonterra in staggering their payments for milk.

Finally, the Commission suggests the removal of a requirement to periodically assess the market value of land assets leaves no specific provision in the Manual for how land assets are to be valued, increasing the flexibility available to Fonterra in applying the Manual. The prescriptive formula contained in Rule 34 of the Manual applies to land, and does not allow any flexibility. We agree, however, that an amendment to cover the addition of new manufacturing sites would be desirable, and will address this issue in the course of the next round of amendments to the Manual, for the 2014/15 season.

1 Introduction

This paper sets out Fonterra's submissions on the Commerce Commission's draft report, dated 15 October 2013, on Fonterra's Milk Price Manual (the Manual) for the 2013/14 Season, prepared in accordance with section 150I of the Dairy Industry Restructuring Act 2001 (DIRA). This submission is intended to satisfy Fonterra's obligations under section 150M(2) of DIRA. The submission has been prepared under the oversight of the Milk Price Panel, and where relevant reflects the Panel's views.

We note, and generally agree with, the Commission's overall draft conclusion is that the Manual is largely consistent with the section 150A purpose statement, albeit subject to several provisos. Our comments in this submission are primarily confined to addressing those provisos.

The submission is organised as follows:

- In section 2, we address the Commission's comments on the level of prescription provided for in the Manual, and comment more generally on Fonterra's views on the role of the Manual.
- In section 3, we comment on the three matters in respect of which the Commission was unable to reach a conclusion (the treatment of stranded assets, R&M and overhead costs).
- In section 4, we address the Commission's comments on working capital and the treatment of land.

2 The Commission's observations on the flexibility of approach afforded by the Manual

On p.19 of its draft report the Commission expresses the view that:

> 2.45 The changes made to the Manual for the 2013/14 dairy season that we consider have introduced a greater degree of discretion, together with our understanding of how the rules are presently applied in the calculation of the base milk price, have raised for us a general concern about the flexibility of interpretation of the Manual. The lack of prescription in some parts of the Manual:
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> 2.45.1 undermines the efficiency objective, as it is important that the Manual reflects a set of stable and prescriptive rules so that it provides a transparent benchmark for Fonterra management to beat; and
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> 2.45.2 means that there is a risk that we may not be able to conclude on the extent to which the rules in the Manual are practically feasible for Fonterra or another efficient processor (eg, the new provision for Repairs and Maintenance costs in Rule 16 and the treatment of stranded assets in Rules 31 and 32, as discussed in paragraphs 2.23 -2.32 and 2.15 - 2.21 respectively); or that our conclusions on the rules of the Manual may need to be modified in light of our assessment of the rules' specific application (eg, the calculation of 'other costs, including site overheads, general overhead costs and R&D costs' in Rule 19, as discussed in paragraph 2.46 below).
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> 2.46 Rule 19 only requires that a reasonable provision is made for costs in respect of site overheads, general overheads, information systems and research and development. We note that in Fonterra's submission to our draft report on the 2012/13 base milk price calculation, Fonterra stated that its review of these costs will "generate a new set of administrative and other overhead costs for implementation in 2014/15."[18] Given the lack of prescription in Rule 19 it would appear no change to the rule is necessary to accommodate methodological changes to calculating these costs, so long as it results in a "reasonable provision." We are therefore no longer able to conclude on the extent to which this rule is consistent with the legislative purpose until we are able to assess its specific application.

The matters raised by the Commission to some extent highlight shortcomings in subpart 5A of DIRA, particularly the statutory requirement to undertake the reviews of the Manual and the base milk price as separate, standalone, exercises. In particular:

