

Proposed focus areas for our review of Fonterra's 2022/23 base milk price calculation

Process paper

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Associated documents

Publication date	Reference	Title
5 July 2021	ISBN 978-1-869459-10-9	Our approach to reviewing Fonterra's Milk Price Manual and base milk price calculation 2021
15 September 2022	ISBN 978-1-99-101230-2	Review of Fonterra's 2021/22 base milk price calculation: Dairy Industry Restructuring Act 2001
15 December 2022	ISBN 978-1-99-101260-9	Review of Fonterra's 2022/23 Milk Price Manual: Dairy Industry Restructuring Act 2001

Introduction

1. This paper provides interested parties with details of our proposed focus areas for our review of Fonterra's base milk price calculation for the 2022/23 season (**the calculation**) under the Dairy Industry Restructuring Act 2001 (**DIRA or the Act**). This paper also invites feedback on those focus areas and seeks relevant information on those focus areas.
2. Our primary role under the Act 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 (**the Manual**). The Manual contains the specific methodology Fonterra uses to calculate its base milk price. 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 Subpart 5A of the Act.
 - 3.2. The second annual review we undertake is of Fonterra's base milk price calculation at the end of each dairy season (**calculation review**). The calculation review assesses whether the costs, revenue and other assumptions used in the base milk price calculation are consistent with the purposes of Subpart 5A of DIRA.
4. The framework for our reviews is contained in our **Approach paper**.² We are currently consulting on an updated Approach Paper which can be found [here](#).³

We are reviewing Fonterra's 2022/23 base milk price calculation

5. This Calculation review is the second of the reviews that we are required to complete under the Act in relation to the base milk price for the 2022/23 dairy season.

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

² Commerce Commission "[Our approach to reviewing Fonterra's Milk Price Manual and base milk price calculation](#)" (5 July 2021).

³ Commerce Commission "[Our approach to reviewing Fonterra's Milk Price manual and base milk price calculation](#)" (30 March 2023).

6. The first review for the 2022/23 season looked at the Manual. We published the final report on our review of the Manual for the 2022/23 season on 15 December 2022.⁴ We 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 includes key areas of focus for the review. We determine the focus areas for each calculation review based on a number of criteria. 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).
9. In addition to the specific focus areas, our annual review of the calculation includes a 'fit for purpose' review of all revenue and cost components of the base milk price calculation. The fit for purpose review compares the component values against our previous reviews of the same components and reviews the assumptions, inputs and processes related to the different components for consistency.
10. As required by the Act, we produce a draft report of our review of Fonterra's base milk price calculation for each season by **1 August**⁶ and a final report by **15 September**.⁷

⁴ Commerce Commission "[Review of Fonterra's 2022/23 Milk Price Manual: Dairy Industry Restructuring Act 2001 – final report](#)" (15 December 2022).

⁵ Fonterra "[Farmgate Milk Price Manual](#)" (1 August 2021).

⁶ In prior years this was 15 August, but the recent DIRA amendments brought the date forward.

⁷ However, if either of these dates falls on a non-working day, the date may be extended to the next working day – see section 55 of the Legislation Act 2019.

Indicative timeline

Indicative date	Publication/event
30 March 2023	Proposed focus areas published
12pm, 27 April 2023	Submissions on proposed focus areas due
1 August 2023	Draft report on the review of milk price calculation published by
15 August 2023	Submissions on draft report due
15 September 2023	Final report on the review of milk price calculation published by

Our proposed focus area

11. Our process for selecting the proposed focus area for the 2022/23 review was informed by:
 - 11.1. outstanding issues from previous calculation and Manual reviews;
 - 11.2. Fonterra's review of assumptions and components in accordance with its Manual;⁸
 - 11.3. Fonterra's amendments to the current season's Manual or any amendments to Fonterra's approach to calculating the components that do not require a Manual amendment; and
 - 11.4. any changes to DIRA.

Calculation of the monthly Benchmark FX Conversion Rate

12. For our 2022/23 calculation review, we are proposing the calculation of the monthly Benchmark Foreign Exchange (FX) Conversion Rate as the focus area.
13. The Manual describes the monthly Benchmark FX Conversion Rate as

“the average rate at which Fonterra actually converts net receipts denominated in any currency other than NZD to NZD in the month, specified as a ratio of USD to NZD and

⁸ The summary calculation of the base milk price is broken down into various revenue and cost components. The Manual provides a timeline for Fonterra to review certain assumptions, revenue and cost components every four years (or when the Panel chooses to complete a review).

calculated with regard to all costs and benefits of Fonterra's hedging activities in respect of amounts converted in that month".⁹

14. The scope of this review will likely include:
 - 14.1. A walkthrough of the FX conversion methodology as outlined in the Manual and Reasons paper in support of Fonterra's Base Milk Price;
 - 14.2. Consideration of adjustments to reflect the scale and range of Notional Producer (NP) product sales;
 - 14.3. Review of the application of Fonterra's hedging policy to the NP;
 - 14.4. Review of the selection of price and conversion date for volume-only informing off-GDT sales;
 - 14.5. Analysis of the conversion of lactose costs; and
 - 14.6. Consideration of the application of s 150B(1)(c).¹⁰
15. This scope is not necessarily exhaustive and does not limit our ability to evaluate other relevant factors.

