



15 August 2023

By email

The Commissioners
Commerce Commission
44 The Terrace
Wellington

REVIEW OF FONTERRA'S 2022/23 BASE MILK PRICE CALCULATION: DAIRY INDUSTRY RESTRUCTURING ACT 2001

We have reviewed the Commission's draft report on the above review. We appreciate the work undertaken by the Commission on the review to date and acknowledge the Commission's draft overall conclusion that:

"... except for inter-site diversion costs, the assumptions adopted, and the inputs and processes used by Fonterra to calculate the 2022/23 base milk price are consistent with the contestability and the efficiency dimensions of the section 150A Purpose [and that our] draft conclusion is that inter-site diversion costs are likely to be consistent with the contestability dimension of the section 150A purpose, and are consistent with the efficiency dimension of the section 150A purpose."

Our comments in this submission are confined to:

- The Commission's analysis and conclusions with respect to inter-site diversion costs.
- The DIRA definition of 'commodity',
- The Commission's consideration of materiality when forming its views on practical feasibility.

Inter-site diversion costs

The overall allowance in the base milk price for inter-site diversion costs is in the vicinity of \$15 million, or 1 cent per kgMS. As the Commission understands, we use a detailed model to estimate the allowance for diversion costs. Like all the models used to calculate inputs into the base milk price calculation, the diversion cost model contains simplifying assumptions. The Commission has highlighted two simplifying assumptions in the diversion cost model which result in minor inconsistencies for a small number of sites in the types of products assumed to be manufactured on those sites and in assumed manufacturing capacity for those products. These simplifying assumptions and the resulting minor inconsistencies have been present since the development of the modelling logic in 2008. Like the Commission, we do not believe these assumptions materially affect the base milk price and, like the Commission, we believe they materially offset. Our assessment is that the net impact is a small **overstatement** of costs, in the vicinity of \$1m - \$2m, or around 0.1 cents per kgMS. We will separately share our analysis with the Commission, and will modify the diversion cost model used for the 2023/24 base milk price to address the matters raised by the Commission.

As a minor point, we note the Commission’s comment in paragraph 3.63 that “as noted at paragraph 3.62.1.7 above, the calculation does not take into account whether a particular site has sufficient capacity to process all milk delivered to the site into SMP **and** WMP” (emphasis added) does not accurately reflect the corresponding observation in paragraph 3.62.17, which explains that the calculation **does** take into account whether a particular site has sufficient capacity to process all milk delivered to the site into SMP and WMP, but **does not** test whether it has sufficient capacity to process all the milk allocated to SMP into SMP, or whether it has sufficient capacity to process all the milk allocated to WMP into WMP.

Other matters

Definition of commodity

On p.37 of the Draft Report the Commission explains, in the context of the DIRA definition of ‘commodity’, that it “would expect Fonterra to address the ... recommendation made in our 2021/22 Calculation review, to revise the Manual to provide guidance on the interpretation of what constitutes significant quantities and over what time frame the assessment is made ... when it next reviews the Manual.”

We provided the Commission with our Manual for 2023/24 and our reasons paper in support of the changes to the Manual on 1 August 2023, and the Commission will have noted that we have not addressed this recommendation. This is because we focused on addressing the commodity definition-related matters raised by the Commission in its final report on the 2022/23 Manual, where the Commission explained in paragraph 48 that:

“ ... as we noted in the 2021/22 Calculation Review, we suggest, from a transparency perspective, that Fonterra considers whether the definition of Standard Product Offering in the Manual can be clarified, particularly with respect to the cascable product rule, or the application of the definition explained more clearly in the calculation Reasons paper.”¹

We are happy, however, to provide the following observations on our interpretation of the phrase ‘significant quantities’ in the context of the DIRA definition of a commodity:

- There is not good data available on the traded volumes of various subcategories of dairy products – e.g., Instant vs UHT vs Regular WMP – meaning we generally rely on indirect evidence that a particular product type is traded in significant quantities, including anecdotal evidence from purchasers of product manufactured by Fonterra, the number of manufacturers promoting the availability of the product, and so forth. While Fonterra will generally be able to put forward informed estimates as to the internationally traded quantities of particular products it would often struggle to source authoritative supporting data.
- We therefore tend to focus on considering the availability of a product which can otherwise be considered to have the characteristics of a commodity, with a focus on whether the equivalent products offered by different sellers have identical technical characteristics, whether buyers consider them to be substitutable, our understanding of the size of the pool of actual or potential buyers, whether the product is widely offered by multiple sellers, on the quantity of the product sold by Fonterra, and on whether it is reasonable to assume the

