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Submission to the Commerce Commission:

Review of Fonterra's 2021/22 base milk price calculation, Draft Report, 15 August 2022

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Subject: Milk Price Calculation 2021/22

This submission is made jointly by Miraka, Open Country Dairy, Westland Milk Products, and Synlait Milk (the Submitters).

Summary

1. This submission addresses certain draft conclusions the Commission makes in relation to qualifying materials primarily as they relate to off-GDT sales included in the milk price calculations. Other issues concerning the draft report may be addressed in further submissions.
2. Prior to the 2016/17 season, the products included in the milk price calculations were uncontroversial. This is because the Notional Producer (NP) revenues and selling prices were almost entirely based on GDT sales. While some of the products on GDT might have been borderline commodities for purposes of the DIRA definition, GDT sales were generally accepted as DIRA compliant. This was because of the confidence created by GDT's independence, transparency, standards of governance and of process control and documentation.
3. Since the 2016/17 Season, a change in policy has led to over 40% of the NP revenue and selling prices being determined from off-GDT sales, increasing the base milk price by up to 11 c/kg MS. This profound change meant the advantages of GDT as a source of reliable and transparent selling prices was lost. Fonterra stoked mistrust in NP selling prices by refusing to provide transparency over the way in which off-GDT sales are selected, or meaningful disclosures of the calculations and outcomes of including off-GDT sales. Off-GDT sales have been controversial ever since, drawing the frequent attention of the Commission. Key concerns remain unaddressed, not least because Fonterra fails to implement key recommendations of the Commission for increased transparency.
4. The sensitivity of the milk price to Fonterra procedures for including off-GDT sales has been demonstrated in the 2021/22 Milk Price Calculations. The Commission has identified that a seemingly innocuous clarification of the "substitutability test", which according to Fonterra led to just "a small number of SKUs" being now excluded as qualifying materials, has led to the substantial reduction in the base milk price of 2.7 c/kg MS. Despite its obvious importance, the "substitutability test" remains insufficiently clear and again needs further attention.
5. Fonterra has now published a list of standard specification products in its reasons paper in support of the 2021/22 Milk Price Calculations¹. This submission addresses two draft conclusions of the Commission in relation to this list:

¹ 'Reasons' Paper in Support of Fonterra's Base Milk Price for the 2021/22 Season (1 July 2022), Attachment 5

- a. all products on the list are qualifying materials for purposes of the Milk Price Manual and therefore “meet the definition of ‘commodity product’ in section 5 of the DIRA”².
 - b. the “incremental product cost adjustments” (IPCs) are practically feasible for an efficient processor³; therefore by implication NP production costs yields and investments (including the IPCs) are practically feasible to support the manufacture of the portfolio of all sales (on and off-GDT) included in the milk price calculations.
6. The Submitters do not agree with these draft conclusions.
 7. The attachment to this paper assesses each of the products in the Fonterra list of standard product offerings and standard packaging against the characteristics for identifying qualifying materials laid out in “Definitions” in the Fonterra 2021/22 Milk Price Manual⁴. Four products do not meet the necessary criteria for qualifying materials and accordingly cannot be included in the calculation of the base milk price:
 - Regular High Heat SMP, and Regular High Heat Heat Stable SMP: not a uniform technical specification, cannot cascade to other standard product offerings, small volume not consistent with a commodity product
 - Instant SMP (Non-Vitamised): not a uniform technical specification, cannot cascade to other standard product offerings, small volume not consistent with a commodity product, non-standard packaging, requires specialised plant
 - Lactic Butter: cannot cascade to other standard product offerings, small volume not consistent with a commodity product
 - Premium AMF 1,250 kg Goodpack: cannot cascade to other standard product offerings, small volume not consistent with a commodity product, packaging not aligned to a meaningful packaging standard
 8. Any product sold on GDT is by default assumed to be a qualifying material. While this was acceptable when NP revenues were derived almost exclusively from GDT, it is not necessarily appropriate in the current environment where selling prices are substantially impacted by opaque off-GDT sales. While the following products are sold on GDT, they do not otherwise comply with the requirements for being included as qualifying materials. The Commission is asked to reconsider why they should qualify as commodities for purposes of the DIRA:
 - Instant WMP Vitamised (A and D)
 - Regular Low Heat SMP
 - AMF 1,000 kg Spacekraft tote
 9. While the Commission considers IPCs are practically feasible for an efficient processor this does not address the purpose of the IPCs in the milk price calculations. In the first instance the calculations mismatch the costs and production investment of the NP, with the revenues and selling prices attributed to the NP. Costs are based on just 5 standard specification products while selling prices are based on a much wider portfolio. The IPCs are intended to adjust for that mismatch.