Milk collection costs considered as a potential focus area

16. In its submission on the proposed focus areas paper for the 2021/22 calculation review, Miraka requested that we undertake a review of the practical feasibility of milk collection costs and consider including a review of milk collection costs in the 2022/23 calculation review.¹¹
17. In our final report on the 2021/22 calculation review, we said that we will consider the inclusion of milk collection costs as a focus area in the 2022/23 calculation review.¹²
18. We have reviewed the arguments and consider that at this time there is insufficient evidence to justify a detailed review as part of our 2022/23 calculation review.

⁹ Fonterra "[Farmgate Milk Price Manual](#)" (1 August 2021), page 38.

¹⁰ s 150B has been amended by the Dairy Industry Restructuring (Fonterra Capital Restructuring) Amendment Act 2022 which has inserted a new s 150B(2) and s 150P(1A). As outlined in our updated Approach Paper, we consider this allows us to assess the appropriateness of the assumptions used under s 150B(1)(c) against the s 150A purpose.

¹¹ [Miraka Limited "Submission on the proposed focus areas paper for base milk price calculation 2021-22" \(6 May 2022\), at 35.](#)

¹² [Review of Fonterra's 2021/22 base milk price calculation: Dairy Industry Restructuring Act 2001, Attachment A, page 45.](#)

19. In the absence of a milk price model that explicitly allocates milk collected by the NP to Fonterra-equivalent processing sites by geographical location, it is difficult to test milk collection cost assumptions. We continue to accept that it may be reasonable to use actual data in setting the base milk price in situations, for example, when there is insufficient information to know what an appropriate notional value would be, or it would be unreasonably costly to obtain this information. For this reason, we consider the use of Fonterra's actual costs of milk collection to be consistent with the efficiency dimension of the s 150A purpose.
20. We consider the base milk price setting is consistent with the contestability dimension if the assumptions adopted, and inputs and process used are practically feasible for Fonterra, or another processor, that is efficiently building an incremental plant.
21. The Manual largely provides for the use of inputs that are based on the average across all relevant notional RCP plants used in the calculation, rather than on any single recently built Fonterra plant, including in respect of milk collection costs. This is consistent with an assumption that there is a national network of facilities for the collection and processing of milk, as allowed by s 150B(a) of the DIRA. The use of parameters that reflect Fonterra's actual 'average' plant capacity rather than its most cost-efficient plant(s) means an efficient processor building an incremental plant should be able to achieve lower costs than this.
22. We therefore consider it is likely that an efficient processor, locating an incremental plant close to its future source of supply can achieve milk collection costs that are lower than the NP and accordingly, that the milk collection costs of the NP are practically feasible.

We invite your views on our focus area(s) for this year's calculation review

23. We invite submissions on the following matters by **12 noon, Thursday 27 April 2023**:
 - 23.1. whether the proposed focus area should form part of our review, and whether there are further focus areas that should be included; and
 - 23.2. any relevant information about the proposed focus area or any further proposed focus areas.
24. Receiving submissions on these matters will:
 - 24.1. assist us to decide what the focus areas should be for our calculation review; and
 - 24.2. provide us with information relevant to the proposed focus areas, so that we may take this information into account when deciding on the focus areas and when examining the focus areas as part of our calculation review.

25. Please address all submissions to:

Keston Ruxton, (Manager, Fuel and Dairy)

c/o market.regulation@comcom.govt.nz

Subject line: Proposed base milk price calculation focus areas paper 2022/23

26. We prefer submissions in both a format suitable for word processing (such as a Microsoft Word doc), and a 'locked' format (such as a PDF) for publication on our website.
27. The protection of confidential information is something the Commission takes seriously. The process requires you to provide (if necessary) both a confidential and public version of your submission and to clearly identify the confidential and public versions.
28. When including commercially sensitive or confidential information in your submission, we offer the following guidance:
- 28.1. Please provide a clearly labelled confidential version and public version of your submission. We intend to publish all public versions on our website.
- 28.2. 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.
29. Please note that all submissions we receive, including any parts that we do not publish, can be requested under the Official Information Act 1982. This means we would be required to release material that we do not publish unless good reason exists under the Official Information Act 1982 to withhold it. We would normally consult with the party that provided the information before any disclosure is made.