1 September 2022

Submission to the Commerce Commission:
Review of Fonterra's 2021/22 base milk price calculation, Draft Report, 15 August 2022

Submitted by email: *market.regulation@comcom.govt.nz*
Attention: Keston Ruxton, Manager Fuel and Dairy
Subject: Milk Price Calculation 2021/22

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

2. It is additional to the submission dated 30 August 2022 to which Open Country Dairy also joined and which addressed qualifying reference sales. This latest submission addresses the following areas:

   - Benchmark Selling Prices
   - Adjustments for Incremental Product Costs
   - Yields: Loss Assumptions and Specification Offsets
   - Notional Producer Costs

3. Abbreviations used in this submission:
   AMF - Anhydrous Milkfat
   BMP - Base Milk Price
   Bmp - Buttermilk Powder
   DIRA - Dairy Industry Restructuring Act 2001
   IPC - Incremental Product Cost
   NP - Notional Processor
   SMP - Skimmilk Powder
   VCR - Value composition ratio
   WMP - Wholemilk Powder

Benchmark Selling Prices

4. This part of the submission addresses four issues related to the benchmark selling prices used to set NP revenue (the practical feasibility of which the Commission has deferred its final assessment pending further information from Fonterra):

   - Prevailing market price test
   - Impact of sales phasing on the practical feasibility of the NP selling prices
   - Volume considerations in calculating weighted average selling prices
   - Disaggregation of benchmark selling prices

Prevailing Market Price Test

5. The Fonterra Milk Price Manual requires that qualifying reference sales can be "reasonably regarded" to reflect "prevailing market prices"[1]. Various submissions have been made pointing

[1] 2021/22 Farmgate Milk Price Manual - Part C: Definitions

out there is no obvious or objective test to confirm that off-GDT sales meet prevailing market prices. Reliance rather seems to be placed on an internal Fonterra performance measure which at best would hold Fonterra staff accountable for selling prices which might fall below comparable GDT prices (and perhaps reward for prices which are higher). There are no review measures systematically triggered when prices might be higher than prevailing market prices. In their Focus Area submissions for this latest review, Miraka and Synlait again requested the Commission review this matter.

6. In the draft report, the Commission states in relation to this request that

   "*Miraka and Synlait have not provided any new evidence or information on these matters and we therefore do not consider these further or revisit our previous conclusions regarding the use of exclusion criteria and the prevailing market price*"[2].

7. The Submitters point out they are not in a position to provide that evidence as there are no detailed disclosures for off-GDT sales and prices. The Submitters continue to raise the issue because it remains unaddressed: the assertion that qualifying reference sales are in line with prevailing market prices is a statement of principle but is not embedded in the milk price procedures.

8. On the other hand the Commission itself is not yet assured that exclusion criteria have properly filtered for qualifying reference sales. The Commission has noted that the price impact for off-GDT sales has increased NP revenues by 3.6 c/kg MS compared to a "like for like" comparison with 20/21[3]. At the time the draft report was issued, the Commission had not yet concluded if the pricing for off-GDT sales (and therefore NP revenue) was practically feasible. It was awaiting further evidence from Fonterra to explain the 3.6c/kg MS increase[4].

9. By definition, the 3.6 c/kg MS arises because off-GDT prices are higher in 21/22, compared to GDT prices, than they were in 20/21. This metric that the Commission relies on and which has triggered a request for further information from Fonterra is the same test (albeit at an aggregate level) the Submitters have sought to be systematically included in the milk price procedures since the inclusion of off-GDT sales from the 2016/17 Season (i.e. that GDT prices are the appropriate benchmark for demonstrating that qualifying reference sales are selected on the basis (amongst other things) they are sold at prevailing market prices). This is not the same as saying that off GDT prices must be no more than GDT prices. Rather, it means that a further filter should be included in the decision tree for qualifying reference sales to ensure that a selling price which exceeds equivalent GDT prices by a pre-established margin is subject to further documented review to demonstrate it is a qualifying reference sale. This is in effect the step that is required to provide the further evidence that the Commission is seeking from Fonterra.

10. The Commission is again requested to consider, in the light of its request for further information from Fonterra regarding the 3.6 c/kg MS increase due to off-GDT sales, that an explicit "prevailing market price" test should be included in the procedure for selecting qualifying reference sales and that test should be set with reference to GDT prices.

