

1 September 2021

**Miraka Submission to the Commerce Commission:
Review of Fonterra’s 2020/21 base milk price calculation: Dairy Industry
Restructuring Act 2001 Draft Report (16 August 2021)**

By online submission: <https://comcom.govt.nz/regulated-industries/dairy/milk-price-manual-and-calculation/milk-price-calculation/milk-price-calculation-202021-season>

Introduction

Miraka appreciates the opportunity to submit on the Commissions draft report on the 2020/21 base milk price calculations (the Commission Draft Report). Miraka is available and would welcome any opportunity to discuss this submission with the Commission.

This submission comprises three sections:

- Inclusion of Instantised Skimmilk Powder (ISMP) in off-GDT Sales
- Assumptions and Processes (of the BMP) are not practically feasible
- Materiality

Inclusion of Instantised Skim Milk Powder (ISMP) in off-GDT Sales

1. In response to submissions from stakeholders including Miraka¹ the Commission included an additional “key focus area” in its 2020/21 Base Milk Price (BMP) review: the classification of ISMP as a “qualifying material” and as “qualifying reference sales”. Miraka appreciates the additional effort the Commission has taken with this issue.
2. At the outset Miraka notes this issue arises from the lack of transparency in the process of including off-GDT sales in the BMP calculations. Specifically, what comprises “qualifying materials”, and the criteria whereby sales of “qualifying materials” become “qualifying reference sales”. For the 2020/21 BMP, off-GDT sales comprise 41% of “price informing” sales² (presumably by volume). In previous years off-GDT sales have been as high as 45% of total sales. According to the Commission, off-GDT sales provide a premium (by comparison to on-GDT selling prices) equivalent to 10.2 c/kg MS for the 2020/21 BMP³. That amount has been as high as 10.9 c/kg MS in previous seasons. These amounts are substantial and material to the BMP

¹ For Miraka, refer Appendix of “Miraka Submission on focus areas for milk price calculation 2020-21_29 April 2021”

² Reasons Paper in Support of Fonterra’s Base Milk Price for the 2020/21 Season – Public Version” pg 17

³ There is possibly a mismatch between the 41% of sales attributed by Fonterra to off-GDT sales (probably comprising all off-GDT sales included in the BMP), and the 10.2 c/kg MS reported by the Commission which excludes any impact of off-GDT butter and BMP sales. This lack of certainty is just one example of the lack of transparency with off-GDT sales.

calculation. Despite their significance, and contrary to Fonterra representations when it expanded the use of off-GDT sales for determining the Notional Processor (NP) selling prices, the processes and rules for off-GDT sales remain opaque to external stakeholders. This is in marked contrast to the transparency for on-GDT sales.

3. While the Milk Price Manual includes various definitions and principles for determining off-GDT sales, it is difficult to assess how these are applied without evidence of what has actually been included as off-GDT sales. As Miraka and others have identified, they also lack credibility when the singular disclosure of ISMP as a “qualifying material” does not comply with those definitions and rules.
4. While the Commission review of ISMP draws different conclusions, its review can be seen to confirm Miraka view that ISMP cannot be considered a “qualifying material”. This adds weight to stakeholder concerns that rules and processes for off-GDT sales lack integrity. In the following paragraphs Miraka responds to the information provided by the Commission. Miraka uses the same headings the Commission used in the Draft Report.

Specialised manufacturing process and use of specialised plant⁴

5. In its Reasons paper, Fonterra states that it has used “Manufacturer’s 2011, 2015 and 2019 quotations for the capital costs of WMP, SMP, BMP, Butter and AMF plants”⁵ (i.e. the “standard plants”). Those quotations will have been provided in response to a Fonterra detailed request. Miraka assumes that detailed request identifies the “standard plants” are required to manufacture the standard specification product (i.e. MH SMP in the case of SMP). The resulting quote will thus include plant that can produce for example MH SMP along with other requirements such as milk handling capacity. Any other SMP that can be produced on that plant would potentially be a “qualifying material”. Any product that can be produced on that plant but with the adaption and inclusion of other plant (“specialised plant”) cannot be classified as “qualifying material”.
6. Miraka requests the Commission confirm that the “Manufacturers quotations” which Fonterra describes in its Reasons paper are based on requests for quotations that specify the “standard specification product”⁶ and that the resulting quotations do not include plant that is not required for the production of the “standard specification products”.
7. Miraka agrees with Fonterra that a plant specified to produce MH SMP can produce ISMP. However, as explained in previous submissions, that plant could not produce ISMP in an efficient manner and it would produce a significant volume of sub-standard product or product which is not “fit for purpose” as ISMP. Its production would also be disruptive to the efficient production of the standard specification product on the

