Implications of Fonterra capital restructure

Report to Open Country Dairy Limited

FEBRUARY 2022

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Definitions

Fonterra	Fonterra Cooperative Group Limited
kgMS	Kilograms of milk solids
Open Country	Open Country Dairy Limited
DIRA	
FSF	Fonterra Shareholder Fund
FSM	Farmers Shareholder Market
TAF	Trading Among Farmers
NZSX	
RVP	Registered Volume Provider
FCG	Identifier for a Co-operative Share on the FSM (Fonterra Co-operative Group)

Executive summary

Fonterra’s shareholder-farmers voted in December 2021 on a proposal to change its capital structure. The proposal reduces the minimum number of shares a farmer must hold to supply the cooperative from 1 share per 1 kgMS to 1 share per 3 kgMS (the Restructure). It also caps the size of the NZX-listed Fonterra Shareholders Fund (FSF), which gives external investors an economic interest in Fonterra shares, and stops farmers exchanging shares for units in the FSF. The Restructure is contingent on a law change to the Dairy Industry Restructuring Act 2001, because it involves changes to the Trading Among Farmers regime.

Castalia was hired by Open Country Dairy Limited to examine the impact of the Restructure on Fonterra’s share price and on competition between dairy processors for milk supply.

Fonterra is concerned about losing more market share

While Fonterra has grown its milk supply since 2001, its processing company competitors have grown faster. Fonterra has gone from 94 percent market share at its creation to around 80 percent market share now. It is very concerned about losing more farmer-suppliers.

There is now widespread agreement that New Zealand milk supply will remain flat or fall due to more sustainable farming practices and fewer farms being converted to dairy, despite on-farm productivity improvements. Fonterra expects total New Zealand milk supply to decrease by 2.4 percent by 2030.[1] Any potential for processor growth in future will come from taking market share off other processors.

This overall situation creates a number of issues for Fonterra:

- Fonterra is unlikely to be able to ensure efficient utilisation of its existing processing capacity from investments made in the mid-2010s without gaining market share. It has at least 5 percent spare capacity available to process milk.
- Similarly, gaining or at least maintaining market share in the declining overall New Zealand milk supply will become critical to reducing cost of sales. In its own words: “if our co-op’s milk supply declines, we are likely to see fixed costs being spread over fewer milk solids, which would reduce the milk price.”

At the same time, declining overall milk supply means that Fonterra will have a lower investment requirement in the coming 20 years compared with the preceding decades. Hence, the focus of the Restructure is to enable Fonterra to gain market share even if it reduces access to new capital.

The Restructure makes it much cheaper for a new farmer to enter the cooperative

The Restructure will make it much easier for Fonterra to attract farmers to join the co-op and supply it with milk. A farmer joining Fonterra after the Restructure will only have to acquire one-third the shares it would have earlier. If the share price remains the same, then new farmers must have only one-third the capital. This significantly reduces a barrier to attracting supply of milk to Fonterra.

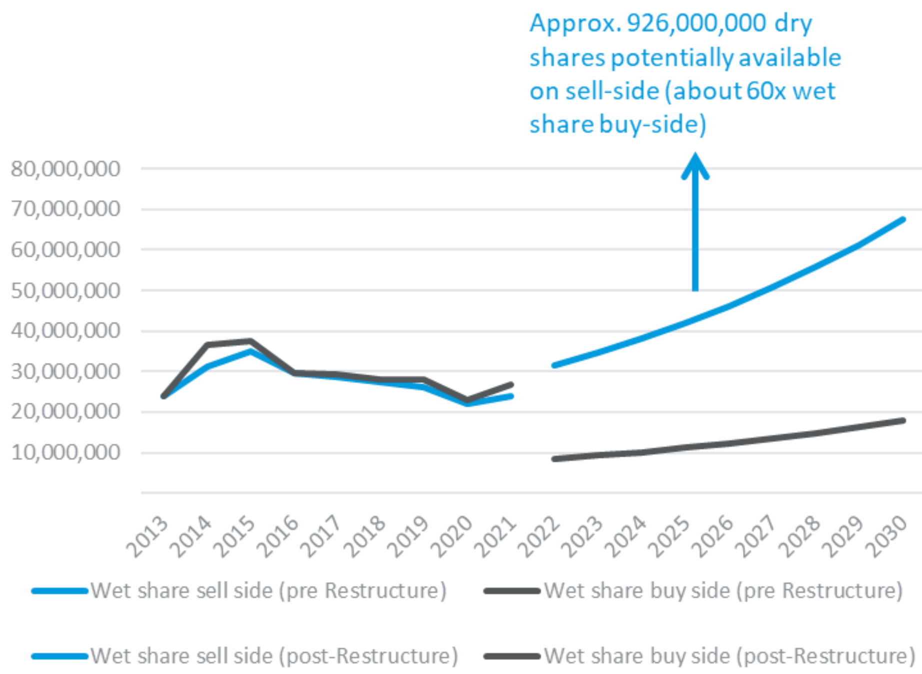
[1] Fonterra (2021), Capital Restructure Booklet, p. 23

The Restructure has already substantially reduced the market price of Fonterra shares and we estimate a further 40 percent drop is likely

The Restructure will also substantially lower the market price of Fonterra shares. The Restructure substantially changes the dynamics of the market for Fonterra shares in the farmer-only Famers Shareholder Market (FSM).

It will cause a massive imbalance between sellers and buyers in the market. Instead of around 13 percent of shares in the "free float" available to be traded as pure investments, around 71 percent will now be traded purely for investment purposes, rather than in order to "share up". The number of farmers who must be in the market to "share up" will drop by two-thirds.

Figure 0.1: Sell-side and buy-side for wet shares in Fonterra, pre-and post-Restructure



Sources: REINZ dairy farm sales, NZX, DairyNZ
Approach: We analysed REINZ dairy farm sales, DairyNZ average New Zealand herd production data, and NZX's TAF share trading data for 2013-2022. Sell-side wet shares is equal to 80 percent of the rolling 3-year average number of dairy farms sold times the average farm production of milk solids for that year. Buy-side wet shares is equal to the same number plus any additional shares a farmer must buy to share-up due to production increases. The post-2022 estimates are based on an assumed increase in farm sales and milk price remaining constant at the same $7.00/kgMS as used in Fonterra's Our Path to 2030 document.
Key assumptions: Farm sales increase from the rolling three-year average in 2021 of 168 sales by 10 percent each year to 2030. Milk production remains constant (despite Fonterra predicting a fall), and average farm/herd size remains constant.

Liquidity on the market will also change because the NZX-listed FSF units will be capped, eliminating the role of financial investors in influencing the FCG share price in the farmer-only FSM. The announcement of the Restructure proposal in May 2021 already caused a divergence in FCG and FSF prices, and a 15 percent drop in the price of farmer-only FCG shares.

Figure 0.2: Fonterra farmer-only FCG shares and FSF units—traded prices 2013-2022

Source: NZX

Restructure will shift wealth from current farmers to Fonterra in the short-term

The Restructure shifts wealth from current Farmers to Fonterra. We estimate the Fonterra share price will fall to settle at a price that reflects the discounted cash flow value of Fonterra's announced dividends. This implies a fall from the May 2021 share price of $4.60 (before the Restructure announcement) to around $2.00. For the average dairy farm producing 176,000 kgMS per year, this is a loss of around $360,000. Multiplied over all Fonterra shareholders, it is a loss of $4.1 billion.

In exchange for suffering this short-term balance sheet hit, farmers are providing Fonterra with the ability to attract new farmers more easily and increase milk supply. More efficient utilisation of capacity should reduce processing costs and enable Fonterra to pay a higher milk price. This should feed back into farmers' wealth in the form of higher dairy farm prices.

Restructure removes last vestige of protection in 2012 DIRA amendment

The 2012 DIRA amendment introduced TAF and the FSM whereby the shares were supposed to be more widely traded to improve price discovery. The FSF complemented this by exposing Fonterra's performance to public capital market discipline. Both aspects were intended to influence Fonterra to not divert revenues towards inflating the milk price at the expense of paying a fair dividend. While these were weak constraints on Fonterra's behaviour (it has still diverted income towards the milk price), Fonterra has always argued they were effective.

The Restructure now removes this last constraint. Fonterra now can use the milk price setting regime to discourage competition.

Restructure will probably feed into higher milk prices and higher (non-taxable) farm value gains

Since farmers are taking a balance sheet hit, we expect additional pressure to fall on the Fonterra board, and the milk price panel, to ensure the farmgate milk price is biased upwards. With the shares losing their financial investment value overall, it is unlikely that shareholders will seek to exercise influence to achieve higher dividends. Instead, the focus will shift primarily to ensuring a higher milk price.

