



Dairy for life

'Reasons' Paper in support of Fonterra's Milk Price Manual for the 2016/17 Season

1 August 2016

Glossary

DIRA	Dairy Industry Restructuring Act 2001.
F15 Base Milk Price Report	Commerce Commission, Review of Fonterra's 2014/15 base milk price calculation, 15 September 2015, http://comcom.govt.nz/regulated-industries/dairy-industry/review-of-fonterra-s-farm-gate-milk-price-and-manual/statutory-review-of-milk-price-manual/201415-season/
F15 Final Manual Report	Commerce Commission, Final Report on the Review of Fonterra's 2014/15 Milk Price Manual, 15 December 2014, http://comcom.govt.nz/regulated-industries/dairy-industry/review-of-fonterra-s-farm-gate-milk-price-and-manual/statutory-review-of-milk-price-manual/201415-season/
F16 Final Manual Report	Commerce Commission, Final Report on the Review of Fonterra's 2015/16 Milk Price Manual, 15 December 2015, http://comcom.govt.nz/regulated-industries/dairy-industry/review-of-fonterra-s-farm-gate-milk-price-and-manual/statutory-review-of-milk-price-manual/201516-season/
F16 Submission	Fonterra, Submission to the Commerce Commission on its Draft Report on Fonterra's 2015/16 Farmgate Milk Price Manual, 15 November 2015, http://comcom.govt.nz/regulated-industries/dairy-industry/review-of-fonterra-s-farm-gate-milk-price-and-manual/statutory-review-of-milk-price-manual/201516-season/
F16 Base Milk Price Reasons Paper	Fonterra, 'Reasons' Paper in support of Fonterra's base milk price for the 2015/16 Season, 1 July 2016, http://www.comcom.govt.nz/regulated-industries/dairy-industry/review-of-fonterra-s-farm-gate-milk-price-and-manual/statutory-review-of-milk-price-calculation-2/review-of-milk-price-calculation-201516-season/
MPG	The Milk Price Group, the independent unit responsible for determining and recommending to the Milk Price Panel the Farmgate Milk Price.
NMPB	Notional Milk Price Business, comprising the notional milk powder manufacturing business implied by Fonterra's Farmgate Milk Price Manual.
R&M	Repairs and maintenance.
RCP	Reference commodity product, comprising WMP, SMP, BMP, Butter and AMF.
F17 Season	The period commencing on 1 June 2016 and ending on 31 May 2017.

1 August 2016

To: The Commerce Commission

1. Fonterra Co-operative Group Limited (“Fonterra”), certifies that in terms of section 150L(d) of the Dairy Industry Restructuring Act 2001 (“Act”), Fonterra considers that its milk price manual to be applied in calculating Fonterra’s Farmgate milk price for the 2016/17 financial year is, in all material respects, consistent with the purpose of subpart 5A of the Act.
2. The above certification is based on our interpretation of subpart 5A, and the other relevant assumptions, views and qualifications set out in the accompanying reasons provided pursuant to s 150L(e).
3. Fonterra further certifies that:
 - a. the Milk Price Panel has recommended to the Fonterra Board of Directors the changes to the milk price manual described in this paper; and
 - b. the Fonterra Board of Directors has approved these changes.



Signed by

Andrew Cordner
Group General Counsel

1 Introduction

This paper provides the reasons in support of Fonterra's certification in respect of the Milk Price Manual to be applied in the calculation of Fonterra's Farmgate milk price in respect of Fonterra's 2016/17 financial year and the corresponding Season (the F17 Manual), as required under section 150L of the Dairy Industry Restructuring Act 2001 (DIRA). The paper has been prepared under the oversight of the Milk Price Panel, and where relevant reflects the Panel's views.

Section 150L provides that Fonterra must:

- Provide the Commission with the milk price manual for the current season (i.e., the season corresponding to Fonterra's 2016/17 financial year) (section 150L(a));
- Provide the Commission with any recommendations by the Milk Price Panel "in relation to the setting of the base milk price"(section 150L(b));¹
- Notify the Commission of any change in the economic and business environment that, in Fonterra's view, requires a change to the milk price manual (section 150L(c));
- Certify to the Commission the extent to which Fonterra considers that the milk price manual is consistent with the purpose of subpart 5A of DIRA (section 150L(d)); and
- Provide the Commission with reasons for the view expressed in its certificate (section 150L(e)).

