Milk Price Calculation Review Workshop Discussion Paper: Practical Feasibility, Transparency, Asset Beta, and Off-GDT Sales

15 May 2017

1 Introduction

The Commerce Commission (Commission) is holding a workshop on the following topics for their review of Fonterra's 2016/17 base milk price calculation:

- Practical feasibility
- Transparency
- The asset beta of the notional producer
- Possible amendment to the milk price calculation to include off-GlobalDairyTrade (GDT) sales

Synlait, Miraka, and Open Country Dairy are pleased to submit this discussion paper, which summarises the evolution of the debate around these four issues, distils the outstanding concerns, and **proposes a set of questions that the workshop should address** to ensure the milk price calculation review is effective.

2 Practical Feasibility

Section 150A of the Dairy Industry Restructuring Act (DIRA) promotes setting a base milk price that incentives Fonterra to operate *efficiently*, while providing for market *contestability* by being 'practically feasible'. To do this, the base milk price calculation is based on a 'notional processor'.

It has proven difficult to achieve consensus on what 'practically feasible' means in the context of DIRA. This creates ongoing issues for the Commission's assessment of Fonterra's base milk price because it exacerbates disagreement across multiple model assumptions, such as which asset beta to use in the capital cost calculations or which sales to include.

Independent processors interpret practically feasible as meaning that the cost structure, the risk profile, and other commercial assumptions about the notional processor should reflect the real-world costs and risks of an efficient market participant (recognising that DIRA assumes a hypothetical participant able to match Fonterra's operating scale). Broadening the common ground among the Commission, Fonterra and independent processors as to the meaning of 'practically feasible' is critical to move DIRA's milk price monitoring functions into a less contentious, more business-as-usual phase.

The Commission, Fonterra and independent processors seem to agree that any reasonable interpretation of practically feasible must incorporate **technical feasibility**. By this, we mean that the notional processor model must make technical assumptions that are practically feasible on an operational level. For example, the notional processor model must determine a realistic, feasible operating capacity for the notional producer's factories. Given this broad agreement at the conceptual level, the focus of the technical feasibility conversation ought to focus on working through the detail of specific issues to reach a shared view.

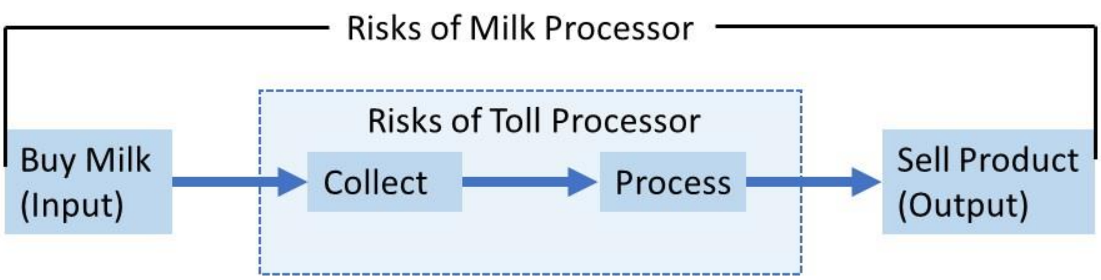
However, in the view of independent processors, looking at practical feasibility solely through a technical feasibility lens results in a somewhat strained interpretation of the relevant statutory provisions. This narrow interpretation can ignore the real-world constraints on the commercial practices of the notional processor (**commercial feasibility**), which have clear implications for the cost and risk profile of the notional producer, and therefore market contestability.

Independent processors struggle to see how a justifiable interpretation could exclude these considerations, and remain consistent with a regulatory regime that is intended to promote a contestable market.

For example, one of the debates has focused on whether it is possible to conceptualise the notional processor as a tolling operator. The Commission[1] has previously expressed a view that the notional processor is a processor which does not assume the risks around the input prices (e.g. milk) and output prices (i.e. of processed commodities) of its operations. In other words, the only risks for a notional processor are technical operation risks common for a tolling processor, with limited exposure to wider commercial risks.

Independent processors continue to hold the view that a tolling operator is not practically feasible, because there is no opportunity to enter the New Zealand market as a tolling processor, and certainly none of the existing independent processors would be able to operate on a tolling basis. The assumptions needed to fit the notional producer into this model are so far removed from the notional producer's operating market context that it ceases to be an economically realistic model. The difference in the views is illustrated in Figure 2.1.

