

Proposed focus areas for our review of Fonterra's 2020/21 base milk price calculation

Process paper

The Commission: Sue Begg
Elisabeth Welton
John Crawford
Vhari McWha

Date of publication: 8 April 2021



Associated documents

Publication date	Reference	Title
15 December 2020	ISBN 978-1-869458-60-7	Final report – Review of Fonterra’s 2020/21 Milk Price Manual: Dairy Industry Restructuring Act 2001
15 September 2020	ISSN 1178-2560	Final report - Review of Fonterra's 2019/20 base milk price calculation
15 August 2017	ISBN 978-1-869455-28-6	Our approach to reviewing Fonterra's Milk Price Manual and base milk price calculation

Commerce Commission

Wellington, New Zealand

Introduction

1. This paper provides interested parties with details regarding our proposed focus areas for our review of Fonterra's base milk price calculation for the 2020/21 season (**Calculation**) under the Dairy Industry Restructuring Act 2001 (**DIRA**). This paper also invites feedback on those focus areas and seeks relevant information on those focus areas.
2. Our primary role under the DIRA is to publicly report on the extent to which Fonterra's milk price setting processes and calculations provide incentives for Fonterra to operate efficiently and are consistent with contestability in the market for purchasing farmers' milk.
3. We undertake two separate reviews each dairy season:¹
 - 3.1. The first review concerns Fonterra's milk price manual (**Manual**). The Manual contains the specific methodology Fonterra uses to calculate its base milk price.² This review assesses whether the rules and principles in the Manual provide an incentive for Fonterra to operate efficiently and are practically feasible for an efficient milk processor, and as such are consistent with the purposes of the DIRA.
 - 3.2. The second annual review we undertake is of Fonterra's base milk price calculation at the end of each dairy season. The second review assesses whether the costs, revenue and other assumptions used in the base milk price calculation are consistent with the purpose of Subpart 5A of DIRA.
4. The framework for our reviews is contained in our **Approach paper**.³

We are reviewing Fonterra's 2020/21 base milk price calculation

5. This Calculation review is the second of the reviews that we are required to complete under DIRA in relation to the base milk price in the 2020/21 season.
6. The first review for the 2020/21 season looked at the Manual. We published the final report on our review of the Manual for the 2020/21 season on 15 December 2020.⁴ We

¹ For a more detailed explanation of our monitoring role under DIRA see our [website](#).

² The base milk price is also known as the farm gate price – the amount farmers receive for each kilogram of milk solids. Our monitoring role is concerned only with the farm gate milk price. We do not monitor retail dairy prices or any other prices in the value chain.

³ Commerce Commission "[Our approach to reviewing Fonterra's Milk Price Manual and base milk price calculation](#)" (15 August 2017).

⁴ Commerce Commission "[Review of Fonterra's 2020/21 Milk Price Manual: Dairy Industry Restructuring Act 2001 – final report](#)" (15 December 2020).

note that the Manual requires periodic reviews of various inputs to the base milk price calculation, normally on a four-yearly cycle.⁵

7. Each annual Calculation review has key areas of focus for the review. We determine the focus areas for each Calculation review based on a number of criteria outlined in our Approach paper. We explain in the next section the basis for the focus areas for this year's review.
8. For each proposed focus area in the Calculation review, we conclude on both the contestability and efficiency limbs within section 150A of Subpart 5A (as we are required to do for the inputs, assumptions and processes underlying the calculation of the base milk price as a whole).
9. In addition to the specific focus areas, our annual review of the Calculation includes a 'fit for purpose' review of all other revenue and cost components of the base milk price calculation. The fit for purpose review consists of an analytical review of component values against our previous reviews of the same components and a review of the consistency of the assumptions, inputs and processes related to the different components.
10. As required by the DIRA, we produce a draft report of our review of Fonterra's base milk price calculation for each season by **15 August** and a final report by **15 September**.⁶

Indicative timeline

Indicative date	Publication/event
8 April 2021	Proposed focus areas published
29 April 2021	Stakeholder submissions on proposed focus areas due
15 August 2021	Draft report published
1 September 2021	Stakeholder submissions on draft report due
15 September 2021	Final report published

⁵ Fonterra "[Farmgate Milk Price Manual](#)" (1 August 2020).