- All rules in the Manual are cast at a relatively general level, creating a situation where the Commission cannot conclude on the extent to which the inputs established under any rule are 'practically feasible' until it undertakes its review of the base milk price for a particular year. (In contrast, for most rules, the Commission is able to conclude on whether the rule promotes efficiency in advance of its review of the base milk price.)
- We therefore do not consider the effectiveness of the oversight regime is compromised if the Commission confines its assessment in its review of the Manual to determining whether a rule is 'consistent with', or 'does not preclude', the establishment of inputs that are practically feasible, and then expresses in its report on the base milk price its opinion on whether the actual inputs calculated in accordance with the rule are practically feasible. In this context we note that neither Rule 16, covering R&M costs, nor Rule 19, covering overhead costs, preclude the establishment of inputs that are both practically feasible and promote efficiency.
- As noted above, we agree some rules are sufficiently general that the Commission is unable to determine whether they promote efficiency until it reviews the application of those rules in its review of the base milk price. The amended Rule 16 falls into this category and it appears the Commission considers Rule 19 also does so. We confirm that in applying these rules we will use methodologies that do not involve the pass

through of current year actual values to the milk price.[1] We will consider amending Rule 16 for 2014/15 to make this point explicit. (As discussed below we consider Rule 19 does not require any amendment in this regard.)

The Commission also suggests that a lack of prescription in the Manual may undermine the efficiency objective, by not providing "a transparent benchmark for Fonterra management to beat." The Manual is not a primary source of information for Fonterra management on the benchmarks used in the calculation of the milk price. The primary benchmark used by management is the milk price itself, rather than the inputs into the milk price, and where necessary management rely on the much more detailed information contained in the various internal operating manuals and position papers. And for notional inputs, the input's value, rather than the rule used to determine the input, is often the more relevant variable.

Like the Commission, Fonterra considers it important that the milk price methodology be consistent over time, such that year on year changes in the base milk price reflect the annual variation in the milk price that could be paid by a processor with the characteristics of the NMPB. To this end, Fonterra makes publicly available a substantial amount of information that is (among other things) intended to explain movements between years in the base milk price, including the extent to which movements are attributable to changes in methodology. The 2012 and 2013 Farmgate Milk Price Statements demonstrate that methodological changes in the past two seasons have had a negligible impact on the milk price. If in future Fonterra was to use the flexibility allowed by the Manual to make a methodological change that had a significant impact on the milk price, this would both be disclosed in the Milk Price Statement and highlighted in the Commission's report on the base milk price. Fonterra faces very strong incentives to ensure that any such changes are fully justifiable so as to avoid an adverse reaction from the capital markets.

[1] Costs covered by the second bullet point in Rule 19 (relating to costs of a one-off nature or that vary considerably over time) constitute an exception to this confirmation, but are generally relatively immaterial.

3 Matters on which the Commission is unable to conclude

The Commission notes on p.5 that it is unable to conclude "on the extent to which the following rules in the Manual are practically feasible for Fonterra or another efficient processor until we are able to assess their specific application:"

- The treatment of stranded assets, where the Commission expresses concern about the different approaches applied to stranded assets depending on the circumstances of the stranding.
- The amended Rule 16 relating to the treatment of repairs and maintenance costs.
- The calculation of site overheads, general overhead costs and R&D costs under Rule 19.

Stranded asset risk

The Commission explains on pp.12-13 that:

2.15 In our review of the Manual for the 2012/13 dairy season we highlighted that the Manual for the 2012/13 dairy season provided for different treatment of stranded assets in Rules 31 and 32. In particular:

2.15.1 In Rule 31 the risk of asset stranding is borne by farmers as suppliers ex post (i.e. when a stranding occurs).

2.15.2 In Rule 32 the risk is borne by shareholders, ex ante, through the asset beta input in the weighted average cost of capital calculation.

2.16 While we consider that sufficient allowance should be made, either ex post or ex ante, for the risk of asset stranding, it is not clear why there should be a different treatment which may affect the prospect of recovering sufficient costs where the stranding is due to changes in available milk supply, or allocation of risk depending on the circumstances of the stranding.

2.17 We acknowledge that the issue of how to provide appropriately for the risk of stranding is a difficult one, and that given the strong historic growth in milk supply, and the projections for continued growth, the risk of asset stranding from an excess of capacity and/or a change in the reference commodity products may not currently be seen as high.

2.18 We consider nonetheless that the rules (depending on which one is applied) may be inconsistent with the purpose, and are potentially material. In our review of the Manual for the 2012/13 dairy season we deferred our conclusion on the extent to which these rules may be inconsistent with the purpose to our review of the 2012/13 base milk price calculation.

