



Process and issues paper

Review of 2015/16 base milk price calculation

18 December 2015

Purpose

1. This paper invites submissions from interested parties on our proposed process, approach and focus areas for our 2015/16 base milk price calculation review under the Dairy Industry Restructuring Act 2001 (DIRA).
2. Our review of the 2015/16 base milk price calculation is the second of two reviews each milk season that we are required to undertake under DIRA on the base milk price. The first review this season, of Fonterra's 2015/16 Milk Price Manual, which describes the rules used to calculate the base milk price, was published on 15 December 2015.¹
3. Details on how you can provide your views on this paper can be found in paragraphs 49 and 51.
 - 3.1 Submissions on this paper may be made to us no later than **5pm on Friday 5 February 2016.**
 - 3.2 Cross-submissions on submissions may be made to us no later than **5pm on Friday 19 February 2016.**

¹ Commerce Commission "Review of Fonterra's 2015/16 Milk Price Manual: Final Report" (15 December 2015).

Proposed process, scope of our review, and how interested parties can contribute

4. Table 1 summarises the key process steps and our indicative timings for the review.

Table 1: Indicative timeline

Process step	Indicative timing
Report on review of 2015/16 Milk Price Manual published	15 December 2015
Process and issues paper released	18 December 2015
Submissions on process and issues paper due	5 February 2016
Cross-submissions on process and issues paper due	19 February 2016
Fonterra provides Commission with information required under section 150T of the Act	1 July 2016
Draft report on base milk price calculation released	15 August 2016
Submissions on draft report due	1 September 2016
Final report on base milk price calculation released	15 September 2016

5. DIRA requires us to consult with Fonterra on our draft report. However, as noted in Table 1 we also intend to provide an opportunity for other interested parties to participate in our review process.
6. We are also inviting cross-submissions on any submissions made on this paper. This will allow parties to comment on any factual or technical misconceptions in submissions, with the aim of resolving them before we get too far into our review, rather than between seasons as in the past when submissions were only in respect of our draft report.
7. We will communicate any updates to the steps or timing of this process as they arise.

Scope of our review

8. The scope of our review is confined to Fonterra's base milk price calculation. We will consider the extent to which the assumptions adopted, and the inputs and processes used, provide an incentive to Fonterra to operate efficiently, while providing for contestability in the market for the purchase of milk from farmers.²

How interested parties can contribute

9. Before preparing this paper, we met with representatives of Fonterra and some of the independent processors³ to better understand their issues and concerns and to help us select the focus areas and decide on the approach to our review.

² These are the statutory tests in s 150A of the *Dairy Industry Restructuring Act 2001* (as amended on 26 July 2012).

³ Open Country Dairy Limited, Miraka Limited and Synlait Milk Limited.

10. We are particularly interested in receiving any comments and suggestions from interested parties on:
 - 10.1 alternative approaches for analysing our focus areas;
 - 10.2 any additional supporting evidence that can be provided that may assist us in our review; and
 - 10.3 specific areas in the milk price calculation where increased ease of access to information could be of benefit to assist the review.
11. We appreciate and value the continuing engagement and effort from Fonterra and the independent processors in our milk price monitoring reviews. We also welcome the opportunity to meet with other interested parties on the focus areas outlined below.

Proposed approach and legal framework for our review

12. This year we propose to concentrate on resolving outstanding issues from last season, including the aggregate assessment that we outlined in our final report of the review of Fonterra's 2014/15 base milk price calculation.⁴
13. While reviewing all other components as efficiently as possible this season, we intend to focus on the following key technical areas outlined in paragraph 15.
14. We also intend to carry out an aggregate assessment of the milk price components as a package.

Proposed focus areas

15. The technical focus areas for the individual components for this year's review of the base milk price calculation in order of priority will be:
 - 15.1 Weighted Average Cost of Capital (WACC), with emphasis on the asset beta and specific risk premium)
 - 15.2 Production yields;
 - 15.3 Consistency of capital cost assumptions; and
 - 15.4 Corporate costs (administration, plant labour, other supply chain costs, site overhead costs, and selling costs).
16. We identified the focus areas for the 2015/16 calculation review from:
 - 16.1 base milk price calculation components where we were unable to conclude on their practical feasibility in our 2014/15 calculation review and our 2015/16 Manual review;

⁴ The aggregate assessment looks at the milk price calculation as a whole and considers the reasonableness of the practical feasibility conclusions on the individual revenue and cost components as a package.

