FONTERRA RESPONSE TO MPI QUESTIONS ON FONTERRA'S ABILITY TO DEVIATE FROM THE FARMGATE MILK PRICE CALCULATED UNDER THE MILK PRICE MANUAL AND TO INFLUENCE ITS MILK SUPPLY

MPI Questions

We are interested in your thoughts on the extent to which Fonterra can influence the milk supply volumes it receives from farmers (who may choose to exercise their statutory right to freely enter and exit Fonterra) through the farm gate milk price Fonterra pays farmers for their milk, as well as through the setting of Fonterra's terms of supply, Fonterra's dividend policy, and Fonterra's share standard.

With respect to the farm gate milk price, we are especially interested to understand what level of discretion do you consider the DIRA provides Fonterra with to deviate from the calculation of Fonterra's Base Milk Price (derived using the methodology set out in Fonterra's Milk Price Manual and monitored by the Commerce Commission) in setting the average price Fonterra pays farmers for milk in the particular season.

Fonterra Response

Summary

1 It would be difficult for Fonterra to attempt to influence milk supply volumes through the level of the farmgate milk price. Fonterra may elect to deviate from the farmgate milk price derived under the Milk Price Manual when it sets its farmgate milk price[1] but in reality it faces some significant constraints on doing this.

2 Even if Fonterra exercised its discretion to deviate from the milk price derived under the Milk Price Manual, it is unlikely milk supply would be responsive to such deviations on a season-by-season basis. Rather, Fonterra would need to signal material and ongoing deviations from the farmgate milk price to influence supply decisions, which is not realistic.

3 As we have previously indicated, Fonterra agrees with the current basis for setting the milk price and does not wish to change or materially deviate from it, whether to influence supply or for any other reason.

4 Similarly, we do not consider the setting of our terms of supply, our dividend policy or our share standard can be readily used to influence milk supply volumes.

5 In our view, a much more effective and efficient method of gaining some control over our milk supply volumes to facilitate more efficient decision making and better enable value add growth is to remove the open entry obligation.

6 More detail on our reasons follows.

[1] In this response, we use the term "base milk price" and the "farmgate milk price" interchangeably. As described below, there may be circumstances where Fonterra pays a farmgate milk price that differs from the milk price generated under Fonterra's Milk Price Manual. Fonterra and the Commerce Commission treat the final adjusted amount as being the "base milk price" under DIRA.

Fonterra may deviate from the farmgate milk price calculated under the Milk Price Manual but in reality it faces significant constraints on doing so

7 Fonterra may deviate from the farmgate milk price calculated under the Milk Price Manual, but in reality, it faces significant constraints on doing so. These constraints include the transparency required under the DIRA milk price oversight regime and the attention of external investors under Trading Among Farmers, as detailed further in the following paragraphs.

8 As you know, the purpose of the milk price regime, as set out in s150A of DIRA, is to promote Fonterra setting an efficient base milk price that provides for contestability in the farmgate milk market. The base milk price must be set in a manner consistent with the specified principles.[2] The milk price methodology seeks to calculate the price that an efficient processor of Fonterra's scale could sustainably pay for the milk collected by Fonterra in New Zealand.

9 As required by DIRA, Fonterra maintains a Milk Price Manual which sets out how its farmgate milk price is set. In broad terms, this provides that the farmgate milk price is based on:

9.1 notional revenue, calculated assuming Fonterra's entire volume of milk is processed and sold as the then current "Reference Commodity Products", with prices primarily reflecting the prices achieved by Fonterra for those Reference Commodity Products on the Global Dairy Trade Events auction platform; minus

9.2 the notional manufacturing costs of an efficient competitor (including capital costs), and overhead, collection and other costs derived from Fonterra's actual costs.

10 While there are judgement calls to be made, the formula is not susceptible to adjustment for strategic or commercial factors that are external to the Milk Price Manual.

