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IDP Joint submission on the Commerce Commission draft report: "Review of Fonterra's 2023/24 base milk price calculation" (issued 1.8.24)

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Subject: Milk Price Calculation 2023/24
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Abbreviations and other references

Approaches Paper – Commerce Commission reference paper: "Our approach to reviewing Fonterra's milk price manual and base milk price calculation" (issued 1 August 2023)

BMP - Base Milk Price

Codex - International food standards set by the Codex Alimentarius Commission and with which NZ dairy processors comply

DIRA - Dairy Industry Restructuring Act 2001

DIRA Amendment Act 2022 - Dairy Industry Restructuring (Fonterra Capital Restructuring) Amendment Act 2022

Draft 23/24 BMP Report – Commerce Commission draft report issued 1 August 2024 "Review of Fonterra's 2023/24 base milk price calculation", the subject of this submission

Focus Areas 23/24 – Commerce Commission paper issued 18 April: "Proposed focus areas for our review of Fonterra's 2023/24 base milk price calculation"

Fonterra 23/24 Reasons – 'Reasons' Paper in Support of Fonterra's Base Milk Price for the 2023/24 Season, issued 17 June 2024

IDPs – Miraka, Open Country Dairy, Synlait Milk, and Westland Milk Products jointly referred to in this submission as the Independent Dairy Processors (IDPs)

IDP Focus Areas Submission – IDP Joint Submission issued 9 May 2024 on the Commerce Commission process paper: "Proposed focus areas for our review of Fonterra's 2023/24 base milk price calculation"

IPC - Incremental Product Cost (an adjustment which has a purpose of restating the selling price of a product to an equivalence with its relevant SSP)

Manual – Fonterra's Farmgate Milk Price Manual

NP - Notional Processor

RCP - Reference Commodity Product (wholemilk powder, skimmilk powder, Butter, Anhydrous Milkfat, Buttermilk Powder); the RCPs comprise a range of SSP and non-SSP products

SSP - Standard Specification Product - the 5 unique products the NP is assumed to manufacture, and which represent the RCPs in the BMP model:
RWMP (Regular Wholemilk Powder)
MH SMP (Medium Heat Skimmilk Powder)
Unsalted Butter
AMF (Premium Anhydrous Milkfat 210 Kg)
BMPwdr (UHT Buttermilk Powder)

Introduction and Summary

1. This submission primarily focuses on the Commission review of the DIRA S 150B assumptions. S 150B was amended by the DIRA Amendment Act 2022, requiring that the assumptions be used in a manner which complies with the dual purposes of S 150A: that the BMP incentivise Fonterra efficiency and that it provides for contestability in the raw milk market. The amendment was understood to have the effect of removing the "safe harbour" status of the S 150B assumptions.

2. The IDPs consider the amendment to S150B required a reset of the BMP calculations because the S150B assumptions as applied in the BMP were not commercially feasible. This was particularly apparent in the NP product yields. How the S150B assumptions are used has

however not changed, and the Commission has now concluded they remain compliant with the DIRA.

3. The IDPs strongly disagree with this conclusion. This submission thus lays out again the fundamental reasons why many BMP assumptions and calculations are not commercially feasible. It also explains why the BMP does not (and cannot) incentivise Fonterra efficiency, and that the efficiency purpose of S 150A can only be met "in the negative" by requiring that the BMP does NOT stand in the way of incentivising Fonterra efficiency.

4. This submission also raises some subsidiary issues arising from the Draft 23/24 BMP Report, and the Fonterra 23/24 Reasons paper.

Compliance of S.150B Assumptions

5. S 150A of the DIRA sets out two overarching purposes for setting the BMP:

   a. to incentivise Fonterra to operate efficiently; and

   b. to provide contestability in the NZ raw milk market

6. In the case of incentivising Fonterra efficiency, the Commission primarily focuses on incentivising Fonterra cost efficiencies[1] (which would include production performance and yields). In practice, the Commission tends to consider the BMP will incentivise Fonterra efficiency where the underlying assumptions are independent of Fonterra and where they are set at a level where their achievement will demand improvements in Fonterra performance. The underlying incentivisation in this case is that efficiency improvements are required to sustain or increase profits. This results in BMP costs which are lower and production yields which are higher than Fonterra achieves from its commodity business. It will thus tend to inflate the BMP depending on the enthusiasm with which difficult targets are set. Fonterra willingly participates in setting difficult targets in the BMP assumptions (e.g. NP yields). The IDPs interpret this to mean Fonterra is comfortable with a procedure that results in a relatively higher BMP. This is consistent with Fonterra's Constitution and is not a criticism of Fonterra. It is though a criticism of the regulation of the BMP.