- 16.2 outstanding issues raised in submissions on our 2014/15 calculation review draft report;
 - 16.3 concerns raised in submissions on our 2015/16 Manual review that relate to the 2015/16 base milk price calculation review;
 - 16.4 base milk price calculation components that Fonterra is required to review for the 2015/16 season under its Milk Price Manual (Rules 14, 17, 18 and 20 of the Manual); and
 - 16.5 our meetings with Fonterra and independent processors.
- 17. For all other base milk price calculation components that are not part of those areas of focus we will undertake a basic 'fit for purpose' review.
 - 18. We intend to focus on the aggregate assessment of the notional producer to allow us to better understand the practical feasibility of the individual components.

Weighted Average Cost of Capital (WACC)

- 19. We could not previously conclude on the practical feasibility of the asset beta assumption and specific risk premium. We received feedback and submissions concerning the asset beta and specific premium and we appreciate that input. We have collated our concerns and those of interested parties and have requested Fonterra and its independent expert provide a response on how they propose to address those concerns.
- 20. We have also encouraged Fonterra to release its WACC rate calculations for the notional producer to improve transparency on how the WACC rate is estimated.
- 21. We have asked Fonterra to provide us with its updated Terms of Reference for its independent review so we can see how the concerns will be dealt with. We expect that Fonterra will publish an updated report from its independent reviewer in due course and will advise interested parties when this is available.
- 22. We plan to engage an independent expert to peer review Fonterra's independent expert's conclusions on the asset beta and specific risk premium in the WACC calculation used in setting the capital charge in the base milk price calculation. If we engage our own independent expert, we intend to publish our independent expert's peer review conclusions on the asset beta and specific risk premium prior to issuing our draft report on the 2015/16 base milk price calculation review.

Production yields and pricing

- 23. It is two seasons since we last reviewed the production yield assumptions using an independent yields expert. The assumed losses in the base milk price calculation have been reducing yearly. Independent processors have voiced concerns about whether the yield assumptions (the production losses and specification offsets) and related pricing are practically feasible. Particular concerns raised include:

- 23.1 whether the yields achieved by Fonterra plants are representative of the notional producer's asset base and footprint when operating for an entire season;
 - 23.2 whether the assumed manufactured volumes meet the specifications sold on GDT (and meeting Codex requirements⁵) and whether price adjustments would be necessary if the assumed manufactured volumes do not meet GDT specifications;⁶ and
 - 23.3 the reliability of GDT prices as a basis for prices in the base milk price calculation model, given the quantities sold by Fonterra off-GDT.
24. In view of the time since we last looked more closely at the yields and the expressed concerns in submissions, we propose this season to again engage an independent expert to assist us in evaluating the practical feasibility of the yields.

Consistency of capital cost assumptions

25. As part of this year's review, we intend to focus on the consistency of the notional producer's capital cost assumptions, in particular:
- 25.1 the completeness and timing of the capital cost components that feed into the calculation of the capital charge (excluding the WACC used to convert the capital costs to a capital charge, which has been identified as a separate topic above); and
 - 25.2 the completeness and timing of the related operating expenditure components that also inform the amount of capital cost (e.g. repair and maintenance).

⁵ Codex Alimentarius – international standard for food descriptions which sets out powder fat minimum content and minimum protein to solids-non-fat ratios.

⁶ Independent processors have specifically mentioned that the notional producer cannot achieve prices sold on GDT if targeting the typical GDT specifications.

26. Independent processors have raised concerns about the assumptions that inform the capital cost used in the calculation of the capital charge. For example, Synlait notes that the notional producer has the benefits of Fonterra's scale and a modern portfolio of high yield, low operating cost plants. However, Synlait's view is that the capital charges in the milk price calculation are inconsistent with such assumptions.⁷
27. Our proposed work in this area is therefore intended to enable:
 - 27.1 assurance that the assumptions used to produce the relative proportions and overall capital costs are appropriate; and
 - 27.2 comparison between yields and operating costs data for upgraded and new plants; and
 - 27.3 an explanation and better understanding of the tilted annuity depreciation methodology that Fonterra applies.

