



Dairy for life

1 August 2022

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'Reasons' paper in support of Fonterra's  
Milk Price Manual for the 2022/23 Season

## Glossary

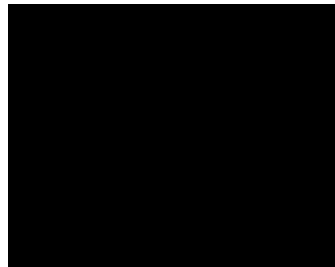
F22 Final Manual Report	Commerce Commission, Review of Fonterra's 2021/22 Milk Price Manual, Final Report, 15 December 2021, <a href="https://comcom.govt.nz/_data/assets/pdf_file/0026/273338/Final-report-Review-of-Fonterra27s-2021-22-Milk-Price-Manual-15-December-2021.pdf">https://comcom.govt.nz/_data/assets/pdf_file/0026/273338/Final-report-Review-of-Fonterra27s-2021-22-Milk-Price-Manual-15-December-2021.pdf</a>
F22 Base Milk Price Reasons Paper	Fonterra Co-operative Group Limited, 'Reasons Paper' in support of Fonterra's Base Milk Price for the 2021/22 Season (Public Version), 1 July 2022, <a href="https://comcom.govt.nz/_data/assets/pdf_file/0026/287360/Fonterra-Reasons-paper-on-review-of-2021-22-base-milk-price-calculation-1-July-2022.pdf">https://comcom.govt.nz/_data/assets/pdf_file/0026/287360/Fonterra-Reasons-paper-on-review-of-2021-22-base-milk-price-calculation-1-July-2022.pdf</a>
MPG	The Milk Price Group, the independent unit responsible for determining and recommending to the Milk Price Panel the Farmgate Milk Price.
NMPB	Notional Milk Price Business, comprising the notional milk powder manufacturing business implied by Fonterra's Farmgate Milk Price Manual.
RCP	Reference commodity product, comprising wholemilk powder (WMP), skimmed milk powder (SMP), buttermilk powder (BMP), butter and anhydrous milkfat (AMF)
F23 Season	The period commencing on 1 June 2022 and ending on 31 May 2023, also referred to as the 2022/23 season.

1 August 2022

To: The Commerce Commission

1. Fonterra Co-operative Group Limited ("Fonterra") certifies that:
  - a. in terms of section 150L(d) of the Dairy Industry Restructuring Act 2001 ("Act"), Fonterra considers that its milk price manual to be applied in calculating Fonterra's Farmgate milk price for the 2022/23 season is, in all material respects, consistent with the purpose of subpart 5A of the Act; and
  - b. none of the circumstances set out in section 150G(1) of the Act have occurred with respect to the milk price manual to be applied in calculating Fonterra's Farmgate milk price for the 2022/23 season.
2. This certification is based on our interpretation of subpart 5A, and the other relevant assumptions, views and qualifications set out in the accompanying reasons provided pursuant to s 150L(e).

Signed by

A large black rectangular redaction box covering the signature of Andrew Cordner.

Andrew Cordner

Director Legal

## Introduction

This paper provides the reasons in support of Fonterra's certification in respect of the Milk Price Manual to be applied in the calculation of Fonterra's Farmgate milk price in respect of Fonterra's 2022/23 Season (the F23 Manual), as required under section 150L of the Dairy Industry Restructuring Act 2001 (DIRA). The paper has been prepared under the oversight of the Milk Price Panel, and where relevant reflects the Panel's views.

Section 150L provides that Fonterra must:

- Provide the Commission with the milk price manual for the current season (i.e., the season commencing on 1 June 2022) (section 150L(a));
- Provide the Commission with any recommendations by the Milk Price Panel "in relation to the setting of the base milk price" (section 150L(b));<sup>1</sup>
- Notify the Commission of any change in the economic and business environment that, in Fonterra's view, requires a change to the milk price manual (section 150L(c));
- Certify to the Commission the extent to which Fonterra considers that the milk price manual is consistent with the purpose of subpart 5A of DIRA (section 150L(d)); and
- Provide the Commission with reasons for the view expressed in its certificate (section 150L(e)).

In addition, section 150G sets out the steps that Fonterra is required to take if it does not amend the Manual in accordance with a recommendation by the Panel, if it amends the Manual contrary to a recommendation by the Panel, or if it amends the Manual without having received a relevant recommendation from the Panel. We advise that none of these circumstances has occurred with respect to the Manual applied by Fonterra in respect of the 2021/22 season (the F22 Manual).

On 22 June 2022 the board of Fonterra approved a number of amendments to the Milk Price Manual, all of which were recommended by the Milk Price Panel. These amendments are set out in 'mark up' form in the Milk Price Manual attached to this paper and, where not obvious given their context, we explain their rationale below. In all other respects, the F23 Manual is identical to the F22 Manual, in respect of which Fonterra submitted a certification and reasons paper on 30 July 2021. Consistent with that paper, we have confined our comments in this paper to areas where our views have changed subsequent to preparing previous reasons papers, or where we wish to provide additional information. In all other respects, we request that this paper be read in conjunction with our reasons papers submitted in respect of the 2012 – 2022 seasons.

We have also recently provided (in our 'reasons paper' in respect of the 2021/22 base milk price) the Commission with our views on the appropriate interpretation of section 150A of DIRA (the purpose provision), and have not repeated these views in this paper.

