

# **Review of Fonterra's 2017/18 Milk Price Manual: Dairy Industry Restructuring Act 2001**

## **Draft report**

The Commission: Sue Begg  
Dr Mark Berry  
Graham Crombie  
Dr Stephen Gale

**Date of publication:** 13 October 2017



## Associated documents

Publication date	Reference	Title
15 August 2017	ISBN 978-1-869455-28-6	Our approach to reviewing Fonterra's Milk Price Manual and base milk price calculation
14 December 2016	ISSN 2382-1772	Final report – Review of Fonterra's 2016/17 Milk Price Manual: Dairy Industry Restructuring Act 2001

Commerce Commission

Wellington, New Zealand

## Table of Contents

<b>Executive Summary</b>	<b>iii</b>
What this report covers	iii
About this review	iii
<b>Chapter 1 Introduction</b>	<b>5</b>
<b>Chapter 2 Scope of this report</b>	<b>8</b>
<b>Chapter 3 Conclusions</b>	<b>10</b>
Our conclusions	10
<b>Attachment A Conclusions on minor amendments</b>	<b>13</b>
<b>Attachment B Outstanding amendments proposed earlier to Fonterra</b>	<b>14</b>
<b>Attachment C Glossary</b>	<b>18</b>

## Executive Summary

### What this report covers

- X1 This draft report sets out our conclusions on our review of Fonterra's 2017/18 Milk Price Manual (**the Manual**). The Manual contains the methodology used to calculate Fonterra's base milk price each season. This version of the Manual is for the 2017/18 season.
- X2 We invite submissions on this draft report from interested parties, which will help inform our final report.<sup>1</sup>
- X3 Submissions are due by **5pm, 15 November 2017**.<sup>2</sup>

### About this review

- X4 Our review of the Manual is required as part of the milk price monitoring regime (**monitoring regime**), which is contained in subpart 5A of the Dairy Industry Restructuring Act 2001 (**the Act**). More details of the intent of the regime can be found in our supporting paper on our approach to the review.<sup>3</sup>
- X5 In response to our process email on this review of 14 September 2017, we received a submission that we consider called for further explanation of how the Manual and the base milk price calculation work under subpart 5A of the Act.<sup>4</sup> Responses to the key points raised in that submission are set out in Chapter 2.
- X6 We have relied on our previous conclusions for those parts of the Manual that have remained unchanged unless there was substantive information causing us to reconsider previous conclusions. We have not received, nor are we aware of any information which would warrant reconsideration of our previous conclusions.

---

<sup>1</sup> Our final report will be published on 15 December 2017.

<sup>2</sup> More detail on how you can provide your views can be found in paragraphs 12-19.

<sup>3</sup> Commerce Commission "Our approach to reviewing Fonterra's Milk Price Manual and base milk price calculation" (15 August 2017). Our report is supported by this separate paper that provides an overview of the approach we have taken in reviewing the Manual for the 2017/18 dairy season. The supporting paper outlines how we conduct our annual reviews of Fonterra's Milk Price Manual and each season's base milk price calculation. It includes our interpretation of key legislative provisions, our practical approach to the statutory reviews, an overview of how Fonterra sets its base milk price, assumptions of the notional producer, and internal and external controls surrounding the integrity of the milk price calculation.

<sup>4</sup> S & L King "Submission regarding Fonterra milk price manual" (28 September 2017).

## Our conclusions

- X7 We conclude that this season's Manual is largely consistent with the statutory purpose set out in s 150A of the Act.<sup>5</sup>
- X8 Our review considers the 'efficiency' and 'contestability' dimensions required by the Act.<sup>6</sup> These focus on whether the Manual and the calculation provide:
- X8.1 an incentive for Fonterra to operate efficiently (the 'efficiency dimension'); and
  - X8.2 for contestability in the market for the purchase of raw milk from farmers (the 'contestability dimension').
- X9 To satisfy the provisions in s 150A, our interpretation is that our statutory reviews must assess both dimensions. We attach equal weight to both dimensions in our reviews.