Corporate costs

28. In line with Fonterra's corporate costs review for the 2015/16 milk price calculation which is required under the Manual, we propose to carry out a review of the following cost components to identify any significant changes in approach and to conclude on whether these are the reasonable costs a processor of the notional processor's scale would expect to incur:
 - 28.1 Administration costs;
 - 28.2 Plant labour costs;
 - 28.3 Other supply chain costs;
 - 28.4 Site overhead costs; and
 - 28.5 Selling costs.

Aggregate assessment of the notional producer

29. Independent processors have re-emphasised their concern that the notional producer is not practically feasible in aggregate. They have cited material differences between the financial performance of an efficient processor and the performance of the notional producer.

⁷ Synlait "Concerns regarding the Commerce Commission's final report on the 2014/15 base milk price calculation" (13 October 2015), paragraphs 8 – 20.

30. To determine whether there is a material performance gap between an efficient producer and the notional producer, we consider that the best way to carry out the aggregate assessment is to start at an Earnings Before Interest, Tax, Depreciation and Amortisation (EBITDA) level for Fonterra's New Zealand ingredients business (Global Ingredients and Global Operations 'GI & GO' businesses, formerly NZMP). We would then work out an equivalent 'actual' EBITDA to that for the notional producer based on this. This will help build understanding about the practical feasibility of the notional producer in aggregate.
31. We consider that EBITDA, rather than EBIT, is the best starting point. The tilted annuity depreciation method makes an EBIT level comparison difficult. We will look at the depreciation method separately.
32. Because GI & GO produces both reference commodity products (RCPs) and non-RCPs, it is necessary to separate the financial performance of each part of the operations to enable a more direct comparison of the RCP part with the RCP financial performance of the notional producer.
33. We will seek to work with Fonterra to compare GI & GO's EBITDA with the notional producer's EBITDA by:
 - 33.1 removing the estimated EBITDA of the non-RCP part of the business, to leave an estimate of the EBITDA for the GI & GO RCP operation; and
 - 33.2 comparing some specific details of GI & GO RCP operations and the notional producer's revenue, foreign exchange and costs at a KgMS level.
34. Because some of the analysis used in separating the financial performance of the RCP and non-RCP parts of the business will involve estimates and judgement calls (particularly where there are shared costs between the RCP and non-RCP production activities), key assumptions will be documented with our conclusions in our draft report on the base milk price calculation review in August 2016.
35. As a cross-check, we will review the data we use in the analysis of the GI & GO EBITDA for consistency with information that is publicly available.
36. We note that our approach to assessing the aggregate assessment of the notional producer is dependent on Fonterra providing the relevant information in a reasonable timeframe for us to complete our analysis.
37. We will also use any comparable cost information received from interested parties to help us identify any cost components that are potentially 'over-optimised' in the base milk price calculation. We request that any data is provided to us **by the end of March 2016** to give us time to factor this into our conclusions.

Other outstanding matters from our previous reviews carried over to this review

38. There are a number of other application matters that we have carried over to this review from our 2014/15 base milk price calculation review and our 2015/16 Manual review, which we will review:
- 38.1 How winter milk premiums are treated in the milk price model. We continue to receive queries from independent processors as to whether winter milk premiums are included in the milk price calculation. We consider that the winter milk methodology needs to be made clearer to ensure that it depicts a fair representation of the notional producer;
 - 38.2 How support payments to suppliers (e.g. financing costs of interest-free loans to farmers) should be incorporated into the base milk price calculation and the milk price model. We understand that other processors have made similar support mechanisms to their suppliers. We welcome any information outlining:
 - 38.2.1 the terms of the support mechanism;
 - 38.2.2 the reasons for providing the support; and
 - 38.2.3 the scale relative to the amount of milk supplied.
 - 38.3 The practical effect of non-GDT sales on the base milk price under Rule 5 of the Milk Price Manual (Sales through GDT);
 - 38.4 How Rule 14 of the Milk Price Manual (Repair and Maintenance costs) is applied in the 2015/16 base milk price calculation, and consideration of whether the rule should be made prescriptive; and
 - 38.5 How Fonterra applies the asset stranding rules (Rule 33 and Rule 44 of the Milk Price Manual). A particular area of interest to us is how asset stranding risk is apportioned between the ex ante allowance provided by the specific risk premium and any ex post adjustments made under Rule 33 due to changes in the RCP basket.
 - 38.6 Our suggestion to Fonterra is that it considers how it can be transparent in how it applies Rule 19 (Non-recurring costs). For example, by describing the one-off costs provided for and breaking down the costs and indicating the timing basis in the milk price model and the milk price statement.