7. The IDPs have always considered (and submitted) that this presumption of incentivisation relies on a false understanding of Fonterra business priorities and drivers. It assumes that Fonterra has the same profit drivers as any corporate business prioritising returns to invested capital. This fails to recognise that Fonterra is a co-operative. Fonterra is undoubtedly motivated to maximise total returns to its co-operative members. Those total returns are however delivered through the combined milk price and profits/dividends. Total returns are unaffected by the calculation processes for the BMP. Fonterra incentives to prioritise milk price compared to profits are unrelated to efficiency drivers. Fonterra prioritises the milk price because that meets its competitive objectives to maximise milk supply, and because members place greater emphasis on the milk price to assess Fonterra performance (and as reflected in the Fonterra Constitution[2]). Fonterra is able to subsidise the milk price from returns achieved in value adding

[1] Approaches Paper, para 4.3

[2] Relevant parts of the Fonterra Constitution are included in the Manual: Part A section 2

segments. Apart from minimum profit objectives perceived necessary to retain credibility in capital markets, there is no obvious disincentive for Fonterra to maximise this subsidy.

8. Noting that Fonterra places a high priority on maximising the milk price, any artificial elevation of the achievement of that objective is more likely to disincentivise Fonterra efficiency. It makes it easier for Fonterra to represent that it is performing through delivery of a high milk price. This is especially as there is no comparable reporting of actual performance. The IDPs consider the BMP itself does not (and cannot) incentivise Fonterra efficiency and the Commission's approach to determining achievement the S 150 A efficiency requirement is misplaced. The IDPs consider the efficiency purpose would rather be better served if the BMP processes were required to show they do not disincentivise Fonterra efficiency or do NOT stand in the way of incentivising efficiency.

9. The dual requirement in S 150A for the BMP to provide contestability in the raw milk market should in principle limit the extent to which the BMP can be inflated to meet Fonterra objectives. S 150A clarifies that contestability requires the BMP assumptions costs and revenues to be practically feasible for an efficient processor.

10. The IDPs have always considered the S150A requirement that the BMP be practically feasible must be interpreted to mean the BMP calculations are commercially feasible. In its Approaches Paper, the Commission similarly considers that

> *"practical feasibility includes commercial feasibility in the sense that it must be possible for an efficient processor operating in New Zealand to replicate or achieve the component* [of the BMP] *being assessed"* [34]

11. The IDPs have however always submitted the BMP assumptions are not in fact practically or commercially feasible because of the S 150B "safe harbour" assumptions. S 150A therefore has not been an effective counterweight to Fonterra incentives to inflate the BMP.

12. The DIRA Amendment Act 2022 was passed to enable Fonterra to complete its proposed capital restructure. At the time, the Government recognised the change in the Fonterra capital structure was not consistent with the purpose of the DIRA because it

> "*could constrain entry into the market or expansion by potentially more innovative or efficient dairy processors…* [which over time] … *could reduce pressure on Fonterra to perform optimally or innovate*" [5]

13. To mitigate against this risk to competition and efficiency, the DIRA Amendment Act 2022 introduced several changes to the regulation of the BMP. This included an amendment to S 150B requiring the way assumptions are used must now comply with S. 150A. The IDPs consider this required a reset of the BMP calculations and especially so that the BMP yield and cost assumptions are commercially feasible.

14. The Commission started considering compliance with the amended S150B in its 2022/23 review. That review was limited to a consideration of the calculations and assumptions for the NP USD

[3] Approaches Paper, para 51
[4] The Commission further clarifies in Approaches Paper para 55 that an "efficient processor" includes existing and "potential entrants" that "may enter the market for the purchase of milk from farmers"
[5] Dairy Industry Restructuring (Fonterra Capital Restructuring) Amendment Bill, Explanatory note

conversion rate determined in accordance with S 150B (1) (c). The Commission concluded the assumptions complied with S150A and were commercially feasible. In the latest review, the Commission has considered the NP yield assumptions[6] and has similarly concluded the yield assumptions are commercially feasible. This largely completes the Commission review of the S150B assumptions following the 2022 Amendments.

15. In summary, despite the removal of presumed safe harbour status from the S 150B assumptions, the Commission has concluded the assumptions are (and implicitly always must have been) commercially feasible and the presumption of safe harbour for S 150B was never necessary.

16. The IDPs disagree and submit this conclusion is incorrect. It cannot be shown to be consistent with the Commission's approach to determining commercial feasibility.

17. As noted in 10 above, the Commission considers commercial feasibility requires BMP assumptions to be achievable by an efficient processor (existing or potential) operating in New Zealand. The Commission further clarifies that feasibility is satisfied

    "if it can be demonstrated that an existing plant, or processor, can achieve the revenue, cost, or other assumption (e.g. the unit costs achieved at one existing plant, or the gross values achieved in a part of Fonterra's current business)"[7]

18. The IDPs submit that the NP yields are not credible for an existing processor or any potential new entrant. In relation to existing processors this was addressed in the IDP Focus Areas Submission at paragraphs 16 to 23. The IDPS submitted that Fonterra average yields across its full business model represented the best (most efficient) yields that can demonstrated to be commercially feasible within the New Zealand pasture based dairy industry.

