15 August 2023

IDP Joint submission on the Commerce Commission Draft report: "Review of Fonterra's 2022/23 base milk price calculation: Dairy Industry Restructuring Act 2001" (issued 1.8.23)

Submitted by email: *market.regulation@comcom.govt.nz*

Attention:	Louise Stephenson (Head of Fuel and Dairy)
Subject Line:	Milk Price Calculation 2022/23
Submitted by:	Independent Dairy Processors (IDPs): Miraka, Open Country Dairy, Synlait Milk and Westland Milk Products

____

Contents

Abbreviations and other references 2

Summary 2

DIRA S 150B Amendment/Review of NP USD Conversion Rate 4

Commission Review of the use of "Actual" Values in the S150B assumptions 5

NP Product Yields 6

Milk Losses (0.38%) 6

Specification offsets (0.63%) 7

S 150A Efficiency Dimension 8

Internal Consistency of Assumptions/Review of Milk Collection Costs 11

Materiality 13

NP Fixed Assets and Capital Charges 14

BMP vs. FGMP 15

Commentary on Draft Report Attachment A 15

Authorisation 16

Appendix: Commentary on Draft Report Attachment A (Commission Responses to Submissions on Proposed Focus Areas) 17

Abbreviations and other references

Approaches Paper (2023): Commerce Commission reference paper: “Our approach to reviewing Fonterra’s milk price manual and base milk price calculation” as updated in 2023.

BMP: Base Milk Price

DIRA: Dairy Industry Restructuring Act 2001

DIRA Amendment Act 2022: Dairy Industry Restructuring (Fonterra Capital Restructuring) Amendment Act 2022

Draft Report: Review of Fonterra’s 2022/23 base milk price calculation: Dairy Industry Restructuring Act 2001 Draft Report (1.8.23)

FGMP – Fonterra’s farmgate milk price.

Focus Areas 22/23 Paper: Commerce Commission paper issued 30 March 2023: “Proposed focus areas for our review of Fonterra’s 2022/23 base milk price calculation”

Fonterra Reasons 22/23 Calculations: ‘Reasons’ Paper in Support of Fonterra’s Base Milk Price for the 2022/23 Season (15 June 2023)

IDPs: Independent Dairy Processors (Miraka, Open Country Dairy, Synlait Milk, Westland Milk Products)

IDP Submission 22/23 Focus Areas: Miraka, Open Country, Synlait Milk and Westland Milk Products - Joint submission on Proposed Focus Areas (27 April 2023)

Manual: Fonterra’s Farmgate Milk Price Manual

NP: Notional Processor

Summary

1. DIRA S 150B amendment:
   a) The DIRA S 150B four assumptions play a central role in setting the BMP. Previously “safe harbours”, the DIRA Amendment Act 2022 placed them into the S150A compliance regime (efficiency and practical/commercial feasibility). Given the wide scope of the amendment the Commission was only able to review its application one of the four assumptions (the NP USD conversion rate). The IDPs consider the Commission is accordingly not yet in a position to confirm the other assumptions now comply with the DIRA S 150A requirements.
   b) Noting the importance of the S 150B assumptions the IDPs request the Commission ensure the remaining assumptions are reviewed in full in the next (2023/24) review cycle.
   c) The IDPs agree with the Commission that the way the S 150 B assumptions are used can be reviewed by the Commission to determine compliance with S 150B and this is regardless of whether those assumptions are interpreted with the use of inputs based on Fonterra actual performance.

2. NP Product Yields
   a) Fonterra has for the first time disclosed the overall total milk losses and specification offsets.
   b) The overall milk losses (0.38%) are unlikely to be commercially feasible for a real world New Zealand commodity processor. This is as had always been expected. The IDPs consider it reflects the way Fonterra interprets the S 150B assumptions. Fonterra has not changed the way it interprets the assumptions (continuing to treat them as safe harbours), and the Commission has not reviewed the assumptions for compliance with the amended S 150B. The IDPs will draw further conclusions when Fonterra releases information in accordance with the new disclosure requirements.

c) Overall specification offsets are 0.63% against a counterfactual of nil offsets. The specification offsets are not sufficiently defined to be able to draw meaning from the 0.63% metric. The IDPs request the specification offset be properly and fully defined.

3. S 150A Efficiency Dimension

   a) The efficiency dimension of S 150A as interpreted by the Commission relies incorrectly on an assumption that Fonterra is incentivised to maximise profits.

   b) The IDPs have long submitted Fonterra is more incentivised by opportunities to increase the milk price than it is to maximise profits. This is now even more so following the changes to the Fonterra Shareholders Fund.

   c) The Commission has also now concluded the extent to which Fonterra is incentivised to maximise profits is uncertain.

   d) The IDPs submit that the interpretation of the S 150A efficiency dimension should now be reconsidered. They consider that the way the BMP is set can only incentivise Fonterra efficiency if it incentives allocative efficiency across the wider dairy processing industry. The IDPs consider this should be a focus area for the 2023/24 review cycle.

4. Internal Consistency of Assumptions

   a) The Commission has reviewed the NP milk collection costs. This has not provided assurance that the NP assumptions for milk collection are aligned to related assumptions (especially arising from the use of the S 150B assumptions).

   b) The Commission considers that NP milk collection costs are "likely to be consistent with" the S150A requirements (efficiency and commercial feasibility). The IDPs do not consider there is sufficient evidence to draw this conclusion.

   c) The IDPs consider this is a further consequence of the limited review of S 150B assumptions.

5. Materiality

   a) The Commission has noted a limited use of a materiality benchmark in the latest review. The IDPs request the Commission confirm how their materiality benchmark should be interpreted. The IDPs further note, assuming their interpretation of the benchmark is correct, that the materiality benchmark is inappropriately high.

6. NP Fixed Asset and Capital Charges

   a) The Commission is asked to obtain clarification for the way in which the increase in the NP fixed asset replacement costs affect the measurement of capital charges including depreciation.

   b) The Commission has also been requested to address certain inconsistencies in reporting on the 2022/23 changes in the NP fixed asset base.

