

## **Proposed focus areas for our review of Fonterra's 2021/22 base milk price calculation**

Process paper

**The Commission:**     Vhari McWha  
                                  Sue Begg  
                                  Elisabeth Welson

**Date of publication:**     19 April 2022



## Associated documents

| Publication date  | Reference              | Title   |
|-------------------|------------------------|---|
| 5 July 2021       | ISBN 978-1-869459-10-9 | <a href="#">Our approach to reviewing Fonterra's Milk Price Manual and base milk price calculation 2021</a>     |
| 15 December 2021  | ISSN 2382-1779         | <a href="#">Review of Fonterra's 2021/22 Milk Price Manual: Dairy Industry Restructuring Act 2001</a>           |
| 15 September 2021 | ISSN 1178-2560         | <a href="#">Review of Fonterra's 2020/21 base milk price calculation: Dairy Industry Restructuring Act 2001</a> |

Commerce Commission

Wellington, New Zealand

## Introduction

1. This paper provides interested parties with details regarding our proposed focus areas for our review of Fonterra's base milk price calculation for the 2021/22 season (**Calculation**) under the Dairy Industry Restructuring Act 2001 (**DIRA or the Act**). This paper also invites feedback on those focus areas and seeks relevant information on those focus areas.
2. Our primary role under the Act is to publicly report on the extent to which Fonterra's milk price setting processes and calculations provide incentives for Fonterra to operate efficiently and are consistent with contestability in the market for purchasing farmers' milk.
3. We undertake two separate reviews each dairy season:<sup>1</sup>
  - 3.1 The first review concerns Fonterra's milk price manual (**Manual**). The Manual contains the specific methodology Fonterra uses to calculate its base milk price.<sup>2</sup> This review assesses whether the rules and principles in the Manual provide an incentive for Fonterra to operate efficiently and are practically feasible for an efficient milk processor, and as such are consistent with the purposes of the Act.
  - 3.2 The second annual review we undertake is of Fonterra's base milk price calculation at the end of each dairy season. This review assesses whether the costs, revenue and other assumptions used in the base milk price calculation are consistent with the purpose of Subpart 5A of DIRA.
4. The framework for our reviews is contained in our **Approach paper**.<sup>3</sup>

## We are reviewing Fonterra's 2021/22 base milk price calculation

5. This Calculation review is the second of the reviews that we are required to complete under the Act in relation to the base milk price in the 2021/22 season.
6. The first review for the 2021/22 season looked at the Manual. We published the final report on our review of the Manual for the 2021/22 season on 15 December 2021.<sup>4</sup> We

---

<sup>1</sup> For a more detailed explanation of our monitoring role under DIRA see our [website](#).

<sup>2</sup> The base milk price is also known as the farm gate price – the amount farmers receive for each kilogram of milk solids. Our monitoring role is concerned only with the farm gate milk price. We do not monitor retail dairy prices or any other prices in the value chain.

<sup>3</sup> Commerce Commission "[Our approach to reviewing Fonterra's Milk Price Manual and base milk price calculation](#)" (5 July 2021).

<sup>4</sup> Commerce Commission "[Review of Fonterra's 2021/22 Milk Price Manual: Dairy Industry Restructuring Act 2001 – final report](#)" (15 December 2021).

note that the Manual requires periodic reviews of various inputs to the base milk price calculation, normally on a four-yearly cycle.<sup>5</sup>

7. Each annual Calculation review has key areas of focus for the review. We determine the focus areas for each Calculation review based on a number of criteria outlined in our Approach paper.<sup>6</sup> We explain in the next section the basis for the focus areas for this year's review.
8. For each proposed focus area in the Calculation review, we conclude on both the contestability and efficiency limbs within section 150A of Subpart 5A (as we are required to do for the inputs, assumptions and processes underlying the calculation of the base milk price as a whole).
9. In addition to the specific focus areas, our annual review of the Calculation includes a 'fit for purpose' review of all other revenue and cost components of the base milk price calculation. The fit for purpose review consists of an analytical review of component values against our previous reviews of the same components and a review of the consistency of the assumptions, inputs and processes related to the different components.
10. As required by the Act, we produce a draft report of our review of Fonterra's base milk price calculation for each season by **15 August** and a final report by **15 September**.<sup>7</sup>

## Indicative timeline

| Indicative date          | Publication/event                                   |
|--------------------------|---|
| <b>19 April 2022</b>     | Proposed focus areas published                      |
| <b>6 May 2022</b>        | Stakeholder submissions on proposed focus areas due |
| <b>15 August 2022</b>    | Draft report published                              |
| <b>1 September 2022</b>  | Stakeholder submissions on draft report due         |
| <b>15 September 2022</b> | Final report published                              |

<sup>5</sup> Fonterra "[Farmgate Milk Price Manual](#)" (1 August 2021).

<sup>6</sup> Commerce Commission, above n 3, at 23 [100].

<sup>7</sup> However, if either of these dates falls on a non-working day, the date may be extended to the next working day – see section 55 of the Legislation Act 2019.

## Our proposed focus areas

11. For our 2021/22 Calculation review, we are proposing the following focus areas:

11.1 asset beta;

11.2 post tax market risk premium (PTMRP); and

11.3 qualifying materials and incremental cost adjustments.