19. That submission did not address the two other scenarios the Commission uses for confirming commercial feasibility: an efficient new entrant, or the performance of one existing Fonterra plant or part of Fonterra. The IDPs submit that these additional scenarios do not change the conclusion that the NP yields are not commercially feasible:

    a. new entrant – it is not credible that any new entrant could achieve the economies of scale available to Fonterra let alone those presumed by the NP. Indeed New Zealand's pasture based production (and associated seasonal milk curve) is a barrier to new entrants because the volume of milk required to compete against Fonterra economies of scale is not accessible.

       OFI is the most recent relevant entrant to the market. OFI commenced manufacture in 2023 with one milk powder plant. It is understood that factory has a daily capacity of around 1 million litres[8]. That is both smaller and less efficient than Fonterra average milk powder plant daily capacity (2.1M litres)[9]. As a single plant operation, OFI can only operate

[6] NP yields rely on a synthesis of the remaining DIRA S 150B assumptions a, b and d: network of facilities, capacity of processing units, and milk volume.
[7] Approaches Paper, para 52
[8] https://digitalpublications.online/waterfordpress/business-north-april-24/37/
[9] Fonterra 23/24 Reasons, page 16

the plant continuously at full capacity for a brief window over the peak milk supply period in October. This is typical of all recent new entrants to the market.

b. an existing efficient Fonterra plant or plants – Fonterra does in fact determine NP yields based on performance of "existing efficient plants" while operating in ideal conditions (full capacity production of a single SSP). Fonterra extrapolates that performance across the NP, assuming the NP plants are operating at full capacity for "90% of their total operating days" processing more than 95% of NP milk[10]. The NP thus manufactures more than 95% of product in these most ideal production conditions at optimised yields. It could be considered that yields based on the performance of "one existing plant, or the gross values achieved in a part of Fonterra's current business" satisfy the Commission's criteria for commercial feasibility. This would be correct if the yield information was determined from plants consistent with the age and scale of the NP and were adjusted to reflect a commercially feasible sales and production plan. None of these are however the case.

20. The IDPs again submit that Fonterra actual performance provides the best evidence of maximum efficiency that can be achieved in dairy commodity processing in the New Zealand pasture based dairy industry. Fonterra performance will not reflect the theoretically optimised processing of 95% of milk assumed by the NP. Equally that processing efficiency is not commercially feasible for any other existing or potential processor. Fonterra scale however means it has the greatest opportunity to demonstrate maximum economies of scale that are commercially feasible in New Zealand. A high standard of evidence would be required to demonstrate that better yields are commercially feasible. That evidence is not currently apparent.

Why does Fonterra and the Commission conclude the NP Yields are Commercially Feasible

21. The exaggeration of NP yields appears to result from a conflation of two sections of the DIRA:
    a. S 150C (2) – portfolio of commodities; and
    b. S 150B (1) (d) – NP milk volume

22. S 150C (2) is a mandatory DIRA requirement that the NP "portfolio of commodities" is "*likely to be the most profitable over a period not exceeding five years*". Fonterra has set the commodity portfolio to comprise five categories of dairy products (the RCPs). The RCPs could comprise any number of different commodity and non-commodity products that meet CODEX definitions. Fonterra has refined and simplified the BMP model by setting conversion costs and yields based on the 5 unique dairy products (the SSPs) which are generally accepted to most represent the commodity part of each RCP. The commodity portfolio required by S150C is thus defined by the five SSPs.[11]

[10] Fonterra 23/24 Reasons, page 47

[11] This simplification ism used to determine costs and yields. The simplification is however compromised in the case of NP revenues. Through a convolution of open-ended concepts (qualifying material, standard product offerings, standard packaging, qualifying reference sales) the door is opened to a wide range of products (most notably those included in "off-GDT sales"). The IDPs have long submitted these unjustifiably complicate the BMP calculations, remain opaque, and increase scope for subjective procedures and reduced confidence in the

23. By contrast S 150B (1) (d) is not mandatory but permits Fonterra to assume the NP purchases the same quantity of milk as Fonterra itself. Along with the other S150B assumptions, this appears to have a purpose of simplifying the BMP model. Fonterra can model major aspects of the BMP on certain of its own characteristics, removing doubt that Fonterra might be required to develop a model divorced from those characteristics.

24. Neither of the two DIRA assumptions are problematic as such. It is however reductive to combine them and conclude the resulting business model is commercially feasible.[12] It is equally reductive to assume the economies of scale available to that fictional business are also commercially feasible.