⁴ Review of Fonterra’s 2020/21 base milk price calculation, Draft report, 16 Aug 2021: para 3.79 ff

⁵ Reasons Paper in Support of Fonterra’s Base Milk Price for the 2020/21 Season – Public Version” pg 33

⁶ This does not mean the relevant plant could not be used to make a range of products, such as in the case of the SMP products sold by Fonterra on GDT, all of which can be manufactured efficiently on a plant specified for MH SMP.

plant, including because throughput of ISMP is up to 30% lower than for standard SMPs. To produce ISMP reliably and efficiently requires bespoke powder handling plant to protect the agglomerated milk powder particles. This plant would necessarily be classified as “specialised equipment” by comparison with plant specified for MH SMP.

8. At 3.84 the Commission confirms that the Fonterra ISMP has “a higher risk of quality failure”. Along with other evidence, this could be consistent with the “price include” Fonterra ISMP being manufactured on plant which is specified for standard SMP but which does not include the additional investment required for efficient production of ISMP. If this is the case, it would mean that only ISMP manufactured on sub-standard plant (in relation to the efficient production of ISMP) could potentially be classified as “qualifying material”. It is however doubtful that the attribution of inefficient Fonterra production to the NP could be consistent with the efficiency dimension of s 150A. It further raises doubts about how Fonterra could differentiate between ISMP produced on sub-standard plant, from other ISMP produced on “fit for purpose” plant which is disqualified as “qualifying material” on the grounds it includes the use of specialised plant.
9. At paragraph 3.82 the Commission confirms that ISMP has a lower bulk density and as a consequence has higher packaging and supply chain costs. The Commission notes these costs are reflected in the provision for incremental production costs (IPCs). While that might be so, the larger issue is that this provides further evidence that ISMP is not a “qualifying material” because it is packed in non-standard packaging. As explained below, this will also mean ISMP cannot be considered cascadable to “general trade”.
10. The Milk Price Manual does not provide a meaningful definition of “standard packaging”: A “qualifying material” must be a “standard product offering” and must be packaged in “standard packaging”. However “standard packaging” is then defined as packaging used for a “standard product offering”⁷. That circular explanation renders meaningless the definition of “standard packaging”. A meaningful definition of “standard packaging” therefore defaults to the characteristics of the “standard specification product” which in this case is MH SMP. Lower density ISMP cannot be packed into the same bags specified for MH SMP and thus providing a further reason why ISMP cannot be classified as “qualifying material”.

*Does the effect of the IPCs imply the costing principles underlying the IPCs are not fit for purpose?*⁸

11. At 3.86 the Commission states Miraka had suggested “ISMP incremental product costs [IPCs] would neutralise the nominal premium on ISMP”. Miraka did not make that suggestion. At the time Miraka was responding to the Commission’s advice that ISMP selling prices are similar to the “standard specification product “after adjusting for any

⁷ 2020/21 Milk Price Manual, Part C Definitions

⁸ Review of Fonterra’s 2020/21 base milk price calculation, Draft report, 16 Aug 2021, para 3.86 ff

costs that are normally recoverable from purchasers of the product”⁹. Miraka indicated it assumed these “normally recoverable costs” were a reference to the IPC adjustment to ISMP selling prices. At 3.87 the Commission repeats its explanation from its 2019/20 report that “cost adjustments ... explain a significant portion of observed price differences between [ISMP and MH SMP]”. At that time Miraka had questioned how nominal ISMP price premiums over MH SMP prices could be similar in scale to the IPCs for ISMP. This is because fit for purpose ISMP is not a commodity, is difficult to manufacture, is produced in only small volumes and thus extracts high premiums well in excess of IPCs.

