



'Reasons' Paper in Support of Fonterra's Milk Price Manual for the 2020/21 Season

Public Version

1 August 2020

Glossary

F20 Final Manual Report	Commerce Commission, Final Report on the Review of Fonterra's 2019/20 Milk Price Manual, 12 December 2019, https://comcom.govt.nz/__data/assets/pdf_file/0028/195553/Final-report-Review-of-Fonterras-Milk-Price-Manual-12-December-2019.pdf
F19 Final Base Milk Price Report	Commerce Commission, Review of Fonterra's 2018/19 base milk price calculation: Final report, 12 September 2019, https://comcom.govt.nz/__data/assets/pdf_file/0037/173998/Final-report-Review-of-Fonterras-2018-19-base-milk-price-calculation-12-August-2019.pdf
F20 Base Milk Price Reasons Paper	Fonterra Co-operative Group Limited, 'Reasons Paper' in support of Fonterra's Base Milk Price for the 2019/20 Season (Public Version), 1 July 2020, https://comcom.govt.nz/__data/assets/pdf_file/0022/220549/Fonterra-Reasons-paper-on-review-of-2019-20-base-milk-price-calculation-1-July-2020.pdf
MPG	The Milk Price Group, the independent unit responsible for determining and recommending to the Milk Price Panel the Farmgate Milk Price.
NMPB	Notional Milk Price Business, comprising the notional milk powder manufacturing business implied by Fonterra's Farmgate Milk Price Manual.
R&M	Repairs and maintenance.
RCP	Reference commodity product, comprising wholemilk powder (WMP), skimmed milk powder (SMP), buttermilk powder (BMP), butter and anhydrous milkfat (AMF)
F21 Season	The period commencing on 1 June 2020 and ending on 31 May 2021, also referred to as the 2020/21 season.

1 August 2020

To: The Commerce Commission

1. Fonterra Co-operative Group Limited ("Fonterra") certifies that:
 - a. in terms of section 150L(d) of the Dairy Industry Restructuring Act 2001 ("Act"), Fonterra considers that its milk price manual to be applied in calculating Fonterra's Farmgate milk price for the 2020/21 season is, in all material respects, consistent with the purpose of subpart 5A of the Act; and
 - b. none of the circumstances set out in section 150G(1) of the Act have occurred with respect to the milk price manual to be applied in calculating Fonterra's Farmgate milk price for the 2020/21 season.
2. This certification is based on our interpretation of subpart 5A, and the other relevant assumptions, views and qualifications set out in the accompanying reasons provided pursuant to s 150L(e).



Signed by

Andrew Cordner
Director Legal

1. Introduction

This paper provides the reasons in support of Fonterra's certification in respect of the Milk Price Manual to be applied in the calculation of Fonterra's Farmgate milk price in respect of Fonterra's 2020/21 Season (the F21 Manual), as required under section 150L of the Dairy Industry Restructuring Act 2001 (DIRA). The paper has been prepared under the oversight of the Milk Price Panel, and where relevant reflects the Panel's views.

Section 150L provides that Fonterra must:

- Provide the Commission with the milk price manual for the current season (i.e., the season commencing on 1 June 2020) (section 150L(a));
- Provide the Commission with any recommendations by the Milk Price Panel "in relation to the setting of the base milk price" (section 150L(b));¹
- Notify the Commission of any change in the economic and business environment that, in Fonterra's view, requires a change to the milk price manual (section 150L(c));
- Certify to the Commission the extent to which Fonterra considers that the milk price manual is consistent with the purpose of subpart 5A of DIRA (section 150L(d)); and
- Provide the Commission with reasons for the view expressed in its certificate (section 150L(e)).

In addition, section 150G sets out the steps that Fonterra is required to take if it does not amend the Manual in accordance with a recommendation by the Panel, if it amends the Manual contrary to a recommendation by the Panel, or if it amends the Manual without having received a relevant recommendation from the Panel. We advise that none of these circumstances has occurred with respect to the Manual applied by Fonterra in respect of the 2019/20 season (the F20 Manual).

On 25 June 2020 the board of Fonterra approved a number of amendments to the Milk Price Manual, all of which were recommended by the Milk Price Panel. These amendments are set out in 'mark up' form in the Milk Price Manual attached to this paper and, where relevant, we explain their rationale below. In all other respects, the F21 Manual is identical to the F20 Manual, in respect of which Fonterra submitted a certification and reasons paper on 1 August 2019. Consistent with that paper, we have confined our comments in this paper to areas where our views have changed subsequent to preparing previous reasons papers, or where we wish to provide additional information. In all other respects, we request that this paper be read in conjunction with our reasons papers submitted in respect of the 2012 – 2020 seasons.