11 There is substantial internal and external oversight that monitor Fonterra's compliance with the Milk Price Manual and the purpose of the milk price regime in setting its farmgate milk price. This oversight is provided by the Milk Price Panel, the Fonterra Shareholders' Market Rules, disclosure and certification requirements, the Milk Price Group and the Commerce Commission. A summary of these is set out in Appendix 1.[3]

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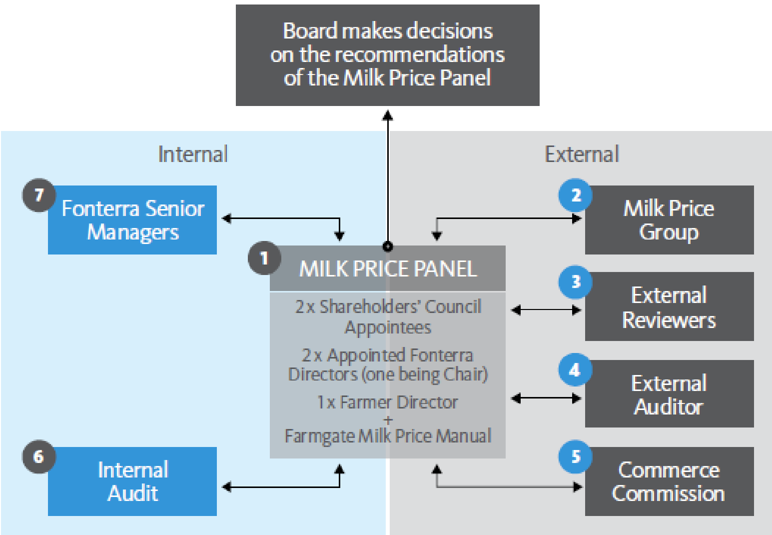
2 DIRA, section 150C.

3 See also our 29 June submission, Annex 1, paragraphs 16-18.

12 The graphic below summarises Fonterra's milk price governance and oversight arrangements:[4]



13 Trading Among Farmers has strengthened incentives on Fonterra to determine an efficient milk price. Compliance with the milk price mechanism is carefully monitored by the investors in the Fonterra Shareholders' Fund as the milk price influences the EBIT of Fonterra and therefore the amount of distributions paid to the Fund. Scrutiny by external investors encourages Fonterra to be transparent in its milk price-setting process.

14 In 2014, the Fonterra Board approved a milk price that was not the milk price derived from the Milk Price Manual. This is described in more detail in Appendix 2. In summary:

14.1 The deviation reflected very unusual circumstances which in Fonterra's view would have resulted in Fonterra earning negative EBIT, which would have risked a serious loss of confidence from its stakeholders.

14.2 Fonterra engaged with the Commerce Commission before making the change, to ensure the Commission understood the position.

15 More recently, on 10 August 2018, Fonterra revised its forecast milk price for the 2017/18 season down by 0.05c to $6.70 per kgMS from $6.75 per kgMS. Accordingly, the Fonterra Board has signalled its intention to pay a final farmgate milk price that is lower than the price calculated under the Milk Price Manual. This decision, like the one in 2014, reflects unusual circumstances, in which a higher milk price has put pressure on Fonterra's earnings, and therefore our balance sheet in a year which was already challenging due to the combination of a significant one-off payment to Danone and the material impairment of the Co-operative's Beingmate investment. The forecast deviation of 0.05c is a small reduction to the amount calculated under the Milk Price Manual but the Fonterra Board has determined it to be necessary to maintain the strength of Fonterra's balance sheet.

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[4] See Fonterra Shareholders' Fund Prospectus and Investment Statement, 26 October 2012, pp 68-69.

16 In both of these cases, the deviation was downwards, and reflected the impact of serious financial considerations for the Co-operative (which given their significance were allowed to impinge on the short-term competitiveness of the milk price). They did not reflect any attempt to influence milk supply volumes.

17 In Fonterra's view, it would be even more difficult to support an upwards adjustment. That is because directors would need to be persuaded that it is in the best interests of Fonterra (including the overall interests of its farmer-shareholders[5]) to voluntarily reduce earnings by paying more than necessary for milk[6]. We would expect there to be only a very narrow range of circumstances where this might arise, and that in any event it would not arise out of a desire to incentivise higher milk supply volumes.

The milk price would not be an effective tool for influencing supply volumes

18 There are a number of reasons why, even if Fonterra were able to influence its supply volumes using the milk price, this would likely be ineffective.