[2] Review of Fonterra's 2021/22 base milk price calculation, draft report (15 August 2022), Attachment A
[3] ibid, para 3.120
[4] ibid para 3.122 and 3.123

11. The 3.6 c/kg MS increase might also be an outcome (at least in part) of a change in phasing mismatches between the price include and volume include sales (see paragraph 13 ff below). By way of illustration of the forces on the phasing mismatch, between 15 June and 7 September 2021 Fonterra progressively reduced WMP availability on GDT by some 60,000 MT (over 14% of annual availability). The reduction was centred on near-term availability – for example September 2021 availability reduced by 36% across that brief period. In its GDT Market Announcements Fonterra explained these reductions were due for example to:

> "*extremely strong demand for Wholemilk Powder over the next six months outside of the GDT Events platform*"[5]

12. This presumably refers to better price opportunities from off-GDT channels. These were unusually large reductions of GDT availability outside of the normal change in volumes attributed to changes in milk supply. Noting price volatility in the 21/22 season, it is quite possible that price consequences (both on and off GDT) of this unusual movement of volume to off-GDT channels has been amplified by the sales phasing mismatch. In any event, in the further information sought from Fonterra, the Commission should also request separate analysis of that part of the 3.6 c/kg MS increase from off-GDT sales that can be attributed to a change in phasing mismatches.

Impact of sales phasing on the practical feasibility of the NP selling prices

13. The benchmark selling prices are derived from Fonterra sales assessed as qualifying reference sales (the "price inform" sales). Those prices are applied to sales phased on the basis of a different (larger) set of sales (the "volume inform" sales). As a result the weighted average prices attributed to the NP are different to the weighted average of prices of the price inform sales. In their Focus Area submissions for the 21/22 calculations review, Miraka and Synlait had requested the Commission consider if the NP weighted average selling prices remain practically feasible.

14. In describing the process for determining the NP weighted average selling prices, Fonterra has assumed:

> "*that Fonterra's overall contract profile for arm's length commodity sales, rather than just the "price include" contract profile, is appropriate*"[6].

15. This assumption leads to the mathematically incorrect approach of weighting the price include selling prices by the different set of volume include sales. In the Reasons Paper, Fonterra offers the following explanation for choosing not to use "price include" sales to weight selling prices:

> "*use of just … 'price include' contract month weightings could result in inefficient decisions regarding the choice of sales channel and would result in unnecessary uncertainty regarding the earnings impact of specific sales that were not "price include" sales*"[7]

16. It is difficult to unpack the meaning of this statement: the "unnecessary uncertainty" to which Fonterra refers is obscure, as is the likelihood of the "inefficient decisions". In any event this explanation provides no obvious reason for the illogical method used to weight prices and

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[5] Market Announcement 15 July 2021, Fonterra Offer Quantities on Global Dairy Trade TE 288
[6] 'Reasons' Paper in Support of Fonterra's Base Milk Price for the 2021/22 Season (1 July 2022), pg 16
[7] ibid pg 18

therefore to determine the NP revenue. Unlike the above explanation, it certainly gives "unnecessary uncertainty" (in fact, a lottery) to how NP selling prices will fall.

17. A possible alternative reason for the weighting of prices by volume inform sales is a concern that there is insufficient depth in sales volumes for the "price include" non-standard specification products. This could raise doubts that weighting on the basis of their associated sales volume will not provide properly representative selling prices. Perhaps Fonterra considers that price smoothing can therefore be achieved by the more substantial volumes included in "volume include" sales. That solution does not however fit the problem, and goes to the heart of the issue created by the expansion of the off-GDT sales in the "price inform" sales series without a corresponding increase in the sophistication of the overall NP model.

18. In its draft report the Commission acknowledges there is an issue with sales phasing but concludes that

    "to the extent there is a mismatch of price and volume metrics the outcome will be unbiased but agree that this may warrant revisiting in a future review"[8]

19. The Submitters do not agree the outcome can be described as "unbiased". The mismatch must inevitably create a bias against demonstrable "real world" weighted average selling prices. That bias could be either towards higher or lower weighted average prices (which is possibly why the Commission describes the outcome as "unbiased"). The bias will increase as price volatility increases. The 2021/22 Season was characterised by high price volatility; this has continued into the 22/23 season. The unknowability of the bias has an impact on the ability to estimate the RCP selling prices and therefore to estimate the full season milk price. This directly impacts dairy processor risk management, the cost of milk being the single largest input cost by a major factor. Fonterra is advantaged in this matter, controlling "all the cards" in its full knowledge of the milk price parameters (it sets and measures but does not disclose them), and its ability to set a final milk price which is different to the base milk price (thus managing risk in the fore-knowledge it can protect margins by setting a milk price different to the BMP[9]).