⁶ However, if either of these dates falls on a non-working day, the date may be extended to the next working day – see section 35(6) of the Interpretation Act 1999.

Our proposed focus areas

11. For our 2020/21 Calculation review, we are proposing the following focus areas:
 - 11.1. asset beta;
 - 11.2. specific risk premium; and
 - 11.3. provision for asset stranding (this includes a review of the assumptions and inputs applied under Rule 33 of the Manual,⁷ and the asset stranding aspects of the asset beta and specific risk premium).

12. The focus areas for the 2020/21 review are informed by:
 - 12.1. Fonterra's periodic reviews of components in its calculation (as specified in the Manual); and
 - 12.2. our intent to review the approach to asset stranding in the Calculation, as stated in our final report on the Manual for the 2020/21 season.⁸

13. According to the Manual, this year is a review year for Fonterra for the asset beta and specific risk premium. Given the asset beta and specific risk premium are key inputs to the cost of capital and are thus material to the Calculation, we propose to include them as focus areas.
 - 13.1. The asset beta provides an allowance in the weighted average cost of capital for 'systematic risk' faced by shareholders, comprising risk which cannot be diversified away by holding a portfolio of shares in different companies.
 - 13.2. The specific market risk premium, another component of the weighted average cost of capital, was introduced to compensate shareholders for potential downside risk associated with stranded assets.

14. This year is also a review year for the assumptions and inputs applied under Rule 33 of the Manual. Rule 33 deals with adjustments to the Farmgate Milk Price Fixed Asset Base where peak milk supply in a region has decreased by an amount that results in one or more standard plants being surplus to requirements.⁹ In reviewing the assumptions and

⁷ Fonterra "[Farmgate Milk Price Manual](#)" (1 August 2020), p. 50. For an explanation of Rule 33, see also paragraph 14 below.

⁸ See Commerce Commission "[Review of Fonterra's 2020/21 Milk Price Manual: Dairy Industry Restructuring Act 2001 – final report](#)" (15 December 2020), paragraph X18. We also noted we intended to review asset stranding in our final report for the 2018/2019 Manual review (see Commerce Commission "[Review of Fonterra's 2018/19 Milk Price Manual: Dairy Industry Restructuring Act 2001 – final report](#)" (14 December 2018), paragraph 25.

⁹ Fonterra "[Farmgate Milk Price Manual](#)" (1 August 2020), p. 47.

inputs applied under Rule 33, we will review how static or declining milk volumes are factored into the base milk price calculation. As such, this review, together with the review of the asset beta and specific risk premium, forms part of our review of provisions for asset stranding that we signalled in our report on the Manual review for the 2020/21 season.

We invite your views on our focus areas for this year's Calculation review

15. We continue to consider that consultation with all interested parties helps to inform us when making our conclusions. We invite submissions on the following matters by **5pm, 29 April 2021**:
 - 15.1. whether the proposed focus areas should form part of our review, and whether there are further focus areas that should be included; and
 - 15.2. any relevant information about the proposed focus areas themselves or any further proposed focus areas.
16. Receiving submissions on these matters will:
 - 16.1. assist us to decide what the focus areas should be for our review of the Calculation; and
 - 16.2. provide us with information relevant to those proposed focus areas, so that we may take this information into account when examining the proposed focus areas as part of our Calculation review.
17. Please make your submission via the [Milk price calculation – 2020/21 season page](#) on our website, by 5pm, Thursday 29 April.¹⁰ The project page will direct you to a form with instructions on how to upload your submission. Your submission should be provided as an electronic file in an accessible form (e.g., PDF, word or an unlocked spreadsheet).
18. The protection of confidential information is something the Commission takes seriously. When including commercially sensitive or confidential information in your submission, we offer the following guidance.
 - 18.1. Please provide a clearly labelled confidential version and public version and provide reasons why you consider information to be confidential or commercially sensitive. We intend to publish all public versions on our website.

¹⁰ <https://comcom.govt.nz/regulated-industries/dairy/milk-price-manual-and-calculation/milk-price-calculation/milk-price-calculation-202021-season>

- 18.2. The responsibility for ensuring that confidential information is not included in a public version of a submission rests entirely with the party making the submission.
19. If we consider information disclosed in the confidential version to be in the public interest, we will consult with the party that provided the information before any such disclosure is made.