25. It appears however that because the assumptions are both either mandated or permitted by DIRA, Fonterra continues to set NP costs and product yields based on those combined assumptions. That approach has previously had some protection from S150B safe harbours but that can no longer be the case.

26. It should also be noted that while costs and yields rely on the S 150B assumptions, revenues are set on an entirely different basis. Prices are set in accordance with Fonterra actual selling prices achieved on much lower volumes but extrapolated across the entire NP production volume. Arguably this latter approach is required by S 150C (1), but as S150B assumptions must now be commercially feasible, the inconsistency between the basis for NP revenues and NP costs and yields are no longer sanctioned by the DIRA and the BMP calculated on that basis cannot be compliant with the DIRA.

27. The IDPs consider that a commercially feasible model for NP yields would require a major reset of the BMP model. As noted above however that would not be required if NP yields are based on annual average yields achieved by Fonterra across its commodity business. A similar approach has been taken and sanctioned by the Commission for setting other key NP cost assumptions, including the NP conversion rate and milk collection costs. Fonterra correctly claims these are demonstrably feasible, and an independent model would be overly complex and cannot be justified. In the case of yields however, Fonterra sings to a different song sheet. Instead of similarly recognising independent modelling of yields is unjustifiably complex, Fonterra has taken this reductive approach to justify simplifying assumptions and calculating yields as though the NP commodity portfolio overlayed by the NP milk volumes are a commercially feasible business model. This reduces costs and inflates yields while revenues remain based on a more complex business model with reduced access to economies of scale and lower production yields.

28. The IDPs strongly object that despite the amendment to S 150B, the assumptions are still used to justify yields that are not commercially feasible. The IDPs submit that the NP yields cannot be achieved across a full season by any commercially feasible business including any potential new entrant. Yields which are instead achieved in actual but ideal processing conditions on certain

BMP. The IDPs believe they result in multiple inconsistencies across the BMP calculations, notably including in the calculations of NP production costs and yields.

[12] The volume of dairy commodities produced by the NP necessarily far exceeds Fonterra (and New Zealand) actual production of those dairy commodities and would undermine international dairy prices especially in the case of the key WMP pricing.

Fonterra plants, are judged to still be commercially feasible when applied against the scale manufacturing opportunities modelled for the NP but which will never be delivered in any survivable commercial sense.

29. The IDPs request the Commission reconsider its conclusion that the NP yields are commercially feasible. They further request the NP yields be compared against Fonterra actual yield performance measures as a commercial benchmark for the NP yields.

NP Yield Calculations

30. Putting aside the fact that the NP yield calculations rely on economies of scale of a business model that is not commercially feasible, the NP calculations themselves raise a number of issues:
    a. Standard Plants and the allocation of NP processing capacity across the NP processing footprint
    b. NP processing losses
    c. NP specification offsets

Standard Plants and the Allocation of NP Processing Capacity

31. The Manual includes a concept of "Standard Plants". This is understood to be related to the permitted simplifying assumption in S 150B (1) (b) that NP factories can approximate the average size of Fonterra's actual factories. The Manual "definition" of Standard Plants simply refers to Rule 26 ("Capacity of Standard Plants"). Rule 26 is complex but in effect states nothing more than that the average capacity of NP plants must be largely the same as the average capacity of relevant Fonterra plants. The rule also refers to the average capacity of standard plants implying multiple "standard" plant sizes and so does not define the Standard Pant as such. In other respects the descriptions and references to Standard Plants in the Manual are dense and often impenetrable[13]. For example there is a lack of consistent nexus between Standard Plant and Reference Assets: in some cases they are the same thing (Standard Plant comprise Reference Assets)[14], where elsewhere they are implicitly desegregated[15] The Manual does not therefore provide a coherent definition or purpose for the Standard Plant concept.

32. Fonterra confirms the NP has 43 WMP and SMP factories[16] with capacities that range from less than 1.9M ltr/day to 2.5M ltr/day[17] and with an average capacity of 2,000 M3 per day[18]. Despite the lack of clarity in the Manual, it is understood that a Standard Plant for WMP and SMP has a

[13] The IDP Proposed Focus Areas submission included an attempt to interpret the meaning of "Standard Plant". Further investigation and information in the Draft 23/24 Report now suggests that earlier interpretation was wrong. This latest submission includes a further attempt unravel the concept.
[14] Manual, Part C section (definition) section 1.4
[15] Manual, In Rule 15 (milk collection) only "reference assets" (which include Standard Plant) are described as allocated to "sites" while Rules 33 and 34 (capacity surplus and shortfall) indicate Standard Plant are only allocated to Regions
[16] Fonterra 23/24 Reasons, Attachment 3
[17] Farmgate Milk Price Statement, 2022/23 Season.
[18] Fonterra 23/24 Reasons, Attachment 3 - the inconsistent nomenclature matches the Fonterra 23/24 Reasons paper, including that the implied capacity of the NP Plants is correct to three decimal places compared to capacity descriptions for the Fonterra plants correct to one decimal

capacity of 2.000 M ltr/day. It is though unhelpful that the Manual also seems to define replacement plants as "Standard Plants"[19] even though the capacity of replacement WMP and SMP plants is understood to be 2.5M ltr/day[20]. The IDPs request the Commission seek a clarification of the meaning and purpose of Standard Plants.