7. BMP vs FGMP

   a) Fonterra and the Commission continue to conflate the BMP and the FGMP. The IDPs consider this is not appropriate as it blurs the line between Fonterra business strategies and objectives, and the statutory and supposedly objective measure of a competitive milk price.

   b) This blurred line is illustrated in Fonterra's persistence in a wide forecast range for the FGMP even when all BMP assumptions are known with certainty. Attributing the same FGMP forecast range to the BMP is therefore misleading.

8. Ongoing disclosure of the NP Conversion rate

a) The IDPs request the Commission reconsider its role in using its authority to encourage Fonterra to make disclosures beyond those explicitly required by the DIRA. This in particular concerns ongoing disclosures throughout the season of the crucial but otherwise completely opaque NP USD conversion rate.

DIRA S 150B Amendment/Review of NP USD Conversion Rate

9. The DIRA Amendment Act 2022 amended the DIRA S. 150B (1) to make the four permitted assumptions explicitly subject to the requirements of S. 150A. This had the effect of removing the previous "safe harbour" status of the assumptions and brought them within full oversight of the Commission reviews[1].

10. The IDPs considered this would require a fundamental change in the way the S 150B assumptions are used in the calculation of the BMP. In their submission on the Commission's Focus Areas 22/23 Paper, the IDPs requested the Commission expand the review to include all the S 150B assumptions[2]. By comparison the Commission had proposed to only review one of the four assumptions (assumption (c), the NP USD conversion rate).

11. In the event, the Commission has limited the 2022/23 review to the USD conversion rate assumption (along with a broad but useful interpretation of the S 150B amendment).

12. At the same time the Commission acknowledges it remains important to review all the S 150B assumptions, and confirms this is a substantive piece of work which it will spread across several years:

    "*reviewing the application of the other assumptions in section 150B(1) is important in the light of the amendments to section 150B, and we will consider how to do this for upcoming reviews of the base milk price and the Manual*"[3]; and the Commission "will *develop a workplan to assess the other* [S 150b] *assumptions over future years*"[4]

13. In the IDP Submission 22/23 Focus Areas, it was acknowledged the review of the S 150B assumptions would be a substantial piece of work. At the same, the IDPs considered it was not possible to conclude the newly required practical feasibility[5] of the S 150B assumptions unless that review were completed.[6]

14. For the 2022/23 review, the Commission has relied on its previous reviews to conclude compliance of the other S 150B assumptions (i.e. apart from the NP USD conversion rate)[7]. This is on the basis that the

[1] Approaches Paper (2023) has appropriately removed the previous references to "safe harbours" in relation to S 150B. Fonterra continues to refer to "safe harbours" (eg Fonterra Reasons 22/23 Calculations page 9). This reflects their more narrow interpretation of the S 150B amendment, supported by a legal opinion (Attachment 5 of Fonterra Reasons 22/23 Calculations). The Commission has not however reinstated the "safe harbour" term. The Commission response to this interpretation is addressed in addressed in paragraph 19 of this submission.

[2] IDP Submission 22/23 Focus Areas, para 25

[3] Draft Report, para 3.21

[4] Ibid Attachment A, pg 34

[5] DIRA S 150A sets a "practically feasible" standard for assuring the BMP provides for contestability in the New Zealand raw milk market. The Commission considers "practical feasibility includes commercial feasibility in the sense that it must be possible for an efficient processor operating in New Zealand to replicate or achieve the component being assessed" – refer Approaches Paper (2023) para 51. While the Commission suggests an assessment of commercial feasibility might be qualified in relation to the S 150B assumptions, it is unclear in what manner that qualification would manifest. In any event, the IDPs consider "commercial feasibility" more correctly captures the intent of S 150A and therefore use that term in the remainder of this submission in place of practical feasibility.

[6] IDP Submission 22/23 Focus Areas, para 25.

[7] Draft Report, para 3.14

calculation methodology has not significantly changed from previous years (which is presumably the case). However, previous reviews obviously did not consider compliance with the newly amended S 150B. While it is understood the limited timeframe and resources available to the Commission has meant the S 150B assumptions have not been reviewed in full, it is necessarily then the case that the Commission is not in a position to confirm the use of those assumptions are now compliant with the DIRA.

15. In summary, the IDPs consider that due to the limited review of the amended S. 150B, it is not possible to conclude the S. 150B assumptions used in the 2022/23 BMP calculations are compliant with the DIRA. **Noting the pervasive importance of the S150 B assumptions, the IDPs also request the Commission complete the remaining review of the S 150B amendment in the next review cycle[8].**

Commission Review of the use of "Actual" Values in the S150B assumptions

16. At the same time though, the review of the NP USD conversion rate has drawn important principles relevant to the wider review of the amended S. 150B. Fonterra had argued (with the support of a legal opinion)[9] that the S. 150B assumptions remain safe harbours to the extent unadjusted Fonterra actuals are used as inputs to relevant BMP calculations.

17. The Commission considers this Fonterra view is overly narrow. It points out that "actual values" can be selected in different manners and this in itself can cause variations in any value attributed to the NP and the resulting BMP[10].

18. In any event, regardless of how an "actual value" is determined, any "actual value" is inevitably transformed through the BMP calculation processes and the resulting characteristic of the NP will therefore always be "notional" and different to the original input value. The NP conversion rate is a case in point:
    - Monthly conversion rates input to the NP calculation procedure are understood to be effectually the same as Fonterra actual monthly conversion rates (and in this sense commercially feasible[11] in their own right).
    - Those monthly rates are then applied to the NP notional cash flows which are different to the Fonterra actual cashflows from which the monthly conversion rates have been derived.
    - The resulting conversion rate for the NP is accordingly different to the Fonterra actual conversion rate for the same activity period. This is self-evident and the conversion rate for the NP is notional.
    - Equally self-evident the NP conversion rate cannot in principle be commercially feasible because of the inherent mismatch between the source conversion rate (outcome of Fonterra hedging of Fonterra cashflows) as applied to the (in principle) fundamentally different NP cashflows.
    - For practical purposes however, if the NP conversion rate is materially similar to the Fonterra actual conversion rate for congruent transactions (i.e. actual sales derived from the relevant season milk supply) it would reasonably be concluded the NP conversion rate is both compliant with the S 150B (c) assumption and is commercially feasible.