20. The Submitters request the Commission revisit the impact of sales phasing on its view that the NP selling prices are practically feasible. This is important given the prima facie evidence that the NP revenues are distorted by comparison with the price inform sales. The analysis to support this review should be relatively simple and based on the data already contained in the Benchmark Selling Price calculation data sets – i.e. there is no reason to defer this review for future seasons (indeed it should be a standard procedure every season).

21. This review would either:

    - show the volume include series provides a materially similar weighted average price to the price include series; or

[8] Review of Fonterra's 2021/22 base milk price calculation, draft report (15 August 2022), para 3.127. Note also that this paragraph 3.127 incorrectly states that "Miraka has raised a particular issue regarding the phasing of off-GDT sales" referring (in Attachment A) to paragraph 29 of the Miraka submission. Paragraph 29 of the Miraka submission makes no such distinction in relation to off-GDT sales – it concerns all sales both on and off-GDT; the Commission is requested to correct this in the final report both as it affects para 3.127 and Attachment A.

[9] The independent dairy processors do not share this advantage because Fonterra dominance in the market means it is the market price setter.

- Fonterra will need to provide a meaningful market based justification for any materially different weighted average prices; and
- the Commission will be in a better position to conclude if the RCP selling prices are practically feasible.

22. Noting the fundamental importance of the RCP selling prices to the BMP, and noting the procedure to determine the RCP selling prices prima facie does not deliver weighted average prices which are practically feasible (because they do not reflect the weighted average prices of the sales from which unit prices are drawn), the Submitters also request that the Commission ensure that the reasonableness of the RCP selling prices be demonstrated by the following disclosures for each RCP:

    - Monthly, quarterly and annual price include volumes and selling prices (weighted by price include volumes)
    - Monthly, quarterly and annual volume include volumes, and (price include) selling prices weighted by volume inform volumes

23. The Submitters again also bring to the Commission's attention the related issue of the manner in which GDT selling prices are represented in the annual Milk Price Statement[10]. While supposedly reporting weighted average quarterly and annual GDT selling prices, the Milk Price Statement almost certainly reports GDT selling prices weighted not by GDT sales but (again) by the "volume include" sales series. This obscures the average prices derived from actual GDT sales as well as the impact of off-GDT sales. To provide confidence that the fundamentally important RCP selling prices are practically feasible, the Commission is asked to ensure Fonterra corrects the misleading presentation of selling prices for GDT sales and provides separate disclosure of:

    - GDT quarterly selling prices weighted by GDT sales (the new disclosure); and
    - GDT quarterly selling prices weighted by volume inform sales (the presumed current disclosure)

24. A similar disclosure for off-GDT sales would further enhance confidence in the RCP selling prices and the Commission is again asked to intervene to encourage Fonterra to make these disclosures.

Volume considerations in calculating weighted average selling prices

25. For the 2021/22 calculations review, Miraka requested the Commission review the volume adjustments required to incorporate selling prices of certain qualifying materials (where yields differ from standard specification products) into the RCP selling prices[11]. This is relevant because the NP nominal production and sales volumes are fixed in accordance with the yields of the standard specification products, and because product mix choices made between the primary commodity products (WMP and SMP, or in practice Regular WMP and Medium Heat SMP) determine the volume of the secondary products (Butter, AMF and Bmp). In the case of sales (and therefore production) of any qualifying material where yields differ from the relevant standard specification product, volume adjustments should in principle ripple through the RCP selling price averaging calculations.

[10] Also refer Miraka Submission (6 May 2022) to the Commission: Proposed focus areas for the review of Fonterra's 2021/22 base milk price calculation, para 31

[11] Miraka Submission (6 May 2022) to the Commission: Proposed focus areas for the review of Fonterra's 2021/22 base milk price calculation, para 33

26. On the basis of advice from Fonterra, the Commission has concluded that IPCs which adjust for milk solids will have the same effect as the volume adjustments noted above. It is unlikely that this is the case. The IPCs are a work-around to determine a reasonable level of equivalence so that the selling price of a qualifying material can be comparable to the selling price of the standard specification product. It is unlikely that this adjusts NP revenues for the overall product mix change (compared to the standard specification products) that occurs for those qualifying materials which are not standard specification products.