12. At paragraph 3.91 the Commission provides crucial new information which brings a number of threads together. The Commission discloses that “the low level of price achievement for off-GDT ISMP in 2019/20 compared to UHT SMP reflects discounts that were driven by the need to clear distressed inventory”. This means the product was not in fact fit for purpose or had not been sold as in-specification ISMP (i.e. it was substantially discounted to a price possibly even less than standard SMP). As already noted, a significant volume of out of specification product would be consistent with ISMP manufactured on the “standard plant” for SMP. Apart from its view that ISMP is not a “qualifying material”, Miraka questions why sales of these distressed products were ever included as “price informing” off-GDT sales. In Appendix B of the Draft Report, the Commission provides a “simplified off-GDT pricing decision tree”. That “decision tree” states “Exclude sales of downgrade: Milk Price provides for downgrade cost allowance”. The Commission is asked to clarify this point.
13. At paragraph 3.88 and Figure 4, the Commission explains that Fonterra has provided a comparison of the price achievement of ISMP compared to UHT SMP for 2019/20 and 2020/21. The price achievements in Figure 4 have been redacted. The Commission considers that Figure 4 does not suggest “that the IPCs create a systematic neutralisation of any nominal premium for ISMP”. Miraka wishes to more clearly understand the points the Commission is making.
 - In the first instance Miraka notes the description in paragraph 3.88 of the data in Figure 4 does not align with the title of Figure 4. Given the purpose of Figure 4, Miraka assumes Figure 4 actually compares an annual weighted average price for each of off-GDT UHT SMP and off-GDT ISMP, both after deducting IPCs, with the annual weighted average price for on-GDT MH SMP. These differences are assumed to be the “price achievements” referred to in the title of Figure 4. Price achievement for UHT SMP is presumably provided as a comparison point for ISMP although it is not clear why that is relevant. Miraka and other stakeholders have not questioned the inclusion of UHT SMP as a “qualifying material”. The Commission is asked to confirm the Miraka interpretation of Figure 4.
 - Based on the previous conclusion of the Commission that IPCs largely neutralised the selling price margin between off-GDT ISMP with on-GDT MH SMP for 2019/20 (now clarified as being due to the sale of distressed product) Miraka assumes the redacted “price achievement” for ISMP (i.e. by comparison

⁹ Review of Fonterra’s 2019/20 base milk price calculation (Final Report), para 2.40

with MH SMP) for 2019/20 is close to zero. Miraka then assumes that the comparison between ISMP “price achievement” as disclosed in Figure 4 for 2020/21 compared to 2019/20 either shows:

- a similar outcome to 2019/20, because 2020/21 also includes a substantial volume of downgrade product, as would be expected for ISMP produced on standard SMP plant; or
 - is materially higher, thus leading to the Commission’s conclusion that IPCs do not “systematically neutralise” the premium on ISMP. But it is then necessary to conclude that unlike 2019/20, volumes in 2020/21 include a substantial volume of ISMP carrying the expected high price premiums. This then leads to the conclusion that this product was NOT manufactured on standard plant, required specialised plant, and is therefore not “qualifying material” (and of course cannot be “qualifying reference sales”).
14. These are broad conclusions but Miraka draws them from the limited information available. Miraka requests the Commission revisit the data in Figure 4 in the light of Miraka comments.
15. Paragraphs 3.89 through 3.93 in the Commission’s Draft Report consider “qualifying reference sales” through the lens of relative selling prices. This should be considered a separate issue to the above discussion on IPCs.
16. At 3.89 the Commission concludes, again based on Figure 4, that ISMP does not “command such premium that it may be clearly distinguished from other standard specification products¹⁰”; this seems to imply that the price of the relevant ISMP sales would not exclude them from being “qualifying reference sales”. At 3.90 the Commission again alludes to price as a distinguishing factor in determining a “qualifying reference sale”. In this case however it is in the context of products seemingly excluded on the basis of higher prices: Fonterra manufactures “a number of ISMP specifications, some of which attract higher price achievement than others, but which do not necessarily inform the base milk price”. The Commission is requested to clarify why it has provided this explanation:
- Is the Commission referring to ISMP specifications which are not “qualifying materials” (and for which price – high or otherwise – is not relevant);
 - or is the Commission referring to “qualifying materials” which are excluded from “qualifying reference sales” on the basis they do not meet a “prevailing price” test¹¹ (whatever that test might be).

¹⁰ It is unclear why the Commission here refers to standard specification products (in the plural). There is only one standard specification product for SMP (MH SMP). It is possible the Commission is trying to draw a comparison between UHT SMP (which is not a Standard Specification Product) and ISMP.

¹¹ According to the 2020/21 Milk Price Manual (Part C definitions), the selling price for a “qualifying material” must reflect “prevailing prices” if it is to qualify as a “qualifying reference sale”

If it is the latter case, further guidance is sought from the Commission on how price achievement has been used as a basis for excluding certain ISMP sales from “qualifying reference sales” while including others.