Lower capital cost of entry to Fonterra should stimulate demand for farms, adding to the higher milk price being capitalised into farmland values. These gains in land value are untaxed when realised on farm sale, unlike dividends on the shares.

Competition in the dairy processing market will be affected, compounding recent anti-competitive changes to DIRA

The Restructure will affect competition in the dairy processing market. By reducing the cost of entry and channelling all benefits of additional supply into the milk price, Fonterra will be able to increase its dominant position in the market and attract additional supply from other processors. By manipulating the milk price away from a fair level, Fonterra harms its rivals. This has negative consequences for sector efficiency, productivity, and innovation.

Since the Restructure requires a law change to DIRA, there is an opportunity to highlight the anti-competitive impacts to the government and its officials. There are other flaws with DIRA, including from the 2020 amendment, which need to be addressed.

The Productivity Commission recommended in 2021 (influenced by Open Country's submission) that the Open Entry rule change to DIRA in the 2020 amendment should be reviewed because it hinders entry by processors and innovation. Ministry for Primary Industries officials' advice also did not align with the 2020 changes.

There is a long-standing issue with the milk price monitoring regime, which permits Fonterra to engage and act in ways that tend to result in a non-transparent and inefficient milk price. A more independent milk price-setting regime that is fully separate from Fonterra could provide a more robust and fair milk price. Open Country should highlight how the Restructure will compound the negative outcomes of DIRA and that change is needed.

Domestic milk product prices will rise as a result

In recent media statements, the Minister for Primary Industries is focussed on domestic dairy product prices and has said there is an opportunity to address these in the context of changes to DIRA required by the Restructure. Domestic milk prices will rise as a result of the Restructure. Any policy change that attempts to de-link domestic milk product prices from the farmgate milk price will be unworkable and will fail. Open Country should demand that the government demonstrate how a domestic price-setting regime would work and be sustainable (it will not work, and will not be sustainable).

1 Introduction

Fonterra is proposing to change its capital structure to reduce the minimum number of shares a farmer must hold to supply the cooperative from 1 share per 1 kgMS to 1 share per 3 kgMS, change the class of persons who may trade the shares, and make changes to the FSF. This will require an amendment to DIRA, because it involves changes to TAF (Trading Among Farmers).

Open Country appointed Castalia to prepare this independent report on the impact of the Restructure.

This report first outlines the proposed Restructure—the current regime and how it will change. We then outline the impact on the Fonterra share price from the imbalance between sellers and buyers, and loss of liquidity that will occur due to the Restructure. We then show how the Restructure will empower Fonterra to defend its milk supply, utilise its spare capacity more efficiently and grow earnings. The net result of the Restructure is a transfer of wealth from current farmers to Fonterra, which will tend to drive up the farmgate milk price and farm values.

As a result, policy changes are required to ensure that the dairy processing market is not further undermined. At the same time, any change to DIRA provides an opportunity to point out failings in the regime.

2 Fonterra's proposed capital restructure

Fonterra's proposed capital Restructure will change the minimum shares required to supply the cooperative, the trading regime for farmer-owned shares and the listed FSF units and change the entry and exit timeframes.

Figure 2.1: Fonterra capital structure pre-and post- proposed Restructure

Minimum Shareholding	1:1 Shares pre kgMS		1:3 Shares per kgMS
TAF and FSM	Fonterra manages TAF and FSM within limits		TAF capped
Eligible farmers	Supplying farmer-owners only	Changes to DIRA and Fonterra constitution	Supplying farmer-owners, sharemilkers, contract milkers, lessors
Entry	Up to to three seasons (buy 1/3 per season)		Up to six seasons
Exit	Up to three seasons (sell 1/3 per season)		• 15 seasons reducing to 10 over 5 seasons for current farmers • Up to 5 years for new farmers • Up to 3 seasons for associated farmers
Voting rights	1:1000 Shares		No change but minimum 1:3 wet share ratio applies

We outline the status quo and then the proposed changes in the following.

2.1 Current Fonterra share standard, trading arrangements and other rules

This sets out the status quo regime.

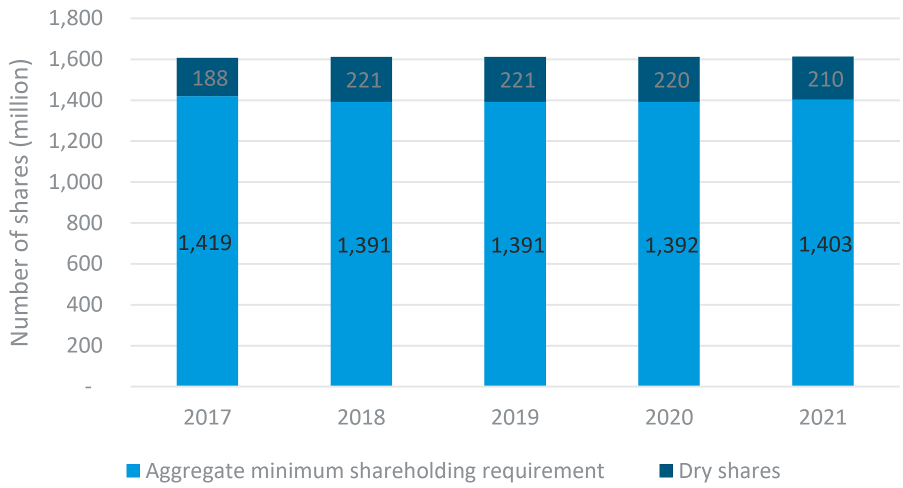
2.1.1 Current Fonterra share standard

Historically, Fonterra required that its farmer-shareholders held one share for each kilogram of milk solids (kgMS) supplied (known as the share standard). Since the introduction of Trading Among Farmers (TAF) in 2012, the share standard requires each farmer shareholder to hold a minimum of one share for every kgMS produced up to a maximum of two shares for every kgMS.

The term "wet shares" is used to describe the component of a farmer shareholder's shareholding that is backed by kgMS production and meets the minimum requirement. Any shares held in excess of the minimum required holding are described as "dry shares". Figure

2.2 shows the number of Fonterra Markets shares from 2017 to 2021 and relative “wet” and “dry” shares.

Figure 2.2: Wet and dry Fonterra shares 2017-2021



Source: Fonterra annual reports

Voting rights attach to wet shares in proportion to milk supplied

Fonterra farmers’ voting rights in the cooperative correspond to the volume of milk supplied (measured in kgMS). Farmers have one vote per 1,000 kgMS supplied, to the extent supply is backed wet shares.

Fonterra has mechanisms to enforce compliance with the share standard

Fonterra enforces the requirement to meet the share standard by giving power to an independent agent to buy or sell shares on a non-compliant farmer’s behalf. Milk supply not backed by wet shares at the end of each month can also result in a non-share-backed milk price being paid to that farmer. This price is set by the Fonterra Board and can be a discount from the full Share-backed milk price.

2.1.2 Current regime for trading Fonterra shares and units

The current TAF regime was introduced to provide Fonterra with redemption risk protection.

TAF currently reduces Fonterra’s redemption risk and provides a mechanism for farmers “sharing up” and farmers “sharing down” to trade

Prior to 2012, Fonterra capital was entirely linked to milk supply and Fonterra farmers did not receive a dividend. DIRA required Fonterra to issue and redeem shares at a price set by an independent valuation to ensure open entry and exit. As a result, the cooperative had no permanent capital on its balance sheet and Fonterra carried the burden of Redemption risk. Fonterra feared having to pay large sums of money if farmers reduced milk supply or left the cooperative.

To reduce the redemption risk, in 2009, Fonterra began to value its shares using a restricted share valuation which lowered the price of Fonterra shares. In 2009, Fonterra also began to allow farmers to hold shares in excess of milk supply and paid a dividend on the value-add component of Fonterra’s milk supply. Redemption risk remained and increased as milk supply flattened and farmers left to competing milk processors. TAF was introduced in 2012 with the primary objective to deal with the issue of redemption risk.

Since 2012, TAF has been the primary mechanism for an exiting farmer (for example, who had sold a farm) to dispose of shares. Farmers have three years to "share down". Those shares would be sold on market and end up either satisfying the demand for shares of a Fonterra farmer who needs to share up to meet the share standard, or a farmer making a financial investment. This is because farmers can trade in dry shares, up to the limit of the size of their wet shareholding (that is, a farmer can hold two times their number of wet shares).

