

Review of Fonterra's 2022/23 Milk Price Manual:

Dairy Industry Restructuring Act 2001

Final report

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Chapter 1 Purpose and structure

Purpose of this report

1. This report sets out our conclusions from our statutory review of the extent to which Fonterra's 2022/23 Milk Price Manual (the **2022/23 Manual**) is consistent with the purposes of the base milk price monitoring regime (**monitoring regime**) under subpart 5A of the Dairy Industry Restructuring Act 2001 (**DIRA**).¹
2. The Manual contains the methodology that will be used to calculate Fonterra's base milk price for the 2022/23 season.

How this report is structured

3. Chapter 2 explains our review framework and the scope of our 2022/23 Manual review.
4. Chapter 3 sets out our conclusions from the review and responds to submissions from stakeholders on our draft report that are within the scope of our 2022/23 Manual review.
5. Attachment A provides a glossary of the key terms and abbreviations used in this report.

¹ DIRA, s 150A.

Chapter 2 Our review framework and scope

Our approach for the Manual review

6. This report should be read along with, *Our approach to reviewing Fonterra's Milk Price Manual and base milk price calculation (Approach paper)*, which we have applied in this review and which forms part of this report. The Approach paper provides an overview of the approach we take in our reviews of Fonterra's Manual and base milk price Calculation and includes:²
 - 6.1 an overview of how the base milk price is set;
 - 6.2 our interpretation of the key legislative provisions guiding our statutory reviews; and
 - 6.3 our analytical and practical approach to our statutory reviews.
7. The base milk price monitoring regime is intended to provide incentives for Fonterra to act efficiently, while providing for contestability in the market for the purchase of raw milk from farmers. The regime also promotes greater transparency of Fonterra's base milk price setting processes.³
8. We undertake a review of the Manual for each season. The Manual contains the methodology Fonterra uses to calculate its base milk price. As such, the Manual contains a set of definitions, rules and formulas specifying the inputs and process to be followed in calculating the base milk price.
9. We consider the extent to which the Manual is consistent with the purpose of subpart 5A of DIRA. In particular, our review considers the 'efficiency' and 'contestability' dimensions of the s 150A purpose as required by DIRA. Our review therefore focuses on whether the methodology used in the Manual:
 - 9.1 provides an incentive for Fonterra to operate efficiently (the 'efficiency dimension'); and
 - 9.2 adopts assumptions, inputs and processes that would be practically feasible for an efficient processor (the 'contestability dimension').⁴
10. As set out in the Approach paper, the efficiency dimension is met if Fonterra uses notional inputs in calculating the milk price (independent from Fonterra's actual data).

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

³ Dairy Industry Restructuring Amendment Bill (Government Bill) 2012, at 2.

⁴ We consider the same 'efficiency' and 'contestability' dimensions when we carry out our base milk price calculation review.

11. Contestability is considered to be provided for if any notional costs, revenues, or other assumptions taken into account in calculating the base milk price are practically feasible for an efficient processor.⁵
12. To satisfy the provisions in s 150A, our interpretation is that our statutory review must assess the extent to which the Manual is consistent with both dimensions. We attach equal weight to both dimensions in our reviews. Our analytical approach to the efficiency and contestability dimensions is described in chapter 4 of the Approach paper.⁶
13. In our Approach paper, we note that the Manual rules are not always prescriptive and an element of discretion and judgement by Fonterra will be required. As a result, we are not always able to conclude on the efficiency and contestability dimensions of notional costs, revenues and assumptions in the Manual review. Where judgement is required and the rule is not otherwise inconsistent with the s 150A purpose, we will, to the extent possible, assess these dimensions during our review of the calculation in the relevant season.⁷
14. In practice, we focus our review each year on changes to the previous year's Manual and on any unresolved issues carried over from our previous reviews.

Scope of this review

15. DIRA requires Fonterra to provide us with the following information for consideration in our Manual review:⁸
 - 15.1 the Manual for the current season;
 - 15.2 any recommendations by the Milk Price Panel (**MPP**)⁹ in relation to the setting of the base milk price;¹⁰

⁵ DIRA, s 150A(2).