## Our recommendations to Fonterra

- X10 Fonterra's amendments to the Manual have improved its consistency with the overall purpose of the milk price monitoring regime. We continue to encourage Fonterra to consider how it could improve the clarity of the rules.
- X11 We welcome Fonterra's commitments to improve its disclosures on its use of the rules in the Manual.<sup>7</sup>

---

<sup>5</sup> We are required by s 150I to make a report on the extent to which the Manual is consistent with the statutory purpose set out in s 150A. We note for completeness that we have previously observed that we are comfortable with the WACC methodology set out in the Manual. See for example para X26 of Commerce Commission "Final report – Review of Fonterra's 2015/16 base milk price calculation - 15 September 2016", footnote 15 of Commerce Commission "Final report – Review of Fonterra's 2016/17 Milk Price Manual – 14 December 2016", and paragraphs 2.24 to 2.27 of Commerce Commission "Final Report – Review of Fonterra's 2016/17 base milk price calculation – 15 September 2017".

<sup>6</sup> These two interlinked dimensions form the s 150A purpose under subpart 5A of the Act.

<sup>7</sup> As noted in our 2016/17 calculation review, we welcomed Fonterra's commitment to additional disclosures relating to the inclusion of off-GDT sales. The effectiveness of Fonterra's additional disclosures in this regard will be tested in future seasons. See Commerce Commission "Final report – Review of Fonterra's 2016/17 base milk price calculation" (15 September 2017), paras X15 and X18.

## Chapter 1 Introduction

1. This report sets out our review of the extent to which Fonterra's 2017/18 Manual is consistent with the purpose of the monitoring regime, which is set out in s 150A of the Act.

### How this report is structured

2. Chapter 2 covers the scope of our review.
3. Our conclusions are set out in Chapter 3 and are supported by the summary tables in Attachments A and B.
4. We have focused our commentary in Chapter 3 on those areas which could affect the extent to which the Manual is consistent with s150A.
5. Our high-level conclusions on minor technical and drafting amendments to the Manual are set out in Attachment A. Where appropriate, our brief commentary is provided.
6. Manual amendments that we proposed to Fonterra in prior reviews and which we consider still outstanding have been summarised in Attachment B.
7. A glossary of key terms is provided in Attachment C.
8. We recommend reading this draft report with our supporting paper.<sup>8</sup>

### We are fulfilling our statutory requirements

9. We are required to review the Manual for each dairy season and make a report on the extent to which the Manual is consistent with the purpose statement set out in subpart 5A of the Act.<sup>9</sup>
10. The Act requires Fonterra to provide us with the following information for consideration in our review:
  - 10.1 Fonterra's Manual for the current season;
  - 10.2 Any recommendations by the Milk Price Panel in relation to the setting of the base milk price;

---

<sup>8</sup> Commerce Commission "Our approach to reviewing Fonterra's Milk Price Manual and base milk price calculation" (15 August 2017).

<sup>9</sup> As required under s 150H and s 150J of the Act.

- 10.3 Notification of any change in the economic and business environment that, in Fonterra's view, requires a change to the Manual;
  - 10.4 Certification on the extent to which Fonterra considers that the Manual is consistent with the purpose of s 150A; and
  - 10.5 Reasoning behind the views expressed in Fonterra's certification.
11. The above information has been provided by Fonterra in the 'Reasons' Paper in support of Fonterra's Manual for the 2017/18 season which is available on our website.<sup>10</sup>

#### **How interested parties can provide their views**

- 12. As required by the Act, we consult with Fonterra on our draft conclusions. We also invite other interested parties to comment.<sup>11</sup>
- 13. We welcome views on any aspects of this draft report or any additional issues that you think should be considered in respect of the Manual before we finalise our conclusions. Your views on our draft report will help inform our final conclusions for our review.

#### *Deadline for submissions*

- 14. To allow us time to consider your views, submissions must be provided to us by no later than **5pm, Wednesday 15 November 2017**. We will consider submissions and publish our final report by **Friday 15 December 2017**.

#### *Format of submissions*

- 15. Submissions must be provided electronically in a format suitable for word processing and publication on our website.
- 16. Please address your submission to:

Keston Ruxton, Manager, EAD Regulation Development

[regulation.branch@comcom.govt.nz](mailto:regulation.branch@comcom.govt.nz)

---

<sup>10</sup> Fonterra "Fonterra's Reasons Paper in support of Milk Price Manual for the 2017/18 season" (2017). Available at <[www.comcom.govt.nz/review-of-milk-price-manual-201718-season](http://www.comcom.govt.nz/review-of-milk-price-manual-201718-season)>.