Under TAF, Fonterra faces a reduced redemption risk. It has a policy to maintain the size of the Fonterra Shareholder Fund (FSF), which is composed of units in a fund that represent the economic interest of a Fonterra share. If the FSF moves outside stated ranges, Fonterra then commits to buying back shares or units. If milk supply reduces and farmers sell dry shares into the FSF so that it exceeds the limits, Fonterra must buy back the FSF units, or the dry shares directly.

Fonterra has not needed to issue significant new equity to new Fonterra farmers

Fonterra has not issued significant new equity capital to the market. This is because of the liquid TAF market and the overall flattening in New Zealand milk production, and Fonterra's declining share of milk supply since 2012. With a declining market share, a new Fonterra farmer wanting to share up could secure shares from the pool of dry shares or from the pool of exiting farmers with wet shares.

FSF gives farmers the ability to sell economic rights to wet and dry shares

Fonterra farmers can sell the economic rights of Fonterra shares to the FSF. When a farmer sells these economic rights, a unit is created and is immediately sold on the NZSX. In return, the farmer receives cash and a voucher[2] (subject to a voucher limit called the FSF Transfer Limit). Both shares and the vouchers can be used by Fonterra farmers to meet the share standard. A Fonterra custodian holds the shares and can return the shares to farmers in exchange for an FSF unit. The FSF size is managed within a target range of 7-12 percent, and the potential size is managed to between 7 and 15 percent of total shares on issue.[3]

The purpose of the FSF was to facilitate liquidity of trading shares to improve price discovery for Fonterra shares and to provide additional flexibility for farmer shareholders. This was also required to reflect Fonterra's unique capital structure under which open entry and exit at a fair price are important features mandated by DIRA.[4] A Registered Volume Provider (RVP) historically facilitated price convergence between the two markets, ensuring fungibility. The RVP could buy and sell shares from the FSM and the FSF.

Anyone can buy and sell FSF units for cash on the NZSX. Investors trade the units in the FSF, and the price has historically matched the price of FCG shares on the farmer-only FSM.

The Fonterra board has discretion to set a FSF Transfer Limit. This restricts the number of wet shares a farmer can convert into units in the FSF. The Fonterra Constitution provides the FSF

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2 A voucher represents the farmer has sold the economic rights to a share but preserves voting rights and rights to full milk supply payment up to a specified limit.

3 Fonterra Shareholders' Fund, Prospectus and Investment Statement, page 122. Note that the Board can permit the FSF to grow to 20 percent under exceptional circumstances.

4 Fonterra (2012) Trading Amongst Farmers Blueprint. Page 6

Transfer Limit does not exceed 33 per cent of wet shares for an individual Farmer Shareholder. During the Farmer Shareholder Supply Offer in 2013 the FSF Transfer Limit was set at 25 per cent.[5] There is no limit to the number of dry shares that a farmer can convert into units.

2.1.3 Current regime for sharing up and sharing down

Entering and exiting Fonterra farmers have obligations to share-up and share-down, with some exceptions.

Sharing-up to the 1:1 share standard within three years, except for MyMilk and "share up over time"

Most new farmers or existing farmers increasing their milk supply to Fonterra currently have three seasons to acquire the shares to meet the 1:1 share standard, but must acquire at least one-third in each season. Alternatively, farmers could opt to share up using a "share up over time" contract. Under this arrangement, share options are used, and a different milk price payment to normal shareholders is received. Fonterra has allowed new suppliers to supply milk to Fonterra without shares under a programme called MyMilk. This was initially only available in the South Island or by signing a growth contract for five years supply only, and was limited to 5 percent of total milk supplied.[6] Under the MyMilk programme new farmers do not have to purchase shares, and receive a milk price that is less than the price paid to shared-up famers. In 2018 this was a five-cent deduction.

Sharing-down over three years

For farmers exiting Fonterra or decreasing production, there is a three-year time limit to sell shares with a minimum requirement of one-third in each season. Exiting farmers can only sell their shares on the FSM. Compliance for each season of entry or exit was enforced at the Compliance Date, which is intended to be on or after 1 December in each season.

2.2 Restructure changes the Fonterra share standard, trading arrangements and other rules

The Restructure will result in the share standard reducing, and share trading arrangements changing. A wider range of people may own and trade shares.

2.2.1 Changes to the share standard

Under the Restructure, the minimum wet shareholding requirement will reduce to 1 share for every 3 kgMS supplied.

Voting rights will remain proportional to the number of wet shares that back supply. Farmer shareholders will continue to receive one vote per 1,000 kgMS supplied in the previous season to the extent supply is backed 1:1 by shares.[7] Farmers that have less than That is, if a farmer has a share to milk supply ratio of at least 1:1, the farmer will have voting rights proportionate to supplied milk only. If a farmer has a share to milk supply ratio of 1:3, then the farmer's voting rights are proportionate to one-third of the milk supplied. Fonterra farmers will no

[5] Fonterra (2013) Fonterra Farmer Shareholders Supply Offer Booklet

[6] James Courtman (2018) TAF-why did we need it, how well is it working and where to in the future. Kellogg Rural Leadership Programme. Course 37

[7] Fonterra (2021), Capital restructure booklet. Page 9

longer receive a discounted milk price for milk supply that is not backed by shareholding. The maximum shareholding limit will increase to four times milk supply.

2.2.2 Change to trading in Fonterra shares and units

The Restructure will change trading on FSM for farmer-only shares, and trading in units in the FSF.

The FSF is being capped and Fonterra is moving to a farmer-only market[8]

Currently, 6.7 percent of all shares on issue are represented by the FSF. This number will be capped under the Restructure.

Since the Restructure will result in a significant increase in the number of dry shares on issue, this would have increased the number of shares that can be exchanged into FSF units without limit. Therefore, Fonterra's redemption risk would increase as it would have to buy back shares under the terms of the FSF fund size risk management policy to meet the 12-15 percent upper thresholds of total shares on issue in the FSF (a 20 percent upper limit is permitted where the Board considers exceptional circumstances exist).

Farmers and a wider range of people can hold shares

Fonterra is extending the pool of people who are eligible to buy shares. Sharemilkers, contract milkers and farm lessors (Farmer Associates) who have contractual arrangements with a supplying farm owner can now buy Fonterra dry shares. There are an estimated 4,000 Farmer Associates. This is intended to provide a pathway to farm ownership and to being a "shared-up" Fonterra farmer.

2.2.3 Sharing-up and sharing-down made easier

Entry and exit provisions are being eased

The proposed capital restructure will give greater flexibility to farmers to meet the share standard and to cease supply to Fonterra. New supplying farmer-owners, or existing supplying farmer-owners who have a material increase in milk supply, would be able to purchase shares, or increase their shareholding, to achieve their 33 percent Minimum Holding over six seasons.

In the first season, they would only be required to hold 1,000 shares, and the remainder would be split evenly over the following five seasons. The existing Share-Up Over Time and MyMilk contract options would no longer be offered, although the Co-op would honour all existing contractual commitments. Also, the share-up obligations under those existing Share-Up Over Time contracts would be reduced to reflect the 33 percent Minimum Holding, and the contract fee under all existing contracts would be set to zero for their remaining terms.

Everyone who is a farmer-owner on the vote date, including any farmers who have already ceased supplying but have not yet sold their shares under the current three-season requirements, would have up to 15 seasons to sell their shares. The 15 seasons would reduce by one year over each of the following five seasons to 10 seasons.

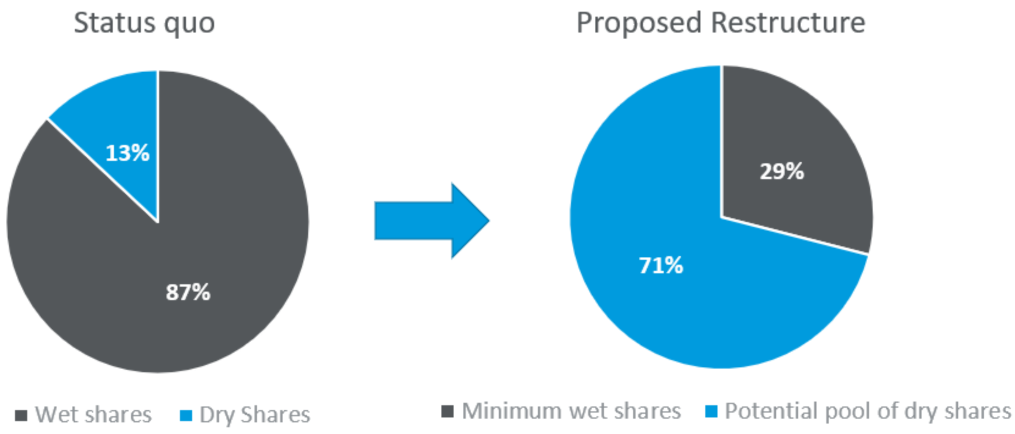
[8] https://www.fonterra.com/nz/en/capital-structure/our-choice/capped-fund.html.html

All new supplying farmer-owners who join after the vote date would have up to five seasons to sell their shares should they cease to supply. All associated farmer-owners would have up to three seasons to sell shares, once they cease to be associated with a supplying farmer owner.