We have also recently provided (in our 'reasons paper' in respect of the 2019/20 base milk price) the Commission with our views on the appropriate interpretation of section 150A of DIRA (the purpose provision), and have not repeated these views in this paper.

The paper is intended to satisfy the section 150L(e) requirement to provide the Commission with the reasons for the view expressed in our certificate. The paper is organised as follows:

- In section 2, we set out, and explain the rationale for, the amendments to the F21 Manual.
- In section 3, we summarise our reasons for not making certain amendments proposed by the Commission.
- In section 4, we summarise changes in the economic and business environment that are potentially of relevance to the calculation of the base milk price, and explain why we have not amended the Manual in response to these changes for the 2020/21 season.

Attached to this paper is a 'marked up' version of the Milk Price Manual, identifying all amendments, and which satisfies the section 150L(1) requirement to provide the Commission with the manual for the current season. Brief comments on the rationale for each amendment are also included in this attachment.

¹ As in our previous 'reasons papers' we have interpreted this provision as in fact relating to recommendations by the Milk Price Panel in relation to amendments to the Milk Price Manual. We have separately provided the Commission with the Panel's recommendations to the Fonterra Board on amendments to the Manual.

2. Amendments to the Manual for F21

The substantive amendments to the Manual for F21 comprise amendments to:

- The Manual's provisions relating to requirements for independent review of various inputs into the Milk Price, along with other Milk Price-related matters.
- The Manual's provisions governing the four yearly 'overheads' (and other fixed cost) reviews and the provision relating to 'within-period reviews' within a four yearly reset period.
- The approach used to establish the asset beta used in the calculation of the Milk Price.

Independent review provisions

A number of rules in Part B of the Manual require that the values determined for various inputs must be either subjected to 'independent review' or that the relevant input must be determined by an 'independent reviewer'. The relevant provisions are contained in Rule 12 (variable manufacturing costs), Rule 13 (fixed manufacturing costs), Rule 14 (repairs and maintenance costs), Rule 18 (other costs, including site overheads, general overhead costs, and R&D costs), Rule 20 (supply chain costs), Rule 23 (Role of independent reviewer), Rule 25 (standard plants and other reference assets), Rule 32 (adjustments for amendments to Reference Commodity Products), Rule 33 (surplus capacity), Rule 38 (adjustments for new technology), Rule 42 (asset beta) and Rule 43 (specific risk premium). The Manual defines an Independent Reviewer as "a valuer or other expert appointed to perform a review or function with respect to the Manual."

Under the amendments to the Manual for F21, responsibility for these various independent reviews is explicitly assigned to the MPG, with an expectation that the MPG will engage external specialist assistance where required. The purpose of these amendments is to align the Manual to the approach that has evolved in practice subsequent to Manual's implementation in 2008.

In particular, when the Manual was introduced the MPG was established as a team that was independent of Fonterra management, and initially tasked with establishing the processes and models required to calculate the Farmgate Milk Price and ensure the integrity of the data used in the calculation. At that time it was envisaged that this would be a temporary arrangement and that after a transition period the MPG's role would be performed by Fonterra management. Consequently, an additional layer of independent review was added to ensure that key inputs were either provided by or reviewed by parties independent of Fonterra management. This anticipated transition did not occur, and the MPG continues to be resourced and operate independently of Fonterra management. The independence of the MPG is further assured by a requirement imposed by the Milk Price Panel that the core members of the MPG team are prohibited from investing both in Fonterra (and other NZ dairy processors) and in dairy farms.

In consequence, the MPG, and where appropriate specialist experts engaged by the MPG, perform the various tasks assigned by the Manual to independent reviewers or experts, and the relevant amendments align the Manual to this practice. The amendments will not result in any substantive change in the approach taken to setting any input, or to the level of engagement of external specialists (where appropriate), or to the Panel's ability to seek further external input on any matter. The amendments therefore do not, in our view, have any effect on the consistency of either the Manual or its application with the s 150A purpose.

'Within period' reviews

The amended version of Rule 23 in Part B of the Manual provides (in relevant part) that:

In exceptional circumstances during a Review Period, a Within-Period Review may be initiated, at which time ~~an Independent Reviewer would be engaged to the MPG will~~ undertake all or some of the reviews that would be undertaken in a Review Year. ~~with~~ The outcomes of those reviews ~~will~~ applying prospectively to the remaining Years in the Review Period, ~~including, where warranted by circumstances, the year in which the review is undertaken.~~

A Within-Period Review should be initiated if there is reason to believe that the ~~costs-allowed value of an input used~~ in calculating the Farmgate Milk Price would not, in the absence of a review, accurately reflect the actual ~~costs value of that input~~ that Fonterra would ~~incur~~ face if it manufactured the Reference Commodity Products using currently appropriate technology to anticipated Farmgate Milk Price Production Plans over the balance of

the Review Period, and the difference between the allowable and actual ~~costs~~-value of that input would be material to either the Aggregate Farmgate Milk Price or to Fonterra's earnings after paying for Milk at the Farmgate Milk Price.