² Commission Commerce Commission Review of Fonterra’s 2021/22 base milk price calculation, Draft report (15 August 2022), para 3.51

³ Commerce Commission Review of Fonterra’s 2021/22 base milk price calculation, Draft report (15 August 2022), para 3.96

⁴ Farmgate Milk Price Manual (Effective 1 August 2021) Part C: 1.2 Definitions – Milk Price Revenue

10. The Commission has acknowledged it has not assessed if the IPCs are “fit for purpose” (out of scope of its review). On a prima facie basis however, the IPCs cannot be fit for purpose because they are drawn directly from the Fonterra product costing system which is based on measured outcomes of the more complex, higher cost real world Fonterra business operations. That business is fundamentally different to the NP simplified assumptions and will inevitably understate the cost adjustments needed to align the NP manufacturing costs, yields and investment with the NP sales portfolio.
11. The Commission is urged to reassess its conclusion that the IPCs are practically feasible for efficient processors and to assess whether the IPCs properly adjust for the additional costs, lower yields and higher investment which result from the portfolio of products sold by the NP compared to the simplified NP manufacturing model.

Introduction

12. This paper assesses whether the list of products which Fonterra classifies as dairy commodities for purposes of the 2021/22 base milk price calculations is consistent with the DIRA definition of dairy commodities and complies with the Fonterra Milk Price Manual. It also considers if the Incremental Product Cost Adjustment (IPCs) adequately adjust the otherwise simplified NP manufacturing assumptions for the complex manufacturing environment necessary to support the NP sales portfolio.
13. Section 150C (1)(a) of the DIRA requires that “revenue taken into account in calculating the base milk price is determined from prices of a portfolio of commodities”.
14. “Commodity” is defined in DIRA section 5 as

“a product made by the processing of milk that is
(a) Traded in significant quantities in globally contested markets, and
(b) Characterised by uniform technical specifications”.
15. Dairy commodities are not further defined in the DIRA, although there are further requirements that the selected portfolio of commodities is “the most profitable” from the possible range of commodities and that the portfolio will “utilise all components of milk”⁵.
16. The DIRA defines commodities by broad characteristics. The Base Milk Price revenue however must be drawn from actual sales of actual products. The DIRA definition must therefore be disaggregated to a point where a line can be drawn between specific or individual products and the DIRA definition of commodities. Unfortunately this disaggregation has resulted in a plethora of product definitions, descriptions and classifications.
17. At the very highest level, the DIRA definition of “products” has been interpreted as broad categories of products drawn from dairy industry norms of classifying products. These broad categories are defined in the Milk Price Manual as the “Reference Commodity Products” (RCPs) and comprise WMP, SMP, Butter, AMF and BMP. The RCPs are not products as such but are groups of broadly similar products categorised by reference to the manufacturing process and/or the fractions of the milk solids from which they are manufactured. Individual products that make up each of those broad groups will not necessarily comply with the DIRA definition of commodities – i.e. they will not all:

⁵ DIRA section 150C (2)(a)(ii)