27. The Commission draws from an example of the IPC for Instantised WMP (IWMP) which provides for the cost of an additional 2% of milkfat. The higher volume of milkfat consumed by IWMP would reduce the total volume of butter, AMF and Bmp which can be included in the NP product mix. No adjustment however is made for these volume changes. Similarly no adjustment is made for the fact that the volume of the WMP RCP including a mix for example of IWMP and RWMP will be different to the WMP RCP comprising only RWMP. All unadjusted volumes (based on the standard specification products) will however presumably be used in the calculations which determine weighted average selling prices.

28. Even if it were possible for the milk cost portion of IPCs to compensate for volume differences, this is undermined by the fact that the separate value Fonterra attributes to fat and to protein do not reflect current market values. Fonterra uses a ratio of the relative value of fat to protein (the Value Composition Ratio or VCR) to split the milk price into a separate price for fat and for protein. The VCR is set at the start of each season, remains unchanged across the whole season, and is based on an analysis which averages relative fat and protein market values over the previous three seasons. The separate price attributed to fat and to protein therefore does not reflect current market values and the IPC based on the separated price for fat and for protein will similarly not reflect current market costs. The VCR is highly volatile, reflecting the general volatility of dairy commodity prices (and relativities), and itself demonstrates that the lagging metric is out of step with current market values[12].

29. In any event, in the absence of a detailed explanation of how price include selling prices are converted into RCP selling prices as discussed in paragraph 30 below, and a detailed description of the methodology for determining milk solids cost adjustments in the IPCs it is not possible to conclude that the IPCs account for the necessary volume adjustments to NP production/sales volumes and therefore weighted average prices.

Disaggregation of the Benchmark Selling Prices

30. In their Focus Area submissions, Miraka, Synlait and OCD sought more information to assist in understanding how selling prices from the price inform sales are converted into the Benchmark Selling Prices, and to improve disclosures which explain the difference between GDT and off-GDT selling prices. This long sought improvement in disclosures reflects the fundamental importance of the RCP selling prices to the BMP, the complexity and currently opaque nature of inputs and processes to determine the RCP selling prices, and the need to provide confidence across the raw milk and dairy processing markets that the BMP can be shown to meet the purposes of the DIRA.

[12] The VCR for the five seasons ending 2021/22 are: 0.89, 1.30, 1.38, 1.31, 0.93. The VCR has no impact on a market assessment of the total milk price itself. It is only where a separate value or cost is attributed to fat or to protein (as occurs in the case of the IPC) that the link to current market values is lost.

31. In the draft report, the Commission encourages Fonterra to provide these more detailed disclosures[13]. The Submitters appreciate the Commission support in recommending these disclosures. Fonterra has previously left unheeded similar recommendations for disclosure stoking doubt that the RCP selling prices are commercially feasible. The Submitters now commend the Commission recommendations to Fonterra in the hope Fonterra will respond in the spirit of the Government proposals to amend the DIRA to improve milk price transparency. The Submitters note that details of product sales included in the milk price revenue calculations should not anyway be commercially sensitive (at an appropriate level of information aggregation) because they

> "are sold at prices that include few, if any, premiums arising from proprietary intellectual property … and are sold in the most freely-contested markets with low trade barriers[14]".

Adjustments for Incremental Product Costs

32. A review of the IPCs was a focus area for the 21/22 calculations review. In the draft report the Commission has concluded the IPCs are practically feasible for an efficient processor. The Submitters do not consider this has been adequately demonstrated.

33. This section of the submission considers three issues:

- IPCs as a proxy to align the NP Manufacturing Costs to the NP sales portfolio
- NP Production Plan and related conclusions on product yields
- Testing procedures to assess if IPCs are fit for purpose

IPCs as a proxy to align the NP Manufacturing Costs to the NP sales Portfolio

34. The Commission has interpreted the Miraka Focus Areas submission for the 21/22 calculations review to

> "*suggest that the IPC adjustment to some extent account for the changes arising from the expanded use of off-GDT sales*"[15].

35. This was in fact more than a suggestion; it is intrinsic to the IPCs ("incremental product cost adjustments"). The substance of the Miraka submission is restated below in an attempt to clarify this important point.