In addition, section 150G sets out the steps that Fonterra is required to take if it does not amend the Manual in accordance with a recommendation by the Panel, if it amends the Manual contrary to a recommendation by the Panel, or if it amends the Manual without having received a relevant recommendation from the Panel. We advise that none of these circumstances has occurred with respect to the F17 Manual.

The Fonterra Board of Directors has approved a number of amendments to the Milk Price Manual. All of these amendments were recommended by the Milk Price Panel. These amendments are set out in 'mark up' form in the Milk Price Manual attached to this paper and, where relevant, we explain their rationale below. In all other respects, the F17 Manual is identical to the Manual applied by Fonterra in respect of the 2015/16 season (the F16 Manual), and in respect of which Fonterra submitted a certification and reasons paper on 1 August 2015. Consistent with that paper, we have confined our comments in this paper to areas where our views have changed subsequent to preparing previous reasons papers, or where we wish to provide additional information. In all other respects, we request that this paper be read in conjunction with our reasons papers submitted in respect of the 2012 – 2016 seasons.

We have also recently provided (in our 'reasons paper' in respect of the 2015/16 base milk price) the Commission with our views on the appropriate interpretation of section 150A of DIRA (the purpose provision), and have not repeated these views in this paper.

The paper is intended to satisfy the section 150L(e) requirement to provide the Commission with the reasons for the view expressed in item 1 of our certificate on page 3 of this paper. The paper is organised as follows:

- In section 2, we set out, and explain the rationale for, the substantive amendments to the F17 Manual, and comment on the consistency of these amendments with section 150A.
- In section 3, we address one 'other matter', comprising the treatment in the base milk price calculation and the Manual of winter milk premiums.

¹ As in our previous 'reasons papers' we have interpreted this provision as in fact relating to recommendations by the Milk Price Panel in relation to amendments to the Milk Price Manual. The relevant paper to Fonterra's board is attached as Attachment 1.

- In section 4, we summarise changes in the economic and business environment that are potentially of relevance to the calculation of the base milk price, and explain why we have not amended the Manual in response to these changes for the 2016/17 year.

The attachments to this paper comprise:

- Attachment 1 – a schedule of amendments of a minor technical or drafting nature.
- Attachment 2 – a ‘marked up’ version of the Milk Price Manual, identifying all amendments, and which satisfies the section 150L(1) requirement to provide the Commission with the manual for the current season. Brief comments on the rationale for each amendment are also included in this attachment.

2 Amendments to the Manual for the F17 Season

We address in this section the four more substantive amendments to the Manual for 2016/17, including comments on the rationale for each amendment, addressing where relevant matters previously raised by the Commission and the consistency of the amended provisions with section 150A of DIRA.

Amendments to ‘consistency over time’ provision

We have further amended section 2.6 of Part A (Consistency over time) of the Manual, which was included in the Manual for F15 and was the subject of minor amendments in F16, as follows:

Although not a Principle, Fonterra recognises that consistency of application of the Manual across years is important. Consequently, it is intended that:

- Other than in exceptional circumstances, the Milk Price, and inputs into its calculation, will evolve in a manner that could be achieved by a ‘real world’ dairy processor that is operated in a manner that satisfies the requirements of Principle 2.
- Where more than one approach to applying a rule is available, Fonterra will disclose any change in approach that results in a materially different value of an input used to calculate the Farmgate Milk Price, and provide an explanation of the rationale for the change, in the Farmgate Milk Price Statement and in the ‘reasons paper’ provided to the Commerce Commission under section 150T(C) of the Dairy Industry Restructuring Act 2001. **Where such a change in approach has been determined prior to the finalisation of the Farmgate Milk Price Statement for the Season preceding the Season in which the change is first applied, Fonterra will disclose the change and provide an explanation of its rationale in the Statement for that preceding Season.**

This amendment was prompted by the Commission’s recommendation that we “consider codifying in the Manual a disclosure requirement for [Fonterra] to publicly explain the rationale and consequences of any material change to the reference basket in advance.”² The amendment encompasses the Commission’s recommendation (so long as a change to the reference basket has been agreed to prior to mid-September in the relevant season – we cannot conceive of any circumstance where this would not be the case),³ and provides a broader commitment to disclose the impact of, and rationale for, other material changes to the Milk Price methodology for a season.