12. These proposed focus areas for the 2021/22 review are informed by:

12.1 Fonterra's periodic reviews of components in its Calculation (as specified in the Manual); and

12.2 outstanding issues from previous Calculation and Manual reviews.

### *Asset beta*

13. The Dairy Industry Restructuring Amendment Act 2020 introduced new requirements for the asset beta that came into effect on 1 June 2021.

14. Our 2021/22 final report on our review of the Manual concluded that with regard to the asset beta, Rule 42, as currently worded, is inconsistent with section 150C(4) and is therefore inconsistent with the statutory purpose set out in section 150A of DIRA.<sup>8</sup>

15. This is the first Calculation review to consider the amended requirements, therefore we propose to include the asset beta as a focus area.

16. We propose to limit the scope of our focus in the 2021/22 Calculation review to our findings from the 2021/22 Manual review. This will include the application of Rule 42 that we found to be inconsistent, in particular the finding that any asset beta that has been adjusted away from the comparator set on the basis of Fonterra-specific systematic risk would not be consistent with the estimated asset betas of other processors of dairy and other food products and, therefore, would be inconsistent with section 150C(4).

### *Post Tax Market Risk Premium (PTMRP)*

17. Because the Manual identifies 2021/22 as a review year for PTMRP, and this input is material to the cost of capital and overall base milk price calculation, we propose to include it as a focus area.

---

<sup>8</sup> Commerce Commission, above n 4, at 8 [27].

*Qualifying materials and incremental cost adjustments*

18. For our 2021/22 Calculation review we propose to include a review of the list of 'Qualifying Materials' and incremental product cost adjustments made to account for differences in product specifications and manufacturing processes as a focus area.<sup>9</sup>
19. Because this proposed focus area will inform future Calculation reviews, we are proposing a scope in this paper. This scope should not be interpreted as exhaustive or otherwise limiting our ability to evaluate other relevant factors. Our purpose, at this time, is to identify possible clarifications to Qualifying Material rules and incremental costs adjustments.
20. The likely scope of this review will include:
  - 20.1 A review of the list of qualifying reference products (to be provided by Fonterra) for the 2021/22 dairy seasons to consider:
    - 20.1.1 whether the products are characterised by uniform technical specifications in accordance with the definition of 'commodity' within DIRA and whether the products constitute reference commodity products on a reasonable interpretation of the Manual;
    - 20.1.2 what changes should be made, if any, to the milk price production loss and yield assumptions to accommodate actual switching costs from the manufacture of one product to another to produce the quantities likely to inform the milk price;
    - 20.1.3 whether any products require the use of specialised plant;
    - 20.1.4 whether there are any aspects of the Manual rules for determining generic product specifications that need to be clearer.
  - 20.2 Further to paragraph 20.1.2, where incremental costs have been used to account for adjustments associated with product switching, consider:
    - 20.2.1 whether the use of incremental costs is reasonable in light of the manufacturing capability of standard plant; and
    - 20.2.2 whether the incremental product costs fully account for the different manufacturing costs (processing and overheads) and component costs

---

<sup>9</sup> We noted in our 2020/21 Calculation review that, given the submissions related to the inclusion of Instantised Skim Milk Powder as a 'Qualifying Material', we intended to examine how the Manual gives effect to the DIRA definition of 'commodity' more closely in a future Manual review. We noted that this process was likely to involve reviewing the list of 'Qualifying Materials' and incremental product cost adjustments made to account for differences in product specifications and manufacturing processes. We also stated we would consider undertaking this review in advance of the 2022/23 Manual review. We are proposing to do this review now.

(eg protein, fat, minerals) of various products, including yield adjustments.

### **We invite your views on our focus areas for this year's Calculation review**

21. We continue to consider that consultation with all interested parties helps to inform us when making our conclusions. We invite submissions on the following matters by **5pm, 6 May 2022**:
  - 21.1 whether the proposed focus areas should form part of our review, and whether there are further focus areas that should be included; and
  - 21.2 any relevant information about the proposed focus areas themselves or any further proposed focus areas.
22. Receiving submissions on these matters will:
  - 22.1 assist us to decide what the focus areas should be for our Calculation review; and
  - 22.2 provide us with information relevant to those proposed focus areas, so that we may take this information into account when examining the proposed focus areas as part of our Calculation review.
23. Please make your submission via email to [regulation.branch@comcom.govt.nz](mailto:regulation.branch@comcom.govt.nz) with '*Proposed Focus Areas Paper*' in the subject line of your email. Submissions must be received by **5pm, Friday 6 May**. Your submission should be provided as an electronic file in an accessible form (e.g., PDF, Word or an unlocked spreadsheet).
24. The protection of confidential information is something the Commission takes seriously. When including commercially sensitive or confidential information in your submission, we offer the following guidance:
  - 24.1 Please provide a clearly labelled confidential version and public version and provide reasons why you consider information to be confidential or commercially sensitive. We intend to publish all public versions on our website.
  - 24.2 The responsibility for ensuring that confidential information is not included in a public version of a submission rests entirely with the party making the submission.
25. If we consider information disclosed in the confidential version to be in the public interest, we will consult with the party that provided the information before any such disclosure is made.