



Dairy for life

15 NOVEMBER 2020

**Submission to the
Commerce Commission on its
Draft Report on Fonterra's 2020/21
Farmgate Milk Price Manual**

Glossary

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| 2020/21 Reasons Paper | Fonterra, Reasons Paper in support of Milk Price Manual for the 2020/21-season, 1 August 2020, https://comcom.govt.nz/_data/assets/pdf_file/0024/225249/Fonterras-Reasons-Paper-in-support-of-the-Milk-Price-Manual-for-the-2020-2021-season-1-August-2020.pdf |
| F21 Draft Manual Report, Draft Report | Commerce Commission, Review of Fonterra's 2020/21 Milk Price Manual, Draft Report, 15 October 2020, https://comcom.govt.nz/_data/assets/pdf_file/0028/226657/Draft-report-Review-of-Fonterras-2020-21-Milk-Price-Manual-15-October-2020.pdf |
| DIRA | Dairy Industry Restructuring Act 2001. |
| NMPB | Notional Milk Price Business, comprising the notional milk powder manufacturing business implied by Fonterra's Farmgate Milk Price Manual. |
| 2020/21 Season | The period commencing on 1 June 2020 and ending on 31 May 2021. |

1 Introduction

This paper sets out Fonterra’s submissions on the Commerce Commission’s draft report, dated 15 October 2020, on Fonterra’s Milk Price Manual (the Manual) for the 2020/21 Season, prepared in accordance with section 150I of the Dairy Industry Restructuring Act 2001 (DIRA). This submission is intended to satisfy Fonterra’s obligations under section 150M(2) of DIRA. The submission has been prepared under the oversight of the Milk Price Panel, and where relevant reflects the Panel’s views.

We note the Commission’s overall draft conclusion is that the Manual is largely consistent with the section 150A purpose statement.

Our comments in this submission are focused primarily on the Commission’s draft conclusions relating to “two aspects of the Manual that [the Commission] consider[s] inconsistent with the purpose in s 150A or would like to see more disclosure in the Manual”:

- Fonterra’s amendments to Rule 23 that allow the ability to apply the outcome of a Mid-Period Review in the year of a review; and
- capacity of standard plants.

We also comment briefly on the Commission’s proposals for further disclosures in the Manual with respect to products considered ‘generic product specifications’, the definition of ‘freely contestable markets’ and the definition of ‘prevailing’.

2 Commission’s Draft Conclusions

We comment in this section on the two matters which the Commission regards as being inconsistent with the s 150A purpose (allowing the outcome of a within-period review to be applied in the year of the review) or on which it would like to see additional disclosure (standard plant capacities).

Application of outcomes of within-period reviews

Rule 23 provides that in “exceptional circumstances” Fonterra may undertake a ‘within-period review’ of inputs which are normally subject to a four-yearly reset. We have amended the provision to make it explicit that it applies to all inputs subject to a four-yearly review, and not just cost inputs, and to provide that “where warranted by circumstances” the outcome of a review will be implemented in the year in which the review is undertaken.

The Commission explains that its “draft conclusion is that we do not consider the introduction of the requirement to apply the outcome of a Within-Period Review to the year in which the review is undertaken is consistent with the efficiency dimension of the s150A purpose ... [because] this change could give rise to the potential replacement of benchmark notional inputs, with current actual inputs in the year of review, thereby removing an incentive for Fonterra to beat those inputs in the year of review.”¹

We note:

- The amended provision does not impose a requirement that the outcome of a within-period review be applied in the year in which the review is undertaken. Rather, it allows this to occur only “where warranted by circumstances”. Our intent, as indicated in our reasons paper, is that we will only implement the outcome of a within-period review in the year of the review in circumstances where the relevant input would otherwise clearly not be practically feasible for an efficient processor (and not just for Fonterra), and where the difference between the previous and new input was sufficiently large such that the overall milk price could potentially otherwise not be practically feasible. The amended provision therefore clarifies and enhances Fonterra’s ability to apply the Manual in a method that complies with DIRA.
- As the Commission notes, the amended provision does not prohibit the potential replacement of benchmark notional inputs with actual current-year inputs, and we agree that if this were to occur it would weaken incentives on Fonterra to efficiently manage the relevant inputs. However, we are very cognisant of this risk, and advise that where practical we would continue to always seek notional inputs, rather than use the relevant actual current-year value to calculate the milk price. We also note that in a year in which the amended provision is used we will be required to explain in the base milk

¹ Draft Report, paragraphs 52 and 59.

price reasons paper for that year why we consider the input is consistent with the s 150A principles, and the Commission will be able to assess the compliance of our reasons with DIRA.