⁶ [Commerce Commission "Our approach to reviewing Fonterra's Milk Price Manual and base milk price calculation – 2021" \(5 July 2021\).](#)

⁷ [Commerce Commission "Our approach to reviewing Fonterra's Milk Price Manual and base milk price calculation – 2021" \(5 July 2021\), at \[99\].](#)

⁸ DIRA, s 150L.

⁹ The MPP is a committee that Fonterra is required to establish and maintain under s 150D of DIRA. The MPP is required, for each season, to supervise the calculation of the base milk price; advise Fonterra on the application of the Manual; and recommend the base milk price to Fonterra. See also [Fonterra "Attachment 1 – Base Milk Price Manual for the 2022/23 season \(marked up version\) - 1 August 2022" \(23 August 2022\), at 26.](#)

¹⁰ Fonterra has "interpreted this provision as in fact relating to recommendations by the Milk Price Panel in relation to amendments to the Milk Price Manual." (See [Fonterra "Reasons Paper in support of Fonterra's Milk Price Manual for the 2022/23 season - 1 August 2022" \(23 August 2022\), at footnote 1.](#) We agree with this interpretation.

- 15.3 notification of any change in the economic and business environment that, in Fonterra's view, requires a change to the Manual;
 - 15.4 certification on the extent to which Fonterra considers that the Manual is consistent with the s 150A purpose; and
 - 15.5 the reasoning behind the views expressed in Fonterra's certification.
16. The above information, where relevant, has been provided by Fonterra and has been considered as part of our review. Specifically, Fonterra has provided us with:
- 16.1 the Base Milk Price Manual for the 2022/23 season (marked-up version);¹¹
 - 16.2 a Reasons paper in support of Fonterra's Milk Price Manual for the 2022/23 season (**Fonterra's Reasons paper**);¹² and
 - 16.3 the MPP recommendations to Fonterra's Board with respect to amendments to the 2022/23 Manual.
17. The 'marked up' version of the 2022/23 Manual shows the changes that have been made to the previous season's version of the Manual. Fonterra has stated in its Reasons paper that the 'marked up' version of the 2022/23 Manual identifies all amendments to the Manual.¹³ In addition, we have reviewed the MPP recommendations to Fonterra's Board and confirmed that all recommended amendments are reflected in the 2022/23 Manual.
18. We have focused on the amendments Fonterra has made to the Manual for the 2022/23 season and matters carried forward from previous reviews. This season, the only substantive change to the Manual was to Rule 42 on asset beta. The matters carried forward from previous reviews are:
- 18.1 materiality; and
 - 18.2 the DIRA definition of commodity.
19. For those parts of the Manual that have remained unchanged we have continued to rely on our previous conclusions. We are not aware of any other new information which would warrant reconsideration of our conclusions in previous Manual reviews.

¹¹ [Fonterra "Attachment 1 – Base Milk Price Manual for the 2022/23 season \(marked up version\) - 1 August 2022" \(23 August 2022\).](#)

¹² [Fonterra "Reasons Paper in support of Fonterra's Milk Price Manual for the 2022/23 season - 1 August 2022" \(23 August 2022\).](#)

¹³ [Fonterra "Reasons Paper in support of Fonterra's Milk Price Manual for the 2022/23 season - 1 August 2022" \(23 August 2022\), at 5.](#)

20. We published our draft report on our review of the 2022/23 Manual on 14 October 2022 (**draft report**).¹⁴ We received submissions on our draft report from the following stakeholders:
- 20.1 Fonterra;¹⁵ and
 - 20.2 Joint submission by Miraka, Open Country Dairy, Synlait Milk and Westland Milk Products (**the Companies**).¹⁶
21. We have responded to stakeholder submissions that are within the scope of our 2022/23 Manual review in Chapter 3.

Other matters raised in submissions by the Companies

22. The Companies raised a range of other matters that are outside the scope of the Manual review as they relate to the application of the rules in practice. These matters included issues related to commodity products and prices, and the valuation of reference assets. In line with our Approach paper, we review the implementation of the rules in the calculation review.

¹⁴ [Commerce Commission "Review of Fonterra's 2022/23 Milk Price Manual: Draft report" \(14 October 2022\).](#)

¹⁵ [Fonterra "Submission on Draft Report of the Milk Price Manual 2022-23" \(15 November 2022\).](#)

¹⁶ [Miraka, Open Country Dairy, Synlait and Westland Milk Products "Joint Submission on Draft Report of the Milk Price Manual 2022-23" \(15 November 2022\).](#)

Chapter 3 Conclusions

23. This chapter summarises our conclusions on the extent to which the 2022/23 Manual is consistent with the s 150A purpose.