Figure 2.1: Risks of a Milk Processor Versus Risks of a Toll Processor



If tolling processing were practically feasible for the notional processor, this would lead to a particular view of risks and costs incurred, and hence would result in a milk price that only enables contestability by processors with that level of commercial risk. However, if the assumed commercial structuring is not practically feasible, then the resulting milk price will not enable an economically efficient degree of contestability.

Independent processors query how a tolling operator model could be consistent with DIRA section 150A and the objective of contestability in the market. It is certainly inconsistent with the commercial feasibility standard which is a key part of section 150A, and so the justification for adopting this approach remains unclear.

The outstanding issues around practical feasibility are set out in **Table 2.1**. We have categorised the issues in three ways:

- **Conceptual clarity**. Issues where different parties have shown a different philosophical approach to practical feasibility, particularly commercial feasibility.
- **Specific measures of commercial feasibility.** This includes issues such as selling costs, risks of mismatch between input and output prices and hedging strategies

[1] For example, paragraph 4.41 of the Commission's 2015/16 Review of the Milk Price Calculation.

- **Specific measures of technical feasibility.** This includes specific technical feasibility issues, such as capacity utilisation.

Table 2.1: Outstanding Practical Feasibility Issues

Issue Type	Issue	Issue Description
Conceptual clarity	What is the commercial nature of the notional producer?	**The parties need to reach a shared view** on the commercial nature of the notional processor, because this will set the precedent for the cost and risk profile. This includes reaching a shared view on how much commercial risk is assumed by the notional producer.
Commercial feasibility	How should commercial feasibility be assessed (as distinct from technical feasibility)?	Wide range of topics, including: ▪ Sales phasing ▪ Foreign exchange hedging ▪ Commission cost for auction sales
Technical feasibility	What technical assumptions are practically feasible?	Wide range of topics, including: ▪ Benchmark against actual Fonterra costs vs aspirational costs ▪ Notional producer plant operating efficiency ▪ The timeframe over which changes to the Commodity Basket are implemented ▪ Normalised vs optimised efficiency

3 Transparency

Transparency has largely been treated as a process concern under the DIRA regime to date, but it is a more substantive issue. Independent processors remain concerned that Fonterra does not make a sufficient level of information publically available to enable independent processors and other interested parties to provide informed submissions. This reduces the ability of the Commission to undertake its assessment of the base milk price calculation because it does not have the full benefit of the independent processors' informed views.

The Commission has recognised that transparency is a critical issue to the success of the DIRA milk price monitoring regime. The independent processors welcome the steps taken by the Commission to encourage Fonterra to provide more information on its milk price calculation more frequently, but believe more needs to be done if market contestability is to increase and achieve the underlying policy objectives of section 150A of DIRA.

The key issue here is to separate market risk from the **regulatory risk** faced by market participants. Independent processors face a high level of regulatory risk over and above the market risks that would exist in a properly contestable market where the milk price is not subject to regulation. This is because they face uncertainty over the milk price calculations. The same would be true of any new market entrant.

When Fonterra updates its base milk price during the season, it is unclear how it accounts for technical and commercial issues like the notional producer's costs, yields and losses, and sales phasing. This represents another risk to market participants, in addition to the typical commercial risks of market participation, because they must try to predict what Fonterra's milk price calculation will be.

Full disclosure of the milk price model and the calculations would mitigate this risk, thereby decreasing the regulatory risks of operating in the dairy market, reducing barriers to entry and increasing market contestability (in line with the policy goal of section 150A of DIRA). It would contribute to the efficient functioning of the market, by providing clarity and understanding to Fonterra's milk price updates.

The relationship between milk price transparency and regulatory risk is therefore directly relevant to the Commission's regulatory functions, and it would be surprising if the Commission disregarded the impact of its decision-making on milk price transparency. To be unconcerned or indifferent to the efficient functioning of the markets that it regulates is out of step with the Commission's usual practice. In the DIRA context, it is not clear how the level of transparency over Fonterra's base milk price calculation could justifiably be excluded from the Commission's decision-making.

Independent processors do not wish to pursue commercially sensitive information disclosure, only the information needed for a more predictable milk price model to better manage regulatory risk. Hence, the topic of transparency is one of finding the right balance between commercial sensitivity and timely disclosure to narrow the gap between the risks faced by the notional processor (which is assumed not to face regulatory risk) and the actual risks faced by real life independent processors. The more narrow that gap, the more likely that the milk price will achieve the legislative objectives.

