



Dairy for life

'Reasons' Paper in support of Fonterra's Milk Price Manual for the 2018/19 Season

1 August 2018

Glossary

F18 Final Manual Report	Commerce Commission, Final Report on the Review of Fonterra's 2017/18 Milk Price Manual, 15 December 2017, http://comcom.govt.nz/regulated-industries/dairy-industry/review-of-fonterra-s-farm-gate-milk-price-and-manual/statutory-review-of-milk-price-manual/201718-season/
F17 Base Milk Price Draft Report Submission	Fonterra, Submission to the Commerce Commission on its Draft Report on Fonterra's 2016/17 base milk price, 1 September 2017, http://comcom.govt.nz/regulated-industries/dairy-industry/review-of-fonterra-s-farm-gate-milk-price-and-manual/statutory-review-of-milk-price-calculation-2/review-of-milk-price-calculation-201617-season/
F17 Base Milk Price Reasons Paper	Fonterra, 'Reasons' Paper in support of Fonterra's base milk price for the 2016/17 Season, 3 July 2017, http://www.comcom.govt.nz/regulated-industries/dairy-industry/review-of-fonterra-s-farm-gate-milk-price-and-manual/statutory-review-of-milk-price-calculation-2/review-of-milk-price-calculation-201617-season/
MPG	The Milk Price Group, the independent unit responsible for determining and recommending to the Milk Price Panel the Farmgate Milk Price.
NMPB	Notional Milk Price Business, comprising the notional milk powder manufacturing business implied by Fonterra's Farmgate Milk Price Manual.
R&M	Repairs and maintenance.
RCP	Reference commodity product(s), comprising WMP, SMP, BMP, Butter and AMF.
F19 Season	The period commencing on 1 June 2018 and ending on 31 May 2019.

1 August 2018

To: The Commerce Commission

1. Fonterra Co-operative Group Limited (“Fonterra”), certifies that:
 - a. in terms of section 150L(d) of the Dairy Industry Restructuring Act 2001 (“Act”), Fonterra considers that its milk price manual to be applied in calculating Fonterra’s Farmgate milk price for the 2018/19 financial year is, in all material respects, consistent with the purpose of subpart 5A of the Act; and
 - b. none of the circumstances set out in section 150G(1) of the Act have occurred with respect to the milk price manual to be applied in calculating Fonterra’s Farmgate milk price for the 2018/19 financial year.
2. This certification is based on our interpretation of subpart 5A, and the other relevant assumptions, views and qualifications set out in the accompanying reasons provided pursuant to s 150L(e).



Signed by

Andrew Cordner
Director, Legal

1 Introduction

This paper provides the reasons in support of Fonterra's certification in respect of the Milk Price Manual to be applied in the calculating Fonterra's Farmgate milk price in respect of Fonterra's 2018/19 financial year and the corresponding Season (the F19 Manual), as required under section 150L of the Dairy Industry Restructuring Act 2001 (DIRA). The paper has been prepared under the oversight of the Milk Price Panel, and where relevant reflects the Panel's views.

Section 150L provides that Fonterra must:

- Provide the Commission with the milk price manual for the current season (i.e., the season corresponding to Fonterra's 2018/19 financial year) (section 150L(a));
- Provide the Commission with any recommendations by the Milk Price Panel "in relation to the setting of the base milk price" (section 150L(b));¹
- Notify the Commission of any change in the economic and business environment that, in Fonterra's view, requires a change to the milk price manual (section 150L(c));
- Certify to the Commission the extent to which Fonterra considers that the milk price manual is consistent with the purpose of subpart 5A of DIRA (section 150L(d)); and
- Provide the Commission with reasons for the view expressed in its certificate (section 150L(e)).

In addition, section 150G sets out the steps that Fonterra is required to take if it does not amend the Manual in accordance with a recommendation by the Panel, if it amends the Manual contrary to a recommendation by the Panel, or if it amends the Manual without having received a relevant recommendation from the Panel. We advise that none of these circumstances has occurred with respect to the F19 Manual.

On 26 July 2018 the board of Fonterra approved amendments to the Milk Price Manual, all of which were recommended by the Milk Price Panel. These amendments are set out in 'mark up' form in the Milk Price Manual attached to this paper and, where relevant, we explain their rationale below. In all other respects, the F19 Manual is identical to the Manual applied by Fonterra in respect of the 2017/18 season (the F18 Manual), and in respect of which Fonterra submitted a certification and reasons paper on 1 August 2017. Consistent with that paper, we have confined our comments in this paper to areas where our views have changed subsequent to preparing previous reasons papers, or where we wish to provide additional information. In all other respects, we request that this paper be read in conjunction with our reasons papers submitted in respect of the 2012 – 2018 seasons.