<sup>11</sup> We consult with Fonterra under s 150U of the Act.

17. We intend to publish all submissions on our website. If you would like the published electronic copy of your submission to be 'locked', please provide one version in a file format suitable for word processing and another in a locked PDF file format.

*Requests for confidentiality*

18. We encourage full disclosure of submissions so that all information can be tested in an open manner. However, we offer the following guidance where you wish to provide any information in confidence:
  - 18.1 If you include confidential material in your submission, both confidential and public versions of the submission should be provided; and
  - 18.2 The responsibility for ensuring that confidential information is not included in the public version of your submission rests entirely with you when you make your submission.
19. You can also request a confidentiality order under s 100 of the Commerce Act. We will provide further information on s 100 orders on request.



## Chapter 2 Scope of this report

20. The scope of this report was signalled in our process email of 14 September 2017 and is aligned with the requirements of the Act.
21. We have relied on conclusions from our previous reviews for unchanged areas of the Manual unless significant new information has come up that has caused us to reconsider previous conclusions. We have not received, nor are we aware of any information which would warrant reconsideration of our previous conclusions.
22. As signalled in our process email, we have focused our review on:
  - 22.1 Fonterra's amendments to the Manual;
  - 22.2 issues arising from our 2016/17 base milk price calculation review;<sup>12</sup>
  - 22.3 issues arising from comments on our process email; and
  - 22.4 outstanding issues from previous Manual reviews.
23. In this report we have grouped issues in the following order:
  - 23.1 The areas of the Manual that are more likely to have an impact on the extent to which the Manual is consistent with s150A.
  - 23.2 Minor amendments to the Manual of a technical or drafting nature (Attachment A).
  - 23.3 A summary of the Manual amendments we have proposed to Fonterra over the course of our milk price reviews which have not been adopted. Given the ongoing nature of our reviews we consider these issues to be of continuing relevance (Attachment B).

### Submission on our process email

24. In response to our process email of 14 September 2017, we received a submission from Stuart and Lorae King, Fonterra farmers and shareholders, who have raised some concerns about how the base milk price is set under the Manual and the Act.
25. We consider these questions important enough to them and other stakeholders that we have included below a summary of our responses to the points raised. These are provided in Table 2.1.

---

<sup>12</sup> Commerce Commission "Final Report Base Milk Price Calculation Review 2016/17" (15 September 2017).

**Table 2.1 Response to questions raised by S & L King<sup>13</sup>**

Issues raised	Explanatory comment
<p><b>In setting the Fonterra milk price, the Manual needs to ensure that all income derived from Fonterra's milk business (Fonterra Ingredients) goes toward milk price.</b></p>	<p>In order to give effect to the s 150A purpose, the Act requires the base milk price to be set in accordance with certain principles.</p> <p>The Act requires the revenue taken into account in calculating the base milk price to be determined using the prices of a portfolio of commodities.<sup>14</sup> It would therefore be impermissible for the Manual to ensure that all income derived from Fonterra's milk business goes to the milk price, as that income includes profits and losses from value-added products that do not meet the definition of a commodity. Profits and losses from value-added products remain a shareholder return rather than a milk supplier return.</p>
<p><b>We believe our view is supported by Fonterra's constitution which in annex 1 states; "...the Milk Price should be the maximum amount that the Company, reflecting its status as properly managed and efficiently run sustainable co-operative, could pay for the Milk supplied to it in a Season if: The Company, on their behalf, processed that Milk into commodity products which were sold on freely contested global markets."</b></p>	<p>We note that the Manual and base milk price must be set under the requirements of the Act. We therefore cannot take account of Fonterra's constitution when we carry out our reviews.</p>
<p><b>We believe that the present Manual is giving a milk price which understates the value contribution to the company of their members' milk and overstates the perceived investment returns as expressed in the earnings and dividend results.</b></p>	<p>We note that the base milk price is only intended to provide the return on the commodity value of the milk supplied by Fonterra farmers, as provided in the Act. The value-added component affects the dividends paid to farmers and investors for their investment in Fonterra.</p>
<p><b>We ask Fonterra to review the range of reference products and to use the value of actual product sales rather than just GDT when calculating the Milk price.</b></p>	<p>Following the amendment to the 2016/17 milk price Manual, Fonterra now includes both on-GDT and off-GDT sales in the recognition of revenue earned from the sale of its commodity products.</p>