17. At paragraph 3.92 the Commission indicates that off-GDT selling prices have included premiums achieved on sales meeting country-related SMP quota. This seems to confirm another Miraka concern regarding cherry picking of off-GDT sales. On the one hand off-GDT sales expressly exclude tender sales which would typically be at lower prices but would otherwise meet the DIRA s 5 definition of commodities. On the other hand, it is now identified that off-GDT sales can include sales which capture rents associated with country related quotas (including what appears here to be due to country supply constraints). Miraka requests this different treatment be explained and justified.
18. At paragraph 3.93 the Commission concludes that “we do not consider that price or price achievement of itself is a reliable indicator that might provide a basis for differentiation of commodity products”. That may be so. It is however generally accepted that commodities are recognised by uniform pricing regardless of supplier of the commodity. An element of pragmatism is of course required and price differences do occur as a result of reputation, supply security, repeatable product quality, and small tweaks in products. To match that more pragmatic approach, it is recognised there will be price variations in commodities. An equally pragmatic response then is to set an upper and lower limit of price achievement compared to a counterfactual as a basis for separating commodities from other products. The obvious counterfactual is GDT prices.
19. Fonterra claims that GDT selling prices are “a key reference point”¹² for determining which qualifying materials are included as off-GDT sales (i.e. “qualifying reference sale”). It is not clear what this means in practice. At the same time, in the Milk Price Manual Fonterra maintains a soft definition of commodity pricing by simply requiring that “qualifying reference sales” must be sold at “at a price that reflects prevailing prices”¹³. “Prevailing prices” is undefined and unexplained.
20. The Commission will take the requirements of the Milk Price Manual into account when assessing practical feasibility of including off-GDT selling prices in the calculation of the NP prices. The Commission clearly places weight on the Milk Price Manual requirements and definitions. In its review of the 2020/21 Milk Price Manual for example, the Commission repeated its recommendation that Fonterra should provide “a detailed description of prevailing prices”¹⁴, and in the summary of recommendations stated that “we consider that defining the term “prevailing” would provide greater clarity in respect of the inputs required to be used by these rules”¹⁵. As a clear signal of its intentions, Fonterra has responded to that Commission

¹² Reasons Paper in Support of Fonterra’s Base Milk Price for the 2020/21 Season, pg 17

¹³ 2020/21 Milk Price Manual, Part C Section 1.2 Definitions

¹⁴ Final Report – Review of Fonterra’s 2020/21 Milk Price Manual – 15 December 2020, Para 30.3

¹⁵ Ibid, para X16.3

recommendation in its 2021/22 Milk Price Manual by changing “prevailing prices” to “market prevailing prices”.

21. At Appendix B of the Draft Report, the Commission includes Fonterra’s “Simplified off-GDT pricing decision tree” to illustrate how the Milk Price Manual is reflected in Fonterra procedures. It is notable that despite its title, the decision tree includes no reference to prices and does not include the “prevailing prices” test from the Milk Price Manual. The decision tree provides no greater transparency and is of limited value.

*Materiality of ISMP Sales*¹⁶

22. At paragraph 3.95 the Commission concludes that ISMP sales do not have a material impact on the 2020/21 BMP. Miraka responds that materiality of ISMP to the BMP has never been highlighted as an issue as such. Indeed a lack of transparency means it has never been possible for Miraka to assess the materiality of ISMP to the NP selling prices. The issue at stake is the wider materiality of off-GDT sales, and the insight provided by the singular identification of ISMP as a “qualifying reference sale”.

*Can ISMP be substituted for MH SMP given their different functional properties?*¹⁷

23. At paragraph 3.97 the Commission refers to the DIRA definition of commodities (s 5) which states that a dairy commodity is “characterised by uniform technical specifications”. The Commission appears to conclude that “technical specifications” are limited to the milk component composition of a product. At 3.98 the Commission goes on to say that “neither the DIRA nor the Milk Price Manual provide for distinguishing reference commodity products on the basis of their different functional properties”. With respect, it can equally be said that neither the DIRA nor the Milk Price Manual distinguish reference commodity products on the basis of their milk components. Rather, the reference commodity products are distinguished by convention (product names) and this is narrowed by prescribing the “standard specification products” (one for each of the RCPs, and none of which are controversial). In any event, the issue here is the requirement in the Milk Price Manual that a “qualifying material” must be a “standard product offering” which requires that it “can be substituted for other standard product offerings”¹⁸. Alternatively, as described in the Fonterra simplified off-GDT pricing decision tree it must be a “cascadable product”¹⁹.
24. The Commission seems to consider that if the technical specifications of a product (such as ISMP) share the same milk component composition as the standard specification product (e.g. MH SMP) it must also be a commodity. This narrow interpretation of “technical specifications” is very unlikely shared by Fonterra and is not shared by the wider dairy industry. Technical specifications go well beyond the

¹⁶ “Review of Fonterra’s 2020/21 base milk price calculation, Draft report, 16 Aug 2021: para 3.94 ff

¹⁷ Ibid, para 3.96

¹⁸ 2020/21 Milk Price Manual, Part C Section 1.2 Definitions

¹⁹ Reproduced in Appendix B of “Review of Fonterra’s 2020/21 base milk price calculation, Draft report, 16 Aug 2021.

product composition specification. Miraka brings two relevant examples to the Commission's notice:

- UHT SMP: while the composition and much of the specification is the same as MH SMP, UHT SMP includes two different technical specifications from which is derived the premium over MH SMP (which on GDT typically amounts to US\$50/MT). These are:
 - A minimum undenatured Whey Protein Nitrogen Index (WPNI) of 4.5 mg/g while MH SMP has a minimum of 1.51 mg/g.
 - A maximum 100 cfu/g aerobic thermophilic spores, while MH SMP does not specify a maximum.

