# Submission to the Commerce Commission on ‘Process and issues paper – review of 2014/15 base milk price calculation’

**Issued on 7 April 2015**

# Glossary

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| **2014 Final Report** | Commerce Commission, Final Report on the Review of Fonterra's 2013/14 base milk price calculation, 15 September 2014, 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-201314-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 2014/15 base milk price calculation*, dated 7 April 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 is to:

> "20.1 [Undertake] a 'top-down' analysis of the financial aspects of the notional producer to review the overall consistency of the individual revenue and cost components of the milk price calculation.
>
> "20.2 Compare the aggregate financial result between Fonterra's notional and actual performance. We will compare the performance of Fonterra's NZ Milk Products (NZMP) dairy ingredients business with the notional producer's modelled performance.
>
> "20.3 Review what the investment markets are saying about the performance of NZMP and the impact of the base milk price (calculated on a notional basis) on the ability to forecast NZMP's (and Fonterra's) actual earnings."

The Commission also explains that, to assist with its review, it invites independent processors to provide cash cost information based on the categories outlined in its separate breakdown of the categories in the milk price model.

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

- The proposed comparison of the performance of Fonterra's NZMP business with the performance of the modelled notional milk price business (NMPB) will provide limited, if any, insight into whether the modelled NMPB is consistent with the performance achievable by an 'efficient processor', as defined by the Commission, comprising the assumptions, inputs and processes that are practically feasible for Fonterra or another processor *that is efficiently building an incremental plant*. In particular, Fonterra's performance reflects a wide range of factors that are not relevant to the NMPB, including the production and sale of non-RCPs and non-commodity products, and the performance of plants that are not comparable to the plants assumed in the milk price model.[1]
- To the extent such a comparison was, however, useful, it would be equally relevant for the Commission to undertake equivalent comparisons of the actual performance of other New Zealand processors. For example, it would be straightforward for other processors to provide the Commission with data on average revenue and total cash costs (and therefore EBITDA) per kgMS of milk processed over the past two or three seasons, thereby providing an aggregate sense-check on claims that average revenue per kgMS assumed in the Milk Price calculation is 'too high' or that average cash costs per kgMS are 'too low' in aggregate.

# 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:

- Pricing, including:
  - Whether the GDT pricing used in the model is consistent with modelled notional volumes
  - Our approach to dealing with 'cross period' billing (we understand this point relates primarily to our treatment of long term supply agreements), and

[1] Given sunk capital, it is rational for Fonterra to continue to operate an old, inefficient plant so long as unit cash costs do not exceed the sum of unit cash costs **and** capital costs associated with a new plant. The consequence of such decisions will be higher cash costs / lower EBITDA (and lower required fixed assets) than that achieved by the Milk Price business. Fonterra does not, however, routinely measure operating performance at the plant level in a manner that enables the overall impact of this issue on NZMP's reported results to be readily quantified.

- The reasonableness of our treatment of non-GDT sales.
- Yields, and particularly the practical feasibility of yield assumptions across a full season.
- Certain cash costs (energy, repairs and maintenance, administration and site overheads).
- Capital charge on fixed assets (WACC rate, capital cost estimates, impact of peak flows of milk, depreciation, company tax and capital charge on net working capital).

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 Commission's other focus areas.

| | **Category** | **Comment** |
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| Pricing | Consistency of GDT pricing with modelled notional volumes | We note, and agree with, the Commission's conclusion in the 2014 Final Report that "In assessing the practical feasibility of GDT prices, we do not consider it necessary to consider the likely impact of an increase in the volume of product sold by a notional producer on prices" since the relevant test is whether GDT prices would be practically feasible for an incremental plant.[2] |
| | Cross period billing | We assume this issue relates to our treatment of certain contracts with multiple pricing dates, and that the Commission's focus will therefore be on the accuracy of the adjustments we make with respect to these contracts. This approach is reasonable. |
| | Reasonableness of our treatment of non-GDT sales | We effectively assume that the non-GDT sales included in the Milk Price calculation are transacted at GDT-equivalent prices. The Commission has previously concluded that this assumption is reasonable (see for example paragraph F18 of the 2014 Final Report). An appropriate approach to assessing the ongoing validity of this assumption is to repeat the Commission's previous analysis of prices achieved by Fonterra on and off GDT. |
| Yields | Practical feasibility of yield assumptions across full season | The Commission concluded in its 2014 Final Report that our yield assumptions in 2013/14 were practically feasible, and that they appropriately accounted for (among other things) 'shoulder' losses. We will make available to the Commission equivalent analysis and data as that provided in 2014 in support of the assumptions incorporated in the 2014/15 Milk Price. |
| Cash costs | Energy | We are comfortable with the Commission's approach to resolving outstanding matters in respect of previous assessments of the reasonableness of our approach to establishing energy usage assumptions. |
| | Repairs and maintenance (R&M) | We have revisited our approach to establishing the provision for R&M costs, and will share with the Commission the supporting data and analysis. |
| | Site overheads | We are currently undertaking a detailed review of overhead costs for use in the 2015/16 Milk Price. The outputs from this review will provide an additional source of information for assessing the practical feasibility of the 2014/15 assumptions. |
| | Administration | |
| Capital costs | WACC | We have provided our independent expert's assessment of an appropriate asset beta and specific risk premium to the Commission. |
| | Capital cost estimates | We will provide additional analysis (and the supporting data) |

[2] Paragraph F22, p.91.

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| | | of various aspects of our capital cost assumptions, including comparisons where relevant against recent and planned Fonterra investments in support of our view that our allowance for capital costs is practically feasible in aggregate. |
| | Impact of peak milk | We will provide further information and analysis to the Commission that in our view strongly supports our position that our current approach to handling uncertainty in peak milk flows generates outcomes that are practically feasible. |
| | Depreciation and tax | We will provide updated data and analysis to the Commission that demonstrates that our tax depreciation calculation is consistent with our assumed economic lives and other relevant inputs. |
| | Capital charge on net working capital | We will provide the Commission with the data and analysis that supports our position that each of the assumptions employed in calculating monthly net working capital balances is practically feasible and that the assumptions are in aggregate internally consistent. |