Capacity of standard plants

In paragraphs 29, 32 and 33 on pp.13-14 and in Table A1 on pp.22-23 the Commission explains that it now accepts that the Manual is not the appropriate vehicle for disclosing assumed FX rates, but that it continues to consider Fonterra should disclose the capacity of standard plants in the Manual.

In our Manual Reasons Paper, we explained that:

We do not consider the Manual is the appropriate vehicle for these disclosures. We routinely put this information into the public domain in our base milk price reasons papers. In the F20 Base Milk Price Reasons Paper we explained that “the most recent review of the fixed asset base was completed this year, and resulted in a decision to maintain the assumed processing capacities of incremental and replacement plants for the manufacture of each of the RCPs at the same levels assumed for the previous 2017-2020 Review Period.”² Consequently for the period F21-F24 we will maintain our assumption that newly installed WMP and SMP plants have capacities of ~2.4m litres of milk per day, our BMP capacity is ~800,000 litres of buttermilk per day, and our AMF and Butter capacity plants can process ~500,000 litres of cream per day.²

In response the Commission’s draft conclusion is that:

We consider that the plant capacity disclosure should be made earlier in the season than in the base milk price calculation reasons paper. We consider that the disclosure of plant capacity in the Milk Price Calculation reasons paper is too late to enable interested parties to assess the practical feasibility of the assumed production volumes.

The Commission’s response highlights an apparent impression that the disclosures in our base milk price reasons papers are routinely restricted to plant capacities for just the current season. Per the extract from our Manual Reasons Paper set out above, this is not the case: since at least 2016 we have summarised the results of the most recent four-yearly review of standard plant capacity, explaining (for example) in the 2016/17 base milk price reasons paper that “the most recent [four-yearly] review of the fixed asset base was completed in 2016, and resulted in a decision to maintain the assumed processing capacities of incremental and replacement plants for the manufacture of each of the RCPs at the same levels assumed for the previous 2013-2016 Review Period.”³

We will continue to make this information available, including on a forward looking basis (clearly reflecting that the current standard plant capacities will apply until the next review period), in our base milk price reasons paper, which is provided to the Commission a month before our Manual reasons paper. This would appear to address the Commission’s concerns regarding the timeliness of our disclosure.

3 Other matters

In Table A1 on pp.22-26 the Commission recommends we make the following clarifying amendments to the Manual, on the basis that they would “better promote the purpose of the Act and provide greater confidence to interested parties through additional transparency:”

- “We consider the publication of the list of all products that constitute ‘Generic product specifications’ in the Manual would greatly assist clarity of what is a standard product offering.
- We consider the conditions that apply to sales that are not considered to be transacted on freely contestable markets should be specified in more detail in Principle 2 of the Manual to clarify how this principle is to be applied.
- The term ‘prevailing’ is used in a number of rules in the Manual. We consider that defining this term would provide greater clarity in respect of the inputs required to be used by these rules.”

We will consider these proposals in detail in the course of drafting amendments to the Manual for the 2021/22 season. With respect to the proposed change to Principle 2 of the Manual we note, however, that the Milk Price Principles are entrenched in Fonterra’s constitution, and can only be amended through a vote by shareholders.

² Fonterra, Reasons Paper in support of Fonterra’s Milk Price Manual for the 2020/21 Season, 1 August 2020, page 4.

³ Fonterra, Reasons Paper in support of Fonterra’s base milk price for the 2016/17 Season, 3 July 2017, page 15.