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Attention Vanessa Turner

Manager Market Assessment & Dairy

Commerce Commission
Level 13, 55 Shortland Street
AUCKLAND

Submission on Fonterra's milk price manual for the 2016/17 season

1. Synlait Milk Limited appreciates the opportunity to provide its views on amendments to Fonterra's Milk Price Manual for the 2016/17 season (**Milk Price Manual**).
2. In this submission we comment on the substantive changes Fonterra has proposed in the Reasons Paper dated 1 August 2016. Synlait's comments are below and follow the headings in Fonterra's Reasons Paper.
3. Synlait reiterates its concern (most recently outlined in its submission dated 1 September 2016) that the Commerce Commission's oversight is not achieving the objectives in the Dairy Industry Restructuring Act (DIRA). Fonterra's latest Milk Price Manual is a further example of this. The changes enhance Fonterra's discretion and will introduce changes which reduce practical feasibility, harm contestability and as a result fail to satisfy DIRA.

Amendments to "consistency over time" provision

4. Synlait supports this change because it supports transparency in the regulatory process used to set the milk price.

Repairs and maintenance costs

5. Fonterra intends to distinguish between "repairs and maintenance costs" and "maintenance department costs". This change has the potential to introduce further transparency in how certain costs are calculated. However, it is not clear whether in practice it will, given the important question is how Fonterra defines "maintenance department costs" as opposed to repairs and maintenance costs more broadly.



6. The Commission's previous comments that Fonterra's approach remained largely discretionary are still valid, and without a clear and transparent definition of the relative cost categories, Fonterra's intended change is not an improvement. Synlait does not believe it is acceptable that Fonterra's approach to these costs remains unclear despite the Commerce Commission's concern.

Capacity of standard plants

7. Synlait is concerned with the change Fonterra has proposed both in substance and in the discretion it will give Fonterra.
8. The capacity of the notional processor's plants is an important determinant of practical feasibility since it flows through to the capital costs the notional processor bears and the practical feasibility of processing all milk. It is essential that this component be set transparently and in a way that complies with the requirement of practical feasibility.
9. Fonterra is proposing to introduce a new methodology for setting the processing capacity for secondary Reference Commodity Products (**RCPs**) (butter, AMF and BMP). We do not have clarity on how this processing capacity was set in the past, however Synlait understood that such capacity approximated that of Fonterra's then current plants. This is the approach taken to date in the Milk Price Manual to setting the processing capacity of plants required to manufacture primary RCPs.
10. We support the approach of using Fonterra's average daily processing capacity to set the notional processor's processing capacity since the notional processor's milk volume is that of Fonterra. So long as this is implemented correctly, this approach should support practical feasibility.
11. However, Fonterra instead intends to use the average daily processing capacity of plants "*currently available from equipment suppliers*" for processing secondary RCPs. Since equipment suppliers can build plant with a wide range of processing capacity, we cannot see how this approach would work. The lack of a credible link between the processing capacity and volume of milk collected poses risks to practical feasibility since the notional processor might not have enough processing capacity to process the milk it collects. This would be detrimental to practical feasibility since the notional processor would be incurring insufficient capital costs to process the volume of milk it collects into secondary RCPs.
12. Beyond Fonterra's change failing to satisfy practical feasibility, Synlait is very concerned that Fonterra's proposed wording is unacceptably open. Fonterra would have significant discretion because of the use of the words "*erring toward*". Such wording is inappropriately uncertain in a regulatory document.
13. In Synlait's view there is no reason why the number, type and capacity of the notional processor's processing assets cannot simply be listed in a schedule to the Milk Price Manual. This is consistent with transparency and increasing confidence in the regulatory process set out in DIRA.