[8] Refer attached Appendix, para 1
[9] Refer footnote 1.
[10] Draft Report, para 3.26
[11] Refer footnote 5.

- Even on the basis of the Commission's materiality measure (which the IDPs consider is benchmarked too high), a materially similar conversion rate would allow for only a small difference not exceeding 16 b.p. (0.0016)[12]. Using the Commission's materiality benchmark a difference exceeding 16 b.p. should require the NP conversion rate to be reconsidered on both counts (practical feasibility, and alignment with S 150B (1) (c)).

19. By contrast with Fonterra, the Commission summaries its interpretation of the amended S 150B as it applies to the NP conversion rate assumption as follows:

    "*we consider that the correct approach to interpreting and applying section 150B(1) (c) and 150B (2) is as follows:*

    "the Commission cannot review whether incorporating into the base milk price "gains and losses experienced by [Fonterra] resulting from foreign currency fluctuations, including from [Fonterra's] foreign currency risk-management strategies" is consistent with the s 150A purpose; but

    the Commission is able to review the way in which Fonterra incorporates these "gains and losses" into the base milk price"[13]

20. Apart from assumption (d) (milk volume and yields) the IDPs agree with this interpretation and consider it provides an appropriate basis for reviewing all the S. 150B assumptions. This is regardless of the use of actual Fonterra data as inputs. Assumption (d) is contradictory to commercial feasibility and it remains to be seen how the use of the assumption is required to be changed as a result of the amendment to S. 150B.

NP Product Yields

21. Apart from the wider consideration of the meaning of the S 150B amendment itself, the Commission did not review the other S 150B assumptions. In relation to the other S 150B assumptions (network of facilities, plant capacity, and volume of milk processed) the IDPs have long submitted that these assumptions are used in a manner which has the effect of inflating the NP yields above commercially feasible yields, and that the yields are only theoretically feasible.

22. In the Fonterra Reasons Paper 2022/23 Calculations, Fonterra has for the first time disclosed the aggregate NP provision for milk losses (0.38%)[14] and specification offsets (0.63%)[15]. It is difficult to draw definitive conclusions from these summary level metrics. It is expected that Fonterra will provide more detail concerning the loss assumptions in the wider disclosures now required to be made, including definitions, disaggregation, and production processing assumptions that support the yield losses.

Milk Losses (0.38%)

23. The BMP is sensitive to milk losses. For example, a 22 b.p. increase in milk losses (from 0.38% to 0.60%) for the 21/22 season would have reduced the BMP by 2.7 c/kg MS (calculated on simple pro-rata basis). This is material by comparison to the Commission's measure of materiality (which as previously noted is already set at a level higher than the IDPs consider is appropriate).

[12] Refer para 67 below for the IDPs interpretation of the Commission's indicative operational materiality measure.
[13] Draft Report, para 3.27
[14] Fonterra Reasons 22/23 Calculations, pg 15
[15] Ibid, pg 16

24. Fonterra advises[16] that provision for milk losses are based on Fonterra loss analysis taken from actual but ideal operating conditions; the IDPs interpret this to mean full capacity uninterrupted processing of a single product. The yields from these ideal conditions are extrapolated across assumed extended periods for the NP relying on the S. 150B assumptions (network of facilities, plant capacity, and total milk processed). Fonterra has not changed the interpretation of these assumptions to reflect the amended S 150B, and the Commission has not reviewed if the assumptions have been used in a manner which complies with S 150A.

25. As has previously been expected, the now identified milk losses of 0.38% appear unreasonably low and associated yields will be unreasonably high. It is difficult to conclude they are commercially feasible for any real world New Zealand processor of dairy commodities. The IDPs cannot however draw firm conclusions without further and disaggregated detail showing how the losses have been determined. The IDPs will be in better position to provide feedback on the milk losses after Fonterra releases further information in accordance with the new DIRA disclosure requirements.

Specification offsets (0.63%)

26. The specification offsets are described by Fonterra as determined by

> *"the volume of finished product relative to a 'nil offset' counterfactual"*[17]

27. It is assumed this refers to the NP production yields, compared to the yield the NP would achieve if product compositions were the same as CODEX minimum composition requirements. It is though not clear how minimum CODEX compositions might have been interpreted. CODEX composition standards are defined by a mix of minimum and maximum components by type (eg fat, protein, moisture) as well as <u>relative</u> minimum compositions (protein as a ratio of milk solids excluding fat). A range of possible compositions (and yields) can in fact meet CODEX "minimums". Fonterra's interpretation of the "nil offset counterfactual" needs to be clarified.

28. Fonterra also indicates the specification offsets are based on "Fonterra actual performance"[18]. This also needs to be clarified. This could for example refer to:

- overall actual Fonterra product (average/typical) compositions
- a subset of production drawn from ideal production conditions
- Fonterra standard (target) product compositions
- or something else?

29. Fonterra asserts it has invested substantial capital and developed considerable expertise to ensure it achieves very tight specification offsets[19]. This is not an idle boast. Fonterra is a world leading efficient dairy processor and the IDPs would agree Fonterra overall actual achieved product compositions are both commercially feasible and would reflect efficient production. It is unlikely that tighter specification offsets could be shown to be commercially feasible.