Table 3.1 captures the issues surrounding transparency. We have categorised the issues in three ways:

- Conceptual clarity. Issues whereby different parties have shown a different philosophical approach to how much transparency relates to contestability.
- Information disclosure. This includes clarification around what aspects of the milk price model ought to be made available.
- Process. This includes the role of the Commission in progressing the transparency issue.

Table 3.1: Outstanding Transparency Issues

Issue Type	Issue	Issue Description
Conceptual clarity	How much transparency is necessary to achieve the underlying policy objectives of section 150A of DIRA	Independent processors are concerned that too little transparency leads to unnecessary and avoidable regulatory risk, which also poses challenges for new market entrants, running contrary to the objectives of section 150A of DIRA. Fonterra remain concerned that too much transparency creates risks around commercial sensitivity. The Commission has encouraged further transparency from Fonterra, without offering a clear view on why, or how much is needed. **The parties must reach a view on what the objectives of transparency ought to be**, and how this contributes to progressing the objectives of section 150A of DIRA.
Disclosure	What should be disclosed?	**The parties must reach a view on what information is required for public disclosure** to satisfy the requirements of section 150A DIRA, whilst preserving commercial sensitivity. This includes considering: ▪ Sales phasing ▪ Notional producer buffer capacity ▪ Notional producer costs ▪ Yields and losses ▪ Conversion rate assumptions **The parties must reach of view on how regulatory information is updated** during the season.
Process	What is the role of the Commission in transparency?	In previous milk price calculation reviews, the Commission has encouraged greater transparency from Fonterra, but stated that they see their role as testing whether the inputs and process used in *calculating* the base milk price are consistent with the purpose of section 150A, not the extent to which publicly *disclosing* the base milk price is consistent with that purpose. Independent processors remain of the view that encouraging greater transparency is crucial to achieving the policy objectives of section 150A, and that there is a duty on a regulator concerned with functioning markets to consider the market consequences of their regulatory actions, including regulatory risk. **A view must be reached on the role of the Commission in encouraging transparency**, based on the view taken on the role of transparency in achieving the policy objectives of section 150A of DIRA.

4 Asset Beta

In the following section, we outline the evolution of the debate around the practical feasibility of the asset beta used in the calculation of the Notional Business's weighted average cost of capital (WACC). We then extract the key issues requiring addressing, and propose which questions the workshop should focus on to resolve these.

How the asset beta must satisfy the DIRA requirements

The asset beta is fundamental to determining the notional producer's cost of equity capital, which is a key cost component used in Fonterra's cost of capital calculation, and therefore the notional milk price calculation. Calculating the asset beta must satisfy the objectives of section 150A of DIRA, including incentivising Fonterra to operate efficiently while providing for market contestability (practical feasibility). It must reflect the volatility of a notional producer risk against the volatility of the broader market.

How the debate of asset beta calculation has evolved

Following the Commission's view in its 2013/14 Milk Price Calculation review that there was not enough information to conclude on the practical feasibility of the asset beta, Fonterra engaged a WACC expert to recommend an asset beta for the notional producer.[2] Fonterra implemented the recommendation of the subsequent report (*the Marsden Report*) of an asset beta of 0.38 for the 2014/15 season.

During the 2014/15 Milk Price Calculation review, independent processors expressed concerns over the report's calculations, and the Commission stated it remained unable to conclude on the practical feasibility of the asset beta.

Fonterra reappointed its WACC expert to address outstanding concerns prior to the 2015/16 Milk Price Calculation review (*the Marsden update*),[3] and the Commission ordered a separate report (*the Lally Report*).[4]

Independent processors voiced concerns over both reports, and the Commission reaffirmed in the 2015/16 Milk Price Calculation review that it was unable to conclude on the practical feasibility of the asset beta.

Table 4.1 summarises the evolution of the debate, and the rationales put forwards by Fonterra, independent processors, and the Commission over the two review periods.

The outstanding issues are then distilled and shown in **Table 4.2**. We have categorised the issues in three ways:

- **Conceptual clarity**. Issues where different parties have shown a different philosophical approach to calculating the asset beta.
- **The asset beta calculations.** This includes clarification around how certain calculations have been performed by Fonterra.
- **Industry engagement.** This includes how the ongoing process can be improved to ensure fairness amongst industry participants.