Review of other revenue and cost components

39. For all other base milk price calculation components that will not be part of the above more-detailed analysis, we will undertake a 'fit for purpose' review. This will involve:
- 39.1 an analytical verification of the values used in the component against our previous reviews of the same component; and
 - 39.2 a review of the consistency of the component with other components.
40. If any aspect of this review identifies inconsistencies with our previous analysis or with other components of the base milk price calculation model, we will consider whether more analysis of that component is required.

Reducing the level of our review

41. We are aware of potential duplication of some aspects of The Milk Price Panel's governance role on the base milk price and the reviews we are required to carry out under DIRA. We understand that under the legal framework there can be reliance on the internal and external audit carried out on the base milk price calculation.
42. The following items could help inform the level of our review:
- 42.1 The internal auditor's report provided to the Milk Price Panel on any matters noted in the course of the 2014/15 internal audit of the base milk price calculation that informs the Panel on any further work required by the internal auditor or the Milk Price Group in the 2015/16 season;
 - 42.2 The audit engagement letter and the external auditor's engagement plan for the audit of the 2015/16 base milk price calculation; and
 - 42.3 The external auditor's management letter provided to the Milk Price Panel on any matters noted in the course of the 2014/15 audit of the base milk price calculation that informs the Panel on any further work required by the auditor or the Milk Price Group in the 2015/16 season.
43. Due to the timing of our review work relative to when the 2015/16 audit is likely to be carried out and finalised, we will not be able to rely on the 2015/16 audit opinion itself. However, an ability to assess and rely on the proposed audit and internal procedures could enable us to carry out a much more limited review of components that are outside of our identified focus areas.

Legal framework

44. We have used substantially the same framework since we commenced our statutory reviews and we consider the framework largely settled. We do not propose to change our legal framework for the review (e.g. our interpretation of ‘efficient processor’). We acknowledge the submissions to us concerning the application of the legislative framework.⁸ However, we believe it is more appropriate to address these concerns by considering the specific potential milk price effects that might arise from those concerns within our current legal framework.

Disclosure of information

45. There is no statutory requirement for Fonterra to publicly disclose information relating to the milk price calculation other than its Reasons Paper on 1 July of each year. However, we consider clarity of published information about the base milk price calculation to be an important element in supporting the milk price monitoring regime.
46. Fonterra’s view is that there is enough information in the public domain for interested parties to be able to understand the calculation of the base milk price and come to a reasonable prediction of the milk price. However, we have received feedback to the contrary.
47. We consider that to allow for greater clarity of information, Fonterra should aim to make its currently available information more accessible. By improving the way the information (in particular forecast milk price information) is presented, this will assist interested parties to better understand the milk price calculation.
48. We will also continue to encourage Fonterra to consider how it can disclose more existing non-confidential information from its underlying calculation models and provide further guidance to already published information for interested parties.

⁸ Miraka “Submission to the Commerce Commission: Process and Issues Paper – Review of 2014/15 Base Milk Price Calculation” (7 April 2015), Synlait “Submission on Process and Issues Paper – Review of 2014/15 base milk price calculation” (28 April 2015).

How you can provide your views

49. We invite you to provide your written submissions on this paper to us by **5pm, Friday 5 February 2016**.
50. We will publish all submissions received unless requested otherwise. Cross-submissions on submissions are due to us by **5pm, 19 February 2016**.
51. Submissions on this paper, labelled with the topic 'Submission on process and issues paper – 2015/16 milk price calculation review', should be addressed to:

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Preserving confidentiality of your submission or other information provided

52. We encourage full disclosure of submissions so that all information can be tested in an open and transparent manner. However, we offer the following guidance where you wish to provide information in confidence:
 - 52.1 If you include confidential information in your submission, the information should be clearly marked.
 - 52.2 Both confidential and public versions of your submission should be provided.
 - 52.3 The responsibility for ensuring that confidential information is not included in a public version rests entirely with the party providing the submission.
53. Under s 145 of DIRA, parties providing us with information can also request us to make confidentiality orders under s 100 of the Commerce Act.
54. Any request for a s 100 order must be made when the information is supplied to us, and must identify the reasons why the relevant information should not be made public. We will provide further information on s 100 orders if requested by parties.
55. Any s 100 order will apply for a limited time only as specified in the order. Once an order expires, we will follow our usual process in response to any request for information under the Official Information Act 1982.