30. In summary it is difficult to draw conclusions on the feasibility of the specification offsets of 0.63%. This is illustrated by considering Fonterra's Regular WMP (the standard specification product for the most

---

[16] For example, Fonterra Reasons 22/23 Calculations, Attachment 3
[17] Fonterra Reasons 22/23 Calculations, pg 16
[18] Fonterra Reasons 22/23 Calculations, pg 15
[19] Ibid

significant by volume of the reference commodities). In the Fonterra product bulletin for RWMP (published on the GDT website)[20] Fonterra represents to customers the typical composition of its product includes total milk solids of 96.9%. This comprises protein (24.5%), fat (26.3%) and other dairy solids (46.1%). By comparison, the relevant CODEX standard requires a minimum 26% of fat, a minimum 34% ratio of protein to milk-solids-not-fat, and a maximum moisture of 5% (i.e. minimum total dairy solids are 95%)[21] [22]. The 34% protein to MSNF translates to minimum protein of 23.46% at maximum moisture of 5%. Compared to CODEX minimums, in all cases the dairy components in the Fonterra typical composition are higher than the CODEX minimums[23] as follows:

- total dairy solids are 2.00% higher
- protein is 4.43% higher
- fat is 1.125% higher[24]

31. At least in this case (WMP), it is then difficult to reconcile the Fonterra average compositions (as represented by "typical compositions") to the implicitly lower overall NP specification offsets of 0.63%.

32. **<u>The IDPs request the Commission seek further clarification of how the specification offsets have been measured.</u>**

S 150A Efficiency Dimension

33. Fonterra claims the process for determining the NP conversion rate incentivises Fonterra to operate efficiently:

> "*Fonterra treasury's team does not have routine access to forecast NMPB monthly cash receipts, and therefore does not generally know whether it is hedging a smaller or larger exposure than faced by the NMPB. This uncertainty means the translation process also appropriately incentivises Fonterra to operate efficiently*"[25]

34. This is barely credible and reflects the often fraught attempts to explain how the processes of the BMP setting processes incentivise Fonterra efficiency. In this case the explanation is presumably provided to explain that the use of Fonterra "actual" conversion rates is not inconsistent with the requirement that the BMP incentivise Fonterra efficiency. The inference is that if the Fonterra treasury team did have access to the NP monthly cash receipts this would somehow discourage efficient foreign currency hedging. It would require some imagination to elaborate how this might occur.

---

[20] https://www.globaldairytrade.info/assets/Uploads/sellers/fonterra/WMP-Regular-NZ.pdf?cb=1680573064
[21] https://www.fao.org/fao-who-codexalimentarius/sh-proxy/es/?lnk=1&url=https%253A%252F%252Fworkspace.fao.org%252Fsites%252Fcodex%252FStandards%252FCXS%2B207-1999%252FCXS_207e.pdf
[22] It is acknowledged that the CODEX minimums (or in the case of moisture the maximum of 5%) might not be consistent with best manufacturing practice or acceptable quality standards. This serves to illustrate why the Fonterra definition of specification offsets needs to be clarified.
[23] Note that in its product bulletin for RWMP, Fonterra represents (and presumably guarantees) minimum compositions that are higher than at least some of the CODEX minimums (e.g. Fonterra RWMP minimum protein is 24.0% compared to the implied CODEX minimum of 23.46%). It is assumed however that Fonterra represented minimum compositions are not relevant to the calculation of the Specification Offset.
[24] In all cases as measured by the percentage difference (as opposed to the percentage point difference) between the Fonterra typical composition and the CODEX minimums.
[25] Fonterra Reasons 22/23 Calculations, page 10

35. The "efficiency dimension" of DIRA S 150A requires the BMP is set in a manner which

> "*provides an incentive to* [Fonterra] *to operate efficiently*".

36. The Commission has interpreted the primary focus of this S 150A requirement is to incentivise Fonterra to achieve <u>cost efficiencies</u> (to achieve productive and dynamic efficiency)[26].

37. The Commission considers the efficiency dimension of S 150A will be met, and the BMP will provide an incentive for Fonterra to operate efficiently ("to drive cost efficiencies")

> *"where the Manual provides for independent notional benchmarks for the revenue and cost inputs in the calculation"*[27].

38. The Commission considers the "independent notional benchmarks" provide an efficiency incentive for Fonterra because

> *"any improvements in actual cost efficiency relative to the notional values used in setting the base milk price will result in higher profits"*[28]

39. This is based on an assumption that Fonterra is incentivised by the opportunity to make accounting profits. By the same rationale, Fonterra would be expected to seek notional benchmarks as high as possible in the case of costs and as low as possible in the case of revenues. Fonterra behaviour however shows the opposite is the case: an act of parliament was required to get Fonterra to set a higher WACC, and Fonterra changed its methodology with regard to the NP selling prices so as to include the higher prices from off-GDT sales. That behaviour is consistent with an incentive to maximise the BMP rather than to maximise Fonterra profits.

40. The weight of any assumption that Fonterra is incentivised by accounting profits has been diminished by the removal from the Approaches Paper (2023) of a section titled "Fonterra has incentives to improve efficiency to maximise profits" (paragraphs 82 and 83 from the previous 2021 version of the Paper). The IDPs have consistently submitted that to the extent Fonterra is incentivised to maximise profits, that is secondary to Fonterra's incentive to maximise the milk price. The bias towards maximising the milk price was magnified by the changes Fonterra has made to the Fonterra Shareholders Fund.

41. In its submission on the 2023 update to the Approaches Paper, Fonterra sought for that section ("Fonterra has incentives to improve efficiency to maximise profits") to be restored. The Commission did not restore the section and responded this was because of

> "*the uncertainty of the strength of the profit maximising incentive on Fonterra*"[29]

42. The IDPs agree there is at least this "uncertainty". Furthermore the IDPs consider this uncertainty must raise doubts that the "independent notional benchmarks" achieve the efficiency dimension of S 150A.

43. In support of the notional benchmarks, the Commission also considers that

[26] Approaches Paper (2023), para 43. The Commission acknowledges (Approaches Paper footnote 26) that it considers allocative efficiency when it reviews revenue items; it does not however consider revenue items are the "primary focus" of the S 150A efficiency dimension.
[27] Ibid, para 45
[28] Ibid, para 89
[29] Commerce Commission "Summary of response to submissions on our approach paper – 1st August 2023", page 7

"*using notional data provides Fonterra with a benchmark to beat. This increases transparency to shareholders about the extent to which Fonterra is achieving efficiency gains relative to the alternative of using data on Fonterra's actual performance to set the base milk price*"[30]

44. There is no evidence to support this view, and Fonterra has no reporting mechanism that would result in the increased transparency the Commission considers is achieved.