Repairs and maintenance costs

In its comments in the F16 Final Manual Report on the amendments to the rule governing the calculation of repairs and maintenance (R&M) costs for F15,⁴ the Commission noted that it considered the amendments we had made to Rule 14, R&M costs, for 2015/16 were an improvement, but that the determination of the fixed cost component of R&M costs remained largely discretionary.

In response to these comments, we have amended the R&M rule to provide that a provision for maintenance department costs, rather than a more general provision for “costs that are largely fixed in nature ...”, will be calculated separately from other R&M costs.

The amended rule is consistent with the approach that has been taken to calculating the provision for R&M costs in the 2015/16 Farmgate Milk Price, and which will be applied in 2016/17.

Capacity of standard plants

For the 2015/16 season, we amended the provision relating to standard plant capacity to distinguish between plants for the manufacture of ‘primary’ RCPs (WMP and SMP, making up around 88 percent of plant replacement costs) and ‘secondary’ RCPs (Butter, AMF and BMP). In its F16 Draft Manual Report, the Commission noted that the amended

² F16 Manual Report, paragraph 93, page 25.

³ We also note in this context that under the Fonterra Shareholder Fund (FSF) rules, changes to the composition of the reference basket require the support of 75% of Fonterra’s independent directors. This provision was introduced in recognition of the significance to shareholders in Fonterra and unit holders in the FSF of changes in the reference basket, providing further comfort that it is highly unlikely Fonterra would introduce any change without announcing the change and its rationale in advance of its implementation.

⁴ Rule 14 in the F16 Manual.

provision did not state how the capacity of standard plants for secondary RCPs would be determined and recommended the Manual be amended to include an explicit statement of treatment of capacity for these products. We undertook in our response to the Commission's draft report to consider the Commission's recommendation in the course of reviewing the Manual for the 2016/17 season.⁵

The amended provision for 2016/17 provides that standard plants specified in a four-yearly 'review assessment year' for:

Secondary Reference Commodity Product should have an average daily processing capacity that is consistent with the capacity of plants currently available from equipment suppliers, and, where these fall in a range, erring toward the average capacity of the plants currently included in the Farmgate Milk Price Fixed Asset Base.

We note that we have recently obtained quotations for 'standard plants', for application in the Milk Price calculation from 2016/17, and that the standard plants for AMF, Butter and BMP have the same capacity as the plants currently included in the model.

The amendment does not, in our view, impinge in any way on the consistency of the Manual with the practical feasibility and efficiency criteria in s 150A.

Definition of Qualifying Reference Sales

We have amended the definition of Qualifying Reference Sales in Part C of the Manual as follows:

Qualifying Reference Sales	<p>For a Reference Commodity Product and a Shipment Month, a sale of a Qualifying Material in the month that is determined by the Milk Price Group to fall in any of the following categories:</p> <p>1. For F11, and for WMP, the product was sold on GDT.</p> <p>1. 2. From F12, for WMP, SMP and AMF, and for For any other product in respect of which the Board has determined under Rule 5 of Part B that it is appropriate to place sole reliance on Benchmark Selling Prices achieved on GDT, the product was sold on GDT.</p> <p>32. For any other Reference Commodity Product, if the sale satisfies the following criteria:</p> <ul style="list-style-type: none"> ▪ The product was sold on GDT; or ▪ The sale can reasonably be regarded as being on arm's length terms at a price that reflects prevailing prices that could be achieved by the Farmgate Milk Price Commodity Business at the time the contract for the sale is entered into; and ▪ The contract complies with the relevant Fonterra Risk Management Policy. <p>43. Any Qualifying Outlier Sales for the month.</p>
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The practical implication of this change is to align the approach used to determine prices for WMP, SMP and AMF to the approach currently used for Butter and BMP, by including sales undertaken off the GDT platform of similar specification product and sold on similar terms to GDT sales.