36. The IPCs only exist in the milk price calculations because all other calculations related to production assume only the 5 standard specification products are manufactured. On the other hand, revenues both on and off-GDT are drawn from a wider portfolio of products including products with a different composition of milk solids than the standard specification products. The NP thus makes the impossible assumption that it sells products it does not produce and in the absence of proper volume adjustments potentially consumes milksolids which it does not purchase. The IPCs seem to be the only part of the milk price calculations that attempt to rectify that failure. The validity of the IPCs must therefore be assessed against what they must achieve – i.e. to bridge the gap between all aspects (e.g. production costs, capacity investment, yields, production scheduling, milk consolidation, square curved plants) of the simple 5 product

[13] Review of Fonterra's 2021/22 base milk price calculation, draft report (15 August 2022), Attachment A: "Weighted Average Selling Prices" and "Off-GDT Sales".
[14] 2021/22 Farmgate Milk Price Manual, Part A, 1.2
[15] Review of Fonterra's 2021/22 base milk price calculation, draft report (15 August 2022), para 3.92

manufacturing model and the more sophisticated manufacturing environment implied by the portfolio of products which the NP is assumed to sell. The Submitters can only guess at the extent of the problem given over 40% of NP sales occur behind the veil of off-GDT sales.

37. It appears the Commission has not assessed the IPCs against their purpose (to "bridge the gap" described above). The IPCs are drawn from the Fonterra costing system and no doubt meet the internal management and control purposes for which they were developed. In relation to the adjustment needed to realign the modelled NP manufacturing alignment to the NP sales portfolio they are however no more than a crude work around and they have not been demonstrated or assessed to determine if they are fit for purpose.

38. To summarise this crucial point, to be fit for purpose the IPCs must reflect:

- Higher production costs arising from the overall increased complexity of the wider range of products that are assumed to be sold (therefore produced)
- Different and typically higher production costs for all qualifying materials
- Higher capital investment required to manufacture some of the qualifying materials
- Different yields due to different product composition and to offset the over-optimised NP unadjusted manufacturing model
- Associated impact of the yield of other products in the wholemilk product stream "bundle" of products
- Costs associated with lower efficiency of multi-production scheduling compared to the over-optimised (5 product) NP model [16]

NP Production Plan

39. The draft report states that:

> "*IPCs for products that are not Standard Specification Products" (products sold on GDT) are based on scheduled production runs specified by the milk price production plan*"[17]

This indicates (presumably unintentionally) that the NP production plan (and costs) includes scheduled production for all qualifying materials included in qualifying reference sales, not just the standard specification products. That is incorrect and should be amended in the final report.

40. The draft report further states that

> "*assuming that the production scheduling is optimised there is no need for further composition adjustments based on more frequent switching between products*"[18]

It should again be clarified that this refers to optimising for the simplified 5 product model (the standard specification products). It therefore means the NP production schedule is over-optimised by comparison with the NP sales portfolio. For example, just 4 of the 15 standard product offerings comprise at least 69 separate products[19]. While many of these products will be similar, that will not be the case for all, and they will all require unique management at phases throughout the production process. This will add to the cost of manufacture and reduce

[16] This should also include additional costs for the standard specification product because the unadjusted NP manufacturing costs account only for an over-optimised (lower) cost of the standard specification products.
[17] Review of Fonterra's 2021/22 base milk price calculation, draft report (15 August 2022), para 3.72
[18] Ibid, para 3.74
[19] Ibid, Table 3.1

production efficiency relative to the over-optimised production of the five standard specification products.

41. The Commission draft conclusion is nevertheless that

> *"the IPCs generally take into account differences in cost arising from slower throughput and associated losses such as cleaning and stack losses"*[20]

This conclusion is not supported by evidence. As previously explained the IPCs are drawn from the Fonterra costing system in which case the standard specification products (the counterfactual against which the "differences in cost" is identified) do not reflect the over-optimised outcome assumed in the NP production plan.

42. The Commission is requested to clarify the scope and effect of the NP production plan and to revisit its conclusion that "the IPCs generally take into account differences in cost" [arising from reduced production efficiency].

Testing Procedures to assess if IPCs are fit for purpose

43. The Submitters doubt the IPC framework could ever bridge the gap between the simple 5 product NP manufacturing model and the NP sales portfolio. With the inclusion of over 40% of price include sales from off-GDT, the only way to confidently realign the NP model is to rebuild it to align to the NP multi-product sales portfolio. The alternative is to revert to the simpler and transparent model based on GDT sales.

44. The Commission has however sought

> "*suggestions of what testing procedures could be used to resolve Miraka's concerns* [fit for purpose] *as we may consider this further in a future review*"[21].