33. The one clear requirement of Rule 26 is that relevant NP and Fonterra WMP and SMP plants should have substantially the same average capacity. The average capacity of Fonterra's WMP and SMP is "circa 2.1 million litres"[21]. Fonterra states this is "materially consistent" with the NP WMP and SMP plants which as noted above are separately stated to be on average 2.000 M litres/day. On the face of it, these capacity numbers are not "materially consistent" and could suggest that by comparison with Rule 26, the NP is short of 4.3M litres/day processing capacity. The IDPs request the Commission obtain an explanation for this difference and consider its implication for NP costs and yields.

34. It appears that the NP "Standard Plant" is used to allocate NP plants to "Regions", to match milk to plants in site based daily NP production plans, and to calculate NP plant operating efficiency and yields. By deduction this process seems to include:
    a. An assumption that the NP factory footprint (location and processing capacity) is the same as Fonterra (S150B (1) (a))
    b. An assumption that the NP processes the same daily volume of milk as Fonterra at each of the processing sites
    c. NP Standard Plants are "allocated" between the North and South Island (the NP "Regions")
    d. Regional processing capacity (not plants as such) are sub-allocated to the NP processing sites
    e. The Commission indicates capacity (not plants) is allocated to match Fonterra actual processing capacity at each site.[22] At the same time the Commission indicates the NP capacity is allocated based on peak milk collection[23]. The Commission does not explain this apparent contradiction.
    f. For purposes of allocating milk to NP factories and thus to determine a daily schedule for NP plant operations (factory daily production plan), milk processed at each site cannot simply be matched against "capacity". It rather must be matched against "actual" factories. It is understood that for this purpose, in the first instance Fonterra assumes all plants processing milk at each site are "Standard Plants" (e.g. WMP and SMP plants with daily capacities of 2.000 M litres). It is further understood that to exactly match site milk allocations, fractions of Standard Plants are "able" to operate at each site. A single "Standard Plant" can thus be distributed across multiple sites and could be deemed to operate at full capacity provided each plant fraction is "full".

35. The allocation of daily NP milk at each NP site to NP factories is a key step to determine the extent to which NP production is optimised and thus determining product yields and factory

[19] Seemingly implied by Rule 27 in the Manual
[20] Farmgate Milk Price Statement, 2022/23 Season: capacity of all (notional) replacement powder plants since 2012.
[21] ibid, page 10
[22] Draft 23/24 Report, para 4.16
[23] ibid, para 4.17

costs. Fonterra has calculated that based on this allocation the NP "factories on average operate at full capacity for at least 90% of their total operating days, and that less than 5% of 2023/24 milk would have been processed in factories operating at partial capacity"[24]. This would be an extraordinary achievement when considered against the New Zealand pasture based milk supply curve (attachment A).

36. The Commission appears to acknowledge that NP capacity is at least in part allocated to NP sites on site-based milk allocations. These allocations would be expected to change on an ongoing basis as Fonterra optimises milk allocation to each site to meet its own production plan objectives (which are fundamentally different to the NP production plan). This constant changing of NP processing capacity is not feasible (in any sense of the word) and even implies retrospective allocation of capacity.

37. The Commission confirms the allocation of capacity "differs from a processor operating in the real world"[25] but "is an appropriate modelling simplification"[26] the impact of which is "likely to be negligible"[27]. The Commission draws this conclusion because NP capacity (but not plants) is materially aligned to Fonterra site capacity[28] (which by comparison can more reliably be presumed to be based on actual whole plants operating in the real world). That conclusion however requires the assumption that "fractions" of Standard Plants are able to be allocated to NP sites. This is not feasible (in any sense of the word) but allows Fonterra to assume the capacity of site-based plants exactly matches changing capacity requirements, thus optimising milk processing and further contributing to the extraordinary optimisation of plants assumed by the NP. It is then unsurprising that the NP plants are assumed to be able to operate at full capacity across almost the entire season milk supply.

