

Rural Economic Note

Fonterra Milk Price Forecast Update

3 December 2021

History doesn't always repeat

Fonterra updates its forecast milk price midpoint to \$8.70 per kgMS

Fonterra has updated its 2021/22 forecast farmgate milk price range, taking the midpoint to a record high. The co-op has lifted the upper end of the range by just 10c to \$9.00 per kgMS, but made a whopping 50c lift at the bottom end to \$8.40.

	2021/22	
	ASB	Fonterra
Milk Price*	\$8.75	\$8.40- \$9.00

* per kg of milk solids (excluding dividend).

Lifting the bottom end of the range is a no-brainer. The co-op's previous one dollar range was looking a little wide at this stage in the season, and at the prices product had already been sold for. Furthermore, when taking into account the likely extent to which the co-op has hedged its FX exposures, it would have taken a massive correction in prices to deliver a figure in the bottom end of the forecast range. The decision to only nudge up the top end of the forecast by 10c is a little more curious, considering bullish futures market pricing is already pointing to a price north of that figure. **We're confident the farmgate price will wind up at or above the midpoint of Fonterra's latest forecast range.**

The fact that Fonterra is lifting the range suggests farmers are unlikely to see a repeat of the 2013/14 season – the previous record season – where the Fonterra board shaved 55c off the Milk Price Manual output because it was pointing to a higher farmgate price than the co-op could actually pay. The manual pointed to a circa \$8.95 per kgMS price, but farmers wound up with a milk price of \$8.40 per kgMS. **This short note explains why a repeat is unlikely.**

A bit of background

When calculating the farmgate milk price, Fonterra's milk price manual divides its products into two categories: **Reference Commodity Products** and **Non-Reference Commodity Products** or RCPs and non-RCPs. The former consists of whole milk powder, skim milk powder, butter milk powder, anhydrous milk fat and butter. The latter category includes cheese, casein and value-added products (think infant formula and those fancy protein powders). For the purposes of calculating the milk price, the manual assumes all of Fonterra's production goes into RCPs.

There are some good reasons for excluding the non-RCPs. Value-added products derive a premium from branding or product features Fonterra has invested in building, so that premium should be reflected in Fonterra's profit rather than what it pays to farmers. Still, their exclusion from the calculation can have some significant implications.

What happened during the 2013/14 season?

In the run up to the 2013/14 season, concerns surfaced about a shortage of milk powder following insufficient domestic milk production and a handful of other shocks (like one of China's biggest milk producers having to recall six

months' worth of production for food safety reasons). Consequently, Beijing encouraged domestic processors to build up stocks of WMP, keeping the supply of staples like infant formula on the shelves.

As a result, WMP and SMP prices went crazy. It's those supply anxieties that saw auction buyers shift their expectations and futures prices rally sharply over spring. In March 2013, WMP prices lifted 18.0% in a single auction, and then another 20.8% at the very next one (SMP prices made even larger gains versus their long-term average). Ongoing supply concerns remained a concern, and for the next twelve months, WMP prices hovered 50-60% above their long-term average.

Non-RCPs didn't move up nearly as much. It's difficult to get good data on how non-RCPs (by definition these value-added goods aren't generic commodities trading on commodities exchanges), but Fonterra's commentary through the season was explicit in noting the unprecedented gap between the prices of RCPs and the non-RCPs.

Cheese – one large non-RCP where we do have good price data because it trades on the GDT platform – is a good example of this. While the WMP price index were trading as much as 15% above the weighted GDT index, the cheese price index was trading 22% lower. Butter and fat process similarly underperformed WMP and SMP's gains. In short, non-RCPs were no longer earning their typical premium over WMP and the like.

In a perfect world, Fonterra would have responded to this dynamic by shifting production away from non-RCPs like cheese and going gangbusters on powders. **But the co-op had capacity pressures that meant it couldn't increase the production of powders during the peak season, when the gap between RCP and non-RCP prices was at its highest.** At the time, something like 55-60% of production capacity was dedicated to producing WMP and other RCPs.