45. The Submitters offer the following suggestions:

- The IPCs identify cost adjustments based on the difference between two product costings: the relevant qualifying material (not "manufactured" by the NP), and the counterfactual of the associated standard specification product (which is "manufactured" by the NP). In principle, the counterfactual needs to reflect NP costs, yields, and factory utilisations assumed by the NP for the relevant RCP. The first test to validate the IPCs is therefore to assess how the cost of the standard specification product from the Fonterra costing system compares to the cost of the associated RCP (in effect, the same standard specification product) in the NP model. The Submitters believe this will demonstrate that at least for the counterfactual, the costs derived from the Fonterra costing system will be overstated resulting in the IPCs being understated. The comparison could be considered in three steps:
    - The milk solids included in the product costing (i.e. milk solids in end product including specification offset, plus provisions for losses)
    - The cost attributed to the milk solids in the product costing (as noted in paragraph 28 above this is unlikely to be fit for purpose)
    - The production cost included in the product costing (separated between direct/variable costs and allocations of fixed costs)

[20] Review of Fonterra's 2021/22 base milk price calculation, draft report (15 August 2022), para 3.75
[21] ibid, para 3.95

It should not be a major task for Fonterra to provide the data to make the comparison between its internal product costing and the NP costing.

- A comparison of the NP yields and the composition of the standard specification products that Fonterra supplies on GDT[22] will also provide evidence of the extent to which the Fonterra costing system reflects yields that are materially worse than the NP cost of the standard specification products. The Submitters can assist the Commission to make that comparison.
- The Commission should also review the Fonterra costing principals (especially including standard costs and cost allocation principles). These will provide important information for assessing the extent to which IPCs are "fit for purpose". Standard costing principles are for example likely to already assume efficient production costs, providing a meaningful context for considering the further efficiency which will be reflected in the NP costings.

Yields: Loss Assumptions and Specification Offsets

46. In line with previous reviews, in the draft report the Commission continues to assess that the NP yields are practically feasible for an efficient processor.[23]

47. By contrast and has long been the case, the Submitters consider the NP yields are not demonstrably nor likely to be practically feasible. It was hoped that the review of IPCs for the 2021/22 calculations review would have included further consideration of this issue. That does not appear be the case.

48. The Fonterra Reasons paper explains that loss allowances are based on

> *"loss surveys … generally carried out over a ten day period when the Fonterra factories are running at or close to full capacity. The losses measured therefore represent loss per tonne of product at the peak"*[24]

49. In other words, loss allowances are based on the most efficient factory operating conditions when losses will be minimised. Fonterra goes on to justify using loss surveys taken at full capacity running on the basis that:

> *"the NMPB* [NP] *can move milk from its collection areas to maximise the length of time factories remain full, by pulling milk from others to shorten their operating season… the NMPB factories on average would operate at peak capacity for around 85-90% of their total operating days"*[25]

50. While the milk price calculations include adjustments for periods when the NP factories manufacturing the 5 standard specification products cannot be assumed to operate at peak capacity, those days are minimised by the assumption of continuous running on the singular standard specification products and the flexibility with which the NP is assumed (at no cost) to be able to consolidate milk at particular factories to maximise peak capacity processing.

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[22] Refer to the "typical composition" in the Fonterra product bulletins for product offered on GDT. The bulletins are available at https://www.globaldairytrade.info/en/gdt-events/gdt-events-sellers-and-products/
[23] Review of Fonterra's 2021/22 base milk price calculation, draft report (15 August 2022), para 3.132
[24] 'Reasons' Paper in Support of Fonterra's Base Milk Price for the 2021/22 Season, Attachment 4
[25] ibid

51. By comparison Fonterra claims that loss surveys taken when plants are not operating at peak capacity (for example at the beginning of the season) cannot be used to calculate the NP loss allowances because Fonterra itself

> *"faces a different set of product mix constraints, given its production of products other than the reference products, and typically manufactures non-standard and customer-specific products at the beginning of a season, implying shorter run lengths"*[26]

52. The Submitters consider that loss allowances based solely on peak capacity operations are also not practically feasible for the full NP sales portfolio for similar reasons (though possibly to a lesser degree) to those described above by Fonterra. IPCs will not adjust for this difference because as previously discussed the counterfactual costing (the standard specification products) do not reflect the over-optimised yields assumed by the NP.

53. The Commission indicates that

> "*specification offsets and losses are in line with those achieved last season*"[27].

According to the Fonterra Reasons paper this is only correct for the combined loss assumptions plus specification offsets:

> *"In combination our loss assumptions and specification offset assumptions … of 1.0% [are] consistent with the 2020/21 base milk price calculation*"[28].