45. In responding to Fonterra's assertion that the procedure for setting the NP conversion rate "appropriately incentivises Fonterra to operate efficiently" (paragraph 33 above) and again apparently to dismiss concerns that the use of actual values would be contrary to the efficiency requirement of S 150A, the Commission stated that

"*we consider Fonterra operates efficiently … when incentives are sufficient to improve certainty of the impacts of foreign exchange on the base milk price*"[31]

46. This introduces a novel and different principle for considering the efficiency dimension in S 150A compared to the principles explained in the Approaches Paper (2023). In this case, the BMP is considered to meet the efficiency dimension if the way the BMP is determined has the effect of "improving" the BMP. This is different to (and in effect the opposite of) incentives to maximise Fonterra profits. The IDPs consider however this is closer to the incentives that drive Fonterra operational management and performance. To be clear however this is in the sense of net returns to milk rather than in the sense of maximising the statutory BMP.

47. In practice, Fonterra operational and performance management framework almost certainly occurs in a framework untouched by the notional framework of the BMP. In the case of Fonterra treasury management it is for example not credible to suggest the treasury team dissects currency risk management between the Fonterra commodity business and the wider Fonterra commercial activities. It is more correctly the case then that Fonterra performance management framework is incentivised to increase total returns to shareholder/ suppliers and is indifferent to the allocation of returns between the milk price and profits.

48. The separation of maximised returns between milk price and profits is however of considerable importance to Fonterra at a strategic level. Fonterra has an interest in maximising the milk price not because this incentivises Fonterra efficiency but because it is the priority performance metric of its supplier/shareholders; at the same time Fonterra wishes to maximise the milk price as a competitive tool to maximise its share of the national milk pool. These objectives are conveniently aligned. Fonterra also needs to meet minimum profit objectives to retain economic credibility in the wider investment community. Achieving these objectives is a narrow strategic function of Fonterra and there is no commercial reason why it would or needs to permeate or incentivise efficient operational management.

49. The IDPs believe it would be difficult to find evidence that would support a view that the BMP based on independent notional benchmarks in fact incentivises Fonterra efficiency, and that it is not reasonable to consider they have that effect. The IDPs further consider that the efficiency dimension of S 150A (setting the BMP to incentivise Fonterra efficiency) can only be achieved through a focus on allocative efficiency across the entire NZ processing industry. The BMP should be a measure of the feasible commercial value of converting raw milk into commodities, leading to an appropriate allocation of New Zealand primary resources to milk production, and an appropriate allocation of dairy processing

[30] Approaches Paper (2023), para 90.
[31] Draft Report, para 3.44.

investment to add value to raw milk in excess of commodity values. By contrast the current approach to setting the BMP risks a bias towards inflating the value/cost of commodity milk, a bias towards milk supply to Fonterra, and a bias away from investment in value creation in the New Zealand dairy processing industry.

50. The IDPs accept this discussion is likely outside the scope of the BMP calculations review and is already familiar to the Commission. It is however raised again here in response to the 2023 update of the Approaches Paper (including as prompted by the major changes that have occurred due to the latest DIRA amendment) and the relevance by example of the review of the NP USD exposure rate. The IDPs will seek to have this issue considered as a focus area for the 2023/24 Calculations Review.

Internal Consistency of Assumptions/Review of Milk Collection Costs

51. The IDPs are grateful to the Commission for expanding the Focus Areas for the review to include the review of milk collection costs.

52. Milk collection costs include the costs of transporting milk from farm to the designated processing site for the milk catchment area, plus onward transport of milk or milk components (e.g. cream, buttermilk) where the designated processing site is unable to process the milk/milk components or to meet production plan requirements.

53. Fonterra has explained that the first element of these costs (transport of milk to the designated processing site for the milk catchment area) for the NP is assumed to be the same as the equivalent Fonterra actual cost[32]. This is not unreasonable because the NP processes the same volume of milk as Fonterra, and because the NP network of processing facilities is assumed to be a geographical overlay of (although is not the same as) the Fonterra actual network.[33]

54. The NP is then assumed to process all <u>wholemilk</u> at the designated site for the catchment area. The Commission usefully describes the simple algorithm that is used to allocate planned production to available milk[34]. Planned production is set for these purposes at an Island level; it seems that planned production is not disaggregated across the season and by plant to reflect production assumptions underpinning yield assumptions.

55. Island level planned production of WMP and SMP is allocated in line with actual Fonterra catchment areas; the cream that would be produced from that catchment area processing is calculated. Where Fonterra (and therefore the NP) does not have cream processing within the catchment area (i.e. at the designated site), the cream is assumed "diverted" to the nearest Fonterra (and therefore NP) processing site and notional diversion costs are added to the milk collection cost. A similar process occurs where buttermilk processing does not co-exist with cream processing. No provision is made for the diversion (onward movement) of wholemilk because it is <u>assumed</u> the NP processing facilities can process the catchment area milk into the SMP and WMP volumes that have been allocated to it.

56. This planning process is artificial and does not match a commercially feasible operation. That artificiality would not be relevant unless it results in milk collection costs which are not commercially feasible for the NP. The Commission has concluded the NP milk collection (including diversion costs) are materially

[32] Fonterra Reasons 22/23 Calculations, pg 23
[33] Relying on DIRA S 150(B)(1) (a)
[34] Draft Report, para 3.62

compliant with the DIRA contestability requirement[35]. On the basis of the information available (and especially that the amendment to S 150B as it affects assumptions (a) (b) and (d) has not been reviewed) the IDPs consider it would not be possible to draw that conclusion with any certainty.

57. It is relevant that the Commission notes Fonterra actual diversion costs, which would include diversion of wholemilk, are "substantially different"[36] (and by inference substantially higher) than the NP costs.

58. An overarching feature of the way Fonterra calculates NP collection costs is the focus on a matching of target production to milk volumes rather than to NP capacities at NP production facilities. The calculations simply assume that the designated site for a catchment area (or for the onward movement of cream or buttermilk) has the capacity to produce the allocated production.