[2] Marsden, A (2014). 'Asset beta for Fonterra's New Zealand-based Commodity Manufacturing Business and Specific Risk Premium for Fonterra's Notional Business', 2 December 2014

[3] Marsden, A. (2016). 'Update on Asset Beta for Fonterra's New Zealand-based Commodity Manufacturing Businesses and Specific Risk Premium for Fonterra's Notional Business', 10 April 2016

[4] Lally, M. (2016). 'Review of WACC Issues', 25 February 2016

Table 4.1: Evolution of the Debate on the Asset Beta Calculation over the Last Two Review Periods

Milk Price Calculation Review Year	Fonterra's Position	Independent Processors' Position	Commerce Commission Position
2014/15	**Fonterra implemented an asset beta of 0.38** for the 2014/15 season, following advice from the Marsden Report.	**Open Country Dairy believed the proposed asset beta was too low**, and the review: ▪ Provided little detail and supporting evidence for the rationale used to derive the asset beta point estimates for Fonterra and the notional producer; ▪ Underplayed the volatility in demand faced by the notional producer. OCD felt that a significant proportion of demand for dairy products (particularly to China) should be characterised as discretionary purchases with a higher price elasticity of demand; ▪ Overplayed the strength of regulation to reduce the asset beta. OCD felt it was inappropriate to compare Fonterra to other regulated entities, because the Commission has no powers to set prices and can only comment on whether the milk price is consistent with DIRA's objectives; ▪ Overplayed the distinctions between Fonterra and the notional producer in creating a 'notional producer discount' of 0.1 to the asset beta, which was not explained. **Synlait argued that the asset beta should be higher**, by being consistent with the notional producer having some exposure to earnings volatility because of the milk pricing actions of competitors, rather than being an assumed price setter.	**The Commission was unable to conclude on the practical feasibility of the asset beta** because: ▪ The Commission was unable to understand the Marsden Report's reduction in the asset beta from 0.48 for Fonterra's actual business to 0.38 for the notional producer. The Marsden Report noted that Fonterra's actual business was exposed to 'stream return' risk for commodities not included in the milk price basket, but it was not clear to the Commission that the stream return risk was systematic, or that the risk justified the asset beta adjustment; ▪ The Commission felt it was unclear to what extent any Fonterra Board decision (or the ability to make such a decision) to reduce milk price payments to farmers in favour of the returns to capital providers was reflected in the Fonterra asset beta,

		Miraka argued that the report introduced new notional business concepts (the 'Fonterra Notional Business' and 'Notional Producer Business') that needed to be clarified and justified as practically feasible.	and whether the Fonterra asset beta was therefore the proper baseline.
2015/16	Fonterra reappointed its reviewer to address concerns raised in 2014/15. **The report (*the Marsden Update*) maintained an asset beta of 0.38**. The Update reached the following conclusions on the concerns of independent processors raised in 2014/15: On **OCD**'s concerns: ▪ It **rejected** the volatility of demand. The Update argued that the demand faced by the notional producer would not be as volatile as OCD suggested because the Milk Price Manual sets the milk price in such a way that insulates from fluctuations in demand and price. ▪ It **rejected** the low impact of regulation. It argued the impact of regulation remains strong because the price-setting mechanism in the Milk Price Manual is like price-setting mechanisms for regulated businesses. ▪ It **accepted** that the distinctions between Fonterra and the notional	In response to the Marsden Update, and a separate report commissioned by the Commission (*the Lally Report*), **OCD remained concerned** that: ▪ Both reports assume the notional producer is only as risky as an Electricity Lines Business (ELB), but the DIRA requires that the business in question is an efficient and practically feasible notional producer. OCD believe the best approximation of an efficient business is the market comparators actually operating, and the asset beta should reflect this, because: – They are subject to the same regulatory environment – The ownership structures may be the same – The risk allocations are likely to be the same ▪ Fonterra had opportunities to engage with Dr Lally which was not offered to independent processors. **Synlait were concerned** that: ▪ The notional producer is assumed to be almost riskless, which is not practically feasible. ▪ ELBs were not appropriate comparators for estimating the asset beta, because they face different risks. ▪ Market comparators would be better, with discounts based on differences in risk the notional producer is exposed to.	**The Commission was unable to conclude on the practical feasibility of the asset beta, but stated there was insufficient evidence to justify Fonterra's downward beta adjustment to 0.38** from the mid-point estimate of beta from the comparator companies (0.51). It stated more work was needed on: ▪ The similarity, and therefore comparability, of betas between ELBs and dairy processors; ▪ The similarity and comparability of betas between comparable companies and the notional producer. In particular, the Commission argued more was needed to explain the difference in the Marsden Update between the beta for the notional producer (0.38) and the range of the comparator company set, including the mid-point asset beta for the comparators (0.51).