19 Most significantly, farmers' ability to alter their choice of which processor to supply is not sufficiently flexible to allow them to respond to intra-season fluctuations in milk price. Most non-dairy farmers would not be able to convert to dairying from another type of farming in time to take advantage of a high milk price within a single season (and even if it were possible, it would not be rational to make such a significant change). And even existing dairy farmers would not be able to switch processor in time to take advantage of a high milk price.

20 The DIRA forecasting process requires Fonterra to announce its forecast farmgate milk price at the beginning of each season, which commences on 1 June. In practice, Fonterra first announces its forecast farmgate milk price for the next season in May (for example, the forecast milk price for the 2018/19 season was first announced on 23 May 2018). The application period for when farmers need to have submitted a notice to leave Fonterra closes at the end of February; that is, at a time when they do not know the forecast milk price for the relevant season. While Fonterra will typically accept applications to supply Fonterra outside of the application period, attracting a material number of new suppliers through milk price signals is unlikely to occur as we understand that farmers supplying other processors are commonly contracted for three to five-year periods.

21 Within a season, it is possible for farmers to change their production levels in response to changes in the forecast farmgate milk price. In response to a higher forecast milk price, farmers may seek to increase production through supplementary feed and extending the time before drying off their cows at the end of the season. However, this is at the margins and would not viably form the basis for any strategy to attract more volume via the milk price. Furthermore, farmers would not consider the milk price in isolation from numerous other factors such as the price of supplementary feed (which can rise significantly in response to a high

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5 Between 2007 and 2009, Fonterra engaged in "tactical pricing" in a limited way – by offering some farmers in specific areas who were considering leaving (or were at risk of leaving) a bespoke contract, which was non-shareholding. However, these tactics were not favoured by shareholders and Fonterra has not subsequently engaged in any tactical pricing. See also paragraph 255 below.

6 Under the Fonterra Shareholders' Market Rules, a decision to pay an aggregate amount for milk in excess of the amount calculated under the Milk Price Manual, or to amend the Milk Price Manual, must be approved by a 75% majority of the Fonterra Board, including *a majority of independent directors*.

milk price and increased demand), weather conditions and the impact on pasture conditions for future seasons.

22 Put another way, if Fonterra were able to freely deviate from the farmgate milk price derived under the Milk Price Manual (which for the reasons set out above is unlikely to be the case in reality), for such a strategy to be effective in attracting more volume we would need to signal an intention to pay a milk price materially in excess of the farmgate milk price derived under the Milk Price Manual over a sustained period (in our view, at least three seasons). As noted above, this would not be financially prudent and consequently even less likely to be rational.

23 Furthermore, if this was to occur, there would be serious questions as to whether the Manual was generating a competitive milk price. This in turn would likely lead to Fonterra having to modify the Manual or inputs into the milk price calculation under the Manual so that its farmgate milk price continued to meet the purpose of the DIRA milk price regime set out in s150A of DIRA. In any event, other processors would likely benchmark against and match the adjusted Fonterra milk price, given that they do currently, in which case the higher Fonterra price would not provide any additional incentive for suppliers to other processors to switch to Fonterra (and any lower price would also likely be matched – non-co-operative processors are incentivised to pay a lower milk price in order to maximise returns to their shareholders). It is worth noting that this also means Fonterra's milk price can impact all New Zealand farmers and the New Zealand economy.

Fonterra does not wish to use the milk price to influence supply volumes

24 For the reasons outlined above, and as set out in our submission of 29 June, in the absence of the milk price regime Fonterra's conduct would be largely unaltered.[7] This is borne out by the fact that our conduct was consistent with the milk price regime, prior to the regime being enshrined in DIRA. The reasons include strong incentives to act prudently in relation to our milk pricing arrangements.

25 More generally, as a co-operative, Fonterra aims to serve our farmers. We do not, and likely would not even if able, decline to accept expansion in supply by our existing farmer shareholders.[8] Our objective is to obtain the best overall returns (milk price and dividends) we can for our farmer-shareholders based on the volume of supply they offer. We do not have a goal to influence their supply decisions beyond the incentives created by the returns we achieve for them[9]. This is also why we do not use our terms of supply, dividend policy and share standard to influence our volume of supply (as described further below).