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

- In section 2, we set out, and explain the rationale for, the amendments incorporated in the F23 Manual.
- In section 3, we summarise our reasons for not making certain amendments proposed by the Commission.
- In section 4, we summarise changes in the economic and business environment that are potentially of relevance to the calculation of the base milk price, and explain why we have not amended the Manual in response to these changes for the 2022/23 season.

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<sup>1</sup> As in our previous 'reasons papers' we have interpreted this provision as in fact relating to recommendations by the Milk Price Panel in relation to amendments to the Milk Price Manual.

The attachment to this paper comprises a 'marked up' version of the Milk Price Manual, identifying all amendments, and which satisfies the section 150L(1) requirement to provide the Commission with the manual for the current season.

We have separately provided to the Commission a paper to Fonterra's board of directors dated 22 June 2022, setting out the Milk Price Panel's recommendations with respect to amendments to the Milk Price Manual.

## Amendments to the Manual for F23

The only substantive change to the Manual for F23 addresses the Commission's conclusions in its Final Report on the F22 Manual on Rule 42 (Asset beta). The Commission concluded that the requirements in Rule 42:

- That "the MPG will have regard to ... any relevant requirements under DIRA" "does not accurately reflect the legal obligation to comply with the DIRA requirements."
- That the MPG have regard to "Fonterra's exposure to systematic earnings risk [with respect to Fonterra's RCP business]" is inconsistent with the requirement to apply the approach set out in s 150C(4).

In light of the Commission's position, we have amended Rule 42 so that it now reads as follows:

The MPG will determine an updated Asset Beta in a Review Year. The Asset Beta must be consistent with the estimated asset betas of other processors of dairy and other food products that are traded in significant quantities in globally contested markets and are characterised by uniform technical specifications.

Where more than one estimate of asset beta is consistent with this mandatory requirement, and those estimates are otherwise equally supportable, the MPG will select the estimate which best reflects the exposure to systematic risk of an efficient New Zealand-based manufacturer of reference commodity products.

The intent of the amendments is to:

- Make it explicit that the MPG's estimate **must** comply with s 150C(4).
- Provide explicit guidance to the MPG if it is required to select a single value from a range of estimates which comply with the DIRA requirements. This guidance recognises the reality (which is acknowledged in numerous documents produced by the Commission) that a number of technical judgements are required when estimating beta, with legitimate choices between approaches often generating slightly different answers. The requirement that the point estimate selected from a range of DIRA-compliant estimates reflects the value which "best reflects the exposure to systematic risk of an efficient ... manufacturer" is consistent with the 'practical feasibility' test in s 150A(2) of DIRA.

## Other Matters

The Commission expressed the following positions in its F22 Final Manual Report:

- "We consider that the publication of the list of all products that meet the criteria for 'Generic product specifications' in the Manual, or the accompanying Reasons paper, would greatly assist transparency of what is a standard product offering."<sup>2</sup>
- "We still consider that the disclosure of a material change threshold, whether stated as a number or key qualitative considerations that are relevant to change decisions other than simple clarifications or

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<sup>2</sup> F22 Final Manual Report, paragraph 73, p.18.

corrections, will provide greater transparency ... [but] do not consider that the absence of this information renders the Manual inconsistent with the s 150A purpose.”<sup>3</sup>

As the Commission is aware, we published a list of all product types which we define as Qualifying Materials in our F22 Base Milk Price Reasons Paper, which we believe satisfies the Commission’s request that we publish a list of all products which meet the criteria for ‘generic product specifications’.

With respect to the Commission’s ongoing interest in our disclosing in the Manual details of the ‘material change threshold’ applicable to our decisions about whether or not to amend the Manual, we continue to believe that we cannot sensibly accommodate this request. We have previously explained the various circumstances which potentially give rise to a decision to amend the Manual, and believe a ‘materiality’ test, whether expressed as a number or a list of qualitative factors, is simply not relevant in most of these circumstances.<sup>4</sup> Most obviously, most of the substantive changes to the Manual in recent years have been made in response to matters raised by the Commission, and we do not apply any materiality lens in determining whether (or how) to address these matters. Similarly, if we identify a ‘gap’ or ambiguity in any provision in the Manual – as in 2020 in the case of Rule 23 (Within period reviews), where we identified gaps in the rule’s coverage – our policy is to rectify them, regardless of the materiality of the immediate or potential long-term impact.

## Changes in the Economic and Business Environment

We confirm we are not aware of any changes in the economic or business environment that would in our view necessitate a change to the Milk Price Manual for the F23 Season. In arriving at this view, we have had regard to the following:

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

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<sup>3</sup> F22 Final Manual Report, paragraphs 44 -56. P.15.

<sup>4</sup> Most recently in our submission on the Commission’s draft report on the 2019/2020 Manual. See [https://comcom.govt.nz/data/assets/pdf\\_file/0024/190338/Fonterra-Submission-on-draft-report-on-review-of-Fonterras-2019-20-Milk-price-manual-8-November-2019.pdf](https://comcom.govt.nz/data/assets/pdf_file/0024/190338/Fonterra-Submission-on-draft-report-on-review-of-Fonterras-2019-20-Milk-price-manual-8-November-2019.pdf).