2.19 Rule 40 requires the provision of an updated asset beta by an independent reviewer in a Review Year. As well as Fonterra's exposure to systematic earnings risk the independent expert is required to have regard to stranded asset risk.

2.20 We reported in our conclusions to our review of the 2012/13 base milk price calculation that we were unable to conclude on the feasibility of the asset beta due to the insufficiency of information provided by Fonterra. The information provided did not explain why there should be different rules for the treatment of stranding risk depending on the circumstances of stranding. Nor did it explain why the risk of asset stranding should be a matter to be considered in the assessment of the asset beta.

2.21 In the absence of any changes to these rules in the Manual for the 2013/14 dairy season, or explanation in Fonterra's Reasons paper, we are again unable to conclude on the extent to which these rules are consistent with the purpose.

Consistent with our submission on the Commission's draft report on the 2012/13 Milk Price Manual,[2] we continue to hold the view that the varying treatments in Rule 31 and Rule 32 of assets stranded for different reasons is appropriate.

Rule 32 provides that where assets are stranded due to a shortfall in milk supply, the assets are to be removed from the NMPB asset base, with the consequence that the effective 'write down' of the stranded assets is borne by the NMPB's owners rather than suppliers. This outcome will generally be appropriate, since in a competitive market losses of this nature will ordinarily not be able to be passed onto either a firm's suppliers of inputs or its customers. It is also appropriate that equity holders be compensated for bearing this risk and that this compensation be provided for on an *ex ante* basis through an adjustment to their return on invested capital. Importantly, we note it will generally only be practically feasible to provide compensation for this risk *ex ante*, since competition for milk in a situation of excess capacity will in most conceivable circumstances preclude any ability to gain compensation from suppliers *ex post*.

Rule 31 addresses the situation where assets become stranded due to a change in the mix of RCPs manufactured by the NMPB. In contrast to the situation where assets are stranded due to a shortfall in milk supply, our view is that it is only practically feasible to provide compensation for this risk *ex post*. In particular, material changes to the NMPB asset base, resulting in material stranding of existing assets, will only occur in the event of a significant structural change in the relative values placed on different dairy products. The competitive dynamics of dairy markets are such that we would normally not expect to see this occur. Instead, it is significantly more likely that future changes to the RCPs will reflect either:

- The commoditisation of products such as infant formula base which are currently considered 'value add', and which can be manufactured using the assets currently included in the NMPB asset base, albeit potentially with additional investment in incremental capital, or
- The incremental extension of the RCP portfolio to include a wider range of commodities, with the expansion coinciding with the notional retirement of existing assets in the NMPB asset base or growth in milk supply.

In both these cases, assets will generally not become stranded as a consequence of changes in RCPs, implying any required *ex ante* compensation for this risk is close to nil. The requirement in Rule 31 that the financial consequences of assets stranded due to a change in RCPs will be reflected in the milk price is intended to signal to stakeholders that sunk costs will be incorporated in assessments of the consequences of adding or removing RCPs from the milk price. In turn, this indicates that in the normal course revisions to the Milk Price product mix and asset base will be gradual, which should enhance stakeholders' confidence in the stability and consistency of the Milk Price framework.

In para 2.20, the Commission also questions the precise mechanism used to provide an *ex ante* provision for the risk of assets being stranded through a shortfall in milk supply, which is through an adjustment to the asset beta. In our submission on the Commission's draft report on the 2012/13 Manual, we explained that:

- We agree with the Commission's views on the technical definition of the asset beta, which excludes any adjustment for firm-specific risk. We also agree that a portion of the risk of assets being stranded due to a shortfall in milk supply is either Fonterra-specific or dairy-sector specific, rather than market-wide. We noted, however, that it is in our view not possible to decompose total stranded asset risk into its various component parts in any supportable manner – this would require supportable estimates of the probability and consequences of, for example: (a) Fonterra consistently paying a materially lower milk price than its competitors, leading to a loss of supply (Fonterra-specific risk), (b) the dairy sector becoming materially less profitable than competing land uses (sector-specific risk), and (c) an outbreak of foot and mouth disease (market-wide risk).

[2] *Submission to the Commerce Commission on its draft report on Fonterra's 2012/13 Farmgate Milk Price Manual*, 15 November 2012.