59. Equally the production plan does not appear to have been disaggregated in a manner which aligns to the assumptions necessarily made to achieve the efficient production and yield attributed to the NP. Accordingly there is no assurance that milk delivered to a processing site can be processed into the allocated production, or is consistent with production assumptions that underpin the NP production costs and yields. Note that in this respect, the NP milk losses (and therefore production yields) assume that

> "*the* [NP] *factories on average would operate at peak capacity for around 85-90% of their total operating days"* [37]

A consequence of this extraordinary assumption is that milk processed at the NP factories would be different to that processed at Fonterra factories and a diversion of wholemilk is likely to be necessary to consolidate milk at designated peak processing sites and to maintain consistency of assumptions.

60. While DIRA S 150B concerns permitted <u>assumptions,</u> assumption (a) as written is simply a statement of fact:

> S 150B(1) (a) "*new co-op* [Fonterra] *operates a national network of facilities for the collection and processing of milk*"

61. Fonterra has interpreted this to mean the NP is permitted to assume it shares a network of facilities that geographically overlay the Fonterra network and has the same milk processing capacity as Fonterra at each geographic site. Fonterra has always treated this assumption as a safe harbour despite the (at best) ambiguity of S 150B (1) (a); to date the Commission has accepted this interpretation.

62. While the NP "network of facilities" as legislated has arguably never been a "safe harbour", the amended S 150B has removed any doubt. It is not now sufficient to assume the NP network of facilities are the same as Fonterra. The NP asset base has changed over time and has almost certainly diverged from the Fonterra network. The changes in the NP network have accrued notional advantages to the NP arising from more efficient production facilities. The NP Network of facilities however has not been adjusted to reflect this evolution of the NP and associated cost consequences such as different milk collection costs.

63. Over its lifetime, the NP has notionally[38]:

- Retired 15 older and smaller powder plants

[35] Ibid, para 3.68
[36] Ibid, para 3.57
[37] Fonterra Reasons 2022/23 Calculations, Attachment 3
[38] Fonterra Reasons 2022/23 Calculations, Attachment 2

- Replaced those older plants with 8 larger and more efficient powder plants
- Added a further 5 new large and efficient powder plants to provide for increased capacity
- Increased processing capacity (presumably through "juggling" the 13 new plants) in each Island to at least match the milk produced in each Island (which the Manual defines as "region" and therefore as the lowest level for capacity planning).[39]

64. Despite all of the above changes (and from which the NP has assumed processing cost efficiencies), Fonterra continues to assume the NP processing capacity remains aligned to Fonterra actual capacity by geographic location. While it is possible this is correct, it cannot be assumed to be so. It is not an onerous task to restate the NP Network of Facilities to take into account the changes in the asset base. In the likely event the NP and Fonterra networks have diverged[40], milk collection costs need to take this into account. Alternatively the NP production facilities could be rescaled (smaller plants and higher production costs) so that the NP remains aligned with Fonterra.

65. In summary, the NP milk collection costs (including diversion costs) have not been determined in a manner which can be shown to be consistent with the NP asset base or with a disaggregated production plan that can achieve the production efficiencies reflected in the NP production costs and yields. The Commission has not reviewed these aspects of the milk collection costs because it has not reviewed the relevant S 150B assumptions that Fonterra has used. The Commission has nevertheless concluded that milk collection costs are "likely to be consistent with the S 150A requirements (efficiency and commercial feasibility)[41]. The IDPs do not agree there is sufficient evidence to draw this conclusion; this adds further weight to the IDP view noted in paragraph 15 above that it is not possible to conclude DIRA compliance of NP metrics which rely on the S150B assumptions.

Materiality

66. In the "fit for purpose" part of the calculations review, the Commission first identifies material changes in NP attributes from previous reviews and whether those changes warrant further analysis. "Material changes" are identified on the basis of:

    "indicative operational" materiality of an equivalent of 0.5% of the WACC used in the milk price reporting model for the season under review"[42]

67. The Commission measure of materiality as written could have different interpretations.
    a) A literal interpretation is that the materiality benchmark is equivalent to 0.5% of the NP WACC costs. For example, 2021/22 WACC costs were $393M. 0.5% is $2.0M or 0.14 c/kg MS. This is however too low to be the benchmark the Commission has used.
    b) An alternative interpretation is that the materiality benchmark is equivalent of the effect of a 0.5 percentage point change in the WACC rate itself. For example the WACC rate for 2021/22

[39] Fonterra Milk Price Manual Rule 34 and Glossary ("Regions")
[40] For example, the replacement of 15 plants by 8 larger plants seems unlikely to be able to be accommodated in a manner which preserves the geographic alignment of NP processing capacity to Fonterra capacity.
[41] In paragraph 3.67 of the Draft Report, the Commission notes that it has considered the possible impact of certain inconsistencies in the way the milk collection costs are determined and concluded the impact is unlikely to be material. That analysis did not consider the possible divergence of NP processing facilities from the NP, or the impact of assumptions on which milk losses depend.
[42] Draft Report, footnote 16

was 5.0%. A 0.5 percentage point movement in the WACC rate (eg to 5.5%) would result in a 10% change in WACC costs or a materiality benchmark for 2021/22 of $39.3M (2.7 c/kg MS).

68. The IDPs consider the materiality benchmark is too high especially for determining materiality of singular items. A materiality benchmark for singular items should not exceed 1 c/kg MS, and that a materiality policy should include wider considerations (quantitative and qualitative) including how materiality considerations should be applied across the range of BMP processes and outcomes. The IDPs will continue to seek a more complete resolution of this issue.

69. For this submission the IDPs assume 67 (b) above is the correct interpretation of the Commission's materiality benchmark and the Commission's benchmark for 2022/23 is similar to the 2.7 c/kg MS calculated for 2021/22.