Our conclusions

24. Based on the information we have before us, our conclusions are:
- 24.1 Regarding Fonterra's amendments to the Manual since last year's review, our conclusion is that the amendments made are consistent with s 150A of DIRA.
 - 24.2 Our overall conclusion is that the Manual is consistent with the statutory purpose set out in s 150A.

Fonterra's amendments to the 2022/23 Manual

25. Fonterra has made the following amendments to the 2022/23 Manual:
- 25.1 Rule 42 asset beta; and
 - 25.2 minor changes in contemplation of future review years for inputs into the base milk price calculation. We do not consider these changes necessitate review.

Rule 42: asset beta

This season's Manual change and reasons

26. Fonterra has amended Manual Rule 42 on asset beta for the 2022/23 season, which now reads:¹⁷

The MPG will determine an updated Asset Beta in a Review Year. The Asset Beta must be consistent with the estimated asset betas of other processors of dairy and other food products that are traded in significant quantities in globally contested markets and are characterised by uniform technical specifications.

Where more than one estimate of asset beta is consistent with this mandatory requirement, and those estimates are otherwise equally supportable, the MPG will select the estimate which best reflects the exposure to systematic risk of an efficient New Zealand-based manufacturer of reference commodity products.

¹⁷ [Fonterra "Attachment 1 – Base Milk Price Manual for the 2022/23 season \(marked up version\) - 1 August 2022" \(23 August 2022\) at 56.](#)

27. In its Reasons paper, Fonterra explains the rationale for this change:¹⁸

The intent of the amendments is to:

- Make it explicit that the MPG’s estimate must comply with s 150C(4).
- Provide explicit guidance to the MPG if it is required to select a single value from a range of estimates which comply with the DIRA requirements. This guidance recognises the reality (which is acknowledged in numerous documents produced by the Commission) that a number of technical judgements are required when estimating beta, with legitimate choices between approaches often generating slightly different answers. The requirement that the point estimate selected from a range of DIRA-compliant estimates reflects the value which “best reflects the exposure to systematic risk of an efficient ... manufacturer” is consistent with the ‘practical feasibility’ test in s 150A(2) of DIRA.

Our review findings in last season’s Manual review

28. In our 2021/22 Manual review, we reached the following conclusion on the first limb of Rule 42 (asset beta):¹⁹

We consider that the first limb of Rule 42 is inconsistent with the s 150C(4) requirement for calculation of the asset beta and is therefore inconsistent with the s 150A purpose.

Section 150C(4) requires the use of an asset beta that is consistent with the comparator set asset betas. In our view, the use of an average from a set of comparators that meet the requirements of s 150(C)(4) would likely meet the legislative requirement, assuming the asset betas for the comparators have been appropriately estimated.

The first limb of Rule 42 enables the Milk Price Group (MPG) to have regard to Fonterra-specific systematic risk in calculating the asset beta. Our view is that any asset beta that has been adjusted away from the comparator set on the basis of Fonterra-specific systematic risk would not be consistent with the estimated asset betas of other processors of dairy and other food products and, therefore, would be inconsistent with s 150C(4).

[footnotes omitted]

¹⁸ [Fonterra “Reasons Paper in support of Fonterra’s Milk Price Manual for the 2022/23 season - 1 August 2022” \(23 August 2022\), at 5.](#)

¹⁹ [Commerce Commission “Review of Fonterra’s 2021/22 Milk Price Manual: Final report” \(15 December 2021\), at \[33-35\].](#)

