23 October 2018

Review of the Dairy Industry Restructuring Act
Submission of Open Country Dairy

Open Country Dairy Limited (**Open Country**) makes this supplementary submission to the Ministry for Primary Industries in support of the views and recommendations set out in our initial submission to the *Terms of Reference for the Review of the Dairy Industry Restructuring Act 2001 and its Impact on the Dairy Industry* dated 29 June 2018.

This supplementary submission is important for a number of reasons. The most directly relevant of these is the experience of final milk price calculation process for the 2018 season, which culminated in the Commerce Commission's formal decision that the base milk price was not practically feasible.[1] There has also been media comment from Fonterra and its representatives since the Commission's final decision, which provide important context to our position and are materially relevant to MPI's decision-making process.

In summary, these supplementary points are:

(a) the continued lack of transparency despite commitments from Fonterra to provide more meaningful information, especially with regard to off-GDT sales;

(b) important discrepancies in Fonterra's statements about the balance between its commodity and value-add businesses as represented by the farmgate milk price;

(c) material misrepresentations in the media by Fonterra regarding the DIRA regime being an audited, objective process; and

(d) yield assumptions which are simply impossible to achieve based on available technology.

These points strengthen the recommendations made in our initial submission.

1. Transparency

Transparency over key variables that inform the farmgate milk price have long been a concern in the dairy industry. As noted in our initial submission, the benefits of such transparency have been affirmed by the Commission.[2] From time to time, Fonterra itself even acknowledges the importance of this issue, and commits to disclosures and other transparency measures that will improve the regime. Meaningful action rarely follows from these commitments.

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1 Commerce Commission *Review of Fonterra's 2017/18 Base Milk Price Calculation* (14 September 2018).

2 Commerce Commission *Review of Fonterra's 2017/18 Milk Price Manual* (15 December 2017).

We now make a related and equally important point that simple disclosure of more information is not always by itself sufficient to provide transparency. For example, Fonterra made a number of transparency commitments in their submission to the 2016/17 base milk price calculation draft report regarding transparency for off-GDT sales. The Commission seems to have accepted that more information is now publicly available as a result of Fonterra has increased its disclosure of information. However, this has not materially increased transparency over the impact of off-GDT prices on how the farmgate milk price is determined.

Unfortunately, the very nature of this issue means that specific examples only present themselves as obvious problems after the fact. We discovered a clear instance of this when attempting to reconcile Fonterra's public statements regarding the impact of off-GDT sales with the official position recorded in Fonterra's Milk Price Statement.

On 24 September 2018, the *Farmers Weekly* magazine published an article entitled "Milk price guardian fights back", which reports on an interview with one of Fonterra directors, Mr Brett Goldsack. In the article, the following statement is attributed to Mr Goldsack:

> *More than 40% of the reference products are now sold off the Global Dairy Trade platform and the effect is to add more than 10c to the milk price.*

Compare this statement to Fonterra's Milk Price Statement for the 2018 season, which is clear that "*the inclusion of off-GDT sales of WMP, SMP and AMF resulted in an increase of NZD 8 cents per kgMS*".[3]

The opacity of off-GDT sales is a significant issue because those sales do not take place over the GDT platform where prices are recorded and announced. Accordingly, any discrepancy over the impact of off-GDT sales raise concerns. In this case the market is forced to struggle with mismatched and inconsistent information.

Having undertaken our own inquiries and analysis, the reason for the discrepancy is that the official position in the Milk Price Statement does not include sales of butter outside of the GDT platform. While an issue remains as to why inconsistent information is being presented to the farming community, critical from our perspective is the failure to include off-GDT butter sales in the Milk Price Statement. This underscores the lack of transparency with sales outside of commodity auctions, because key variables with a material impact on the farmgate milk price are still being withheld from official statements and information.

It is not clear to us how the Commission can be satisfied with Fonterra's disclosures when such fundamental transparency concerns remain. Either way, this is an issue that must be addressed in any move towards a more robust DIRA regulatory regime.

2. Discrepancies in public statements

In our initial submission, we quoted public statements from Fonterra's then chairperson, John Wilson, that 46 cents had "migrated" away from Fonterra's value-added business to its commodity business through increases in the farmgate milk price over the years. These statements were part of our evidence base demonstrating that it is difficult to delineate

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[3] Fonterra's Milk Price Statement, page 6.

the commodity and value-added businesses in an objective and transparent manner. There is an appreciable risk that, contrary to the DIRA requirements, non-commodity elements are shaping the product mix that determines farmgate milk price.

Fonterra's 2018 Milk Price Statement muddies the water on this issue further. Contrary to the public statements of Mr Wilson, the Milk Price Statement records that only 29.6 cents of the farmgate milk price can be attributed to changes in the milk price calculation since the 2009 season.[4] This leaves around 16 cents unaccounted for, or around $240 million for the 2018 season alone.[5]

If such large amounts are able to fall into the gap between Fonterra's commodity and value-add businesses, this raises serious transparency and objectivity concerns. These amounts are too large to simply go unaccounted for by a credible regulatory regime. That DIRA seems indifferent to such concerns is a poor indictment on its current form. The risk of a misallocation that skews the farmgate milk market and the corresponding market investment signals is simply unacceptable. Ignoring calls for reform and allowing this situation to continue would be nothing short of mismanagement of a critical aspect of New Zealand's domestic economy.