producer are not valid where Stream Risk cannot be shown as systemic. The concerns raised by **Synlait** and **Miraka** were determined to be out of scope of the Update.	**Miraka remained concerned** with the introduction of new notional business concepts, which Miraka felt still needed clarifying and were not an adequate test of practical feasibility.

Table 4.2: Outstanding Asset Beta Issues

Issue Type	Issue	Issue Description
Conceptual clarity of the asset beta	The appropriateness of introducing new notional business concepts to Fonterra's asset beta calculation	It is unclear why Fonterra have introduced new notional business concepts into its WACC calculation, and how this achieves practical feasibility. **Fonterra must**: ▪ Adequately define the concepts of the 'Fonterra Notional Business' and the 'Notional Producer Business'. ▪ Explain why the introduction of the concepts is relevant for calculating the WACC for the Farm Gate Milk Price (FGMP). ▪ Explain how the concepts meet the 'practical feasibility' test, considering that the Marsden Update states that "The pricing methodology to set the Farmgate milk price under the Milk Price Manual exposes the [notional] capital or business owners of Fonterra's Notional and Actual Businesses to *significantly less risk compared to a normal business*" (E6).
	Choosing whether to use ELBs or comparator companies to determine asset beta	The Marsden Update and the Lally Report both envisage the notional producer as a regulated entity that is close to riskless—primarily only facing the potential for divergence between non-milk costs and regulatory allowances. This led to determining an asset beta using ELBs' asset betas. However, Dr Marsden's analysis produces estimates of asset beta for comparator companies with a material commodity exposure that are much higher than the Commission have estimated for ELBs. **Fonterra must explain** how its approach remains 'practically feasible' despite having a much lower asset beta than real comparator companies. If it cannot justify this discrepancy, **the Commission ought to comment** on why it is prepared to accept this approach despite the discrepancy, so that other interested parties can understand the circumstances in which Fonterra is entitled to depart from the 'practically feasible' standard.
The asset beta calculations	Understanding the downwards adjustment of the notional producer's asset beta from the mid-point asset beta of comparator companies	It is unclear why the Marsden Report adjusted the notional producer asset beta downwards to 0.38, from the mid-point asset beta of comparator companies of 0.51. **Fonterra must explain this**, with particular regard to: ▪ How differences between the ways the independent processors and Fonterra set their milk prices creates a difference in the residual exposure to systematic risk, to justify a lower asset beta for a notional producer. ▪ Why the notional producer's ability to transfer systematic risk is greater than for the comparator companies in Dr Marsden's

		sample, given that processors in other markets also adjust their prices for farmers' milk both during the season and at the end of the season, which can similarly transfer risk, including commodity price risk, to their suppliers.
Industry engagement	Ensuring independent processors have the chance to engage	Several independent processors commented that Fonterra had opportunities to engage with Dr Lally while the Lally Report was being written, but this was not offered to independent processors. **The best response from the Commission would be to develop a process** for the next stage of asset beta review that ensures all industry participants can voice their views fairly through the appropriate channels.

5 Off-GDT Sales

In this section, we outline the evolution of the debate concerning the inclusion of off-GDT sales in the Milk Price Manual for calculating the farmgate milk price, describe the key issues requiring resolving, and highlight the questions the workshop should focus on to resolve these.

How the notional producer's sales must satisfy the DIRA requirements

The Milk Price Manual explains how the farmgate milk price is calculated by subtracting the notional producer's operating, overhead, and capital recovery costs from its revenue. The revenue is calculated using Fonterra's actual sales prices of Reference Commodity Products (RCPs) scaled up to reflect milk price volumes over a period. The notional producer's sales must satisfy section 150A of DIRA by giving Fonterra an incentive to be efficient while providing for a milk price that is practically feasible. This leads to the question: what should the notional producer be assumed to sell, and how should it be assumed to sell it?