It is however not correct for the specification offsets themselves (which have reduced by an undisclosed amount[29]) and by implication is also not correct for the loss assumptions which must have increased (by an equivalent offsetting amount). The Commission is requested to confirm it has reviewed the changes in specification offsets and loss allowances. Also noting that the specification offsets and loss allowances are hypothetical (and not the same as Fonterra's own performance), the Commission is asked to recommend that Fonterra disclose the loss allowances and specification offset assumptions for each of the RCPs. This would go a long way to shine light on the NP yields issue.

54. Fonterra explains that the Milk Price Group has engaged two "external technical experts" to review the specification offsets. Without in any way disputing the professional standards of these experts, one of them seems to have been a recent Fonterra employee working in the same area for which they are now being represented to provide external (and by implication independent) technical expertise. The Commission is asked to consider whether this meets an acceptable standard of independent review.

55. The Submitters request the Commission revisit its conclusions regarding the practical feasibility of NP yields.

Notional Producer Costs

56. This part of the submission addresses the following issues:

    - Practical feasibility of milk collection costs

[26] 'Reasons' Paper in Support of Fonterra's Base Milk Price for the 2021/22 Season, Attachment 4
[27] Review of Fonterra's 2021/22 base milk price calculation, draft report (15 August 2022), para 3.129
[28] 'Reasons' Paper in Support of Fonterra's Base Milk Price for the 2021/22 Season, footnote 12
[29] ibid, page 15

- Adjustments to costs to account for price inflation
- NP Asset Beta
- Mothballed plants

Practical Feasibility of Milk Collection Costs

57. In its focus areas submission, Miraka again requested the Commission review practical feasibility of milk collection costs[30]. This was particularly because the costs had not been subject to focussed review since the 2012/13 milk price calculations, the substantial changes that had occurred since then, and the broad fit with considerations that were expected to be included in the review of the IPCs.

58. The Commission did not carry out a focussed review of milk collection costs in the 21/22 review. As explained in previous submissions, the Submitters consider that based on the information available the milk collection costs are unlikely to be practically feasible and they are likely to be understated. In the draft report, the Commission does though indicate:

    "*we will consider the inclusion of milk collection costs as a focus area in a future Calculation review*"[31].

59. The Submitters seek a firm statement of the Commission intentions. If the Commission considers a review is warranted a firm commitment needs to be made to carry it out. On the other hand, if the Commission is undecided it should state how it will form a decision. It is unsatisfactory to simply leave it hanging. The Submitters seek a commitment by the Commission to address this in the 21/22 calculations review.

60. The Commission makes similar incomplete commitments to review other issues in the future. The Submitters request they similarly be replaced by firm statements of the action intended to be taken. These include:

    As regards asset beta:

    "*We will consider reviewing the comparator set as a focus area when it is next updated*"[32]

    As regards weighted average selling prices:

    "*We will consider reviewing phasing* [mismatch of price inform volumes and volume inform volumes] *of off-GDT sales* [sic[33]] *as a focus area in a future review*"[34].

Adjustments to costs to account for price inflation

61. In their Focus Area submissions Synlait and OCD sought confirmation that the NP capital asset base and the cash costs have been adequately adjusted to account for price changes. This has become more important with the step change that has occurred in inflationary pressures. Synlait also requested that the basis for setting costs be disclosed (noting 6 alternative approaches are set down in the Milk Price Manual[35]).

[30] Miraka Submission (6 May 2022) to the Commission: Proposed focus areas for the review of Fonterra's 2021/22 base milk price calculation, para 35
[31] Review of Fonterra's 2021/22 base milk price calculation, draft report (15 August 2022), Attachment A
[32] ibid
[33] Refer note 8 above
[34] Review of Fonterra's 2021/22 base milk price calculation, draft report (15 August 2022), Attachment A
[35] 2021/22 Farmgate Milk Price Manual, Table 3.1

62. In the draft report, the Commission has provided a breakout of cost increases for variable manufacturing costs along with the basis for determining costs[36]. It has also disclosed the rate at which the replacement cost of the capital asset base has increased[37]. The Submitters are grateful for these new disclosures. They request that the Commission seek this standard of disclosure in future Fonterra Reasons papers.