3. Fonterra's misrepresentations in the media

As noted above, on 24 September 2018 the *Farmers Weekly* magazine published an interview with Mr Goldsack under an article entitled "Milk price guardian fights back". In the article, Mr Goldsack gives the clear impression that Fonterra relies on the farmgate milk price being set by an objective regulatory process over which Fonterra has little or no control. This impression is further enforced by statements that the Commission's statutory review of the farmgate milk price is an audit of Fonterra's calculation.

In particular, Mr Goldsack is directly quoted as saying that:

(a) the farmgate milk price is "subject to regulation";

(b) the farmgate milk price is "determined by the regulations in DIRA"; and

(c) the farmgate milk price is "audited by the Commerce Commission".

Each of these statements is fundamentally misleading when taken individually, and are completely inaccurate when taken in the context of the article as a whole. Specifically:

(a) The farmgate milk price is not 'regulated' in any sense of that word. It is set by Fonterra's board in accordance with a statutory framework that affords the board a very high degree of discretion.

(b) While the DIRA statutory framework sets out a mandatory timeframe and review process in respect of the determination of the farmgate milk price, it

4 Fonterra's Milk Price Statement, page 11.

5 This calculation is based on public statements by Fonterra that each 0.1 cent movement in the farmgate milk price has a $1.5 million impact on Fonterra's business.

deliberately leaves the Board free to determine the price under its own motion.

(c) The Commission's statutory functions manifestly do not amount to an 'audit'. The review is limited to a very short, high-level assessment of opaque economic standards. Further, where the Commission finds that those standards have not been satisfied, Fonterra remains free to ignore the Commission's findings. This is precisely what happened in the Commission's assessment of the asset beta estimate for the 2018 milk price calculation.

The article and interview candidly reveal that Fonterra's board is acutely aware of the fact that farmers, investors and consumers all place considerable value on the farmgate milk price being determined by an objective process. It is a plain attempt to reassure the farming community that they can have confidence in the milk price. However, the gap between rhetoric and reality is so great that the farming community can only have this level of confidence if it is based on a profound misunderstanding of how DIRA operates in practice.

All parties – including Fonterra – see considerable merit in a robust, objective regulatory regime of the kind we advocate in our initial submission. This is precisely what a review of the DIRA regulatory regime should be aiming for.

4. Fonterra's yield assumptions are impossible to achieve

Fonterra's yield assumptions are a crucial input into the base milk price calculation. These assumptions relate to the ability to convert milk supply into commodity product. In the real world, it is impossible for the entire milk supply can be directly converted into commodities with 100% efficiency because:

(a) There are technical limits on the efficiency that existing plant can achieve. Even with advances in technology, 100% yields are not physically possible.

(b) It is unrealistic to assume zero losses in the milk supply. It is necessarily the case that some losses occur, even if a large proportion of the milk supply is efficiently converted into commodities.

Independent processors have noted with some concern that Fonterra's yield assumptions have significantly improved each year for a number of years without a clear explanation in the milk price manual that might justify these increasingly unrealistic assumptions. Indeed, Miraka's submission on the Commission's review of the 2018 base milk price calculation specifically queried the practical feasibility of the following aspects of Fonterra's assumptions:

(a) Fonterra plant is assumed to be operating at maximum capacity for long periods of the season that cannot be reconciled with actual seasonal variance in milk production levels.

(b) Fonterra appears to ignoring important costs that would be necessarily incurred to allow for such optimisation, including the mothballing of obsolete plant, and milk transfer and transport costs.

In short, the concern being raised here is that Fonterra has adopted a policy of assuming maximum optimisation with zero cost. The effect of this approach is to raise the farmgate milk price itself to unrealistically high levels, meaning it is not practically feasible.

In response to Miraka's concerns, Commission's decision simply states:[6]

> *Yields and losses were looked at as part of this year's review. The changes from 2016/17 were not considered material and were able to be explained by Fonterra.*

This is simply an unacceptable dismissal of genuine concerns raised by independent processors who are best placed to understand the inputs into the milk price.

It suggests a lack of close scrutiny by the Commission, either because Commission staff did not understand the importance of the issue or because the limited time and budget available for reviewing the milk price calculation effectively prohibited a deeper assessment. Whatever the reason, Fonterra's yield assumptions require further explanation for at least two reasons:

(a) to our knowledge only one analyst from the financial or dairy sectors tracking the farmgate milk price estimated a final price of $6.75, indicating that Fonterra's assumptions are consistently out of step with what the market considers to be realistic (or, in the language of DIRA, practically feasible); and

(b) Open Country has undertaken *ex post* analysis of the milk price calculation, and can only reconcile Fonterra's approach with the final price by using completely unrealistic yield assumptions of the kind described by Miraka.

A credible statutory review mechanism would have exposed this inconsistency and called upon Fonterra to lower its final price if an adequate justification, subject to scrutiny of interested parties, was not forthcoming. Instead, this result indicates that Fonterra retains a high degree of discretion over certain key inputs that have a material impact on the farmgate milk price, and that the Commission's review is not attuned to addressing that discretion.

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[6] Commerce Commission *Review of Fonterra's 2017/18 Base Milk Price Calculation* (14 September 2018), page 11.

5. Conclusion

In our initial submission we undertook to discuss further with the Ministry issues relevant to our submissions. The Ministry will appreciate the significance of the supplementary evidence set out in this letter in light of the outcomes of the Commission's determination and Fonterra's public statements. They highlight and reinforce many of the key points made in our initial submission, but also raise concerns in their own right. It is vital that they form part of the evidence base for any proposed reform of DIRA.

No doubt this evidence will spark the Ministry's own inquiries into these matters, and we look forward to being involved in that continuing process.

Best regards

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