70. <u>The IPDs request the Commission confirm how it interprets its materiality benchmark and if necessary change the way the measure is described to remove uncertainty.</u>

NP Fixed Assets and Capital Charges

71. The Commission has confirmed the overall increase in the replacement cost of the NP asset base was 10.4% for 2022/23[43]. The IDPs understand that this cost increase is an input to determine the cost of any new plants added to NP asset base for the 2022/23 Season, and also affects the calculation of the NP repairs and maintenance costs. It is potentially also an input to the annual update of the reference asset annuity calculations for purposes of determining capital recovery charges. This is though unclear and <u>the IDPs request this be clarified</u>. The Commission for example attributes a reduction in depreciation cost for 2022/23 (down 10.5%)[44] to

    "*higher inflation impacting the future value of the asset base upwards*"

    It is unclear if this "higher inflation" refers to the 10.4% current year increase in the NP asset base replacement cost; in the face of a similar increase in replacement cost for 2021/22 (10.5%)[45], depreciation did not similarly decline.

72. <u>The Commission is asked to obtain an explanation of the relationship between the annual price adjustment of asset replacement costs, the tilted annuity calculations, and the impact on depreciation and WACC.</u>

73. Fonterra has provided a summary of movements in the NP fixed assets for 2022/23[46]. The IDPs request the following inconsistencies be addressed:
    a) The opening book value is shown as $6,580.9M. However the closing book value at the end of the 2021/22 season was reported in the FGMP Statement as $6,595M.
    b) Fonterra reports depreciation is $266.5M. By comparison, the Commission has indicated depreciation expense has reduced by 10.5%[47] which compared to the 2021/22 depreciation of $283M indicates a <u>lower</u> depreciation expense of $253M.

[43] Draft Report, para 3.113
[44] Ibid, 3.120
[45] Review of Fonterra's 2021/22 base milk price calculation (Final Report 15.9.22), Para 3.131
[46] Fonterra Reasons 2022/23 Calculations, Attachment 2, pg 46
[47] Draft Report, 3.120

74. In the same summary, Fonterra reports capital expenditure of $349.4M for 2022/23. This is presumed to be primarily if not exclusively the cost of the two replacement powder plants identified by Fonterra[48]. That replacement cost appears low and the Commission is requested to review the scope and cost of the replacements.

BMP vs. FGMP

75. Fonterra conflates the BMP (the statutory measure of a competitive milk price) with the FGMP (a measure of the milk price Fonterra pays to its farmers and which has no statutory status). The IDPs consider Fonterra does this purposefully to validate and reinforce the use of the statutory measure to meet Fonterra purposes. This includes the (permitted) use of inflated measures of aspects of Fonterra actual performance. Conflating the BMP with the FGMP blurs the line between Fonterra business strategies and objectives and the statutory and supposedly objective measure of a competitive milk price.

76. The Commission explains that Fonterra uses the term “farmgate milk price” or FGMP when referring to the BMP[49]. At the same time the Commission confirms that it refers to the BMP (the correct statutory term). The Commission nevertheless gives credence to the FGMP and the BMP being the same in its advice that the forecast BMP for 2021/22 is currently $8.10 to $8.30[50]. That forecast is in fact the Fonterra forecast FGMP. While the Commission is well intended in providing that information, the IDPs consider the Commission should not validate the conflation of the BMP and the FGMP. In this case, the FGMP range of $8.10 to $8.30 serves Fonterra’s interests in managing milk price expectations. This is undoubtedly their prerogative although it would be interesting to compare it against compliance standards with forecasting by stock exchange listed entities. It is however not credible at this late stage that the BMP remains unknown within that wide range. Virtually all parameters are known, and it is misleading to suggest the BMP could still vary within that range. Fonterra might well wish to retain secrecy over its final milk price, including retaining the ability to discount it below the BMP should it consider that necessary. It is however the IDPs view that there is no good reason (other than Fonterra commercial advantage) that a much more accurate disclosure of the BMP (as opposed to the FGMP) is not already available. It is then misleading to represent the Fonterra forecast range is a valid and compliant assessment of the likely statutory BMP[51].

Commentary on Draft Report Attachment A

77. In Attachment A of the Draft Report, the Commission responds to certain points raised in the earlier Focus Area submissions. The IDPs comment on certain of those responses in the attached Appendix.

[48] Fonterra Reasons 22/23 Calculations, Attachment 2 compared to the same attachment in the 2021/22 Reasons Paper.
[49] Draft Report para 2.7
[50] ibid, para 2.6
[51] The issue of conflating the BMP with the FGMP was addressed in detail in the IDP Joint Submission to the Commerce Commission on the draft 2023 update of the Approaches Paper (paragraph 45 ff). The Commission made useful changes to the Approaches Paper (2023) but overall continues to conflate the terms (Approaches Paper (2023) – para 10).

Authorisation

This submission is authorised by:

<table>
<tr><td>___________________
Karl Gradon
CEO
Miraka</td><td>______________________
Mark de Lautour
CEO
Open Country Dairy</td></tr>
<tr><td>___________________
Grant Watson
CEO
Synlait Milk</td><td>______________________
Richard Wyeth
CEO
Westland Milk Products</td></tr>
</table>

Appendix: Commentary on Draft Report Attachment A (Commission Responses to Submissions on Proposed Focus Areas)

1. The Commission will develop a plan to assess the S 150B assumptions not included in the 2022/23 Review (page 34).

Submitter(s)	Key points	Cross Submissions (where applicable)	Our response
Calculation of the monthly Benchmark FX Conversion Rate			
Joint IDP Submission	Assess the other three s 150B(1) assumptions (assumption (a), (b) and (d)), in addition to the assessment of s 150B (1) (c) as this alone is unlikely to alter the lottery result nature of FX.[49]	No cross submissions	We have decided to consider the s150B(1)(c) assumption as part of this year's FX focus area. We will develop a workplan to assess the other assumptions over future review years.

