

Addendum to draft report: Review of Fonterra's 2015/16 base milk price calculation

1. This addendum provides a brief explanation of:
 - 1.1 the 71 cents per kgMS difference in 2014/15 revenue between Fonterra's Global Ingredients and Global Operations (GOGI) RCP operation and the notional producer; and
 - 1.2 Fonterra's approach in calculating the commodity prices over and above GDT prices (which is referred to as 'price achievement').
2. In our aggregate assessment of the practical feasibility of the notional producer, we said that Fonterra's GOGI RCP operation's revenue was estimated to be \$0.71 per kgMS higher than for the notional producer.
3. Due to the significant differences in revenue and the prices that GOGI receives from off-GDT sales, we concluded that using the GDT as the sole basis for RCP reference prices for whole milk powder (WMP), skim milk powder (SMP) and anhydrous milk fat (AMF) in calculating the milk price may no longer be appropriate.
4. We indicated that we would review the expansion of notional producer revenues to include off-GDT sales for our 2016/17 reviews.
5. Since we released our draft report, we have been asked by an interested party to provide further detail on how the difference was obtained to enable parties to make more informed comments on our draft report. That interested party questioned whether there is a scale inaccuracy in our analysis (\$0.71 revenue difference) when compared with publicly available information and Fonterra's \$0.05 net estimated milk price impact if non-GDT sales are used as a part of the revenue component in the milk price calculation.

Explanation of the 71 cents difference in revenue

6. The analysis provided to us by Fonterra shows that the 71 revenue cents difference is attributed to:
 - 6.1 price achievement, which is around 22 cents;¹
 - 6.2 the price impact of the different timing of sales resulting from calculating the milk price revenue by financial year instead of by season, which worked out at around 28 cents;² and
 - 6.3 the remaining 21 cents has not been pinned down in detail. Fonterra has advised that the primary contributors to this difference are most likely the pricing mechanism for intercompany sales and prices achieved on sales into consumer and food service channels.
7. In our view, neither of the differences outlined in 6.2 and 6.3 above should impact the milk price calculation, as they reflect both different sales timing assumptions and the much broader scope of Fonterra's actual business than the assumptions adopted for purposes of the milk price calculation.
8. The revenue and cost amounts used in our aggregate assessment were obtained from Fonterra's gross margin system which the amounts are unaudited.

Fonterra's approach in calculating price achievement for the GOGI RCP operation

9. Fonterra has calculated the price achievement of around 22 cents by comparing the GOGI base equivalent sales in a given period with the equivalent milk price contract.
10. For example, a 200 metric tonne (MT) of RCP sale in September 2014, which is contracted in July 2014 for USD\$4,000 base equivalent sales, is compared with the milk price contract month two price for September 2014 shipment of USD\$3,200. The calculated difference is the incremental return over the milk price = \$800 per MT or USD \$160,000.
11. The total price achievement for all GOGI RCP products was then converted into NZD, and then divided by using the GOGI RCP operation's 2014/15 milk solids to convert into cents per kgMS.³

¹ As outlined in footnote 25 of our draft report, The GOGI RCP operation's revenues include non-standard RCP specifications, contract sales through sales channels where customers are not willing to purchase on GDT or high risk markets, customers who are willing to pay a premium over GDT prices for security of supply and sales contracted with a shipment date after 5 months.

We note that the notional producer only includes sales contracted between 1 to 5 months of shipment date, sales to non-high risk markets and would still predominately sell on GDT.

² This was calculated by Fonterra by converting the milk price calculation into a financial year calculation. For the purposes of the aggregate assessment, the GOGI RCP operation's sales were based on the 2014/15 financial year from 1 August 2014 to 31 July 2015. In comparison, the notional producer's sales are from production in the dairy season from 1 June to 31 May, and were assumed to occur over the period from 1 September to 31 October 2015.

³ The exchange rate used is largely aligned to the exchange rate used in the 2014/15 milk price calculation.