3 Impact of Restructure on Fonterra share price

The Restructure will fundamentally change the balance of buyers and sellers in the market. Under the status quo, 13 percent of shares are traded by farmers than must trade due to a farm transaction, plus movement from year to year of farmers "sharing up" or "sharing down".

Figure 3.1: Pool of available shares for trading under status quo and proposed restructure



Source: Fonterra Annual Report 2021; Fonterra 2021 capital restructure booklet

The market has already discounted the shares by 15 percent due to future reduction of liquidity and the future imbalance of buyers and sellers. The Restructure is likely to force the share price down to a level where a small number of farmers with free capital will buy the shares to earn a market return. The historical performance of Fonterra compared to alternative investments has been poor, which is also likely to negatively impact the price buyers are willing to pay in the market.

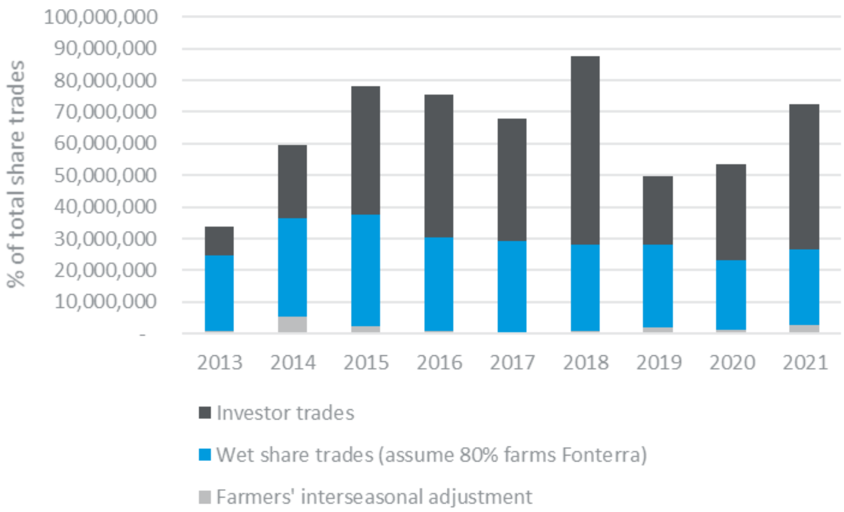
3.1 Pricing of Fonterra shares under current regime

Prices of Fonterra shares are currently set by two broad groups of people. One the one hand, farmers that are sharing up or sharing down. On the other hand, investors making a financial investment—both farmers and unitholders.

Under the current regime, most trades among farmers have been unrelated to meeting the share standard

Our analysis suggests that in the nine full years since TAF commenced, around 44 percent of trades on FSM related to farms changing hands, and 3 percent related to farmers making adjustments due to fluctuating milk production to meet the share standard.[9] Therefore, 47 percent of all trades related to the compulsory sharing-up or sharing-down requirements under Fonterra's constitution. This is the base level of demand and supply for Fonterra shares that should persist regardless of share price. This base level of demand and supply, and the investor interest is illustrated in Figure 3.2.

Figure 3.2: Estimated volume of historical FSM trades involving sharing-up or sharing-down



Sources: REINZ dairy farm sales, NZX, DairyNZ statistics, Fonterra annual reports
Approach: We analysed REINZ dairy farm sales, DairyNZ average New Zealand herd production data, and NZX's TAF share trading data for 2013-2022. We estimated the number of wet shares traded based on the rolling 3-year average number of farms that changed hands and assumed that 80 percent of farm sales were for Fonterra supplying farms. We assume that the farms which change hands produced the average milk solids for that year.

Base level buy-side demand and sell-side supply

The main motivation for a share transaction where a party is sharing up or sharing down is not a financial one. The party is meeting the minimum requirement to supply Fonterra, or is meeting requirements under the Fonterra constitution to sell shares after exiting the industry. In both cases, the driver of liquidity in the market is farmers buying and selling farms. Farmers will make separate decisions about the outlook for milk prices and costs, including land, dairy herd, labour and farm infrastructure, as well as taking into account personal circumstances. Since milk supply in recent years has been stable, and the medium-term forecast is for stable or falling volumes, the liquidity is driven by how many of a fixed pool of farms are changing hands. Since 2012, the average number of dairy farms bought and sold in New Zealand (which includes non-Fonterra suppliers) was 223, according to REINZ. A subset of those farms will be Fonterra farms—we estimate around 80 percent.

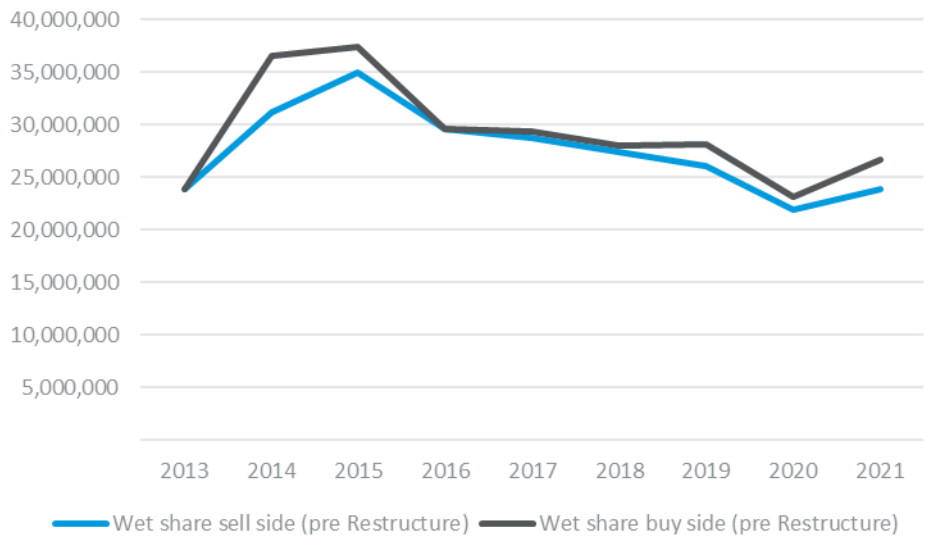
Using these assumptions, we estimate a base level of demand for wet shares from farmers needing to meet the share standard has ranged between 23 million shares and 37 million

[9] We analysed REINZ dairy farm sales, DairyNZ average New Zealand herd production data, and NZX's TAF share trading data for 2013-2022. We estimated the number of wet shares traded based on the rolling 3-year average number of farms that changed hands and assumed that between 70 and 80 percent of farm sales were for Fonterra supplying farms. We assume that the farms which change hands produced the average milk solids for that year.

shares per annum since 2012. The base level of sell-side supply depends on the farmers needing to share-down. That is because they have left Fonterra. Our analysis suggests this has ranged between 22 million and 35 million per annum since 2012.

In other words, between 20 and 40 million shares would be on the buy-side and sell-side of the market each year, if the current share standard were retained.

Figure 3.3: Sell-side and buy-side for wet shares pre-Restructure



Sources: REINZ dairy farm sales, NZX, DairyNZ statistics, Fonterra annual reports
Approach: We analysed REINZ dairy farm sales, DairyNZ average New Zealand herd production data, and NZX's TAF share trading data for 2013-2022. Sell-side wet shares is equal to 80 percent of the rolling 3-year average number of dairy farms sold times the average farm production of milk solids for that year. Buy-side wet shares is equal to the same number plus any additional shares a farmer must buy to share-up due to production increases.

Farmer Associate demand for shares will shift share purchases in time only

The 4,000 additional potential buyers and sellers (Farmer Associates who are sharemilkers, contract milkers and farm lessors) will not add to the buy side pressure. Many Farmer Associates will be making share purchases that they would have made anyway. For example, a sharemilker that buys shares incrementally on their way to buying a farm to become a Fonterra farmer will simply be changing the time period over which they share up. This has no net impact on buy side pressure over time.

Dry share trades driven by financial motives and access to capital

As Figure 3.2 shows, the other half of the buyers and sellers on the TAF market were by farmers (or the Fonterra market maker) acting as "investors". These traders were engaging in financial trades, unrelated directly to meeting the share standard. The trades would have involved dry shares. The sellers and buyers would have been motivated either:

- To realise the financial value of a dry share (the sellers)
- Because they expected to make a risk-adjusted market financial return for their capital (the buyers).