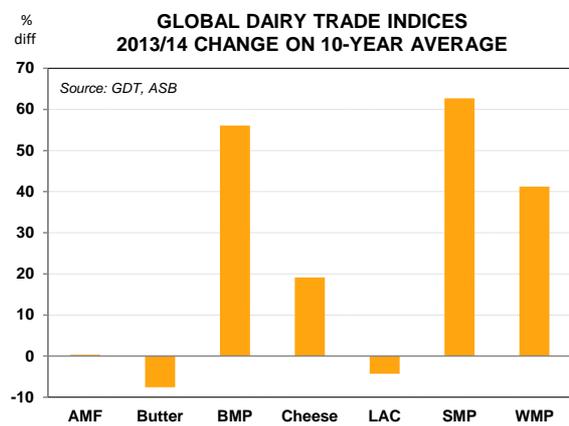
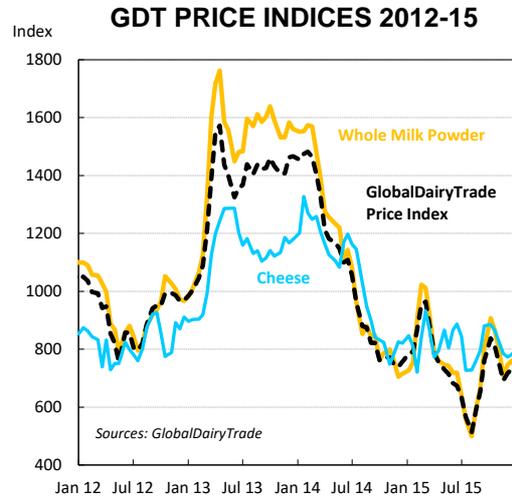
In short, Fonterra was forced to produce more of the lower-earning non-RCPs and not enough of the higher-earning RCPs (particularly WMP). Because the milk price manual assumes all of Fonterra's production goes into RCPs, it was implying a higher figure – circa \$8.95 per kgMS – than Fonterra could actually pay without incurring a big loss.

The upshot saw the Fonterra Board decide to overrule the milk price manual output. As was legally required, Fonterra published a '[Reasons Paper](#)' in support of its decision. In the co-op's view, making such a big loss over the FY would put it at "serious risk of loss of confidence of its stakeholders." Accordingly, it shaved 55c off the forecast and paid a price of \$8.40 per kgMS – still a record high.

Why we don't expect a repeat:

WMP prices surged in March, but not by as much as they did eight years ago, and not for as long. WMP prices did undergo a large 21% auction-on-auction lift at the start of March and remain about 25-30% above long-run averages, but that's still less dramatic lift than what we saw in 2013/2014. WMP's gains also aren't dissimilar to where other products are relative to long-run averages. That tells us that the rally in dairy prices this time around is broader based, rather than a distortionary boost to a single product.

Non-RCPs have also been overperforming and not under-performing this time around. It's still tough to get good non-RCP price data, but Fonterra's comments have been bullish on the outlook for its food service business. Cheese

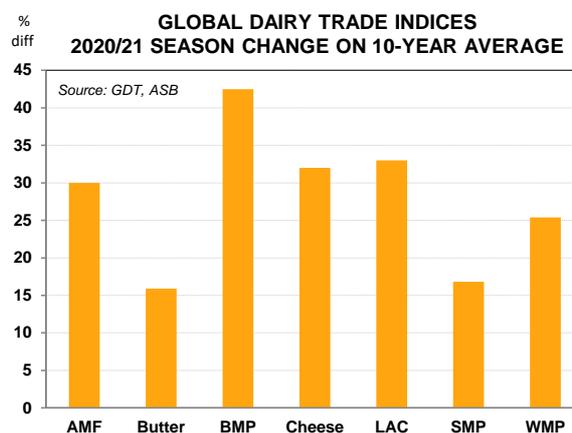
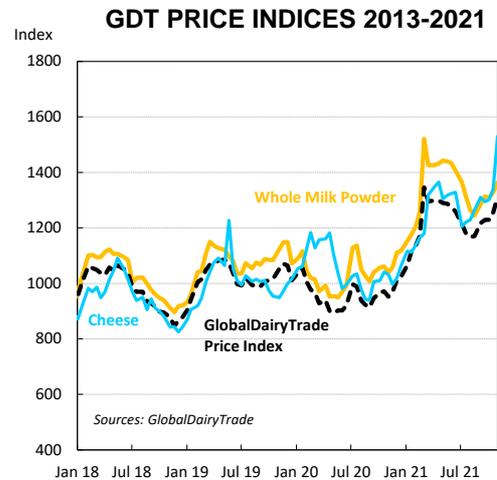


prices are actually posting the strongest gains vs. their long-run average of any commodity on the GDT platform. In short, buyers are willing to pay a premium for value-added dairy products, and these products are actually earning a higher premium than WMP.

These days, we also suspect Fonterra is also less capacity constrained and better placed to flex production between its RCP and non-RCP streams than it was seven years ago, thanks to all the capex its undertaken in the interim.

We don't see this dynamic changing. This season's strength isn't being underpinned by a shortage of a single product in a single (albeit extremely large) market. Global production as a whole is looking softer, and demand has strengthened pretty much everywhere as the global economy has recovered and consumption has lifted. One of the big themes of this season has been an increase in buying from South East Asia and the Middle East, rather than just China.

The high price will still impact margins in Fonterra's consumer business. The co-op has revised down its earnings guidance from 25-40c per share to 25-35c. So there's a little given-and-take, but its likely to be more modest than a whopping deduction from the milk price.



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