The intent of the amendments is threefold:

- To assign to the MPG responsibility for undertaking Within Period Reviews, for the reasons discussed in the "Independent review provisions" section above.
- To clarify, where necessary, the outcome of a review to be implemented in the year in which the review was undertaken, rather in the following year. The necessity of this amendment became apparent in the context of the 2019 review of overhead costs, where it became evident that it was necessary to implement a portion of the review's outcome immediately, in the 2018/19 season, rather than as scheduled in the 2019/20 season, to ensure the practical feasibility of the provision for overhead costs for the 2018/19 season.
- To extend the ability to undertake a Within Period Review with respect to all inputs established on a four-yearly basis, rather than just cost inputs. (Other inputs established on a four yearly basis include, for example, resource usages and certain capital inputs.)

We consider these amendments are consistent with the s 150A purpose, since they provide additional ability for Fonterra to adjust inputs subject to four-yearly resets so as to maintain the practical feasibility of those inputs, while continuing to provide that inputs will be adjusted within a four-yearly reset period only in 'exceptional circumstances', thereby maintaining incentives on Fonterra management to efficiently manage the corresponding Fonterra costs.

Asset beta

Rule 42 (Asset beta) has been amended as follows:

~~An Independent Reviewer will provide~~The MPG will determine an updated Asset Beta in a Review Year. In calculating the Asset Beta, the ~~Independent Reviewer is required to~~MPG will have regard to:

- Fonterra's exposure to systematic earnings risk with respect to the portion of its business corresponding to the Farmgate Milk Price Business, as implied by the allocation of risks between Fonterra and suppliers under the Farmgate Milk Price Methodology.
- **Any relevant requirements under DIRA.**

The intent of these amendments is to:

- Assign to the MPG responsibility for determining the asset beta, for the reasons discussed in the "Independent review provisions" section above.
- Explicitly acknowledge any relevant requirements of DIRA (which would include, for example, the relevant requirements in the proposed provisions in the Dairy Industry Restructuring Amendment Bill (No 3) if this Bill is passed into law in its present form).

The MPG is currently in the process of undertaking its assessment of appropriate asset beta and specific risk premium for implementation in 2020/21.

We do not consider these amendments have any direct impact on the consistency of the Manual with the s 150A purpose.

3. Other Matters

For completeness, we note that we have not changed our position on the matters summarised in Table B1 of the Commission's F20 Final Manual Report, and again summarise our reasons in the table below.

Proposal	Response
<p>We consider the Manual should outline what is considered a 'material change' when considering a change to the Manual and specify the timeliness of making such a change in order to set a minimum level for disclosure of changes. While there is no s 150A consistency issue; however, we continue to consider such disclosure would provide greater transparency</p>	<p>No change in our position, for reasons explained on page 5 of our submission on the Commission's F17 Draft Manual Report (a 'bright line' materiality threshold is likely to lead to less disclosure).</p>
<p>We recommend that Fonterra considers disclosing its plant capacity for both primary and secondary plants in the Manual. This earlier disclosure should provide increased transparency of the assumed capacity of the notional producer for the season. We consider Fonterra's latest amendment still allows a significant level of discretion.</p>	<p>We do not consider the Manual is the appropriate vehicle for these disclosures. We routinely put this information into the public domain in 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.</p>
<p>We consider there should be more transparency of information on the actual foreign exchange rates assumed to be achieved by the notional producer. We suggest providing an average FX conversion rate assumed to be achieved by the notional producer throughout the season.</p>	<p>We do not consider the Manual is the appropriate vehicle for these disclosures. We routinely disclose the information suggested by the Commission with respect to both the prior season average FX conversion rate and the forecast rate for the current season in the Milk Price Statement, released each September.</p>

² F20 Base Milk Price Reasons Paper, p.9.

4. Changes in the Economic and Business Environment

We confirm we are not aware of any changes in the economic or business environment that would in our view necessitate a change to the Milk Price Manual for the F21 Season. In arriving at this view, we have had regard to the following:

- None of the amendments to the Milk Price Manual were prompted by changes in the economic or business environment.
- As a general matter, our view is that changes in the economic or business environment will in most circumstances not necessitate changes to the Manual, though they may result in changes in the approach taken to applying existing provisions of the Manual. Among other things, the existing provisions of the Manual could accommodate the changes in approach required to reflect the impact of changes in relative demand for (and profitability of) different product streams that affect industry-wide patterns of new investment, of assets becoming 'stranded' due to a significant reduction in milk supply, or abnormal costs attributable to COVID-19.