

Commerce Commission – Proposed approach and focus areas for our review of Fonterra’s 2018/19 base milk price calculation – 7 June 2019

Dear stakeholder,

This email is to provide interested parties with details regarding our proposed approach and focus areas for our review of Fonterra’s base milk price calculation for the 2018/19 season (**Calculation**).

As required by the Dairy Industry Restructuring Act 2001 (**DIRA**) for each season, we produce a draft report of our review of the Calculation by **15 August** and a final report by **15 September**.

This review is the second of the reviews that we are required to complete under DIRA on the base milk price each milk season. The framework for our reviews is contained in our **approach paper**, available on our website at https://comcom.govt.nz/_data/assets/pdf_file/0035/59984/Our-approach-to-reviewing-Fonterra's-Milk-Price-Manual-and-base-milk-price-calculation-15-August-2017.PDF.

The first review for this 2018/19 season looked at the Milk Price Manual (**Manual**). We published the report on our review of Fonterra’s 2018/19 Manual on 14 December 2018 which is available on our website at <https://comcom.govt.nz/regulated-industries/dairy/milk-price-manual-and-calculation/milk-price-manual/milk-price-manual-201819-season>.

This current review looks at the extent to which the assumptions adopted, and the inputs and processes used by Fonterra in calculating the base milk price are consistent with the Manual and purpose of DIRA.

Our proposed approach for this year’s review of the Calculation

Our review of the Calculation builds on the conclusions from our previous reviews. In each review we can consider outstanding issues from our previous Calculation and Manual reviews.

In our review of Fonterra’s Milk Price Manual 2018/19, we concluded that in respect of issues raised by static or declining volumes of milk collected by Fonterra, our best course of action would be to monitor the asset stranding rules against real world behaviours for the time being with a more substantive review to be included in the 2020/21 season alongside Fonterra’s review of the specific risk premium. We note that the 2018/19 milk volume forecast is greater than the 2017/18 total volume, so there are no additional short-term plant mothballing issues we consider we need to address in this year’s review of the Calculation. We will look to include the long-term issue of asset stranding in our review of the 2019/20 Manual, after its four-yearly update later this year.

Fonterra has provided us with a new report on asset beta – *Report to Fonterra: Discussion of the asset beta for use in milk pricing, Graham Partington and Stephen Satchell, 14 March 2019*. We have published the report on our website along with this notification email. We have asked Cambridge Economic Policy Associates (**CEPA**) whether this new report changes their previous advice on asset beta. We expect to publish this updated advice from CEPA in July.

Our proposed focus areas

- **Materiality**

We intend to consult with stakeholders on their view of materiality. Of particular interest to us is how Fonterra and its auditors approach materiality with respect to the components of the milk price calculation and how each uses its materiality assessment to inform any work undertaken on Manual amendments, calculation amendments or the site audit work programmes (if relevant). We are also interested in Fonterra’s and other stakeholders’ views on whether (and if so, how) materiality should play a role in setting the scope of work for our reviews.

- **Environmental costs**

We are interested in how the milk price calculation factors in any environmental costs. In particular, how the costs of renewal of resource consents are dealt with and the costs of updating existing plants to meet more stringent consent requirements than those that applied when the plants were first constructed.

- **Energy costs**

We would like to understand how Fonterra’s decarbonisation plans have or will be factored into the calculation model, and over what timeframes.

For revenue and cost components that are not part of the more detailed analysis, we undertake a ‘fit for purpose’ review which at a minimum involves:

- 1) an analytical verification of the values used in respect of the components against our previous reviews of the same components; and
- 2) a review of the consistency of the assumptions, inputs and processes related to the different components.

For a detailed explanation of how we determine the scope of our reviews, please refer to our **approach paper**, referenced above.

Indicative timeline

Indicative date	Publication/event
July 2019	Updated advice from CEPA on asset beta
15 August 2019	Draft report published
28 August 2019	Deadline for stakeholder submissions on draft report (including Commerce Commission's view on matters raised by Partington and Satchell's report on asset beta)
12 September 2019	Final report published

We invite your views on our proposed approach and focus areas for this year's calculation review

We are now inviting submissions on our proposed approach and focus areas by **12 noon, 21 June 2019**.

Submissions should be sent by email to regulation.branch@comcom.govt.nz, with the subject line 'Base milk price calculation review 2018/19'. We intend to publish all submissions on our website. This is an important step as it allows us to test all information received from stakeholders in a fully transparent way. If it is necessary to include confidential material in submissions, the information should be clearly marked, with reasons why that information is confidential. If it is necessary to include confidential information in submissions, both confidential and public versions of the submissions should be provided.

We look forward to hearing from you.

Kind regards,

Stephen Bass

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