Including off-GDT sales for the notional producer

According to the 2015/16 and previous years' Milk Price Manuals, basing Benchmark Selling Prices on prices achieved through Global Dairy Trade leads to selling prices that:

- Reflect actual prices realised by Fonterra on the sale of RCPs across a range of contract terms which is consistent with prevailing market conditions
- Result in Fonterra facing strong incentives to optimise its product mix
- Result in Fonterra facing strong incentives to maximise its Benchmark Selling Prices.

However, in 2016/17 Fonterra decided to change the Milk Price Manual to include off-GDT sales for whole milk powder (WMP), skim milk powder (SMP), and anhydrous milk fat (AMF) because of the view that:

- Sales undertaken off GDT are almost invariably transacted at higher prices, and therefore other NZ processors on average achieve prices for RCPs in excess of GDT prices
- The proposal was consistent with the section 150A DIRA principles.

Independent processors have raised concerns that this approach is <u>not</u> consistent with the section 150A DIRA principles, and that it lacks transparency and provides discretion for Fonterra to influence the milk price.

During the 2016/17 Milk Price Manual review, the Commission decided it could not conclude on the inclusion of off-GDT sales pending further analysis of the off-GDT revenue and the associated selling costs. It proposed completing the analysis in the 2016/17 Milk Price Calculation review.

Table 5.1 summarises the arguments put forwards by Fonterra, independent processors and the Commission. The outstanding issues are then distilled and shown in **Table 5.2**. We have categorised the issues in three ways:

- **Conceptual clarity**. This includes fundamental questions around whether to include off-GDT sales, what this means for the notional producer's business characteristics, and the role of the Commission.
- **Calculating off-GDT sales.** This includes questions on how off-GDT sales are calculated and factored into the milk price, if the Commission does deem it appropriate to include off-GDT sales.
- **Transparency and fairness.** This includes ensuring transparency so that Fonterra are not provided with the discretion to unfairly influence the milk price.

Table 5.1: Position of the Parties for Inclusion of Off-GDT Sales

Fonterra's Position	Independent Processors' Position	Commerce Commission Position
Fonterra amended the definition of *Qualifying Reference Sales* in the Milk Price Manual in the 2016/17 Review, leading to **inclusion of off-GDT sales** for whole milk powder (WMP), skim milk powder (SMP), and anhydrous milk fat (AMF). Reasons included: ▪ GDT sets the 'base' price for sales of RCPs, with sales undertaken off GDT almost invariably being transacted at higher prices, and the view that other NZ processors on average achieve prices for RCPs higher than GDT prices for these RCPs ▪ The proposal is consistent with the section 150A DIRA principles (practical feasibility and contestability), because: – the Commission has previously said it is reasonable to use actual data where there is insufficient information to know what an appropriate notional value would be – It is practically feasible because using a sample of prices actually achieved by Fonterra on the sale of RCPs on freely contested global markets means the revenue inputs will continue to be practically	**OCD argued the changes were not consistent with section 150A of the DIRA** because: ▪ Off-GDT sales are characteristically different to on-GDT sales in that they are generally under longer-term contracts or relationships, providing greater price and/or supply security. Selling such products involves greater costs which Fonterra have not included. ▪ Using off-GDT sales raises significant methodological challenges. It is unclear how Fonterra would analyse which sales qualified as sales of the notional producer. There must be a robust, objective and transparent way of allocating such sales. ▪ The issue raises even greater issues for transparency and the discretion Fonterra has to influence the milk price. **Synlait argued the changes were inconsistent with DIRA and lacked transparency** because: ▪ The change in products sold by the notional producer was not envisaged by DIRA, and a business selling such longer-term products would have different business characteristics, like capital requirements, that the Manual would need to acknowledge. ▪ There are concerns over transparency and the discretion Fonterra has to influence the milk price. **Miraka argued the changes were inconsistent with DIRA, non-transparent, and not characteristic of the notional producer**:	**The Commission was unable to conclude on the inclusion of off-GDT sales** pending further analysis of the off-GDT revenue and associated selling costs. **The Commission's initial view** is the inclusion of off-GDT prices could produce a more accurate representation of what the notional producer might earn, but they did not necessarily accept Fonterra's reasons for changing the Manual. They requested further information from Fonterra to conduct their analysis.

achievable for Fonterra or another efficient processor

- Fonterra will be incentivised to operate efficiently because the price achieved on GDT will be used as a benchmark to measure sales team performance with respect to off-GDT sales.
- Prices achieved on GDT will continue to be materially representative of the prices used in the Farmgate Milk Price calculation

For transparency, Fonterra stated they 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.