63. In the spirit of these disclosures, the Submitters also request the same disclosures be made for the remaining cash costs at an appropriate level of disaggregation[38]. Again these disclosures should also be made in future Fonterra Reasons papers. The additional cost disclosures would be for[39]:

- milk collection costs
- fixed manufacturing costs
- repairs and maintenance costs
- sales costs
- other costs, including site overheads, general overhead costs and R&D costs
- supply chain costs

NP Asset Beta

64. The Commission focus areas for the 2021/22 review included a review of the NP asset beta. The context for that focus area included:

- New DIRA requirements (section 150C (4)) for determining the NP asset beta came into force for the 2021/22 BMP calculations
- Fonterra 2020/21 reassessed the asset beta and comparator set in anticipation of the new DIRA requirements noted above. The Commission concluded the Fonterra interpretation of the DIRA amendment (which at the time had not yet come into effect) was not satisfactory. The Commission also advised it would

  "consider reviewing the full list of comparator's for [the 2021/22] calculation review"[40].

- Adverse findings from the Commission review of the 2021/22 Milk Price Manual that Fonterra continued to misinterpret the DIRA amendment that had now come into force.
- The broader context that the NP WACC has never been found to be unreservedly compliant with the DIRA, and the DIRA amendment was intended to force compliance on Fonterra.

65. While Fonterra had failed to amend the 2021/22 Milk Price Manual following the adverse findings noted above, it has confirmed it would make the revision in the update of the 2022/23 Manual. Of significant note, and breaking with its previous contentious practice, it did however bring that revision into effect in the 2021/22 calculations[41]. This sets an important precedent that Fonterra can and must implement Commission findings of non-compliance in the milk price calculations for the season in which the non-compliance is identified. The Commission is

[36] Review of Fonterra's 2021/22 base milk price calculation, draft report (15 August 2022), para 3.107
[37] ibid, para 3.104
[38] A guide for minimum disclosure cost categories would be those identified in the Fonterra Reasons paper, 21/22 Milk Price Calculations at page 20 ("Overview of Calculation of Cash Costs")
[39] 2021/22 Farmgate Milk Price Manual, Table 3.1 items 13 to 20
[40] Review of Fonterra's 2020/21 base milk price calculation (Final Report, 15 September 2021), para 3.56
[41] In previous similar instances, Fonterra has delayed implementation until the year in which the Manual itself is updated.

requested to expressly note this change in Fonterra practice and to confirm its expectation that Fonterra will act accordingly in the future.

66. As a result of these changes, the NP asset beta has been increased from 0.45 to 0.48 and the NP WACC has increased from 4.8% (as announced in the 2020/21 Milk Price Statement of September 2021) to 5.0%. The underlying comparator set and related analysis from which the asset beta is drawn has however neither been updated nor reviewed. This is despite the inconclusive findings from the 2020/21 calculations review, as underlined by the Commission's then signalled intention that it was considering reviewing the comparator set for the 2021/22 calculations review.

67. The DIRA sets out various provisions for the determination of the annual BMP. The Milk Price Manual establishes a review year calendar for major reviews of substantive elements of the BMP to ensure compliance with the DIRA. In the case of the asset beta the Manual notes the last review year was 2020/21 and the next review year will be 2024/25[42]. The "review year" calendar is a pragmatic approach to assuring reasonable overall compliance on an ongoing basis without detailed reviews being required every year. The BMP must nevertheless comply with the full DIRA every year, and the review year calendar must be put aside where compliance is in doubt.

68. Following more than a decade in which the NP WACC had been contentious and the Commission was unable to find it was in compliance with the DIRA, Parliament expressly intervened by providing the specific requirements contained in new section 150C (4). Given the controversial nature of the issue and having resorted to the extreme step of legislative intervention to have it resolved, it cannot be acceptable that full and demonstrated compliance with the new section be subservient to the Fonterra Milk Price Manual and its timetable for annual reviews (i.e. until 2024/25 in the case of the asset beta). The Commission is accordingly requested to note that issues remain outstanding with regard to the compliance of the asset beta comparator set and related analysis, and that this will be subject to full review for the 2022/23 calculations.

Mothballed Plants

69. The Fonterra Reasons paper implicitly confirms that following the 2018/19 season the NP de-commissioned 4 plants that had previously been assumed to be mothballed[43]. The Submitters request the Commission clarify how de-commissioning costs were provided in whichever year the relevant de-commissioning was assumed to occur.

[42] 2021/22 Farmgate Milk Price Manual, Glossary

[43] 'Reasons' Paper in Support of Fonterra's Base Milk Price for the 2021/22 Season, Attachment 3 (plant numbers and explanatory note in footnote 4), and plant numbers advised in the same Reasons Paper for the 2018/19 season.

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Karl Gradon
CEO
Miraka

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Richard Wyeth
CEO
Westland Milk Products

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Robert Stowell
CFO
Synlait Milk