Miraka does not disagree that UHT SMP can be included in the NP selling prices including because it can be made on the standard plant and it can readily be sold as (cascaded to) MH SMP. The point however is that the premium for UHT SMP derives not from its composition by milk components (which are the same as MH SMP) but by other technical specifications to which the product must comply.

- ISMP (or more correctly agglomerated SMP): again while the composition by milk components might be the same as MH SMP, it has other crucially different technical specifications which when achieved, command far higher premiums than UHT or MH SMP. These primarily are:
 - Wettability (a function of agglomeration); and
 - Density (a consequence of agglomeration) which can vary by customer, gives little room for variation, and is substantially lower than for MH SMP. The density specification is much more important for an ISMP customer which will typically repack the product to a consumer pack. A narrow density specification is crucial to enable the customer to reliably fill a consumer pack to achieve guaranteed product weight AND pack headroom.
 - Again in this case the product is differentiated from the standard commodity specification by technical specifications quite apart from the composition of the product.
 - Unlike UHT SMP however, ISMP is not “cascadable to general trade materials” (i.e. could not be used to fill an order for MH SMP without further notification and negotiation)²⁰. This is because the lower density of the product means it cannot use “standard packaging” and adds to product handling costs (e.g. reduced pallet loads).

²⁰ Reasons Paper in Support of Fonterra's Base Milk Price for the 2020/21 Season: Attachment 5 explains that a cascadable product “can be used to satisfy an order for a standard product offering, such as regular WMP [*i.e. the standard specification product*] without any additional notification to the customer”.

Impact on base milk price of shorter production runs²¹

25. At 3.101 and 3.102 the Commission indicates that IPCs for ISMP account for the additional costs associated with yield and shorter production runs. This is comforting to know. However, this is not the primary concern. The main issue is that “base calculations” for yields and production costs for the NP assume that:

“all product manufactured is standard ... specification product (e.g. regular WMP and medium heat SMP)”²².
26. Fonterra further states that “allowances for effluent have been determined from detailed loss surveys carried out at Fonterra factories running as far as possible, in a similar manner and with similar technology and operating processes as the Milk Price assumptions. These loss surveys are carried out over a 10-day period when the Fonterra factories are running at or close to full capacity”²³. Thus Fonterra measures effluent losses on the basis of the most ideal operating environment of a factory producing just one product at peak capacity continuously across ten days. This might be consistent and practically feasible for the NP production assumptions. It is NOT however practically feasible for the NP selling price assumptions which assume a much wider product range is produced and sold.
27. Combined with the assumption that NP factories “operate at peak capacity for around 85-90% of their total operating days”²⁴ this means that ideal yields and production costs are extrapolated across almost all operating days. Thus the NP operates with unbroken production runs of a single SKU, with the least number of number of plants operating at full capacity, for the maximum period possible. This is not commercially or practically feasible when at the same time, the NP is deemed to sell a much wider range of products including for example the disruptive manufacture of ISMP. While an attempt might be made to capture relatively different costs in the IPCs, this does not address the flawed counterfactual from which the IPCs are calculated – i.e. the yields and costs associated with the standard specification product based on the idealised NP single product model which does not align to the NP sales.
28. The production efficiency, including throughput, yields and factory costs for a single product factory will be different (higher in the case of throughput and yields, and lower in the case of production costs) than in the case of a multi-product factory. In the latter, this is exacerbated by detailed production planning which needs to account for specific customer demand (offtake volume and timing) for specific SKUs – i.e. production planning at the level of customer offtake demand is far more disruptive for the manufacturing process than the simple production of a single product which does not heed particulars (volume/timing) of customer offtake demand. It is unrealistic to assume ICPs can account for the vastly different efficiencies, yields and costs of multi-

²¹ “Review of Fonterra’s 2020/21 base milk price calculation, Draft report, 16 Aug 2021: para 3.100 ff

²² Reasons Paper in Support of Fonterra’s Base Milk Price for the 2020/21 Season, pg 12

²³ Ibid, Attachment 4, Loss Allowances

²⁴ Ibid

product factories compared to the single product factory from which the counterfactual (the cost of the standard specification product) is drawn.