<sup>13</sup> S & L King "Submission regarding Fonterra milk price manual" (28 September 2017). This submission can be found at [www.comcom.govt.nz/regulated-industries/dairy-industry/review-of-fonterra-s-farm-gate-milk-price-and-manual/statutory-review-of-milk-price-manual/review-of-milk-price-manual-201718-season/](http://www.comcom.govt.nz/regulated-industries/dairy-industry/review-of-fonterra-s-farm-gate-milk-price-and-manual/statutory-review-of-milk-price-manual/review-of-milk-price-manual-201718-season/).

<sup>14</sup> See s 150C of the Act. A commodity means a product made by the processing of milk that is - (a) traded in significant quantities in globally contested markets; and (b) characterised by uniform technical specifications, as outlined in section 5 of the Act. Further, Fonterra is required to select those commodities that "are likely to be the most profitable over a period not exceeding 5 years from the time when the portfolio is determined".

## Chapter 3 Conclusions

26. This chapter summarises our conclusions on the extent to which the 2017/18 Manual is consistent with the s 150A purpose.

### Our conclusions

27. Our overall conclusion is that the 2017/18 Manual is largely consistent with the s 150A purpose.
28. However, although not material to our overall conclusion, as outlined in previous calculation reviews and Manual reviews, we consider the following aspects of the Manual to be inconsistent with the purpose in s 150A:
- 28.1 farmer support; and
  - 28.2 capacity of standard plants.
29. To better promote the purpose of the Act and provide greater confidence to interested parties, we think it would be desirable for Fonterra to provide additional transparency in the following areas:
- 29.1 consistency over time - disclosure requirement;
  - 29.2 actual FX rates assumed;
  - 29.3 base milk price on standard terms; and
  - 29.4 proposal for sales criteria clarity.
30. These are summarised in Attachment B.

### Conclusions on Fonterra's amendments

31. Table 3.1 summarises our conclusions on the changes to the Manual for this season where Fonterra has provided specific commentary in its 2017/18 Reasons paper.

**Table 3.1 Summary of our conclusions on Fonterra's amendments<sup>15</sup>**

Manual reference	Detail	Description of issue	Fonterra reasoning	Commission comment
<b>Part B, Rule 16</b>	Rule 16, Amendment to solve ability to retrospectively pick the lactose cost informing the calculation.	Added requirement that the determination as to which lactose cost methodology is used must be made by the MPG prior to the commencement of the relevant season removing the ability to pick retrospectively.	Retains the same approach as used previously but adds a requirement that the choice between price series must be made prospectively, at the start of the season, rather than retrospectively, at the end of the season. Made in response to Commerce Commission's finding that a retrospective choice is not practically feasible.	Fonterra's amendment resolves Commission's concern.
<b>Part B, Rule 14 and Part C, Definition</b>	Rule 14, R&M costs - making rule more explicit by referencing a defined term for Maintenance Department Labour Costs (previously an undefined generic cost category).	R&M rule has been amended to include a specific definition of Maintenance Department Labour Costs (as defined in Part C).	New definition consistent with undertaking in Fonterra's submission on Commission's draft report on the F17 Manual.	No consistency issue; the change responds to an issue previously raised by the Commission. Fonterra's amendment resolves Commission's concern.

*Lactose costs*

32. We conclude that Fonterra's amendment solves our concern that Fonterra's ability to retrospectively pick the lactose cost informing the milk price calculation was not consistent with the contestability dimension. By adding the requirement to make a decision about the methodology used prospectively this removes the ability to pick pricing retrospectively for calculating lactose costs and thereby ensures consistency with contestability.

---

<sup>15</sup> See also Attachment A which outlines the amendments of a minor or drafting nature.