We consider Rule 42 is consistent with the s 150A purpose

29. Our conclusion is that the amended Rule 42 on asset beta is consistent with the s 150A purpose.
30. Section 150C(4) of the DIRA requires Fonterra to use an asset beta that is consistent with the estimated asset betas of other processors of dairy and other food products that are both traded in significant quantities in globally contested markets and characterised by uniform technical specifications. Our conclusion is that Rule 42 complies with this requirement and is consistent with the DIRA.
31. The reason for this conclusion is that the rule requires that the asset beta estimate used in the base milk price calculation meets the s 150C(4) requirement. A choice is only available to Fonterra when each of the estimates available is consistent with s 150C(4) and “otherwise equally supportable”.
32. The Companies submitted that to reduce Fonterra’s discretion in selecting between different but supportable asset beta outcomes, the asset beta should be the simple average of those outcomes.²⁰
33. We have considered this submission and do not think that this degree of specificity is required in this rule. As explained in paragraph 13 above and our Approach paper, the Manual is not required to be completely prescriptive. Therefore, we remain of the view that Rule 42 is consistent with the s 150A purpose. If Fonterra were to select an asset beta in any calculation that was not consistent with s 150C(4), we would address this in the relevant calculation review.

Issues carried forward from previous reviews

34. We have also considered the following issues carried forward from previous reviews:
 - 34.1 materiality;²¹ and
 - 34.2 how the Manual gives effect to the DIRA definition of commodity.²²

²⁰ [Miraka, Open Country Dairy, Synlait and Westland Milk Products "Joint Submission on Draft Report of the Milk Price Manual 2022-23" \(15 November 2022\) at 11 \[57\].](#)

²¹ [Commerce Commission “Review of Fonterra’s 2021/22 Milk Price Manual: Final report” \(15 December 2021\), at 15.](#)

²² [Commerce Commission “Review of Fonterra’s 2021/22 Milk Price Manual: Final report” \(15 December 2021\), at 18.](#)

Materiality

35. In our final report on our review of the 2019/20 Manual, we suggested Fonterra should disclose what constitutes a 'material change', when considering whether a change to the Manual should be made.²³
36. Fonterra has explained that in various circumstances, which potentially give rise to a decision to amend the Manual, a materiality test is simply not relevant. That position remains the same whether the test is expressed as a number or a list of qualitative factors. Fonterra also provided examples of when changes have been made to the Manual, despite having minimal impact on the base milk price.²⁴
37. Based on Fonterra's explanation and our review of past changes to the Manual, we are satisfied that materiality has not been a relevant consideration. As such, implementing a materiality test would be unlikely to provide any meaningful effect or additional transparency.
38. In its Joint submission, the Companies requested that we reconsider our draft opinion on this matter but described materiality in respect of compliance with DIRA and existing references to materiality in the Manual that require the application of judgement in preparing the milk price calculation.²⁵
39. This is a different dimension of materiality than the one on which we have concluded in this report, which relates to materiality considerations made by Fonterra in undertaking Manual amendments.
40. In respect of the discretion that a materiality standard introduces in applying the Manual, we concluded on this in our 2018/19 Calculation review. There we stated that a number of rules express principles which require the exercise of judgement in the selection of inputs from within a practically feasible range and that this approach is appropriate for the preparation of the base milk price calculation.²⁶

How the Manual gives effect to the DIRA definition of commodity

41. In our 2020/21 Calculation review, we said we intended to examine more closely how the Manual gives effect to the DIRA definition of commodity in a future Manual review.²⁷ In our 2021/22 Manual review, we expanded on this, noting that this

²³ [Commerce Commission "Review of Fonterra's 2019/20 Milk Price Manual: Final report" \(12 December 2019\), at \[80\].](#)

²⁴ [Fonterra "Reasons Paper in support of Fonterra's Milk Price Manual for the 2022/23 season - 1 August 2022" \(23 August 2022\), at 6.](#)

²⁵ [Miraka, Open Country Dairy, Synlait and Westland Milk Products "Joint Submission on Draft Report of the Milk Price Manual 2022-23" \(15 November 2022\) at 11-12 \[58-63\].](#)

²⁶ [Commerce Commission "Review of Fonterra's 2018/19 Base Milk Price Calculation: Final report" \(12 September 2019\) at 25, table 3.](#)

²⁷ [Commerce Commission "Review of Fonterra's 2020/21 Base Milk Price Calculation: Final report" \(15 September 2021\), at \[3.7.4.2\].](#)

process was likely to involve reviewing the list of Qualifying Materials and Incremental Product Cost adjustments made to account for differences in product specifications and manufacturing processes.²⁸ This became a focus area in our 2021/22 Calculation review.²⁹