- trade in significant quantities in globally contested markets; or
 - all be of “uniform technical specifications”
18. The RCPs are therefore not sufficiently defined in themselves to demonstrate compliance with the DIRA definition of commodities. Further sub-classification is required.
19. Prior to the 2016/17 Season, the Fonterra Milk Price Manual made the broad assumption that any product sold on GDT was itself sufficient for it to be classified as a dairy commodity for purposes of the DIRA. Milk price revenues were accordingly almost exclusively based on GDT sales. This was uncontroversial because of:
- the assurance provided by independent governance of GDT
 - the independent management and control of the GDT auctions, including the high standards in the prescribed GDT guiding principles and rules
 - transparency of auction processes and outcomes
 - alignment between the GDT purpose and vision, to the DIRA definition of dairy commodities:
 - GDT Vision: “to be the world’s pre-eminent price discovery platform for core dairy products...”
 - GDT purpose: “GDT exists to ensure buyers and sellers can trade with confidence in global and regional dairy markets”.
20. From the 2016/17 season, Fonterra changed the milk price procedure to include selling prices achieved from off-GDT sales. Over the four seasons up to and including the 2021/22 Season off-GDT sales have comprised 41% of all milk price informing sales. By comparison with GDT prices, by the 2020/21 season off-GDT sales had added up to a further 12.6 c/kg MS⁶ to the base milk price⁷. Off-GDT sales are accordingly substantial by volume, and make a substantial impact on the Base Milk Price.
21. The change in policy to include off-GDT sales had a fundamental impact on the reliability, independence and transparency of the base milk price revenue. The above noted advantages of basing milk price revenues on GDT sales were substantially undermined. This has led to an increasing focus on how Fonterra selects off-GDT sales to be included in the milk price revenue calculations. While initially committing to considerable disclosures when it introduced the policy to include off-GDT sales, Fonterra has in fact provided only minimal disclosures. This has included variously incomplete or unsatisfactory definitions for example of standard product offerings, standard packaging, and specialised plant. Prior to the current 2021/22 calculations review, Fonterra had even refused to disclose the actual products which

⁶ This is the total impact of off-GDT sales including all 5 RCPs. Fonterra and the Commission have a tendency to focus just on the off-GDT impact of WMP, SMP and AMF because only those products were affected by the change in policy. Off-GDT sales of Butter and BMP are however also significant and have added as much as 3 c/kg MS to the milk price over the 5 years to 20/21. Because butter and BMP are also affected by the definitions and procedures for off-GDT sales, it is not appropriate to exclude them when assessing the compliance of the milk price calculations to the DIRA.

⁷ All metrics in this paragraph are sourced from Fonterra annual milk price statements, Fonterra reasons papers supporting the annual milk price calculations, or from Commerce Commission annual reviews of the base milk price calculations. The contribution of off-GDT sales to the 2021/22 Base Milk Price remains unknown until Fonterra reports it in in the 2021/22 Annual Milk Price Statement (due for release in mid-September 2022, over 4 months after the season is finished). The Commission has though identified that off-GDT sales of WMP, SMP and AMF have added 10.9 c/kg MS to the 21/22 milk price (an increase of almost 1 c/kg MS on 20/21).

it had selected as “qualifying materials”, though these products should have been simple commodities and should not therefore have been commercially sensitive.

Review of qualifying materials for 2021/22 Milk Price Revenue Calculations

22. A focus area for the Commission’s review of the 2021/22 milk price calculations includes a review of “the list of ‘Qualifying Materials’ and the incremental cost adjustments made to account for differences in product specifications and manufacturing processes”⁸. Presumably as a result of that review, Fonterra has now finally listed “the full range” of Standard Product Offerings and of Standard Packaging that have been used to determine the 2021/22 milk price revenue⁹. It is apparent that each of the listed “Standard Product Offerings” is again not a singular product but is a generic description for a set of singular products. These must be presumed to comprise a group of products which are substantially the same.
23. Fonterra has also provided some further clarification for the “cascadability test” which requires that Standard Product Offerings must be able to cascade to other Standard Product Offerings (within the same Reference Commodity Product group)¹⁰. The cascadability test provides evidence by proxy that a standard product offering is consistent with the DIRA requirement that dairy commodities are “characterised by uniform technical specifications”. The definition of cascadability however remains unsatisfactory and unclear.
24. The milk price manual provides that a standard product offering must be able to be “substituted for other standard product offerings”. This substitutability is not otherwise defined in the Manual but is the subject of the “cascadability” test. The test is further defined in the Fonterra Reasons Paper (2021/22 milk price calculations): a standard product offering must be “cascadable to general trade materials (i.e. can be used to satisfy an order for a standard product offering, such as regular WMP, without prima facie reason to believe prior consultation is required with the customer”¹¹. The proviso excluding products requiring consultation with clients is a refinement introduced in the 21/22 season.
25. Unfortunately but not atypically this further definition brings in yet another undefined category of products, the “general trade materials”. It is though informative that Fonterra provides the standard specification product for the WMP RCP (i.e. Regular WMP) as an example of “general trade materials”. In the context of the highly simplified Notional Producer model (the assumption that the Notional Producer manufactures just the 5 standard specification products) it would be appropriate that the benchmark for substitutability would be the standard specification product. A lesser but still useful test of product uniformity is where a standard product offering is cascadable to another standard product offering (which is the requirement prescribed in the Milk Price Manual).
26. The refinement of the “substitutability test” to exclude products that require prior consultation with customers might seem innocuous. According to Fonterra it led to just “a small number of SKUs” being now excluded as qualifying materials¹². It has however led to a