The sell-side of dry shares will be, at a maximum, reflective of the total number of dry shares. This has been between 181 and 210 million since 2017. Some parties will buy and sell multiple times in a year (for example, the market maker), but most farmers that hold dry shares are likely to sell them infrequently.

However, the buy-side of the farmer-only FSM is limited by farmer's access to capital. Unlike a liquid share market with many financial investors and unlimited external capital, FSM participants do not have unlimited capital. While there is a minor role for the market maker (a stockbroking firm that is in the market to bridge the gap between buy and sell orders), the underlying demand to buy dry shares will be determined by farmers' ability to raise capital to purchase these.

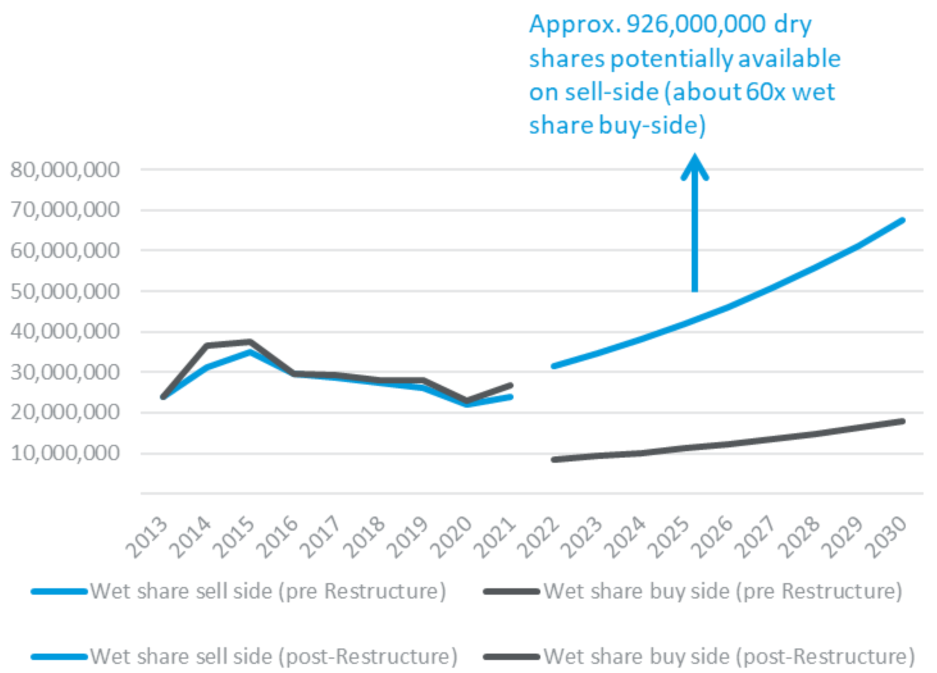
FSF units improved price discovery through a liquid market of financial investors

The FSF ensures that the price of Fonterra shares reflects the risk-adjusted expected return on capital. This is because external public investors and financial institutions can acquire the economic rights to Fonterra shares (wet or dry) and value them like any other financial instrument. Financial investors on the FSF have potentially limitless capital. If the FSF units were under-priced relative to their riskiness, a financial investor could allocate capital (or borrow at a lower cost of capital) and invest.

3.2 Pricing of Fonterra shares after Restructure

The Restructure is likely to have a significant impact on the price of shares. The sell-side and buy-side will be imbalanced. There will be almost four times as many sellers which other parties must buy to meet the share standard. By 2030 there will be around 60 times more shares potentially available for sale than there are buyers who must purchase to enter Fonterra. Figure 3.4 illustrates the divergence after the Restructure. We assume a growing number of dairy farms are bought and sold in New Zealand, in part because the capital investment for sharing-up to join Fonterra will be lower under the Restructure.

Figure 3.4: Sell-side and buy-side for wet shares in Fonterra, pre-and post-Restructure



Sources: REINZ dairy farm sales, NZX, DairyNZ
Approach: We analysed REINZ dairy farm sales, DairyNZ average New Zealand herd production data, and NZX's TAF share trading data for 2013-2022. Sell-side wet shares is equal to 80 percent of the rolling 3-year average number of dairy farms sold times the average farm production of milk solids for that year. Buy-side wet shares is equal to the same number plus any additional shares a farmer must buy to share-up due to production increases. The post-2022 estimates are based on an assumed increase in farm sales and milk price remaining constant at the same $7.00/kgMS as used in Fonterra's Our Path to 2030 document.Key assumptions:
Farm sales increase from the rolling three-year average in 2021 of 168 sales by 10 percent each year to 2030.
Milk production remains constant (despite Fonterra predicting a fall), and average farm/herd size remains constant.

3.2.1 Sell-side will be significantly larger

The Restructure will have a massive impact on the number of potential sellers in the market. The base level of potential sellers will increase very significantly. At a minimum, around 32 million to 68 million shares will **need** to be sold (assuming farm sales increase in future).[10] However, the total number of shares that **can** be sold will increase to around 900 million shares.

The 15-year sharing-down period will only spread the number of sellers that need to sell shares over a longer time period. This will only slightly increase the number of dry shareholders in the pool.

[10] One of the drivers for Fonterra's Restructure is to increase the attractiveness to aspiring farm-owners to buy farms and become farmer-suppliers. Therefore, assuming growing numbers of farm sales is consistent with Fonterra's assumptions.

3.2.2 Buy-side will be significantly diminished

The Restructure significantly reduces the base level of buyers in the market. Four factors are likely to then impact the level of demand to buy Fonterra shares:

- The impact of Fonterra's proposed $300 million share buyback facility: We think it will be insufficient
- The attractiveness of the shares to farmers (and the new classes of potential shareholders) who can finance the purchase: Farmers are most capital constrained, and would probably prefer more liquid investments
- Fonterra's historical financial performance: This has been very poor, suggesting a significant change in corporate strategy would be needed to convince investors that dividends will increase
- Voting rights attaching to the shares: Voting rights are capped at the amount of milk supply.

$300 million buyback facility likely to be insufficient

Fonterra is proposing to support the farmer only FSM by putting $300 million into an on-market share buyback programme. This will probably be exhausted after one year.

The buyback would reduce the number of shares on issue. At the current market price of $3.00, the buyback would reduce the potential sell-side by about 10 percent to 926 million shares. At the same $3.00 price, the implied volume of shares traded is 100 million. This is about 18 months of the average share trading volume on FSM since inception.

Shares will only be attractive as a financial investment to farmers

The Restructure significantly reduces the pool of farmers that must purchase shares. It, therefore, leaves mostly farmers (and sharemilkers, contract farmers and farm lessors) who want to buy the shares as a financial investment only. The attractiveness of the shares will depend on the outlook for Fonterra's earnings, discounted at the opportunity cost of capital for a farmer.

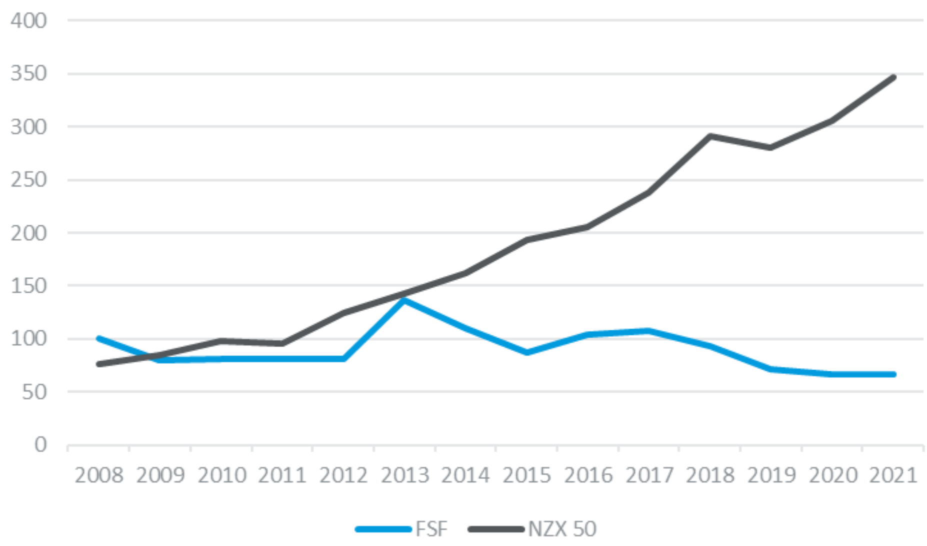
Dairy farmers are often cash-constrained. Most capital is tied up in the farmland. Freed-up capital is usually used to improve on-farm production, for example, by improving milking equipment, buying in additional feed, or improving herd genetics. Most dairy farmers also carry bank debt. This means the opportunity cost of capital for a farmer is probably the prevailing mortgage interest rate. A farmer that pays down debt is effectively making a tax-free economic rate of return equivalent to the mortgage interest rate.