29. Again in its Reasons paper, Fonterra states that “loss assumptions for the 2020/21 base milk price were made by an external technical expert” in whose view “the loss allowances represent achievable, but challenging, targets for the NMPB, given the size, technology and operating parameters assumed for this business”²⁵. Miraka understands this opinion was based on the same assumptions as the effluent loss study noted and peak operating days noted in paragraphs 26 and 27 above, and assumes single SKU production across the entire season. Miraka considers that had that external expert been asked to provide an opinion on effluent losses for the NP assuming production that is aligned to the NPs full sales portfolio, the expert would express a quite different opinion. Miraka considers that Fonterra should obtain a revised opinion of the external expert after they have reassessed losses on the basis of a production plan consistent with the detailed NP sales plan.
30. In summary and conclusion, the Commission review of ISMP as a “qualifying material” and “qualifying reference sales” has:
- Identified a substantial portion of 2019/20 ISMP in off-GDT sales was in fact “distressed” product and so did not provide representative selling prices for fit for purpose ISMP. This:
 - Accounts for the Commission conclusion from 2019/20 that ISMP does not deliver substantial margins (after deducting IPCs) over standard SMP.
 - Is consistent with Miraka assertions that ISMP cannot be manufactured efficiently on SMP “standard plant”.
 - The Commission is silent on selling price margins for ISMP for the 2020/21 BMP but if a substantial portion of fit for purpose ISMP (relative to distressed ISMP) is included in the 2020/21 BMP that indicates the product has been manufactured with specialised plant and cannot be “qualifying material”.
 - Identified that off-GDT sales includes sales which have captured quota rents and this is evidence of cherry picking when compared to the exclusion of tender sales.
 - Materiality of ISMP to the BMP is not relevant to the consideration of whether inclusion of ISMP as “qualifying reference sales” is evidence that the process for determining and including off-GDT sales lacks integrity.
 - The classification of a product as a commodity based on technical specifications needs to consider more than the subset of technical specifications defining composition by milk components.
 - ISMP cannot automatically cascade to general specification SMP (i.e. without further negotiation and likely price discounting) because of its different density and impact on logistics and supply chain costs for customers.

²⁵ Reasons Paper in Support of Fonterra’s Base Milk Price for the 2020/21 Season, pg 14

- NP yields and production costs do not account for the complex production model that would be required to service the NP sales plan including the wide range of products and customer specific demand (including volume and timing of off-take) necessarily assumed to comprise off-GDT sales.
31. Miraka concludes that the Commission investigation of ISMP adds weight to its view that ISMP cannot be classified as “qualifying material”. Any ISMP made on standard plant should be excluded on the efficiency dimension of S150A. The evidence confirms the way Fonterra has blended off-GDT sales into the NP revenues does not prevent leakage of specialty product sales into the NP revenues. The NP model for factory configuration, production yields, conversion costs, and milk management has not been constructed to deliver a sales plan that the NP reflects in its revenues and therefore cannot be practically feasible. It remains Miraka view that the current model is materially compromised by the inclusion of off-GDT sales and will remain so unless the production side of the model is adapted to match the complex sales plan, or alternatively the sales plan reverts to the much simpler (and more transparent) model based on GDT sales.

Assumptions and processes are not practically feasible

32. The Commission concludes the 2020/21 BMP is practically feasible. Miraka does not agree. Reasons include those summarised in paragraph 31 above and in the earlier Miraka submission on the CEPA asset beta report²⁶. The Fonterra Reasons Paper includes numerous other occasions where assumptions are not consistent with the requirement for practical feasibility or simply ignore the requirement to demonstrate practical feasibility. Two of the more egregious examples are addressed below. Miraka has raised these issues before but believe they merit more consideration by the Commission.

Safe Harbours: Network of Facilities – s 150B (a) and (b)

33. Relying on DIRA Sections 150B (a) and (b), the NP model assumes “the same number (and location) of commodity manufacturing sites as is actually maintained by Fonterra, and that total processing capacity by site is materially aligned to Fonterra’s”²⁷. Miraka agrees this assumption is permitted by the safe harbour. It is not however mandated by the safe harbour. Having elected the safe harbour and the complexities it adds to the NP model, Fonterra cannot (but does) then fail to address these complexities by extending the safe harbour beyond its statutory coastline.
34. In its Reasons Paper Fonterra states that on to say that
- “This assumption [alignment with actual Fonterra factories] is reflected ... in various other aspects of the model, including the calculation of milk collection costs, inter-site diversion costs and inland freight costs. The model also assumes

²⁶ Miraka – Submission on CEPA advice on dairy asset beta and specific risk premium – 24 August 2021

²⁷ Reasons Paper in Support of Fonterra’s Base Milk Price for the 2020/21 Season, pg 9

the annual volumes of milk processed on each site are materially aligned to the volumes actually processed [by Fonterra]”²⁸.