The primary reason for making this change is that it has become increasingly clear in recent years that GDT sets the 'base' price for sales of RCPs, with sales undertaken off GDT almost invariably being transacted at higher prices. We have separately made available to the Commission an extensive set of data that supports this assertion with respect to Fonterra's sales, and have also provided evidence that strongly suggests other NZ processors on average achieve prices for RCPs in excess of GDT prices for these RCPs.

It therefore follows that continuing to place sole reliance on GDT for WMP, SMP and AMF would imply that the revenue inputs into the Milk Price were not consistent with the requirement in Rule 8 of Part B, to the effect that sole reliance should be placed on GDT only where the Fonterra Board was satisfied that:

⁵ F16 Submission, page 7.

... the prices achieved on GDT can be considered to be materially representative of the prices Fonterra (and its competitors) should generally be able to achieve for Qualifying Materials traded on terms comparable to those typically provided by sellers of those products.

Further, and from Fonterra's perspective most importantly, it would also follow that continuing to place sole reliance on GDT would mean the Milk Price revenue inputs (and therefore the Farmgate Milk Price) were not consistent with the requirement in the Milk Price Principles (and Fonterra's constitution) which require that the Farmgate Milk Price should be the maximum amount that Fonterra, reflecting its status as a properly managed and efficiently run sustainable co-operative, could pay for the milk supplied to it in a season if Fonterra processed that milk into commodity products which were sold on freely contested global markets.

In considering the consistency of this amendment with the s 150A DIRA principles, we note:

- The Commission has previously observed that Fonterra has a stronger incentive to operate efficiently where notional inputs are used, but it will be reasonable to use actual data where there is insufficient information to know what an appropriate notional value would be. Revenue data series has always used an actual revenue series, given the volatility of global commodity prices. For the same reasons, there is insufficient information to provide a notional value for the additional sales of RCPs.
- Because we will be using a sample of prices actually achieved by Fonterra on the sale of RCPs on freely contested global markets, it follows that the revenue inputs will continue to be practically achievable for Fonterra or another efficient processor. These revenue inputs are also practically feasible in aggregate. This can be demonstrated by the prices achieved on the sales included in the Farmgate Milk Price calculation not being systematically higher than the prices achieved by Fonterra on sales that continue to be excluded from the calculation. We are comfortable that we will be in a position to demonstrate that this condition holds in the course of the review of the 2016/17 base milk price calculation, drawing both on analysis undertaken of sales over the past four years and on the fact that the sales that will continue to be excluded from the calculation typically have higher 'value add' elements, comprising either physical product attributes or additional services, for which Fonterra is able to achieve higher prices.
- While we will be extending the range of actual sales taken into account in the Farmgate Milk Price calculation, we will continue to exclude a material proportion of sales of RCPs and all sales of non-RCPs. As now, the price achieved on GDT will continue to be used as a benchmark against which to measure sales team performance with respect to off-GDT sales. Thus Fonterra will continue to be appropriately incentivised to operate efficiently.

We understand this change in approach will raise some concerns for the Commission and external stakeholders about a potential reduction in transparency. We note:

- Prices achieved on GDT will continue to be materially representative of the prices used in the Farmgate Milk Price calculation. For example, the average price that would have been used in the calculation between 2013 – 2016 under the new approach would have been within USD 20 per MT of the GDT prices actually used.
- We will publish each quarter the average year-to-date difference between the average prices used in the calculation and the relevant average GDT reference price, and will also publish this information in the annual Farmgate Milk Price Statement.

3 Other matters

We comment in this section on one matter – the treatment of winter milk premiums – where in its review of the 2015/16 Manual the Commission proposed we amend the Manual, and in respect of which we have not made any amendment.