IDP Comment: The Commission is intending to spread this compliance review across several years. The IDPs appreciate this is a substantial piece of work. However, the S 150B assumptions perform a central role in the BMP calculations and outcomes. It is not appropriate that it will take several years for the Commission to review the amendment to S 150B which is already in force. The IDPs are willing to assist the Commission in these reviews where feasible and appropriate. However, **if the Commission is unable to complete the remaining reviews during the 2023/24 season normal review cycle, the IDPs request the Commission consider outsourcing the reviews, and also consider an out of cycle review to bring forward the full review of S 150B.**

2. Ongoing disclosures regarding the NP Conversion Rate (page 34)

Submitter(s)	Key points	Cross Submissions (where applicable)	Our response
Calculation of the monthly Benchmark FX Conversion Rate			
Joint IDP Submission	Assess the need for increased transparency and disclosure and consider the feasibility of further disclosures, in particular amending the range of the FGMP as the season progresses and less currency exposure is faced.[50]	No cross submissions	Fonterra is now required to make publicly accessible all "non-sensitive information" within 20 working days after the Commission makes publicly available its final report on the base milk price calculation – see section 150QA.
	Consider the feasibility of increasing frequency of existing disclosures, at every FGMP forecast update as opposed to annually.[51]	This was not envisaged by legislators, who explicitly recognised the aim was to require release of information after year end.[52]	

IDP Comment: The IDP Focus Areas submission pointed out the NP conversion rate was the single most material assumption for the BMP after NP selling prices. Unlike selling prices, that assumption remains opaque (to all but Fonterra) throughout the Season and until September following the end of the Season. The IDPs consider it is appropriate (and not commercially sensitive) that Fonterra provide ongoing relevant disclosures. Both Fonterra (in cross submission) and the Commission responded that this was not a requirement of the new DIRA disclosure requirements. The IDPs had already acknowledged that was the case but had requested the Commission use the authority of its status to encourage Fonterra to consider ongoing disclosures.
Precedent for this exists in the on-going disclosures Fonterra now makes concerning the impact of off-GDT sales on the BMP. Fonterra was initially reluctant to provide meaningful ongoing disclosures but finally responded to the Commissions continued recommendations it do so. The off-GDT sales are an important on-going disclosure of information for which there is otherwise no visibility throughout the

year. By comparison, the NP conversion rate is massively both more significant and more opaque. It is also subject to the uniquely specific and invisible volatility arising from Fonterra management estimates of currency exposures – i.e. estimated commodity selling prices - and the timing of hedging transactions. Suitable ongoing disclosures concerning the conversion rate are possible without undue disclosure of Fonterra hedging decisions.

The IDPs request the Commission reconsider their response to this matter and consider how it might use its authority to continue to encourage disclosures that might not be mandated by the DIRA.

3. Commercial feasibility of Fonterra actual milk collection costs (page 35)

Submitter(s)	Key points	Our response
	Milk Collection Costs	
Joint IDP Submission	The Companies request that the commission also consider the practical feasibility of using Fonterra Actual costs for Notional Producer Milk Collection costs, due to higher unit cost for milk transport associated with the wider catchment area of large plants[55].	An issue might occur if certain sites in the Milk Price Fixed Asset Base had a materially different processing capacity to the same site as Fonterra. These sites with different processing capacity are likely to have different catchment areas and thereby different collection costs, arising from the longer or shorter distance that milk tankers need to travel. We will consider this issue when we address the national network assumption in future calculation reviews.

IDP Comment: The IDPs did not make the above highlighted request. The IDPs were responding to a point made by the Commission that Fonterra milk collection costs might be high compared to an incremental plant located close to its milk supply. The IDPs explained that higher costs are necessarily due to the scale of Fonterra processing sites and therefore the necessarily wider catchment area. The scale of the processing sites affords scale processing efficiency advantages; higher milk collection costs are a necessary additional cost to achieve those scale advantages. To the extent the NP operates at the same scale, the Fonterra higher collection costs would be equally applicable and commercially feasible.

4. Prevailing market price test (page 36)

	Prevailing Market Price Test	
Joint IDP Submission	Include compliance review of Off-GDT qualifying reference sales based on an appropriate and disclosed prevailing market price test.[58]	We consider we have addressed the outstanding issues in respect of the application of the "prevailing market price" test. Our final report on our 2019/20 Calculation Review concluded that the "prevailing market price" should not be limited to GDT standard specification products only and that we consider there may be good reasons higher prices may be achievable off-GDT. [para. 2.61] We also responded to this point in our 2021/22 Calculation review and we confirmed our previous conclusions. [Attach A]

IDP Comment: The IDPs retain the view that a prevailing market price test is necessary. Fonterra continues to assert that all "price informing" off-GDT sales "*used the most recent relevant GDT price as a key reference point*"[52]. This claim is hollow in the absence of an objective prevailing market price test used in the selection of the "price informing" sales.

[52] Fonterra Reasons 2022/23 Calculations, page 18

5. Delays in implementing Commission recommendations concerning the substitution test for standard product offerings (page 36) and the definition of significant quantities (page 37).

Standard Product Offerings (substitution test)		
Joint IDP Submission	Review unresolved issues relating to the substitution test including those raised by the Commission in its final report on the 2021/22 BMP calculations review.	We consider we have addressed the outstanding issues in respect of the application of the "substitution test," in our final report on our 2021/22 Calculation Review. [para. 3.75 onwards]

Significant Quantities		
Joint IDP Submission	Ensure that Fonterra, explicitly, demonstrates that qualifying reference sales in the 2022/23 BMP Calculations are compliant with the DIRA definition ("Significant quantities") of dairy commodities. Particularly, as the Manual does not define "significant quantities."[59]	We consider the recommendation made in our 2021/22 Calculation review, to revise the Manual to provide guidance on the interpretation of what constitutes significant quantities and over what time frame the assessment of quantity is made [Para. 3.64], to have addressed this issue. We would expect Fonterra to address the points raised in the 2021/22 Calculation review when it next reviews the Manual.

IDP Comment: It is unreasonable that Fonterra is permitted to defer implementing a Commission requirement and recommendations until it has first addressed that requirement through an amendment in the Manual. Given the underlying cycles this means Commission requirements remain unaddressed for 12 months and the actions taken by Fonterra to address those requirements remain unknowable for two years.