- We therefore consider it appropriate from a practical perspective to provide a single allowance for the risk of assets being stranded due to a loss of milk supply, and that it does not particularly matter whether this is achieved through an adjustment to the asset beta, as a separate ad hoc adjustment in the WACC, or as an explicit provision in the NMPB's income statement.

As a practical matter, however, our view is that at least at this time this issue is largely academic. We have separately provided the Commission with our assessment of the impact on the asset beta of incorporating within it a provision for supply-related stranded asset risk, which demonstrates that a plausible estimate of the required adjustment is in the range of 1 – 3 percentage points, which is well within the margin of error attaching to any beta estimate.[3]

Repairs & maintenance costs

The Commission explains in paragraphs 2.27 and 2.32 that it cannot conclude at this time on the extent to which the amended Rule 16 relating to repairs & maintenance costs is practically feasible, and that, depending on the manner in which the new rule is implemented, it may result in weakened incentives for efficiency. The Commission also notes that the amended rule "appear[s] to provide the basis for greater internal consistency of assumptions ... [and] for a better alignment of expenditure by asset class."[4]

We advise that:

- As noted by the Commission, our intent in amending this rule is to provide for the establishment of a provision that is more closely aligned with the R&M costs that would be incurred by a commodity milk powder manufacturer, having regard to the relevant characteristics of the NMPB (nature of the assets, assumed economic lives, assumed asset maintenance policy etc.)
- Our amended approach will continue to draw on Fonterra's historic R&M expenditure, rather than current-year expenditure, and should therefore not result in any weakening of incentives for efficiency.
- We accept that the Commission will not be able to conclude on the practical feasibility or the efficiency implications of the revised methodology until it undertakes the 2013/14 base milk price review.
- As noted above, however, we consider the Commission is in a position to conclude that the amended rule does not preclude the establishment of a provision for R&M costs that is consistent with s150A.
- As noted in section 2, we are considering amendments to Rule 16 for 2014/15 to make the rule more prescriptive, and to clarify that the provision for R&M costs will be calculated independently of Fonterra's current-year actual R&M costs.

Site overheads, general overhead costs and R&D costs

The Commission concludes in paragraph 2.46 that it is "no longer able to conclude on the extent to which this rule is consistent with the legislative purpose" since Fonterra is reviewing these costs, with the results of that review to take effect in 2014/15.

As the Commission notes, the outputs from the review of overhead costs that will be undertaken by Fonterra this year will first be used in calculating the base milk price for the 2014/15 season. Since the Commission's current review of the Manual is in respect of the Manual for the 2013/14 season we do not believe the fact of the overheads cost review is relevant to the Commission's assessment of the extent to which Rule 19 is consistent with the legislative purpose for the current season.

Putting timing to one side, our view is that Rule 19 is clearly consistent with s150A. In particular:

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[3] It is relevant that the asset beta is re-estimated at four-yearly intervals (and if circumstances warrant can be re-estimated more frequently) and that it therefore only has to accommodate near-term stranding risk.

[4] Page 16, para 2.29.

- The rule provides that the allowances in the milk price for overhead costs should align to the costs "that Fonterra could reasonably be expected to incur if [it] only undertook the activities performed by the [NMPB]", which we consider equivalent to requiring that the allowance be practically feasible.
- The rule requires that the allowance be notional, as it is to be established in the year prior to the first year of a 'review period', and then inflation-indexed for the balance of the period. It follows that any provision established in accordance with rule is therefore consistent with the Commission's efficiency criterion.

In para 2.48 the Commission notes "the lack of clarity around what constitutes a 'Review Year'" and asserts that there is "no apparent formal process for the designation of review year status other than by including items in the Milk Price Group's annual work programme." We advise that:

- The definition of Review Year provides that the Milk Price Panel has formal responsibility for determining the timing of Review Years and that, unless the Panel determines otherwise, reviews will continue to take place at four-yearly intervals.
- The Panel has determined that 2014/15 is a Review Year with respect to Rule 15 (fixed manufacturing costs), Rule 19 (site overheads, general overhead costs & R&D costs) and Rule 20 (certain supply chain costs). The next subsequent scheduled Review Year for these items will be 2018/19.
- 2016/17 is the next scheduled Review Year for Rule 13 (variable manufacturing costs), Rule 24 (reference assets), Rule 27 (allocation of reference assets), Rule 32 (surplus capacity), Rule 36 (new technology) and Rule 40 (asset beta).