26 Further, as discussed in our submission, we acknowledge that dairy farming has grown further and faster than, in some cases, the land and environment can tolerate. In our 29 June submission, we outline our support for targeted measures to address the environmental impact of dairying. However, endeavouring to address environmental concerns through Fonterra's pricing signals would risk

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7 29 June submission, paragraph 2.86.

8 Ibid, paragraph 2.41(a). Note that the structure of Fonterra as a co-operative body largely eliminates the prospect of exercising market power against farmers (see NERA, *Assessment of Competition in Raw Milk Markets and Costs and Benefits of the DIRA provisions* (17 August 2015), paragraph 2.1).

9 In contrast, to compete for new supply to the Co-operative and to retain supply to the Co-operative, we rely on both our total returns (a competitive Milk Price and dividends) and a range of other factors, including access to our regional networks of managers and sustainable dairying advisors providing specialist dairy knowledge and sustainability expertise, the Farm Source Rewards Scheme, smart technology offerings, and financial tools such as the Share-Up Over Time contracts.

creating inefficiencies and, for the reasons outlined above, is unlikely to be effective.

27 In our view, concerns about inefficient incentives to supply Fonterra should be addressed by removing open entry. This would be materially more effective at giving Fonterra control over its volumes, and would do so without risking distorting its financial performance and creating other unintended consequences.

Fonterra cannot readily use our terms of supply, dividend policy and share standard to influence our volume of supply

28 As noted above, in our view Fonterra cannot readily use these tools to influence our volume of supply. In brief:

28.1 *Terms of supply:* The terms of supply are largely about setting minimum standards for quality, animal welfare, safety and environmental standards. They also govern how the milk price is paid to farmers, and the parameters that apply, such as the relative fat:protein ratio, and a capacity adjustment to cover the additional cost of peak supply. While we do not think that a farmer's decision whether to supply Fonterra, or supply volumes from existing Fonterra suppliers, are materially influenced by our terms of supply, it may be that farmers who cannot meet our standards for environmental compliance (for example) choose to supply another processor. As we have previously indicated, in the absence of open entry Fonterra would look to strengthen its entry requirements and supply terms to support environmental sustainability and restrict milk growth in sensitive areas. Even then, however, we issue our terms of supply each year, and any variations year on year go through a rigorous review process, including a review and challenge process with the Shareholders' Council. It would accordingly be difficult to use Fonterra's terms of supply as a means to control supply volumes for commercial reasons.

28.2 *Dividend policy*: While the level of dividend is important for Fonterra farmer shareholders and may be one of the factors in a farmer's decision whether to supply to Fonterra, it is difficult to see how our dividend policy would materially affect milk supply volumes from Fonterra's farmer shareholders, as all other things being equal, a higher dividend yield will be offset by a lower expected increase in share value, leaving a shareholder's total expected returns unchanged. Further, as you will know from the data we have separately provided on Fonterra's milk price and dividend each year, last season, the milk price was $6.12, and the dividend was $0.40c/share. As the dividend accounted for only 6% of a farmer's total returns, we do not consider that changing Fonterra's dividend policy would affect the farmer's total returns enough to encourage an increase in milk supply.

28.3 *Share standard*: The requirement to purchase Fonterra shares to back supply is a material factor in a farmer's decision whether to supply to Fonterra. We also expect that farmers who are considering increasing (or decreasing) their milk production will consider the impact on their shareholding requirements (noting that shareholding requirements are based on a three year average to mitigate the effect of seasonal swings). However, Fonterra's share standard is set out in its Constitution, and any change accordingly requires approval of at least 75% of Fonterra's farmer shareholders. The share standard cannot therefore be readily used as a tool to control supply volumes.

APPENDIX 1: MILK PRICE OVERSIGHT

1 The Milk Price Panel oversees the calculation of the milk price.[10] The Milk Price Panel must include a majority of members who are independent from Fonterra, including the chair.[11] Among other activities, the Milk Price Panel:[12]

1.1 oversees the governance of the milk price and the Milk Price Manual, including undertaking reviews;

1.2 supervises the calculation of the milk price and makes recommendations on it to the Fonterra board; and

1.3 makes recommendations to the Fonterra board relating to the Milk Price Manual.