42. Our 2020/21 Manual review recommended that publication of a list of all products constituting 'generic product specifications' would greatly assist clarity of what is a Standard Product Offering.³⁰ Responding to this, Fonterra indicated in its Reasons paper in support of the 2021/22 Manual that it did not consider it appropriate as a matter of general principle to include in the Manual the outcomes from the application of the Manual's rules and processes, but would continue to look for other means of providing information about the range of price-informing products.³¹
43. In its Reasons paper in support of the 2021/22 Calculation, Fonterra provided a table of Standard Product Offering categories and Standard Packaging formats. Fonterra noted that products which do not fall within these categories are excluded from the schedule of Qualifying Materials.³²
44. As set out at paragraph 13 above, we note that the Manual rules are not always prescriptive. The scope of the Commission's reviews is limited to assessing consistency with the s 150A purposes. It does not extend to prescribing the rules in Fonterra's Manual.
45. Our 2021/22 Calculation review included a full review of the list of Qualifying materials to determine whether the products met the DIRA definition of commodity and whether they constituted Reference Commodity Products on a reasonable interpretation of the Manual. We concluded that we were satisfied the range of Qualifying Materials was appropriate and that the approach taken provided an incentive for Fonterra to operate efficiently and was practically feasible for an efficient Notional Processor.³³
46. We consider that the approach taken by Fonterra to disclose information in relation to Standard Product Offerings and Standard Packaging formats in the Reasons paper in support of the calculation is reasonable and provides additional transparency in

²⁸ [Commerce Commission "Review of Fonterra's 2021/22 Milk Price Manual: Final report" \(15 December 2021\), at \[74\].](#)

²⁹ [Commerce Commission "Review of Fonterra's 2021/22 base milk price calculation: Final report" \(15 September 2022\), at \[2.12.3\].](#)

³⁰ [Commerce Commission "Review of Fonterra's 2020/21 Milk Price Manual: Final report" \(15 December 2020\), at \[X16.1\].](#)

³¹ [Commerce Commission "Review of Fonterra's 2021/22 Milk Price Manual: Final report" \(15 December 2021\), at \[72\].](#)

³² [Fonterra "Reasons Paper in support of Fonterra's Milk Price Calculation for the 2021/22 season – 1 July 2022" at 49.](#)

³³ [Commerce Commission "Review of Fonterra's 2021/22 base milk price calculation: Final report" \(15 September 2022\), at \[3.7.3\] and \[3.8.3\].](#)

relation to Qualifying Materials. We recommend that Fonterra continues to disclose this information.

47. We will continue to assess whether the implementation of the rules in relation to Qualifying Materials satisfy the contestability and efficiency dimensions of DIRA in future calculation reviews. We use both publicly available and confidential information in this assessment. This is consistent with our stated approach to consider the outcomes of non-prescriptive rules in the calculation review.
48. However, 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.³⁴
49. A key concern of submitters regarding the specification of Reference Commodity Products, relates to how the Manual gives effect to the DIRA definition of commodity, in particular the Uniform Technical Specification criterion and the commodity portfolio requirements in s 150C.
50. We consider the Manual rules for selecting Reference Commodity Products are not inconsistent with the contestability and efficiency limbs of s 150A.

³⁴ [Commerce Commission “Review of Fonterra’s 2021/22 Milk Price Calculation: Final report” \(15 September 2022\), at \[3.6.3\].](#)

Attachment A Glossary

Term/Abbreviation	Definition
DIRA	Dairy Industry Restructuring Act 2001
Base milk price	Base milk price, in relation to a season, means the price per kilogram of milk solids (kgMS) that is set by Fonterra for that season.
Calculation review	Commission's review of Fonterra's base milk price calculation for the season.
Manual review	Commission's review of Fonterra's Milk Price Manual for the season.
Dairy season	1 June to 31 May annually
MPG	Milk Price Group
Milk Price Manual or the Manual	Fonterra's Milk Price Manual
MPP	Milk Price Panel
Notional processor	The notional commodity business that is used to calculate the base milk price (in its Reasons paper Fonterra uses the term notional producer).
Reasons paper	Fonterra's Reasons paper which is provided alongside the Manual for each dairy season (this is also provided when Fonterra discloses its base milk price calculation at the end of each dairy season).