Winter milk premiums

On page 29 of the F16 Final Manual Report the Commission explained that:

116. We consider that the treatment of winter milk is relevant to the practical feasibility of the Manual and that Fonterra should increase its level of transparency on the level of winter milk premiums included in the base milk price calculation. We recommend that the Manual includes a rule that covers winter milk premiums in the Manual so that it is clearly explained how Fonterra works out the notional costs for winter milk premiums and that these costs are included in the base milk price calculation.

117. We intend to look more closely at how winter milk premiums are calculated and presented during our review of the 2015/16 base milk price calculation.

We reiterate our position that the nature of Fonterra's constitutional arrangements, under which the Milk Price Panel is responsible for determining the total aggregate amount available to pay for milk, but not the allocation of that aggregate amount across individual supplies of milk, is such that it is not appropriate to include in the Manual a rule detailing the treatment of winter milk premiums.

We have, however, provided further explanation and information to the Commission on our treatment of winter milk premiums, which makes it clear that a portion of the winter milk premiums actually paid by Fonterra are in fact treated as if they were a cost, inasmuch as they result in a reduction in the average price paid for other milk. We will expand our explanation of this process and treatment in the Farmgate Milk Price Statement in support of the 2015/16 Farmgate Milk Price.

4 Changes in the economic and business environment

We confirm we are not aware of any changes in the economic or business environment that would in our view necessitate a change to the Milk Price Manual for the F17 Season. In arriving at this view, we have had regard to the following:

- None of the amendments to the Milk Price Manual set out in the attachments to this paper were prompted by changes in the economic or business environment.
- As a general matter, our view is that changes in the economic or business environment will in most circumstances not necessitate changes to the Manual, though they may result in changes in the approach taken to applying existing provisions of the Manual. Among other things, the existing provisions of the Manual could accommodate the changes in approach required to reflect the impact of changes in relative demand for (and profitability of) different product streams that affect industry-wide patterns of new investment, or of assets becoming 'stranded' due to a significant reduction in milk supply.

Attachment 1 – Schedule of minor amendments

The table below summarises the amendments of a minor technical or drafting nature which have not been addressed in the body of the paper.

Reference	Amendment	Comment
p.19	Change to explanation around use of GDT-only prices.	Aligns explanation to (a) 2015/16 changes to Rule 5 and (b) current year amendments to definition of Qualifying Reference Sales.
p.30	Minor drafting tidy-ups.	Drafting only.
p.34, Rule 3	Insertion of 'Farmgate' before 'Milk Price'.	Drafting only.
p.36, Rule 8	Reference to 'Qualifying Reference Sales' amended to provide that it refers only to paragraphs (2) and (3) of the definition of Qualifying Reference Sales.	Technical amendment to correct a drafting error. No practical effect.
p.43, Rule 16	Provision relating to calculation of the lactose price revised to explicitly reflect approach applied in practice.	Intended to improve transparency of the Manual.
p.43, Rule 17	Rule relating to Sales Costs amended to provide that the mix of sales channels considered when setting sales costs is to be consistent with the mix of channels included in the revenue calculation.	Previous language emphasised the maximisation of sales through GDT, which is not necessarily consistent with the mix of sales included in the revenue calculation.
p.44, Rule 18	Removal of the requirement that "the continuing reasonableness" of the provisions for overhead costs be assessed each year by the MPG.	Requirement to undertake an annual review, whether or not there is any indication one might be required, potentially diverts MPG resources from other higher priority projects. Appropriate that the need for any review goes through the same prioritisation process as other projects.
p.84	Definition of GDT amended to provide that references to GDT apply only to the twice-monthly GDT Events.	Required to maintain the status quo treatment of GDT sales in the Milk Price following the introduction of the GDT Marketplace platform.
p.87	Definition of 'Review Year' amended to provide that next scheduled review of asset beta and specific risk premium will be undertaken for the 2020/21 Season.	Absent this amendment next review would have been required for the current 2016/17 Season, which is not necessary given the recent report from Dr Marsden. (Amendment does not preclude a review being undertaken earlier if required or desirable.)