These assumptions are not sanctioned by the safe harbour, and would only be practically feasible if the NP uses the Fonterra aligned “network of facilities” in the same way that Fonterra uses them. This is clearly not the case.

35. For example, Miraka has long submitted that the NP milk collection costs are not consistent with the NP production assumptions. Compare for example the Fonterra description of inputs process and assumptions for determining milk collection costs, with assumptions on Loss Allowances:
- Inputs, Processes and Outputs for Milk Collection Costs²⁹: Fonterra explains that NP milk collection costs are based on its own collection costs. Fonterra however excludes its inter-factory diversion costs and inter-island milk transport costs on the unjustified assumption that these costs would not be incurred by the NP; that assumption also conflicts with the assumption noted above that “annual volumes of milk processed on each site are materially aligned to the volumes actually processed [by Fonterra]”. An adjustment based on the NP product mix is made to reflect the transport of cream and buttermilk from sites that do not process cream or buttermilk. Apart from this however no attempt is made to reflect the movement of milk that would be required to meet the NP production plan (let alone an NP production plan aligned to its sales plan).
 - Loss Allowances³⁰: By contrast, in Attachment 4 Fonterra describes that the NP “can move milk from its collection areas to maximise the length of time some factories remain full, by pulling milk from others to shorten their operating season”. Fonterra provides the description to explain why “the [NP] factories on average would operate at peak capacity for around 85-90% of their total operating days”. No allowance is made for the milk transport cost that this would require and no attempt is made to determine what that might be. It can be concluded that the NP milk collection costs are highly unlikely to be practically feasible, or at least that no attempt has been made to demonstrate they are.
36. Miraka sees no reason why the NP model does not include a production plan that delivers the NP full sales mix (including on and off-GDT), processing and matching all milk (by catchment area) with all factories (by fixed geographic location) from which to properly determine milk transport costs, monthly plant production assumptions, and production costs that reflect those plant production assumptions (including real world assumptions about processing run lengths and period of time operating at peak capacity). The absence of that plan means it is not possible to determine practical feasibility across a large range of production efficiency and cost assumptions.

Weighted Average Prices/Sales Phasing

²⁸ Ibid

²⁹ Reasons Paper in Support of Fonterra’s Base Milk Price for the 2020/21 Season, pg 22

³⁰ Ibid, Attachment 4

37. The NP selling prices are drawn from a large number of individual transactions. Data is then manipulated to the point that the final weighted average selling prices cannot be attributed to any real world set of commodity sales. The following description of the processes and transformations of data to determine the NP weighted average selling prices is drawn from the Milk Price Manual definition of the Benchmark Selling Prices³¹.

- In the first instance, GDT auction results (C1 to C5) from March of the previous season through to September of the following season are translated to a shipment date basis. After purging those shipments deemed sourced from previous season and next season milk, the remaining sales and volumes are included in the “price inform data set”. ICPs are deducted from selling prices of relevant products to determine a Standard Commodity Price for GDT sales.
- A similar process presumably occurs for off-GDT sales.
- A weighted average monthly selling price (shipment date basis) is then determined across all the price inform sales. At this point, the monthly and full year weighted average selling prices should reasonably reflect the weighted average selling price of all the NP “price informing sales”.
- A final translation takes these monthly weighted average selling prices and applies them to a larger series of sales based on Fonterra actual sales of all RCPs including products which do not inform the NP selling prices. This larger sales series will inevitably carry different phasing to the “price inform” sales series and so the weighted average prices (the Benchmark Selling Prices) will be different to the weighted average prices for the price inform sales. In other words the resulting weighted average price does not reflect the average price achieved for any real world set of sales made by Fonterra, and those weighted average prices cannot therefore be represented to be practically feasible.

38. In its explanation for “Average Base Commodity Prices” Fonterra includes the assumption that

“Fonterra’s overall contract profile for arm’s length commodity sales, rather than just the “price include” contract profile, is appropriate”³².

39. No reason is provided for this assumption and it is difficult to consider what reason might exist. As a consequence of this assumption, the weighted average selling price attributed to the NP cannot be observed and does not emerge from any actual sub-set of Fonterra sales or any actual identified market for Fonterra sales. Miraka has previously described the resulting weighted average selling prices as a lottery and continues to do so. It can not in any way be shown to be practically feasible.

³¹ 2020/21 Milk Price Manual, Part C Definitions.