2 Under the Fonterra Shareholders' Market Rules, a decision to pay an aggregate amount for milk in excess of the amount calculated under the Milk Price Manual, or to amend the Milk Price Manual, must be approved by a 75% majority of the Fonterra Board, including a majority of independent directors.

3 If Fonterra sets a farmgate milk price other than in accordance with a recommendation by the Milk Price Panel (including where Fonterra receives no recommendation), certain disclosures are required.[13] Fonterra is also required to certify that the Milk Price Manual and the milk price calculation are consistent with DIRA.

4 Day-to-day administration of the Milk Price Manual is undertaken by the Milk Price Group. Its head is independent of Fonterra's management and reports directly to the chair of the Milk Price Panel.[14] Among other things, the Milk Price Group ensures that the farmgate milk price is calculated in accordance with the Milk Price Manual, considers amendments to the Milk Price Manual and ensures amendments are consistent with the Milk Price Principles in Fonterra's constitution.[15]

5 Finally, the Commerce Commission reviews and reports on the extent to which the Milk Price Manual[16] and the milk price[17] are consistent with specific principles of DIRA. While Fonterra is not bound by the Commerce Commission's findings, it can and does amend its calculation of the Milk Price and the Milk Price Manual in light of Commerce Commission reports.

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[10] DIRA, section 150D.

[11] Fonterra's constitution, clause 10.3(c)(ii) and (iv).

[12] DIRA, section 150D and Fonterra's constitution, clause 10.3(a).

[13] Ibid, section 150N.

[14] *Farmgate Milk Price Manual – Part A: Overview*, [5.3] and [5.4].

[15] Ibid, [5.4].

[16] Ibid, section 150H.

[17] Ibid, section 150O.

APPENDIX 2: FONTERRA'S 2014 DEVIATION FROM THE DIRA MILK PRICE

1 In respect of the 2013/14 season, the Fonterra Board approved a farmgate milk price that was 53 cents below the price of $8.93/kgMS calculated under the Milk Price Manual.

2 The reasons for this can be described as follows:

2.1 Returns to the product streams that inform the milk price under the Milk Price Manual (Reference Commodity Products or ***RCPs***) were significantly higher than returns to other commodity product streams (***non-RCPs***) as a result of a significant increase in Whole Milk Powder (***WMP***) prices from February 2013 due to a decline in domestic milk production in China in early 2013 coupled with continuing growing demand for milk products. This stimulated a significant increase in China's demand for imported WMP, which coincided with reduced milk production in New Zealand due to a deep late-summer drought and uncertainty over the drought's implications for milk production in FY14. As New Zealand then accounted for nearly 90 per cent of China's imported WMP volumes, a substantial spike in WMP and other milk powder prices resulted. The meeting of these demand and supply influences for WMP resulted in divergences in stream returns between RCP and non-RCP streams that were unprecedented. The higher stream returns for products that inform the milk price led to a higher milk price over the first half of the year. However, Fonterra's asset footprint impeded its ability to fully respond by switching production to milk powders particularly in the peak months of October and November.

2.2 Capacity constraints across this period resulted in a material decrease in Fonterra's actual earnings in two ways:

(a) Fonterra's ability to respond by switching production from non-RCPs to more profitable RCPs was substantially constrained; and

(b) Physical capacity constraints meant Fonterra:

(i) had to incur additional costs to transport milk to plants that could process milk (including between the North and South Islands);

(ii) did not have sufficient capacity to process all milk components; and

(iii) had to resort to "partial standardisation" of some milk powders, reducing returns for those products.

2.3 With no adjustment to the milk price, Fonterra would have derived negative EBIT for its financial year ending 31 July 2014. Such loss could have put Fonterra at material risk of loss of confidence of its stakeholders. Accordingly, in early December 2013 (following extensive deliberation by the Fonterra Board), Fonterra signalled its intention to pay a milk price that was lower than the price calculated under the Milk Price Manual. The Fonterra Board subsequently confirmed this decision when it approved the milk price for the 2014 season.

3 We engaged with the Commerce Commission before we made this change to ensure they understood the reason for the change.