Definition of Qualifying Reference Sales

14. Fonterra's proposal to include sales of WMP, SMP and AMF Fonterra makes off-GDT is the most important and concerning change to the Milk Price Manual for 2016/17. Fonterra has announced that this change will increase the milk price by 4 to 5 cents. This is clearly an important issue and Synlait has two primary concerns:
- (a) this represents a change in the nature of the products the notional producer sells, in a way that was not envisaged by DIRA;
 - (b) the selection of off-GDT Qualifying Reference Sales grants Fonterra significant discretion and enables the milk price to be manipulated to Fonterra's advantage.
- (a) change in the nature of the products the notional producer sells*
15. Fonterra says that it has become clear that its sales undertaken off GDT are "almost invariably" at higher prices than on GDT sales. Synlait has not had the opportunity to scrutinise the information that Fonterra says supports this proposition.
16. The Commission has previously noted that the Fonterra global ingredients and global operations (**GOGI**) off-GDT sales are generally:
- (a) long-term contracts for more than five months;
 - (b) aimed at security of supply; and
 - (c) often are for products with non-standard specifications.¹
17. Off-GDT sales having the first two characteristics are very different kinds of products to simply selling the RCPs at the market price on the day. This is likely the main driver behind why prices on-GDT and off-GDT have been observed to differ, and which demonstrates the difference between the products. The third characteristic relates to products never intended to be traded through the GDT mechanism, and could relate to sales of products with huge margin variances depending on their specifications which are irrelevant for the purposes of DIRA.
18. Including these off-GDT sales in the notional processor's revenues changes what the notional processor is assumed to sell in a way that does not seem to have been intended by DIRA.
19. Further, a business selling these longer-term products has different business characteristics, including capital requirements, that would need to be acknowledged in the Milk Price Manual.

¹ Commerce Commission addendum to draft report: review of Fonterra's 2015/16 base milk price calculation, footnote 1.



20. Fonterra's reasons paper says that sales with higher "value-add" elements, being physical attributes or additional services, will continue to be excluded. Products with non-standard specifications should simply never be included as Qualifying Reference Sales. They are not Reference Commodity Products.

(b) selection of off-GDT Qualifying Reference Sales grants Fonterra significant discretion and enables the milk price to be manipulated to Fonterra's advantage

21. Under this change, Fonterra will determine what sales satisfy the requirement of being "Qualifying Reference Sales", in particular whether *"the sale can be reasonably regarded as being on arms-length terms at a price that reflects prevailing prices that could be achieved by the farm gate milk price commodity business at the time the contract for the sale was entered into."*
22. Fonterra will also be able to include Qualifying Outlier Sales of WMP, SMP and AMF, which to date has not been the case. Qualifying Outlier do not have to reflect prevailing prices and are at higher prices than on-GDT sales. In practice, this enlarges Fonterra's discretion to include or exclude sales which results from this change.
23. Fonterra correctly acknowledges that the change may cause concerns about transparency in the calculation of the milk price. Fonterra proposes to publish information about the difference between prices used and the GDT *"reference price"*. However, this does not address Synlait's concern about transparency, which is that Fonterra will have a large discretion to decide what sales to include, and what to exclude, from the Qualifying Reference Sales, and that this discretion will be insufficiently controlled or scrutinised, leaving room for Fonterra to manipulate the milk price to its advantage.
24. Synlait has previously made the point that there is no reason why the milk price methodology should not be published in full (see submissions of 1 September 2015 and 1 August 2016).
25. As it stands, there is legitimate concern that Fonterra's decisions affecting the milk price are not subject to appropriate scrutiny and can be manipulated to Fonterra's advantage. This change heightens that concern.

Winter milk premiums

26. Fonterra's approach to winter milk premiums is unacceptable. DIRA allows Fonterra to assume that the notional processor's volume of milk collected is the same as Fonterra's. This means the notional producer gets the "volume benefit" of winter milk, which spreads fixed costs over more units, lowering cost and therefore increasing the milk price. However, because the associated cost of paying winter milk premiums are excluded, the notional processor is effectively getting "free milk".
27. We cannot accept the rationale that, because the notional processor would not pay winter milk premiums, that such costs should not be included in the Milk Price Manual.
28. In Synlait's view, there are two options:
 - (a) Remove the volume of winter milk collected from revenues; or



- (b) Assume that the notional processor pays for winter milk as an additional cost.
29. Any approach other than these two cannot satisfy practical feasibility. As the first option is not allowed by DIRA, the second is the only one that can work and satisfies practical feasibility. Winter milk premiums must be included as a cost of the notional processor. Fonterra has failed to engage with this point and has not provided a credible reason for this.
30. In summary, Synlait's position is that Fonterra's approach to four of the five matters outlined in its Reasons Paper do not meet the requirements of DIRA, and we expect that the Commerce Commission will address the matters raised in this letter in its draft report.

Yours faithfully

Quentin Lowcay
General Counsel & Commercial Manager