We have also recently provided (in our 'reasons paper' in respect of the 2017/18 base milk price) the Commission with our views on the appropriate interpretation of section 150A of DIRA (the purpose provision), and have not repeated these views in this paper.

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

- In section 2, we set out, and explain the rationale for, the substantive amendments to the F19 Manual, and comment on the consistency of these amendments with section 150A.
- In section 3, we summarise the more minor changes.
- In section 4, we summarise our reasons for not making certain amendments proposed by the Commission.
- In section 5, we comment on changes in the economic and business environment that are potentially of relevance to the calculation of the base milk price, and explain why we have not amended the Manual in response to these changes for the 2018/19 year.

The attachments to this paper comprise:

- Attachment 1: a summary of all proposed amendments (other than very minor edits).
- Attachment 2: a worked example showing the impact of the amendments set out in section 2.

¹ As in our previous 'reasons papers' we have interpreted this provision as in fact relating to recommendations by the Milk Price Panel in relation to amendments to the Milk Price Manual. We have separately provided the Commission with the Panel's recommendations to the Fonterra Board on amendments to the Manual.

Attachment 3: a 'marked up' version of the Milk Price Manual, identifying all amendments, and which satisfies the section 150L(1) requirement that Fonterra provide the Commission with the manual for the current season. Brief comments on the rationale for each amendment are also included in this attachment.

2 Substantive amendments to the F19 Manual

Attachment 1 to this paper summarises all amendments to the F19 Manual, other than very minor changes to correct cross-references or editorial errors.² The only substantive amendments are intended to:

- Create better alignment between the Manual and the terminology used by the Fonterra in other contexts with respect to communications around the Milk Price. In particular, the amendments mean the term 'Farmgate Milk Price' now refers to the average price paid by Fonterra for milk supplied on standard terms of supply. Consequently, and consistent with the Commission's finding in its 2015/16 calculation review, the forecast Milk Price announced during a season will formally comprise the forecast price for milk supplied on standard terms.
- Codify the Milk Price Panel's role in recommending to the Fonterra Board precisely which payments should (and which should not) be funded from the aggregate amount payable for milk calculated under the Manual.

The relevant amendments to the Manual:

- A. Align the terminology in the Manual with common usage by:
 - defining the 'Aggregate Farmgate Milk Price' as the aggregate amount paid for milk fat and protein supplied under Fonterra's standard terms of supply.
 - defining the Farmgate Milk Price as 'the Aggregate Farmgate Milk Price' divided by total kgMS supplied to Fonterra.
 - defining new terms (discussed below) to make explicit which other payments for milk and adjustments to payments are taken into account when calculating the average share-backed Farmgate Milk Price.
- B. Codify the principles used to determine which payments for milk will in the normal course be funded from the aggregate amount calculated under the Manual, comprising:
 - Payments for milk fat and protein supplied under Fonterra's standard terms of supply (the Aggregate Farmgate Milk Price).
 - The net amount arising from adjustments to payments for milk supplied under Fonterra's standard terms of supply by way of the volume adjustment, the capacity adjustment, DDE charges and milk quality demerits (Standard Supply Adjustments).
 - The net amount of all premiums and discounts, calculated relative to the Farmgate Milk Price, applied to payments for milk supplied other than on standard terms of supply where (and to the extent) the Panel determines it would be commercially appropriate for the Notional Commodity Business to source that milk on the relevant terms for conversion into RCPs (Additional Commodity Milk Payments). Amounts currently captured under this definition include the portion of winter milk premiums funded from the Milk Price and certain discounts for 'contract milk' which is not supplied under standard share-backed terms.
- C. Define the aggregate amount calculated under the Manual as the 'Aggregate Commodity Milk Payments Amount', and provide that the Aggregate Farmgate Milk Price equals:
 - Aggregate Commodity Milk Payments Amount
 - Less
 - Additional Commodity Milk Payments
 - Less
 - Standard Supply Adjustments.
- D. Codify the principles used to determine which payments for milk will not in the normal course be funded from the aggregate amount calculated under the Manual, comprising the portion of payments (or premiums) for milk that is explicitly sourced for the manufacture of products that are not RCPs (e.g., organic milk and winter milk for local market supply or conversion into UHT or food service products) ("Non Commodity Milk Payments") that a manufacturer of the RCPs would not be prepared to pay if the milk was used to manufacture RCPs. The key principle is that the amount of payments for milk sourced for value-add uses that will be funded from the Aggregate Commodity Milk

Payments Amount will be capped at the maximum amount that the Notional Commodity Business would rationally have paid to source that milk for conversion into RCPs.