⁸ Commerce Commission process paper: Proposed focus areas for our review of Fonterra’s 2021/22 base milk price calculation (19 April 2022).

⁹ Attachment 5, Reasons Paper in Support of Fonterra’s Base Milk Price for the 2021/22 Season

¹⁰ Reasons Paper in Support of Fonterra’s Base Milk Price for the 2021/22 Season, Attachment 5

¹¹ *ibid*

¹² Commission Commerce Commission Review of Fonterra’s 2021/22 base milk price calculation, Draft report (15 August 2022), Attachment C

material reduction in the base milk price of up to 3 c/kg MS¹³. The milk price calculation is thus clearly sensitive to the definitions applying to qualifying materials and it is not satisfactory that the substitutability test remains unclear and ill-defined. The Commission is requested to review this again and to modify its conclusions in its final report.

27. Based on the list of standard product offerings it appears that Fonterra applies an even more liberal benchmark for cascability than described in its Reasons paper. It appears that Fonterra only requires that cascability be between products within the same standard product offering. This renders the cascability test meaningless, doing little to confirm “uniform technical specifications” within the relevant RCP. In any event, the milk price manual requires that a product be able to be “substituted to **other** standard product offerings” (emphasis not in the original) not to a product within the **same** standard product offering.
28. In its draft report on the 2021/22 milk price calculations, the Commission concludes that all products on the list of standard product offerings meet the requirements of qualifying materials and therefore “meet the definition of ‘commodity product’ in section 5 of the DIRA.”¹⁴
29. The attachment to this paper analyses how each of the standard product offerings listed by Fonterra compares to the DIRA definition of commodities, and whether each of the products meets the definitions Fonterra has provided for standard product offerings and qualifying materials. The substitutability test is assessed by whether a product can cascade across standard product offerings (as required by the Milk Price Manual) rather than within a single standard product offering. The analysis does not agree with the Commission’s draft conclusion noted in 28 above.
30. The analysis concludes the following products should not be classified as qualifying materials:
Regular HH SMP and Regular HH HS SMP should be excluded on the grounds that:
 - Specifications are not uniform with other standard product offerings (the HH specifications are designed to meet requirements for limited and specific ingredient applications)
 - Cannot cascade to the standard specification product or to any other standard product offerings (not fit for purpose for typical applications of the other offerings)
 - Small volume is not consistent with a commodity product
 - While HH HS SMP is listed as a product for sale on GDT, it has neither been sold nor offered for sale since November 2019. It therefore does not qualify for the “free pass” of being “sold on GDT”
 - Incurs higher production costs and costs associated with production disruption; these costs are unlikely to be properly reflected in the adjustments for incremental processing costs (IPCs)

Instant SMP (non-vitamised) should be excluded on the grounds that:

- The specification is not uniform with other standard product offerings (lower bulk density)

¹³ Ibid, para 3.12. The measured impact of the change in procedure on the 20/21 milk price calculations is a reduction of 2.7 c/kg MS. A similar impact can therefore be attributed to 21/22.