33. We consider it would be desirable for Fonterra to publicly disclose this decision prior to the beginning of the season to better promote the purpose of the Act. This would provide interested parties with certainty of the methodology used for determining the lactose costs.

#### *Repairs and maintenance costs*

34. Fonterra's amendment to the repairs and maintenance rule responds directly to our recommendation to Fonterra to include a definition of 'maintenance department labour costs' to provide greater clarity raised in our 2016/17 Manual review.<sup>16</sup>
35. We are satisfied with this change as it responds directly to our recommendation to provide greater clarity.
36. Table A1 of Attachment A sets out our conclusions on minor technical and drafting amendments to the Manual.

#### **Future Manual developments**

37. We welcome Fonterra's commitment to providing additional disclosures in the Manual in support of the inclusion of off-GDT reference sales. Fonterra has advised that it intends to include definitions of "standard packaging", "specialised plant or technical resources", and "standard product offerings" in its 2018/19 Manual.<sup>17</sup>

---

<sup>16</sup> Commerce Commission "Review of Fonterra's 2016/17 Milk Price Manual: Dairy Industry Restructuring Act 2001 - Final Report" (14 December 2016), Table X1.

<sup>17</sup> Commerce Commission "Review of Fonterra's 2016/17 base milk price calculation: Dairy Industry Restructuring Act 2001 - Final report" (15 September 2017), Table X1. We note that Fonterra proposed the inclusion of these additional definitions after it had already provided the amended 2017/18 Manual to us (1 August 2017).

## Attachment A Conclusions on minor amendments

**Table A1 Summary of minor technical and drafting changes**

Manual reference	Detail	Category	Description of issue	Fonterra reasoning	Commission comment
<b>Part A</b>	Fonterra Manual Amendment	Added complete year for clarity ie, F16 to F2016 (which in this example refers to the 2015/16 season)	N/A	N/A	No consistency issue; minor drafting amendment
<b>Part B, Rule 21</b>	Fonterra Manual Amendment	The word "GlobalDairyTrade" changed to "GDT"	N/A	N/A	No consistency issue; minor drafting amendment
<b>Part B, 29</b>	Fonterra Manual Amendment	Rule removed	Removed rule. Considered superfluous given: (a) independent test for surplus assets is already required under Rule 34 (b) MPG annually determines, on a forward looking basis, whether there is currently sufficient capital in the model (c) consequences of insufficient peak processing capacity are dealt with automatically in the calculation and (d) the MPG's assessment is subject to review by external auditor and the Commerce Commission.	N/A	No consistency issue; minor technical amendment
<b>Part C, Definition</b>	Fonterra Manual Amendment	Qualifying reference sales - Definition	Added bullet point numbers for clarity.	N/A	No consistency issue; minor drafting amendment
<b>Part C, Definition</b>	Fonterra Manual Amendment	kgMS farmgate milk price - Definition	Added kgMS to definition for clarity.	N/A	No consistency issue; minor drafting amendment

## **Attachment B Outstanding amendments proposed earlier to Fonterra**

- B1 This Attachment provides a summary of the amendments we have proposed to Fonterra over the course of our milk price reviews which have not been adopted.<sup>18</sup> For the continuity of our reviews and consideration of future submission points, we consider this to be a valuable summary for all interested parties.
- B2 We do not consider these outstanding amendments to be material to our review. However, we consider these proposed amendments would better promote the setting of a base milk price that provides an incentive to Fonterra to operate efficiently while providing for contestability in the market for the purchase of milk from farmers.<sup>19</sup>
- B3 Table B1 outlines our proposed amendments, Fonterra's responses and our brief comments.

---

<sup>18</sup> Both the Manual and calculation reviews.

<sup>19</sup> s 150A of the Act.