These amendments:

- Do not result in any changes to the aggregate amount available to pay for milk that is calculated under the Manual or to the allocation of that amount across payments for standard share-backed milk supply and other payments.
- Are intended to provide a framework within which Fonterra can focus its public communications around the 'Farmgate Milk Price' as that term is commonly understood.
- Will effectively formally extend the Milk Price Panel's role to include advising the Board on which payments for milk can be considered Additional Commodity Milk Payments which should therefore be funded from the aggregate amount calculated under the Manual. This extension is consistent with actual practice since the 2009/10 season.
- Will preserve the current demarcation between the responsibilities of the Milk Price Panel, the Co-operative Relations Committee (the Fonterra Board sub-committee responsible for advising the Fonterra Board on the detail of the milk payments system), and the Fonterra Board. In particular, the amendments do not require the Panel to recommend or advise on how the milk payments system should be structured (including terms of supply, milk component allocations or payment adjustments); just on whether particular payments as mandated by the Board (or the Co-operative Relations Committee) should or should not be funded from the aggregate amount (the Aggregate Commodity Milk Payments Amount) calculated under the Manual.
- Do not otherwise impact on the Fonterra Board's overall responsibility with respect to the final determination of the Farmgate Milk Price for a season.
- Are consistent with Fonterra's obligation under DIRA to certify that the assumptions, inputs and processes used to calculate the 'base milk price' are consistent with the DIRA purpose provision.

3 Minor amendments

We summarise in the table below minor amendments that are consistent with undertakings provided to the Commission in our submission on the Commission's draft report on the F17 base milk price, as summarised in paragraph 43 of the Commission's F18 Final Manual Report.

Amendment	Comment
Definition of Qualifying Material amended to make explicit that a product can only be included in the Milk Price revenue calculation if it has three commodity product related attributes (per the definitions below).	In response to transparency-related concerns raised by the Commission we undertook in our submission on the draft 2017 base milk price report to provide further clarity around the attributes of product specifications which we consider to be commodity products and therefore eligible for inclusion in the Milk Price revenue calculation.
New defined term Standard Product Offering.	Per above, clarifies that the only product specifications included in the Milk Price calculation are specifications that are sold on GDT or generic products sold to multiple customers in multiple regions, and which are substitutable for the relevant base offerings.
New defined term Standard Packaging.	Per above, clarifies that only products which are packaged in standard commodity-category packaging formats are included in the Milk Price revenue calculation.
New defined term Specialised Plant.	Per above, clarifies that product that can only be manufactured in plants that are materially different to the standard reference plants included in the Milk Price asset base cannot be included in the Milk price revenue calculation.

4 Other matters

For completeness, we advise that we have not changed our position on the matters summarised in Table B of the Commission's F18 Final Manual Report (other than disclosure of the base milk price for milk supplied on standard terms of supply), and again summarise our reasons in the table below.

Commission's proposal	Fonterra's response
The omission from the Manual of costs associated with providing supplier support (to ensure continued supply to the notional producer) is not consistent with the contestability dimension.	No change to our position that it is not appropriate to fund these costs from the Milk Price.
We agree with Fonterra that the Manual should evolve over time consistent with the methodology of a real-world processor. We consider the Manual should outline what is considered a 'material change' when considering a change to the Manual and specify the timeliness of making such a change in order to set a minimum level for disclosure of changes	No change, for reasons explained on page 5 of our submission on the Commission's F17 Draft Manual Report (a 'bright line' materiality threshold is likely to lead to less disclosure).
We recommend that Fonterra considers disclosing its plant capacity for both primary and secondary plants in the Manual. This earlier disclosure should provide increased transparency of the assumed capacity of the notional producer for the season. We consider Fonterra's latest amendment still allows a significant level of discretion.	We do not consider the Manual is the appropriate vehicle for these disclosures. We have previously put this information into the public domain, including in the F17 and F18 Base Milk Price Reasons Papers, and the relevant assumptions will not be revisited until F20.
We consider there should be more transparency of information on the actual foreign exchange rates assumed to be achieved by the notional producer. We suggest providing an average FX conversion rate assumed to be achieved by the notional producer throughout the season.	Outside scope of Manual.

5 Changes in the economic and business environment

We confirm we are not aware of any changes in the economic or business environment that would in our view necessitate a change to the Milk Price Manual for the F19 Season. In arriving at this view, we have had regard to the following:

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

Attachment 1: Summary of amendments

Manual Reference	Amendment	Comment
Amendments consequential on revised 'Farmgate Milk Price' related terminology		
pp.5-6	Rearrangement of existing text & introduction of new 'Aggregate Farmgate Milk Price' and 'Farmgate Milk Price' definitions.	No substantive impact, other than to align text with new defined terms.
p.32	Addition of requirement for the annual Milk Price Statement to explain how the Farmgate Milk Price has been determined and how it ties back to the aggregate amount calculated under the Manual.	Consistent with both past practice and a key purpose of these changes, which are intended to enable better alignment of the Milk Price Statement and Manual to other supplier Milk Price-related communications.
p.56 Rule 44	Aggregate amount available to pay for milk which is calculated under the Manual now defined as 'Aggregate Commodity Milk Payments' rather than 'Farmgate Milk Price'.	New terminology: <ul style="list-style-type: none"> Reflects fact that a portion of the aggregate amount calculated under the Manual is not applied to the payment of the Farmgate Milk Price as that term is commonly understood. Highlights that payments for milk that are not related to the generation of commodity-related returns are not funded from the aggregate amount calculated under the Manual.
p.56 new rule 45	Payments for milk not supplied on standard terms will only be funded from the aggregate amount calculated under the Manual if the Panel determines that it would be 'commercially appropriate' for an RCP-only commodity processor business to make those payments.	Consistent with past practice but not previously made explicit in the Manual.
p.56 new rule 46	Adjustments to payments for milk supplied on standard terms (eg demerits deductions) will be added back to / deducted from the Aggregate Farmgate Milk Price.	Consistent with past practice but not previously made explicit in the Manual.
p.57 new rule 47	Aggregate Farmgate Milk Price (for payment for valued components in milk supplied on standard terms) to be calculated as the total aggregate amount calculated under the Manual, less the amounts calculated under the new Rules 45 and 46.	Calculation method is consistent with past practice, but term 'farmgate milk price' now applies specifically to payments for milk supplied on standard terms.
p.58, new rule 48	Defines the Farmgate Milk Price as the total amount available to pay for valued components (milk fat and protein) supplied on standard terms divided by total kgMS supplied to Fonterra.	The average Milk Price paid for milk supplied on standard terms is the amount that is most commonly reported to Fonterra's suppliers, but has not previously been separately defined in the Manual.
p.58, new rule 49	Provides that payments for milk sourced for value-add purposes will not be funded from the Aggregate Farmgate Milk Price if an RCP-only processor would not have made those payments.	This rule is technically not necessary, given the new Rule 45. However, we consider it useful for communication purposes to make it explicit that certain 'value-add' type payments for milk are not funded from the aggregate amount calculated under the Manual (on the basis that the related

Manual Reference	Amendment	Comment
		value-add returns are also not included in the calculation).
Amendments in respect of Fonterra's undertakings to the Commerce Commission		
p.64	Definition of Qualifying Material amended to make explicit that a product can only be included in the Milk Price revenue calculation if it has three commodity product related attributes (per definitions below).	In response to transparency-related concerns raised by the Commission we undertook in our submission on the 2017 base milk price report to provide further clarity around the attributes of product specifications which we consider to be commodity products and therefore eligible for inclusion in the Milk Price revenue calculation.
p.64	New defined term Standard Product Offering	Per above, clarifies that the only product specifications included in the Milk Price are specifications that are sold on GDT or which are generic products sold to multiple customers in multiple regions, and which are substitutable for the relevant base offerings.
p.64	New defined term Standard Packaging	Per above, clarifies that only products which are packaged in standard commodity-category packaging formats are included in the Milk Price revenue calculation.
p.64	New defined term Specialised Plant	Per above, clarifies that product that can only be manufactured in plants that are materially different to the standard reference plants included in the Milk Price asset base cannot be included in the Milk price revenue calculation.
p.80	New defined terms Standard Supply Milk Payments, Additional Commodity Milk Payments and Non-Commodity Milk Payments	Consequential on, and provide additional detail on, the new Part B Rules 45, 46 and 47.

Attachment 2 – Worked example of amendments described in section 2

Assumptions

Total supply (million kgMS)	1,500
Winter milk supply (million kgMS)	40
Contract milk supply (million kgMS)	30
Aggregate amount calculated under Manual (\$ m) (now defined as Aggregate Commodity Milk Payments Amount)	9,000
Net demerit & DDE deductions (\$ m)	12
Commodity winter milk premium (\$ per kgMS)	0.75
Average contract milk discount (\$ per kgMS)	-0.10

Calculations

Aggregate Commodity Milk Payments Amount (\$m)	9,000
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Additional Commodity Milk Payments calculation

Winter milk supply x commodity winter milk premium (\$ m)	-30
Contract milk supply x average contract milk discount	3

Additional Commodity Milk Payments	-27
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Standard Supply Adjustments calculation

Net demerit & DDE deductions	12
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Standard Supply Adjustments	12
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Aggregate Farmgate Milk Price calculation

Aggregate Commodity Milk Payments	9,000
less Additional Commodity Milk Payments	-27
plus Standard Supply Adjustments	12

Aggregate Farmgate Milk Price	8,985
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Farmgate Milk Price calculation

Aggregate Farmgate Milk Price	8,985
divided by total supply	1,500

Farmgate Milk Price (\$ per kgMS)	5.99
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