¹⁴ 1, Commerce Commission Review of Fonterra’s 2021/22 base milk price calculation, Draft report (15 August 2022), para 3.51

- Cannot cascade to the standard specification product or to any other standard product offerings (lower bulk density can interfere with typical applications of other offerings)
- Small volume is not consistent with a commodity product
- Does not use standard packaging: while pack weight is 25 kgs, bags themselves are larger due to lower bulk density, leading to higher internal and export handling and freight costs and further differentiating the product from other standard product offerings
- Requires specialised transport system for conveying the more fragile powder from the dryer to the packing bins. This is notwithstanding the Commission conclusion that ISMP does not require specialised equipment¹⁵. The Commission however focusses on agglomerating plant functions but does not address the transport system.
- Incurs higher rates of product loss because of the difficulty of meeting product specification targets; it is unlikely these higher losses would be covered in the overall 1.0% provision for loss and specification offsets assumed in the Notional Producer yield assumptions¹⁶. The higher costs and higher losses are also unlikely to be properly reflected in the incremental processing costs.
- Incurs materially different processing costs which are unlikely to be properly reflected in the adjustments for IPCs

Lactic butter should be excluded on the grounds that:

- The specification is not uniform with other standard product offerings (fermentation agent causing change in flavour with the product only being suited to direct consumption consumer or food service applications)
- Cannot cascade to the standard specification product or any other standard product offerings (lactic fermentation)
- Small volume not consistent with a commodity product
- Higher product losses (eg production at start-up and shutdown, and general product fallout) because lactic butter cannot be used as a raw material for AMF (contaminated by lactic fermentation); it is unlikely these higher losses would be covered in the overall 1.0% provision for loss and specification offsets assumed in the Notional Producer yields, or properly reflected in the IPCs

Premium AMF packed in 1,250 kg Goodpack should be excluded on the grounds that:

- The product cannot cascade to the standard specification product or to any other standard product offerings (customer must maintain product handling facilities specific to the 1,250 kg packing format)
- Small volume is not consistent with a commodity product
- In the case of AMF the meaningless nature of the Fonterra definition of Standard Packaging comes into focus. The Milk Price Manual defines Standard Packaging as “Packaging formats used for Standard Product Offerings”. This is circular and renders meaningless the definition of “Standard Packaging”. To be meaningful in assuring commodities are characterised by uniformity, and as is the case for the other RCPs, Standard Packaging should default to the format of the standard specification product (which has after all been selected on the basis that it is the most representative and undifferentiated commodity product within each RCP). In the case of AMF this is

¹⁵ Ibid, Para 3.56

¹⁶ Note 12, Reasons Paper in Support of Fonterra’s Base Milk Price for the 2021/22 Season

appropriately the 210kg drum, and the 1,250 kg Goodpack would be excluded from qualifying materials. The AMF 1,000 kg tote is an anomaly arising because the product is sold on GDT. The principle that products sold on GDT should by default be included as dairy commodities for purposes of the milk price calculations is problematic in the current context of off-GDT sales.

31. Aside from whether products should be classified as qualifying materials, the fact that Fonterra has now published a list of standard product offerings and standard packaging does not confirm this list was used previously. It also does not prevent the list from being changed in the future. After suitable retractions, the list should now be included as a matter of course in the annual milk price manual with appropriate justification for any additions or deletions.

Product Sold on GDT Default to Standard Product Offerings

32. As discussed in 19 above, prior to the 2016/17 season it was uncontroversial that products sold on GDT were by default included in the calculation of milk price revenues. It is appropriate to consider if that should remain the case. This is especially because of the difference in transparency, governance and control over pricing sourced from GDT sales compared to off-GDT sales. The confidence in sourcing prices from GDT has been lost in the sourcing of prices from off-GDT sales. With Fonterra now increasingly codifying the rules for standard product offerings and qualifying material, it should now be reconsidered whether products sold on GDT but which do not otherwise meet those rules should still be classified as standard product offerings.
33. Assuming selling on GDT did not itself automatically grant the status of qualifying material, off-GDT sales of the following further products would be unlikely to be able to be included in calculations of milk price revenue:
 - Instantised WMP Vitamised (A and D)
 - Regular LH SMP
 - AMF 1,000 kg Spacekraft tote
34. There seems no good reason for products listed on GDT to be classified by default as standard product offerings and qualifying materials. This is especially true in the case of off-GDT sales.
35. The Commission should reconsider how or why the default classification for product sold on GDT being classified as standard product offerings (and therefore as qualifying materials) is consistent with the DIRA definition of dairy commodities.