³² Reasons Paper in Support of Fonterra’s Base Milk Price for the 2020/21 Season, pg 16

Materiality

40. Miraka has for some time sought a definition and standard of materiality be established for use in the milk price review processes. This was for example addressed in depth in the Miraka submission on the review of the 2018/19 BMP calculations, and included suggestions for possible materiality standards³³.
41. Miraka notes the Commission has now started to address this issue in its 2021 update of its framework for its approach to reviewing the milk price³⁴. That update only comes into effect for the 2021/22 milk price reviews. The framework update sets a materiality level at “an equivalent of 0.5% of WACC”³⁵ for determining materiality of changes in various aspects of successive BMP calculations. Miraka seeks clarification of this new materiality standard.

Scope

42. The Commission indicates the materiality standard would apply to the “fit for purpose” review to determine if any change in a “component” under review merits more analysis³⁶. This seems to be a misstatement of intent. The “fit for purpose” review only applies to “revenue and cost components that are not part of the key areas that we focus on”³⁷. This implies the materiality standard would not apply to the broader review framework which is “particularly focussed on the issues that are most likely to have a material impact on the [BMP] calculation”³⁸; it would also not apply to the more detailed process by which the Commission determines the “key focus areas” for its annual review. In both cases, the underlying activities require materiality based judgement³⁹. For example, activities for determining the “key focus areas” include “sensitivity of the base milk prices to changes in components”⁴⁰. Miraka assumes the new materiality standard would necessarily also apply to determining “key focus areas” and to the broader review framework.
43. Miraka requests the Commission confirm this is the case and update the framework paper accordingly.

Measurement

44. It is not fully clear how “0.5% of WACC” would be interpreted and measured. In the BMP calculations WACC is represented as both a percentage and as a dollar cost (after tax WACC charge on fixed assets and on working capital). Miraka assumes the intention is to measure materiality with reference to the after tax WACC charge. For

³³ Miraka Submission: Draft Report (15 August 2019), Review of Fonterra’s 2019/199 BMP Calculation (2 Sept 2019), section 3.1

³⁴ Commerce Commission: “Our approach to reviewing Fonterra’s Milk Price Manual and base milk price calculation 2021, published 5 July 2021.

³⁵ Ibid, footnote 50

³⁶ Commerce Commission: “Our approach to reviewing Fonterra’s Milk Price Manual and base milk price calculation 2021, published 5 July 2021., para 103

³⁷ Ibid, para 102

³⁸ Ibid, para 88

³⁹ Ibid, para 88.1 ff and 100.1 ff

⁴⁰ Ibid, para 100.6

example, this would amount to NZ\$1.8M in the case of the 2019/20 BMP (0.5% of NZ\$361 M). That however seems a relatively low benchmark for materiality. A measure of materiality set to 5% of after tax WACC charges would equate to approximately 1 c/kg MS in 2019/20 and seems a more workable scale. Or more simply, a materiality standard of 1 c/kg MS would mean the standard remains constant over time. In this case the Commission should also consider a separate metric to trigger review of any measured item that, while not meeting the 5% of WACC standard, is nevertheless large in and of itself to merit further consideration. Miraka suggests that be set at 5% (i.e. change in measured outcomes of the item), but would be after eliminating the effect of commodity price movements.

45. Miraka requests the Commission consider the above comments before the new “Approach Paper” is implemented for the 2021/22 Season reviews.
45. Miraka supports the Commission recommendation that Fonterra include a materiality standard for managing the Milk Price Manual and model⁴¹. To date Fonterra has however failed to act on this recommendation. Fonterra continues to make assumptions and draws conclusions relying on a standard of materiality which it fails to define. This extends to its statutory declaration under s 150T (b). That declaration requires that Fonterra “certify the extent to which ... the assumptions adopted and the inputs and process used by [Fonterra] in calculating the proposed base milk price are consistent with the purpose of [s 150A]”. Fonterra provides that statutory declaration at the start of its Reasons paper. It states that the calculations etc. are “in all material respects, consistent with the purpose of subpart 5A of the Act”. In Miraka view, that statutory declaration is meaningless and Fonterra has not in fact complied with s 150T (b) unless and until it defines what it means by “all material aspects”. Miraka acknowledges that establishing an appropriate standard of materiality for the NP model might require some effort. There is however ample professional support to provide assistance, some of which was alluded to in the Miraka submission on the 2018/19 BMP calculations. In any event, Fonterra’s failure to establish a standard of materiality for the NP Model disqualifies the Fonterra Statutory declaration and other instances in which Fonterra asserts materiality in its Reasons Papers.

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⁴¹ For example, Review of Fonterra’s 2020/21 Milk Price Manual (Final Report), paragraph 29