4 Other matters

We comment in this section on the following matters raised by the Commission:

- The Commission's comments in para 2.38 on working capital, including on the use of Fonterra's Advance Rate Schedule.
- The Commission's observations in para 2.41 on the treatment of land assets.

Working capital

In its comments on our amendment to Rule 38 to provide for the annual update of working capital assumptions the Commission notes that:

- "The annual update introduces greater scope for actual rather than notional inputs to be used. This, combined with the introduction of more variable benchmarks, is likely to weaken incentives for efficiency" (para 2.36).
- "It is not clear what the implications are, if any, for practical feasibility" (para 2.38).

The Commission also requests submissions on whether the assumption of Fonterra's Advance Rate Schedule "constitutes a unique feature that cannot be replicated by another processor" (para 2.38).

With respect to the Commission's comments on the amendments to Rule 38, we note:

- Where actual Fonterra costs or prices are used in the Milk Price calculation, it is appropriate to also assume working capital terms similar to Fonterra's, and doing so will help ensure the practical feasibility of the assumed inputs, since payment terms will normally be reflected in prices.
- We do not use Fonterra's actual accounts payable days in the calculation. We use assumptions that are established by reference to Fonterra's standard terms, but which leave the consequences of variances in achieved payable days relative to the milk price assumptions accruing to Fonterra's earnings.
- We also do not use Fonterra's actual accounts receivable days We use assumptions that reflect Fonterra's actual payment terms for product sold on GDT, but in a manner that results in the consequences of variances in Fonterra's actual performance accruing to earnings.

With respect to the Commission's comments on the assumption of Fonterra's Advance Rate Schedule:

- All dairy processors in New Zealand employ similar mechanisms, both for cash flow reasons and because of uncertainty over final milk prices for a year.
- Fonterra's current Advance Rate Schedule is widely publicised among suppliers, and can therefore be matched by other processors if they choose to do so.
- Most significantly, use of Fonterra's actual Advance Rate Schedule means suppliers are compensated (at the milk price WACC) for the actual deferral of payments for their milk – use of any other assumption would necessarily result in suppliers being under or over-compensated, and would simply incentivise Fonterra management to defer payments to suppliers. (Equivalently, use of Fonterra's actual Advance Rate Schedule leaves Fonterra relatively neutral between funding seasonal working capital requirements with debt or by deferring payments to suppliers.)

Land

The Commission asserts in para 2.41 that "the removal of [the requirement to determine the market value of land assets in each review year] in Rule 24 leaves no specific provision in the Manual for how land assets, existing after 31 March 2008, are to be valued." The Commission also argues on pp.34-35 that removal of this requirement "affords additional flexibility in the approach."

We do not consider the Manual provides any flexibility with respect to the approach to be taken to establishing the annual capital charge for land assets. Rule 34 specifies that the annual capital charge for all reference assets (other than collection assets) is to be determined by applying the annuity formula specified in the rule, and this approach has been used to determine the capital charge on land assets since the introduction of the current milk price methodology in 2008. (The formula reduces to WACC less inflation, multiplied by the inflation-adjusted asset value, for assets like land with infinite lives.)

We note, however, that the Manual does not contain any provision specifying how the initial value of the land required for a new manufacturing site is to be determined.[5] We added two manufacturing sites to the model in 2012/13 (Darfield and the former NZDL site at Studholme), and in both cases used independent market valuations to set the initial land values. We will amend the Manual to address this issue in the course of the next round of amendments, for the 2014/15 season.

[5] Rule 29 provides that "where an updated estimate of the costs of installing a ... Reference Asset is not obtained, the installation cost shall be deemed to be the prior ... year's installation cost increased by [inflation]", arguably implying that where an estimate of 'cost' is obtained (e.g. by way of market valuation) that estimate may be used. It is preferable, however, to include an explicit provision in the Manual.