Incremental Production Costs (IPCs)

36. The NP milk price revenues include adjustments to take into account “incremental production costs” for any products which are not the “standard specification products”. This is intended to create consistency between revenues (determined from a multi-product sales portfolio) and costs in the Notional Producer model (in the first instance determined on the basis of highly efficient production of just 5 products - the standard specification products).
37. In its review of the 2021/22 Milk Price Calculations, the Commission included a review of “the incremental cost adjustments made to account for differences in product specifications and

manufacturing processes”¹⁷. That review is largely outside the scope of this paper. This paper does however conclude (for example in the case of ISMP) that the IPCs are unlikely to properly adjust the costs of the NP. That position requires further explanation.

38. In its draft report, the Commission has concluded the IPCs are practically feasible for an efficient processor. This is on the grounds that they are generated by Fonterra’s internal costing system^{18 19}. At the same time, the Commission acknowledges that it has not considered if the Fonterra internal costing system is “fit for purpose” for determining the IPCs for the NP (the Commission advises a “fit for purpose assessment is outside the scope of the current review”²⁰. It is difficult to understand how the Commission can conclude the IPCs are “practically feasible” when it has not assessed whether the Fonterra internal costing system is fit for purpose for determining the IPCs for the NP.
39. It should in fact be clear that the Fonterra internal costing system is designed for a different purpose and it is unreasonable to assume it is fit for purpose for determining the NP IPCs. The Fonterra costing system calculates the cost to Fonterra (including yields) of each of its products. IPCs drawn from that system would therefore compare the cost to Fonterra of producing a standard product offering compared to the cost to Fonterra of producing the relevant standard specification product. These costs would be determined from Fonterra actual business operations and would reflect the real world costs of the Fonterra sophisticated and complex production environment.
40. By contrast, the NP calculates production costs and yields for a simplified and highly efficient production model that assumes just 5 products (the standard specification products) are manufactured. To be practically feasible, the IPCs for the NP must “bridge the gap” between that highly efficient 5 product model and the more complex production model that is implied by the NP sales portfolio. While it is possible the Fonterra costing system will produce a meaningful NP cost for the standard product offerings, it will not deliver a meaningful cost for the NP standard specification product. The production environment for the NP standard specification product is vastly (and infeasibly) more efficient than the real world production environment for the same product manufactured by Fonterra and reflected as such in its costing for that product. The Fonterra costing model would inevitably calculate a higher cost for the standard specification products, and the IPC based on the Fonterra costing system would be lower than required to “bridge the gap” in the NP production costs.

¹⁷ Commerce Commission process paper: Proposed focus areas for our review of Fonterra’s 2021/22 base milk price calculation (19 April 2022).

¹⁸ Commerce Commission Review of Fonterra’s 2021/22 base milk price calculation, Draft report (15 August 2022), para 3.96

¹⁹ As a matter of reliability, the Commission notes the costing system is subject to audit review. From a statutory audit perspective the relevance and materiality of the Fonterra inventory valuation system is considered against the requirement to carry over a portion of annual production costs (by way of year-end inventory valuation). That carry-over is a small portion of total Fonterra production costs (i.e. typically inventories for any NZ dairy processor including Fonterra are at their lowest as at the July statutory year-end). Statutory audit review materiality considerations will be adjusted to reflect that fact. Internal audit on the other hand will review the costing system from the perspective of its fit for purpose for management decisions of the real world Fonterra business (price and margin management; product mix optimisation). Neither of these audits are relevant to a fit for purpose audit of the ability of the inventory system to determine NP IPCs.

²⁰ Ibid, para 3.89

41. This reflects one of the step changes in complexity that was required when off-GDT sales were included in the calculation of milk price revenues. Fonterra and the Milk Price Panel have however failed to adapt the NP model to reflect that step change in complexity.
42. The Commission is requested to reconsider its conclusion that the IPCs are practically feasible for efficient processors and its implied conclusion that the IPCs bridge the gap between the costs, yields and investment reflected in the simplified NP manufacturing model and the higher costs, lower yields and higher investment required to manufacture the wider portfolio of products sold by the NP.

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