Fonterra's historical performance for shareholders has been poor

Fonterra's track record in providing its shareholders with an adequate return on capital has been poor. While past performance does not indicate future returns, the consistency of the poor performance has been notable. The past performance and credibility of the company to earn its shareholders a market return is likely to be questioned.

Figure 3.5 shows the historical performance of Fonterra shares compared to the benchmark NZX50 index.

Figure 3.5: Fonterra compared to NZX50



Source: NZX

Farmer Associates will not affect demand for shares significantly

The newly eligible Farmer Associates should also not impact demand significantly. Farmer Associates will face the same investment considerations as the rest of the dry shareholders. Furthermore, Farmer Associates are almost by definition capital constrained. If they had the capital, they would have bought shares in Fonterra to become farmers. If Farmer Associates do have spare capital, and opt to buy shares (rather than put savings into a financial investment that might perform better than Fonterra shares historical poor performance) then they would probably be on their way to becoming Fonterra farmers anyway, and are just substituting demand for Fonterra shares across time.

Voting rights are capped at the level of wet shares

Farmers that elect to buy the surplus shares from other farmers do not get any additional voting rights above a 1:1 ratio of shares to milk supply. Therefore, acquiring additional shares provides the buyer with no additional influence over the direction of the cooperative, further disincentivising share purchases.

3.2.3 Fonterra shares will be priced lower due to liquidity constraints and capped FSF

The Restructure also changes the liquidity of Fonterra shares. Fonterra's shares will become less liquid because only farmers will trade them, and because there is no longer an uncapped ability to sell into the FSF. The economic literature suggests the Restructure will cause a drop in price due to liquidity constraint. The price difference that emerged in May 2021 between FSF units on NZX and the FCG shares on the FSM implies a 15 percent liquidity penalty.

Lack of marketability discount will apply to Fonterra shares

When shares are traded on a closed market, a discount for lack of marketability (DLOM) is typically applied. Multiple studies suggest that illiquid stocks should trade at a discount, implying a positive relation between stock liquidity and firm value.[11] Pastor and Stamburgh (2001) estimate a spread in expected returns of 7.5 percent per annum between low-and high-liquidity stocks.[12] A well-cited paper by Silber (1991) presented the evidence on the impact of liquidity by examining price differences across securities that are identical in all respects except resale provisions[13]. The study found that "restricted stocks" where the holders are subject to a minimum two-year illiquidity sold at an average price discount of 33.75 percent. The study finds that average price discount varies with firm and issue characteristics, investors presumably expect to hold such securities through their period of illiquidity, hence will settle for a smaller price discount.

Observed market behaviour implies at least 15 percent liquidity penalty to Fonterra shares

The value of Fonterra shares has already fallen since the Restructure was announced. The price of FCG shares on the farmer-only FSM has fallen relative to the listed FSF units. This is because Fonterra suspended shares from being exchanged into FSF units, thereby placing a liquidity constraint on any trading.[14] From May 2021, farmers no longer had the option to realise value via FSF, so the demand for any shares a farmer wanted to sell was limited by the pool of willing farmer-buyers.

We can observe differences in the liquidity of the FSF units and FCG shares in Figure 3.6 below. For the entire period from 2012 to 2021, the FSF units and FCG shares were essentially the same price. Since 5 May 2021, there has been a significant divergence in prices. Farmer-only FCG shares have traded 15 percent lower than FSF units.

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[11] https://onlinelibrary.wiley.com/doi/pdf/10.1111/irfi.12082

[12] https://onlinelibrary.wiley.com/doi/pdf/10.1111/j.1540-6288.2005.00118.x?casa_token=MY8tLeSeCQ4AAAAA:wlSLyIS74ZoVmjb2uP9ZwHPrsQpCfNWVdybWWGNQhModJhqMSC-JRtaVJYX6Ep9ddzJOvv1o0y1xjqpM

[13] https://www.jstor.org/stable/pdf/4479457.pdf?casa_token=a8gStBYtwSMAAAAA:K6pl0fsuAekzxNsxI0JjUZWQakRQrqyIR9XFqmmr_W9PTR6t2TPPzSj43GPpXdfCWsuwY3OASvdGojrsi8nDcGC1KL7OrWxQXKRLvR3K7MWjE9_2CHDHTQ

[14] NZX market announcement 6 May 2021: To allow its farmers to have open conversations and consider all options during consultation, the Co-operative is temporarily capping the size of the Fonterra Shareholders' Fund (the Fund) by suspending shares in the Fonterra Shareholders' Market (FSM) from being exchanged into units in the Fund.

Figure 3.6: Fonterra farmer-only FCG shares and FSF units—traded prices 2013-2022

Source: NZX

3.3 Conclusion on impact of Restructure on Fonterra share price

The net result of the Restructure is likely to be a reduction in the share price of about 40 percent. The massive imbalance between potential sellers and potential buyers will drive the price lower. This is already evident from the 15 percent reduction in FCG share price, relative to FSF units since May 2021.

The price is likely to be determined by the willingness of farmers, sharemilkers, contract farmers and farm lessors with available capital to purchase dry shares. Since these people have limited access to capital, the price will be determined with reference to their opportunity cost of capital.

Share price more likely to reach equilibrium where underlying earnings drive pricing

The stark imbalance between the shares available for sale, and the pool of buyers that must buy shares means the price will be determined by the prospects of financial return only. The market will value the expected return on invested capital, adjusted for risk. The Fonterra share price should reflect the expected dividend and capital value increase, adjusting for the riskiness of the market in which it operates.

Based on Fonterra's own estimates of the dividends it intends to pay between now and 2030, the discounted cashflow estimate of share price is between $1.79 and $2.32, as set out in Table 3.1. These estimates are well below the current FCG share price on the FSM of $3.00, and $3.59 for the FSF units, and the $4.60 price on both markets in early May 2021 prior to the Restructure announcement.

Table 3.1: Estimated share price using discounted cashflow method

	Discount rate (%)	Dividend 2022 ($)	Dividend 2030 ($)	Estimated price ($)
Low estimate	6.24	0.15	0.4	1.79
High estimate	4.24	0.2	0.45	2.32

Source: Fonterra (2021), Our Path to 2030: Long-Term Aspirations, p. 7; https://www.anz.co.nz/rates-fees-agreements/agri/; RBNZ November 2021 Monetary Policy Statement (OCR forecast)

4 Impact on competition between processors

Fonterra has had an underlying incentive to inflate the farmgate milk price. This helps it retain supply and also win supply from its rivals. The 2012 amendments to DIRA were intended to restrict Fonterra's discretion to divert net revenues to paying a higher milk price, at the expense of a dividend for shareholders. The Restructure removes the final (albeit weak) constraint on Fonterra to ensure a fair and transparent milk price is paid to farmers.

4.1 Fonterra has underlying incentive to attract supply from rivals using share price and farmgate milk price

Fonterra is incentivised to secure milk supply to both preserve and grow its net revenues. It seeks to avoid losing more market share, and corresponding capacity management risk and stranded assets. If it can grow milk supply (in the flat to falling national milk supply environment), it can improve net revenues more. The Fonterra CEO stated in the document that accompanied the Restructure proposal "Our strategy to 2030" that its "ability to achieve these targets depends on a sustainable supply of New Zealand milk and in turn a capital structure that enables this."[15]

Fonterra wants to keep milk price high to retain farmers

If Fonterra can keep the farmgate milk price consistently high in the long-run relative to the competing independent processors, it will ensure that suppliers choose Fonterra and remain loyal, relative to other processors. This incentive is confirmed by the Commerce Commission's own assessment that in the absence of DIRA, there is a risk that Fonterra would engage farmers in long-term supply contracts, and possibly prejudice against any farmers that left the cooperative and sought to return.[16]

Fonterra has consistently demonstrated this bias toward increasing the farmgate milk price in its preparation of the Milk Price Manual and in the Milk Price Calculation used to determine farmgate milk price, for example:

15 Fonterra (2021), Our path to 2030: Long-term aspirations, p. 3

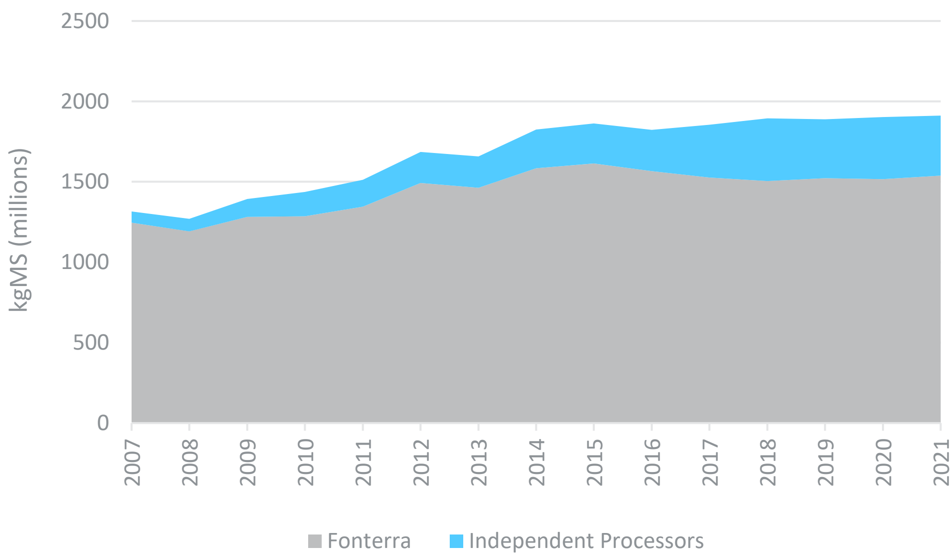
16 Commerce Commission (2016), Review of the state of competition in the New Zealand dairy industry, available at: https://comcom.govt.nz/__data/assets/pdf_file/0018/62370/Final-report-Review-of-the-state-of-competition-in-the-New-Zealand-Dairy-Industry-1-March-2016.pdf

- Systematically pushed for a higher asset beta to be used in the farmgate milk price calculation. It eventually required a law change (2020 DIRA amendment) to stop Fonterra acting on this
- Used sales data from private contracts with buyers for commodity milk products, rather than the publicly available Global Dairy Trade (GDT) platform. This violates the “law of one price” whereby Fonterra claims it has buyers willing to pay more for commodity milk products in confidential sales contracts than the prices available on the open GDT
- Historical returns to shareholders have lagged the market, whereas farmer incomes from milk price payments have been very high (as Figure 3.5, above, illustrates).

Fonterra wants to retain and attract supply to avoid capacity management risks

Fonterra is incentivised to keep a high milk price, and low barriers to entry, to avoid capacity management risk. This is acute in light of the market share it has lost, illustrated in Figure 4.1.

Figure 4.1: Fonterra and Independent Processors share of total milk solids processed



Sources: DairyNZ, Fonterra

If Fonterra continues to lose more supply relative to its competitors, it risks imposing further costs on the business from having under-utilised processing assets. Fonterra’s currently under-utilised assets impose costs on its shareholders without earning an economic return. Its excess capacity is acknowledged:

- In the 2014/2015 season, Fonterra demonstrated its maximum processing capacity when it processed its highest ever 1,614 million tonnes of milk solids. This is 5 percent higher than its average processing performance over the subsequent six seasons

- Fonterra invested heavily in new capacity around 2014/2015, during a period of high prices for New Zealand milk products and high on-farm milk production.[17] For example, it significantly expanded the Lichfield plant in South Waikato for $555 million so it can now process 4.4 million litres of milk per day.[18] However, the Lichfield plant remains under-utilised, running at 30 percent capacity, and has not run a full season since opening, as Fonterra's CEO and news media reports confirm.[19]

4.2 Erosion of protections for a fair milk price

The effect of the Restructure will be to lower the costs of entry for a farmer to supply Fonterra by at least one-third (more once the share price reaches its predicted level). The Restructure will also erode the final, albeit weak, protection for a fair milk price, fair share price, and therefore a level playing field for all processors. This follows similar erosion of anti-competitive provisions in the 2020 amendment to DIRA.

It is useful to first explain why Parliament changed DIRA in 2012 to establish a mechanism for a fair share price. This mechanism will be removed if the Restructure proceeds.

2012 DIRA amendment introduced TAF to moderate Fonterra's incentive to increase farmgate milk price

In 2012, DIRA was amended to provide some protection to ensure a fair milk price was set to ensure that Fonterra did not take advantage of its dominant position. This is because as a supplier-owned cooperative, Fonterra had a dominant incentive to over-pay for its largest input cost—raw milk. The milk price regime was included following a 2011 review. The 2011 review concluded that Fonterra "could have the incentive and the ability to pay a price that could distort the market".

Legislators were concerned about Fonterra's dominance and impact of that dominance on competing processors. In select committee MPI advised that the amendment was intended to "promote transparency of, and confidence in, Fonterra's milk price setting process and to promote a price that would arise in a contestable market for farmers' milk."[20]

When the 2012 DIRA amendment passed, and TAF was established, Parliament intended for the farmgate milk price to provide for the highest price that is consistent with an efficient processor, and which provides for contestability in the processor market. Put very simply, the farmgate milk price is intended to be a price that is fair to farmers and would result in a contestable market.[21] The law—reflected in section 150A of DIRA—was designed to stop

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17 "In 2014 we made the decision underpinned by the legislation over expected significant farm conversions in the central North Island. We invested $380m in the central North Island to cater for that growth, and then in 2016 a decision was made to halt those conversions, so now we have a facility running at 30 per cent capacity." Fonterra CEO Miles Hurrell, Submission to Primary Production Committee 24 October 2019.

18 https://www.fonterra.com/nz/en/our-stories/media/fonterra-officially-opens-worlds-joint-largest-milk-powder-dryer-at-lichfield.html

19 https://www.stuff.co.nz/business/114035432/fonterra-comfortable-with-lichfield-plant-running-half-a-season

20 In MPI's Departmental Report to the Primary Production Select Committee considering the Dairy Industry Amendment Bill 2012, MPI stated: "The objective of the regime is to promote transparency of, and confidence in, Fonterra's milk price setting process and to promote a price that would arise in a contestable market for farmers' milk." (available at: https://www.parliament.nz/resource/en-NZ/50SCPP_ADV_00DBHOH_BILL11262_1_A240504/20bb7440f168fab89f3dde2ef672a7662932386f)

21 We note that during the 2019-2020 DIRA amendment process, the Minister and the MPI officials fundamentally misunderstood the function of the milk-price setting regime, contrary to the 2012 policy intent. Officials and the Minister seemed to think the farmgate milk price was a mere guide for farmers to judge Fonterra's efficiency. This is simply wrong.

Fonterra from abusing its dominant position and make the existing price setting mechanism more transparent. In 2012, the government Minister responsible for the legislation stated:

> *"Because of Fonterra's dominance, its farm-gate milk price is effectively the default price that all dairy processors in New Zealand must pay in order to attract supply from dairy farmers … The bill legislates for greater transparency of the way Fonterra currently sets its farm-gate milk price through its milk price manual, to ensure that the farm-gate milk price is consistent with outcomes in a contestable market. A contestable market should, in practice, result in a farm-gate milk price consistent with that which would emerge in a workably competitive market."*[22]

FSF unitholders and a liquid TAF were supposed to be a constraint on Fonterra—will be removed under the Restructure

Fonterra has argued[23] that the unitholders in the FSF impose a discipline on Fonterra from setting the farmgate milk price too high. It has also argued that shareholders are a distinct group from farmer-suppliers, and these shareholders impose a discipline on how Fonterra sets the farmgate milk price.

Fonterra has argued that the existence of TAF and the FSF created a "balance of incentives" between shareholders and farmers as two distinct groups. Now the Restructure ensures that both are essentially the same. The 4,000 Farmer Associates do not restore any balance either, because those people want a lower share price to make entry to Fonterra easier.

Fonterra's revealed preference is to set a high milk price

Fonterra's returns to its supplier farmers have favoured the milk price over the dividend. The evidence of farmer-returns since TAF are clear: a consistent bias toward minimising the dividend and a return on capital that is lower than the return on the farmer's mortgage payments. The Restructure will remove proper price discovery and remove the influence of external capital completely.