38. The manner by which capacity is allocated to NP sites is not commercially feasible or feasible in any sense of the word. It should also be clear that procedure is not sanctioned by S150B (1) (b). That section permits (but does not require) the simplifying assumption that the NP plants are "Standard Plants" (for 23/24, WMP and SMP plants with a daily capacity of 2.0M litres). In all other respects, the way the Standard Plants are assumed to operate must be commercially feasible. Plants cannot "move" between sites, and they cannot be "cut and diced" across multiple sites and across time. The NP thus either needs more factories than the "perfect" configuration that is currently assumed, or the NP assumptions on milk allocations to sites needs to change. This would though still not address the fact that the NP business model itself is not commercially feasible. As already stated, all complexity and fiction from yield calculations is unnecessary and can be removed if NP yields are based on the demonstrably feasible average yields Fonterra actually achieves, providing a fair measure of the best yields that are commercially feasible in the NZ processing industry.

39. <u>The IDPs request the Commission reconsider whether S 150B (1) (b) has been used in a manner which can be considered commercially feasibility in accordance with S 150A.</u>

[24] Fonterra 23/24 Reasons, pg. 47
[25] Draft 23/24 Report, para 4.19
[26] ibid
[27] ibid, para 4.21
[28] ibid

40. While the "Standard Plant" appears to be used to allocate daily milk to NP plants as described above, it is unclear whether Standard Plants are also relevant to determining fixed (daily through to annual) factory cash costs and capital charges. The IDPs request this be clarified, and the Commission confirm these cost assumptions are consistent with a commercially feasible daily processing plan for each Standard Plant.

NP processing losses

41. Rule 7 of the Manual requires product yields to be calculated in a manner which is consistent with milk losses in the Standard Plants. As noted above, "Standard Plants" are not defined in the Manual but are assumed to mean plants equivalent to the average capacity of plants in the NP asset base. For WMP and SMP plants the Standard Plant as previously noted is understood to have a daily capacity of 2.000 M litres.

42. NP processing losses are in fact not determined by losses that can be attributed to Standard Plants. They are based on processing losses of larger actual Fonterra plants, measured while operating in ideal full capacity operating conditions. This includes losses measured in the 2.5M litre and 4.5M litre powder dryers at Darfield commissioned in the 2012/13 and 2013/14 Seasons. These plants are respectively 25% and 225% larger than the NP Standard Plants.

43. The NP asset base includes older plant including 67% of WMP and SMP plant dating back well before 2012. These older plants have an average daily processing capacity of 1.9M litres (para 32 above) and many will be smaller than the "Standard Plant". The Commission states the actual Fonterra plants on which milk processing losses are based use the "*same equipment that the Notional Processor has incurred capital expenditure on*".[29] Does this mean that the NP older plants are in effect assumed retrofitted with modern technology and has NP plant capital and operating costs been adjusted to reflect that? For example, many of the older plants will have been commissioned before more modern innovations such as modern plant for baghouse CIP. Rule 25 of the Manual only states that "*current and appropriate technology*" is used for establishing the *"installation cost and specification of new and replacement Reference Assets".* This only applies to NP plant commissioned since 2012. Rule 38 provides for the upgrade of old plant where it is technologically feasible. But has that been the case for the 67% of WMP and SMP plant including smaller plant dating back prior to 2012.

44. The IDP Focus Areas Submission pointed to the inconsistency between NP plant and the Fonterra plant used for milk loss sampling. The Commission has considered this issue and has concluded that losses determined from the selected Fonterra plants are commercially feasible for the NP plants. The Commission explains this in paragraphs 4.37 to 4.43 of the Draft 23/24 Report which in summary seems to be because:
    a. there are no differences in the age and technology of relevant equipment in the NP plants and the Fonterra plants selected for measuring processing losses and Notional Processor plants;[30] and

[29] Draft 23/24 Report, para 4.40
[30] ibid, para 4.40

b. "because testing occurs at the equipment level on specific loss events, capacity of the plant is not a relevant consideration" [31]

45. The IDPs do not consider this explains why the milk losses on larger, newer and more efficient plants can simply be attributed to all the NP plant. The IDPs request the Commission further clarify this conclusion, including in relation to the mix of factories in the NP asset base.

Target product composition/specification offsets

46. The Appendix to the IDP Focus Areas Submission provided an analysis which demonstrates NP product compositions are materially diluted compared to typical product compositions Fonterra represents to its customers. The IDPs considered this provided further evidence that the NP yields are not commercially feasible.

47. The Commission advises it has been provided information by the independent technical expert appointed by the Milk Price Group which demonstrates (at least in the case of WMP) that Fonterra in fact achieves tighter product compositions than the "typical compositions" it advises to its customers in its product bulletins [32] – i.e. dairy solids in Fonterra actual product is generally lower, and Fonterra yields are generally higher than indicated in "typical compositions". It is difficult to accept this explanation of differences in product composition is credible. If this were the case Fonterra would presumably update its product bulletins and correct the representations it is making.