**Table B1 Summary of amendments proposed earlier to Fonterra**

Manual reference	Detail	Category	First raised by the Commission	Previous Commission conclusion <sup>20</sup>	Description of issue	Fonterra reasoning
<b>N/A</b>	Fonterra decision for no change	Farmer support	2015/16 calculation review	Although, immaterial, we conclude that Fonterra should include the costs of providing shareholder support to ensure continued supply to be consistent with the contestability dimension.	Financing and associated administration costs of providing farmer support loans and costs of providing other mechanisms of farmer support.	No change to our previous position that it is not appropriate to fund these costs from the Milk Price.
<b>Part A, Section 2.6</b>	Fonterra decision for no change	Consistency over time - disclosure requirement	2016/17 Manual review	No consistency issue; however, we consider such disclosure would provide greater transparency.	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.	No change, for reasons explained in our F16 reasons paper (a 'bright line' materiality threshold is actually likely to lead to less disclosure).

---

<sup>20</sup> Our previous conclusions in these areas from prior reviews. These reports can be found here <http://www.comcom.govt.nz/regulated-industries/dairy-industry/review-of-fonterra-s-farm-gate-milk-price-and-manual/>.



Manual reference	Detail	Category	First raised by the Commission	Previous Commission conclusion <sup>20</sup>	Description of issue	Fonterra reasoning
<b>Part B, Rule 26</b>	Fonterra decision for no change	Capacity of standard plants	2016/17 Manual review	We recommend Fonterra considers disclosing its plant capacity for both primary and secondary plants in the Manual early in each season to provide certainty of the notional producer's assumed capacity for the related season. We consider this would improve the ability of interested parties to assess the practical feasibility of the assumed production volumes.	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.	No change – we do not consider the Manual is the appropriate vehicle for these disclosures. We have previously put this information into the public domain, and the relevant assumptions will not be revisited until F20.
<b>N/A</b>	Fonterra decision for no change	Actual FX rates assumed	2016/17 Manual review	We suggest there should be more transparency of information on the actual FXD rates assumed to be achieved by the notional producer.	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.	Outside scope of Manual. <sup>21</sup>

---

<sup>21</sup> Although outside of the scope of the Manual and a safe harbour under the Act, we consider the disclosure of the assumed rates would promote the purpose of the Act. We note this does not affect our ability to conclude on the Manual.

Manual reference	Detail	Category	First raised by the Commission	Previous Commission conclusion <sup>20</sup>	Description of issue	Fonterra reasoning
<b>N/A,</b>	Fonterra decision for no change	Base milk price on standard terms	2015/16 calculation review	We consider disclosure of the cost of milk in standard terms (prior to any adjustments) would provide greater transparency to the milk price regime.	We consider that if Fonterra disclosed the base milk price on standard terms in periodic reviews throughout the season, this would provide greater transparency of Fonterra's base milk price setting process.	Outside scope of Manual. <sup>22</sup>
<b>Part C, Definition</b>	Amendment proposed but not made	Proposal for sales criteria clarity	2016/17 calculation review	We welcome such additional definitions to provide greater clarity around sales criteria.	In Fonterra's submission on the 2016/17 Milk Price Calculation draft report it proposed including definitions of "standard packaging", "specialised plant or technical resources", and "standard product offerings" and "standard packaging" in its Milk Price Manual.	N/A

---

<sup>22</sup> Although outside of the scope of the Manual and a safe harbour under the Act, we consider the disclosure of the assumed rates would promote the purpose of the Act. We note this does not affect our ability to conclude on the Manual.

## Attachment C    Glossary

Term/Abbreviation	Definition
<b>The Act</b>	Dairy Industry Restructuring Act 2001
<b>Base milk price</b>	Farm gate milk price expressed per kilogram of milk solids
<b>Calculation review</b>	Review of Fonterra's base milk price calculation for the prior season
<b>Dairy season</b>	1 June to 31 May annually
<b>FX</b>	Foreign exchange
<b>GDT</b>	GlobalDairyTrade, Fonterra's online auction platform used to sell commodity products
<b>kgMS</b>	Kilogram of milk solids
<b>Manual review</b>	Review of Fonterra's Milk Price Manual for the current season
<b>Milk Price Manual or the Manual</b>	Fonterra's Milk Price Manual
<b>Notional producer</b>	The notional commodity business that is used to calculate the base milk price
<b>R&amp;M</b>	Repairs and maintenance
<b>Reasons paper</b>	Fonterra's Reasons paper which is provided alongside the Manual for each dairy season (this is also provided when Fonterra discloses its base milk price calculation at the end of each dairy season)