¹ https://comcom.govt.nz/_data/assets/pdf_file/0022/301819/Final-report-Review-of-Fonterra27s-2022-23-Milk-Price-Manual-15-December-2022.pdf, p.13.

prices Fonterra realises on sale of the product are not systematically different to the prices achieved by other sellers of the same product manufactured to the same specification. The emphasis placed on each of these (and other) indicia will vary with circumstances and data availability, and we therefore do not believe it is feasible to draft a sensible formulaic test for inclusion in the Manual.

- Our amendment to the Manual for 2023/24 clarifies that we consider it appropriate to apply the 'significant quantities' test by reference to the quantity of functionally-equivalent products traded in globally-contested markets, and not by reference to the quantity traded of individual product specifications. This clarification is relevant to the assessment of the single product specification queried by the Commission in its detailed 2021/22 assessment of the qualifying materials included in the base milk price revenue calculation. That product was a standard specification AMF product sold in a specific 1250kg packaging format which is generally available for use by dairy processors, but which it appears not many processors offer. In the context of the amended definition, the relevant commodity category is standard specification AMF, and not standard specification AMF sold in a non-customer specific 1250kg packaging format, and the product specification therefore clearly satisfies the 'significant quantities' test.²

Practical feasibility and materiality

As noted above, the Commission's draft conclusion with respect to diversion costs is that our allowance is "likely to be practically feasible for an efficient processor" on the basis that while the Commission believes there is "a small net understatement of ... costs" the understatement is "immaterial." Previously, where the Commission has identified that a cost input is potentially understated by an immaterial amount, the Commission has not qualified its conclusion on practical feasibility. For example, the Commission's report on the 2013/14 base milk price contained the following passage:³

² The inclusion in the 2021/22 base milk price of this particular AMF specification, which was the only product specification queried by the Commission in the context of the 'significant quantities' test, had an impact of 0.02 cents per kgMS.

³ https://comcom.govt.nz/_data/assets/pdf_file/0030/63966/Final-report-Review-of-Fonterras-2013-14-base-milk-price-calculation-15-September-2014.PDF, p.128.

Is the calculation practically feasible?

- O11 As it is based on costs already achieved by Fonterra for plant comparable to the notional producer, we consider that the calculated percentage of repairs and maintenance costs to fixed asset replacement costs is practically feasible.
- O12 The percentage ratio is then multiplied by the notional producer's fixed asset replacement cost in order to obtain the modelled repairs and maintenance cost. We are unable to conclude that fixed assets are practically feasible (outlined in Attachment U: fixed assets). However, for the purposes of calculating repairs and maintenance costs, the potential errors in the fixed assets do not lead to a material uncertainty. If the asset value was in error by 20%, which is a generous margin, the Manual-consistent milk price would change by around 1.4 cents per kgMS.
- O13 As we have concluded that the benchmark percentage ratio of repairs and maintenance costs to fixed assets is practically feasible and that the uncertainties in the notional fixed asset replacement costs are unlikely to lead to a material impact on repairs and maintenance costs, we conclude that the repairs and maintenance costs are practically feasible. However, we note a caveat that any error in the notional fixed asset replacement cost will translate into a proportionate error in the repairs and maintenance costs.

The Commission took a similar approach in this excerpt from its 2014/15 base milk price report:⁴

- 7.59 We have been provided with analysis from an independent processor, which has indicated that the specification offsets for WMP and SMP should be higher. We consider that the impact on the milk price resulting in using the data is largely immaterial.
- 7.60 We therefore consider the specification offsets to be practically feasible and accept Fonterra's explanation on the reduction of WMP moisture content for WMP.

The Commission's historic approach of disregarding immaterial under-estimates (or over-estimates) when opining on the practical feasibility of inputs is in our view appropriate, among other reasons because it effectively acknowledges the necessary trade-offs between accuracy, simplicity (and understandability) and the costs involved in maintaining and operating the Farmgate Milk Price model.

Yours sincerely,

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Director Group Finance

⁴ https://comcom.govt.nz/_data/assets/pdf_file/0028/63964/Final-report-Review-of-Fonterras-2014-15-base-milk-price-calculation-15-September-2015.pdf, p.86.