48. The Commission indicates the NP product compositions are informed by Fonterra's budget product composition[33]. At least in the case of WMP, the Commission confirms the NP target compositions are "slightly" tighter (lower specification offset/higher yield) than Fonterra budgets but does not indicate how it determines the difference is merely "slight". In any event the NP target compositions are apparently different to Fonterra actual compositions.

49. Given NP target product compositions are different to Fonterra actual compositions, there seems no reason why they remain confidential. In the absence of disclosure of NP product compositions and noting Fonterra has not changed its product bulletins to reflect the now claimed lower typical compositions, the IDPs consider it remains doubtful that the NP product compositions are commercially feasible as demonstrated in the analysis in the IDP Focus Areas Submission.

Other Issues – Draft 23/24 Report

Full capacity versus partial capacity

50. The Commission states that[34]
    a. NP plants are assumed to operate at full capacity when (daily?) milk allocated to the plant is at least 90% of (Standard Plant?) processing capacity. This presumably refers to continuous 24 hour per day processing.

[31] ibid, para. 4.43
[32] Draft 23/24 Report, para 4.49
[33] ibid, para 4.53
[34] ibid, para 4.31

b. NP plants are assumed to operate at partial capacity when daily allocated milk falls below 50% of capacity. In this case plants are assumed to operate two days out of three with commensurate lower yield performance.
c. Left unsaid is what happens when milk allocated to an NP plant falls between 50% and 90% of plant capacity.

51. As noted at paragraph 35 above, just 5% of total NP milk is processed in plants operating at partial capacity. The Commission is requested to confirm if this 5% is based on plants operating at less than 50% of capacity. The Commission is also requested to explain what happens if plants are allocated milk that is between 50% and 90% of capacity and how that affects calculated plant efficiencies, milk losses and yields.

Impact of off-GDT pricing

52. The Commission states that off-GDT sales have contributed 8.8 c/kg MS to the BMP and the this compares with 8.3 c/kg MS in 2022/23[35]. On the face of it, this seems only to include off-GDT sales of WMP, SMP and AMF but excludes butter and BMPwdr.

53. The IDPS request that the Commission clarify this. The IDPs request that any consideration of off-GDT sales includes all RCPs, and where reviews and associated information only concern part of the off-GDT outcomes that this be highlighted and explained.

Incremental Product Costs

54. The Commission has provided an example of the IPC for an Instant WMP [36] to assist the IDPs to understand the IPC procedures in the BMP. The IDPs appreciate this effort. The example however provides only minimal useful information and does not address the IDPs primary concerns for two main reasons:
    a. It does not explain how yield differences between non-standard specifications and the SSPs are accounted for. This would require disclosure of the chain of calculations by which selling prices and production volumes are translated to determine weighted average SSP equivalent selling prices.
    b. The milk cost portion is the most significant portion of the IPC given the framework Fonterra uses. However apart from the delta milk solids, the example provides no information concerning the calculation of that milk cost. It does not even state what the milk cost is although there is no obvious reason that would be confidential. The example does however highlight that the milk cost portion is based on a previously unknown BMP calculation procedure to determine a monthly milk "price" (in this case calculated for January 2024). That procedure is entirely opaque and is not even addressed in the Manual. This raises significant issues such as:
        i. Is the relevant milk price based on the month of sale or month of production?
        ii. What is the policy for the USD conversion rate?
        iii. What is the procedure for determining average selling prices relevant for the month in which the milk price is calculated?
        iv. How is the milk price separated between a cost of fat and a cost of protein?

[35] Draft 23/24 Report, para 7.18
[36] ibid, Attachment B

55. The IDPs consider the procedure for calculating and applying a monthly milk cost to the IPCs is wrong in principle, and in practice is unacceptable as it remains completely opaque. The IPC is a "cost" concept – it accounts for the difference between the NP modelled costs (based on the SSPs) and delta costs which would be incurred if the non-standard product were produced by the NP. The IDPs do not have sufficient information to determine if the IPC procedure is appropriate, but it is not even applied consistently in the case of the milk cost element. The monthly milk price does not reflect the cost of milk to the NP. The annual BMP itself is that cost of milk and the milk cost portion of the IPC should therefore be based on the annual BMP. This would also remove objections that the current IPC milk cost calculation is completely opaque. This approach would require a separation of the milk cost into component fat and protein values based on market values, but otherwise requires no changes to the BMP procedures.

56. The IDPs request the Commission further consider the basis for determining the milk cost portion of the IPC and whether it is adequately addressed in the Manual and in other disclosures.

Sustainability Costs

57. The Commission has reviewed the Fonterra policy for including costs of sustainability projects in the BMP. Fonterra has not yet determined whether any additional such costs will be included in the 23/24 BMP calculations.