Fonterra does not believe it needs to publish further details on the criteria for determining the sales that inform the milk price calculation beyond that already provided by Part C of the Milk Price Manual.

- Fonterra implied they regard GDT sales as the appropriate benchmark, if they will continue to measure sales team performance against it
- Previous Milk Price Manuals have stated that basing Benchmark Sales Prices on GDT sales will result in greater efficiency for Fonterra; this represents a reversal
- The use of off-GDT sales does not satisfy the requirements of Section 4.3 of Part A of the Manual, which describes the circumstances when off-GDT sales can be used
- Concerns over transparency and the discretion Fonterra has to influence the milk price
- An acceptance of off-GDT sales requires a fundamental review of the notional business model to the more sophisticated Fonterra business model.

Table 5.2: Outstanding Off-GDT Issues

Issue Type	Issue	Issue Description
Conceptual clarity	Consistency of off-GDT sales with DIRA's section 150A	It is unclear that including off-GDT sales provides incentives for Fonterra to be efficient, as per the requirements of DIRA's section 150A. The 2015/16 Milk Price Manual stated that basing Benchmark Sales Prices on GDT sales would result in greater efficiency for Fonterra. **Fonterra must explain** their policy shift from this position. **Fonterra must explain** how their use of off-GDT sales satisfies the requirements of Section 4.3 of Part A of the Manual, which describes the circumstances when off-GDT sales can be used.[5]
	The characteristics of the notional producer, and Fonterra's characteristicall y different business model	If off-GDT sales are deemed appropriate, the characteristics of the notional producer must be updated to reflect this. Selling off-GDT products involves additional non-milk costs, which Fonterra have not included. Equally, a business selling such longer-term products would have different business characteristics, like capital requirements, that the Manual would need to acknowledge. **The Commission should insist** that Fonterra update the methodology to reflect changes in the characteristics of the notional producer. If it does not, then the notional producer avoids incurring necessary costs, which is not practically feasible.
	Commission direction	If the Commission did deem it appropriate to include off-GDT sales and update the characteristics of the notional producer, **they must provide clear direction** to Fonterra on what is expected of the methodology for robust, objective, and transparent calculations of off-GDT sales, costs, and capital requirements.
Calculating off-GDT sales	Off-GDT sales	It is unclear how Fonterra would analyse which sales qualified as sales of the notional producer. **There must be a robust, objective, and transparent way of allocating such sales.**
	Appropriate cost changes	**Fonterra must adopt and calculate appropriate cost assumptions** if they are permitted to use off-GDT sales.
	capital requirements	The use of off-GDT sales will influence capital requirements, including WACC and asset beta calculations. **The Commission must insist** these are factored in to the WACC calculations, and

[5] This includes where GDT "does not cover a sufficient volume of sales to provide a reliable benchmark price" and "where prices on GDT are not… materially representative of the prices Fonterra and its competitors should generally be able to achieve for sales of the Reference Commodity Products".

		build this into the asset beta review, to ensure that a consistent approach is used throughout.
Transparency and fairness	Transparency around how Fonterra factor in off-GDT sales into milk price calculation	If off-GDT sales are deemed appropriate, and notwithstanding a clear direction from the Commission on what is expected on the methodology from Fonterra, **Fonterra must make the following available** as per the Commission's 2016/17 Milk Price Manual review conclusions: ▪ The explicit criteria for determining the sales that inform the milk price calculation ▪ The historical data from GDT auctions ▪ How inclusion of off-GDT sales affects other assumptions ▪ An average FX conversion rate assumed to be achieved by the notional producer ▪ A methodology for determining a "material change" in applying its consistency over time provision ▪ The plant capacity for both primary and secondary plants ▪ The milk price on standard terms (post the milk price adjustments) in periodic reviews of the farmgate milk price Without this information, there is no way for the Commission or independent processors to determine whether Fonterra's approach is practically feasible as required by DIRA.