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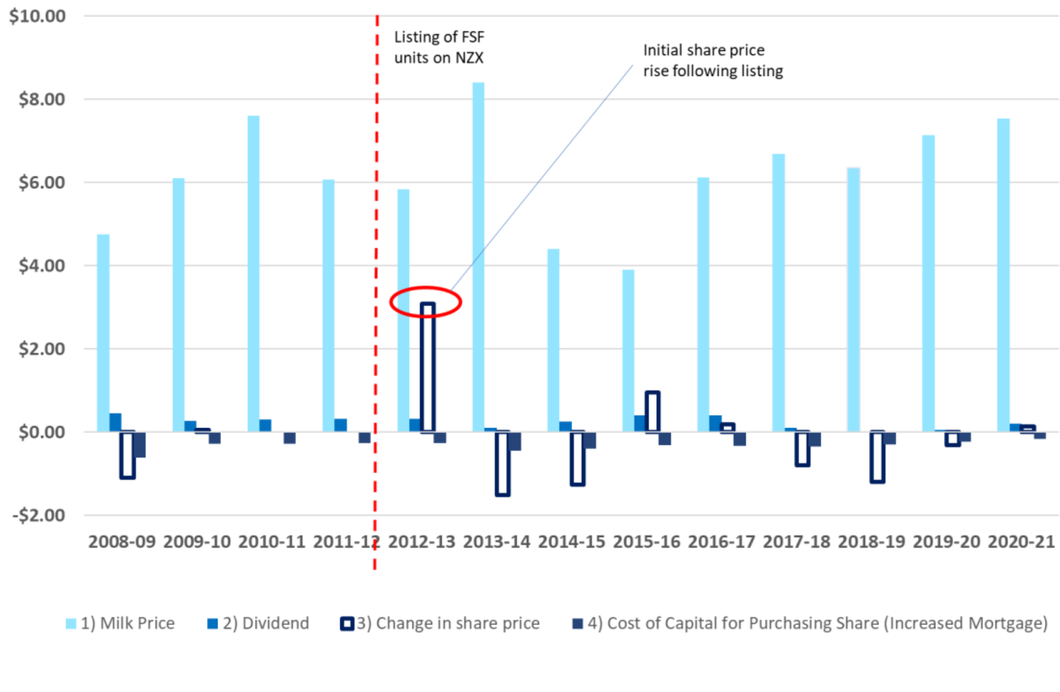
[22] - David Carter (3 April 2012) DIRA Amendment bill first reading (emphasis added)

[23] For example in the judicial review proceedings Open Country Dairy Limited v Commerce Commission, CIV-2018-485-957

Figure 4.2: Components of returns to Fonterra farmers



Sources: Fonterra, NZX

5 Conclusion on impact of Restructure

The Restructure is a wealth transfer from current dairy farmers to Fonterra. It will reduce the efficiency of the dairy sector overall by boosting the milk price payment, and therefore land prices at the expense of the share price. The Restructure could potentially change Fonterra's approach and underlying incentives in setting the farmgate milk price.

5.1 Restructure transfers wealth from current farmers in exchange for power to grow market share

Fonterra shares will collapse by about 40 percent because of the Restructure. The analysis above shows how Fonterra shares are likely to collapse in value due to restricted liquidity, a major imbalance between sellers and buyers, capital constraints on farmer-buyers and Fonterra's historical poor financial performance. As set out in section 3 above, the share price will tend towards the value of the discounted dividend cashflows.

This is a transfer of wealth from current shareholders so that Fonterra can defend its supply, and move to grow supply by winning farmers off other processors. With the cost of entry to Fonterra significantly lower, Fonterra is in a better position to attract supply.

5.2 Restructure will drive a higher milk price at expense of dividend

The Restructure changes the incentives around setting the milk price. Farmers will prefer that Fonterra's earnings are passed on to them via a higher milk price, rather than a higher dividend.

We think it is unlikely that farmers will try to influence the dividend policy set by the board and management to provide higher dividends. Fonterra's dividend forecasts are already optimistic about the performance of the business, and return on capital to shareholders. The dividend is unlikely to track much higher than the current forecasts. Regardless of the level of the dividend, the shares will always suffer a liquidity discount, and pricing will be influenced by farmers' access to spare capital.

The more likely outcome is that farmer-shareholders advocate for a higher milk price payment. Since the share price will be severely curtailed for the abovementioned reasons, the shares are likely to revert to their status prior to TAF, and settle at a value akin to a nominal price. It now much easier for Fonterra to set a higher milk price because there is no discipline from TAF and the FSF on Fonterra's board to achieve a return on capital for farmers.

To summarise, farmers and therefore Fonterra will have many reasons to favour payment of a higher milk price, at the expense of the dividend:

- A higher milk price payment capitalises into the price of dairy land
- Land price gains are tax-free, whereas dividends are taxed. A change in land price due to an increase in revenue from milk revenues would be an untaxed gain. The net result is a reduction in overall efficiency of the dairy sector with capital flowing to land, rather than innovations in processing plant and R&D
- The milk price is cash paid with greater certainty, and regularity than the annual dividend
- The external investor monitoring of Fonterra due to the listed FSF units will reduce, thus reducing the external pressure on dividend policy
- A higher milk price attracts new supply to Fonterra, whereas a higher dividend would increase the cost to join
- A higher milk price weakens Fonterra's domestic competitors, making it easier for Fonterra to compete on global markets for customers.

6 Policy change is required

The Restructure will have major detrimental effects, meaning policy change is required. Other government agencies have pointed out the issues, so change can be built on a sound foundation of analysis.

Competition will be harmed

The Restructure has a major impact on competition between dairy processors. The fall in Fonterra's share price has significantly reduced the cost of entry for a farmer, and our analysis suggests the share price will fall even further. This obviously makes it much easier for Fonterra to win supply off other processors.

Fonterra's board and management also have renewed and more powerful incentives to increase the farmgate milk price. It is also easier to increase the milk price at the expense of dividend payments. This attracts farmers away from competitors and makes it much harder for competitors to sustain their business and processing assets.

Change was already needed to the DIRA entry and exit regime, as well as the milk price monitoring regime.

Productivity Commission recommends repeal of DIRA open entry, and is aligned with MPI officials

The 2020 amendment to DIRA removed the right of open entry to Fonterra by farmers that had left. This was a punitive measure to deter farmers leaving Fonterra by preventing re-entry on similar terms. The Productivity Commission concluded that this change was detrimental to competition, would deter new entry, and negatively affect innovation in the dairy sector. Fonterra's power to deter farmers from leaving was increased. It recommended that the government should assess the July 2020 amendment and consider amending it.

Ministry for Primary Industries officials' advice[24] to the Primary Production Select Committee at the time of the 2020 DIRA amendment also did not align with the changes that the Select Committee eventually inserted into the amendment, and which were ultimately passed.

Milk price monitoring regime is flawed and Restructure compounds flaws

The milk price monitoring regime under DIRA is flawed. Over the past eight years, Fonterra has consistently used its discretion under the regime to bias the farmgate milk price to inefficient levels in a non-transparent way. It has taken many years for the cost of capital component in the milk price manual to be changed—ultimately requiring a law change. Fonterra has consistently used a growing share of non-transparent off-Global Dairy Trade sales prices to set the prices of the reference commodity products that feed into the milk price calculation. A range of other inputs to the calculation have been biased towards an inefficient milk price.

The Commerce Commission administers the milk price monitoring regime, and has lacked the legislative tools to properly demand a robust calculation informed by the right mix of accurate data.

The Restructure will compound these failings. It establishes an even greater structural bias toward an inefficient milk price. Therefore, Open Country should seek to change the milk price monitoring regime when changes to DIRA are proposed to give effect to the Restructure. One option is:

- An independent milk price setting body:
  - Separate from Fonterra
  - Receives contestable information and submissions from independent processors and Fonterra

[24] Ministry for Primary Industries Departmental Report on Dairy Industry Restructuring Amendment Bill 2020, available at: https://www.parliament.nz/resource/en-NZ/52SCPP_ADV_91054_PP3326/172110f0f102fc29687b4294748c49dc5283b186

- Guided by the established base assumptions (for example, cost of capital asset beta) already agreed since the current milk price regime began.

Domestic milk product prices will rise

In recent media statements, the Minister for Primary Industries said that domestic dairy product prices will be examined in the context of changes to DIRA required by the Restructure.[25] The focus on domestic consumer prices is important, given the likely impact of the Restructure.

The Restructure will push up the farmgate milk price, with flow-on effects for milk products (cheese, yoghurt, pasteurised milk) produced for the domestic market. Fonterra dominates the domestic milk market and is regulated under the Raw Milk Regulations to provide raw milk to domestic processors at the farmgate milk price. The Restructure's effects will be unavoidable. There are no workable solutions that could keep domestic milk products at lower prices than international commodities without serious flaws and unintended consequences.

The only way to prevent domestic milk prices from rising would be to not proceed, and implement a more transparent and independent length milk price setting regime as proposed in this report.

[25] See: https://www.nzherald.co.nz/business/retail-dairy-prices-could-get-a-lookover-in-fonterras-capital-restructure-talks-with-govt/YYEFC2T53FYGP3OZZTYCFGJPHE/

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