58. Pending further information on the basis for inclusion or exclusion of actual projects in the BMP, the IDPs have not formed a view in this issue.

Other Issues – Fonterra 23/24 Reasons

Ocean Freight Costs

59. The FAS price of NP sales prices takes into account actual ocean freight costs charged to Fonterra[37].

60. Fonterra also then assumes the NP receives a further ocean freight rebate on the basis that a business with the NP export volumes "could be expected to be able to negotiate with shipping companies"[38]. This makes no sense. The NP processes the same volume of milk and exports virtually the same volume of dairy products as Fonterra. Fonterra thus has the same negotiating power as the NP, and any rebate would already be reflected in Fonterra actual ocean freight costs which the NP has already included. An additional notional rebate is a "double dip".

61. It is possible that Fonterra here is attempting to account for benefits or payments from its investment in Kotahi Logistics (a JV with Silver Fern Farms). However that JV is not within the scope of the NP, and the negotiating power of the JV is even greater than Fonterra standing alone. And again that benefit will already be reflected in Fonterra arm's length freight charges that it has negotiated with Kotahi Logistics.

[37] Fonterra 23/24 Reasons, para 4 page 19
[38] ibid, para 4 page 19

62. The IDPs request the Commission consider why this additional ocean freight rebate is appropriate.

Insurance Recoveries

63. The 23/24 NP calculations provide for an insurance recovery related to costs (Cyclone Gabrielle) which were accounted for in the 2022/23 BMP calculations[39].

64. The IDPs submit that the recovery is unrelated to the 23/24 calculations and should not be included in them. While Fonterra may have over-provided for the costs of the 22/23 BMP, the BMP model is not some sort of accounting system providing for adjustments related to prior periods. The BMP is required to determine a milk price for the current period. Adjustments related to the BMP for prior periods are not relevant or appropriate.

65. In a previous similar situation, the NP was prematurely assumed to make cost savings (commencing for the 2015/16 BMP) that Fonterra only planned to make ("Velocity"). The savings were not in fact achieved and were removed from NP costs in the 2018/19 BMP. The costs which had been understated in the interim were never then reopened or accounted for in the 2018/19 BMP.

66. The IDPs request the Commission consider if it is appropriate to make retrospective adjustments for prior period BMPs in the current period BMP calculations.

Authorisation

This submission is authorised by:

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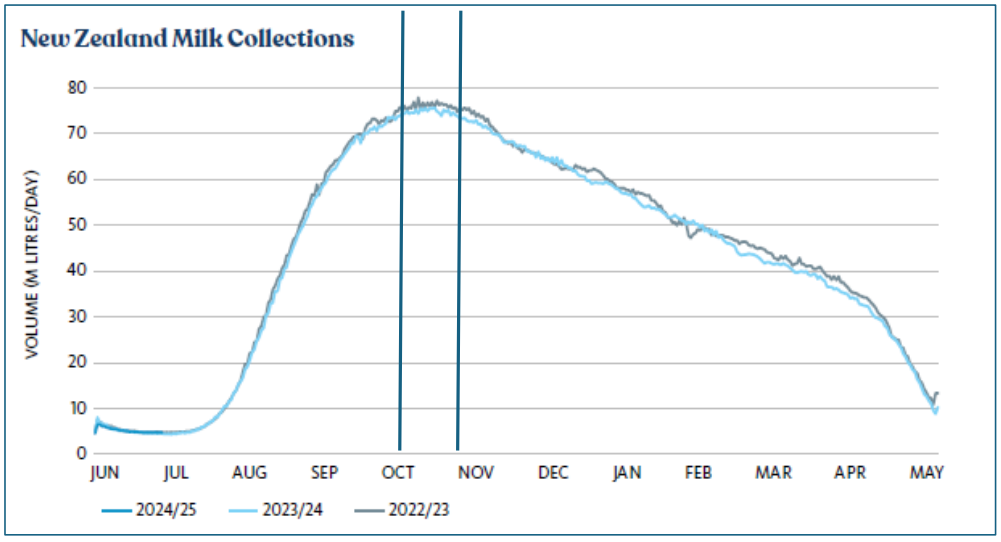
[39] ibid, page 32 "One-off Costs"

Attachment A: New Zealand Seasonal Milk Supply



Source: Global Dairy Update (Fonterra) July 2024

	MS (000)	%
Jun-23	20,784	1%
Jul-23	25,116	1%
Aug-23	112,564	6%
Sep-23	210,436	11%
Oct-23	254,432	14%
Nov-23	239,213	13%
Dec-23	225,182	12%
Jan-24	201,791	11%
Feb-24	174,718	9%
Mar-24	172,573	9%
Apr-24	149,987	8%
May-24	96,364	5%
Total	1,883,160	

Data Source:
https://dcanz.com/resources/