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## 'Reasons' Paper in Support of Fonterra's Milk Price Manual for the 2021/22 Season

30 July 2021

## Glossary

F21 Final Manual Report	Commerce Commission, Review of Fonterra's 2020/21 Milk Price Manual, Final Report, 15 December 2020, <a href="https://comcom.govt.nz/_data/assets/pdf_file/0014/230270/Final-report-Review-of-Fonterras-Milk-Price-Manual-15-December-2020.pdf">https://comcom.govt.nz/_data/assets/pdf_file/0014/230270/Final-report-Review-of-Fonterras-Milk-Price-Manual-15-December-2020.pdf</a>
F21 Base Milk Price Reasons Paper	Fonterra Co-operative Group Limited, 'Reasons Paper' in support of Fonterra's Base Milk Price for the 2020/21 Season (Public Version), 1 July 2021, <a href="https://comcom.govt.nz/_data/assets/pdf_file/0042/258999/Fonterra-Reasons-paper-on-review-of-202021-base-milk-price-calculation-1-July-2021.pdf">https://comcom.govt.nz/_data/assets/pdf_file/0042/258999/Fonterra-Reasons-paper-on-review-of-202021-base-milk-price-calculation-1-July-2021.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), skim milk powder (SMP), buttermilk powder (BMP), butter and anhydrous milkfat (AMF)
F22 Season	The period commencing on 1 June 2021 and ending on 31 May 2022, also referred to as the 2021/22 season.

30 July 2021

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 2021/22 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 2021/22 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

Andrew Cordner  
Director Legal

## 1. 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 2021/22 Season (the F22 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 2020) (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 2020/21 season (the F21 Manual).

On 23 June 2021 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 relevant, we explain their rationale below. In all other respects, the F22 Manual is identical to the F21 Manual, in respect of which Fonterra submitted a certification and reasons paper on 1 August 2020. 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 – 2021 seasons.

We have also recently provided (in our 'reasons paper' in respect of the 2020/21 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 to the F22 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 2021/22 season.

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. Brief comments on the rationale for each amendment are also included in this attachment.

<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. We have separately provided the Commission with the Panel's recommendations to the Fonterra Board on amendments to the Manual.

We have separately provided to the Commission a paper to Fonterra's board of directors dated 23 June 2021, setting out the Milk Price Panel's recommendations with respect to amendments to the Milk Price Manual.

## 2. Amendments to the Manual for F22

The only changes to the Manual for F22 are intended to address some minor matters raised by the Commerce Commission in its Final Report on the F21 Manual. The relevant amendments and their rationale are set out in the table below.

Manual Reference	Amendment	Comment
Rule 23, p.46	<p>Amended to make it explicit that “where feasible, the amended value should be calculated in a manner that does not result in an actual outcome to Fonterra being passed in full through into the Farmgate Milk Price” in any instance where a within-period review determines an input should be revised outside of a four-yearly ‘reset’ cycle.</p> <p>We have also made some ordering changes to improve the logical flow of the Rule.</p>	<p>This amendment is consistent with our comment to the Commission in our submission on the draft 2020/21 Manual Report that we would provide that, where feasible, an amended value should be calculated in a manner that does not result in an actual outcome to Fonterra being passed in full through into the Farmgate Milk Price.</p> <p>This was in response to the Commission’s finding that “Fonterra’s amendments to Rule 23 is not consistent with the efficiency dimension of s 150A of the Act. Having the ability to apply the outcome of a Within-Period Review to the year in which the review is undertaken could give rise to the use of actual rather than notional inputs, potentially reducing Fonterra’s incentive to operate efficiently. We recommend that the rule be amended to make it clear that current year actual inputs cannot be used to replace notional inputs in the year of review, except where it is impracticable to obtain notional data.”</p>
Rule 8, p.36, and Glossary, p.86	<p>Rule 8 (Benchmark selling price) amended to include a reference to ‘freely-contested global markets’ (consistent with Principle 2) and definition of ‘freely-contested global markets’ added to the Glossary in Part C.</p>	<p>This amendment responds to the Commission’s proposal in the Final F21 Manual Report that “The conditions that apply to sales that are not considered to be transacted on freely contestable markets should be specified in more detail in Principle 2 of the Manual to clarify how this principle is to be applied.”</p> <p>We do not consider it appropriate to directly amend Principle 2, among other reasons because this would require a shareholder vote, as the Principles are also included in Fonterra’s constitution, but consider the amendment addresses the Commission’s request by making it explicit that sales which are not transacted on freely-contested global markets (now defined as markets where there are not significant barriers to access by Fonterra’s NZ competitors) are not included in the Milk Price revenue calculation.</p>
Pages 19, 37, 63 and 68.	<p>Clarifying amendments in instances where the term ‘prevailing’ is used in different contexts:</p>	<p>These amendments respond to the Commission’s observation in the F21 Final Manual Report that: “The term ‘prevailing’ is used in a number of rules in the Manual. We consider that defining the term ‘prevailing’ would provide greater clarity in respect of the inputs required to be used by these rules.”</p> <p>On review, we found that the term ‘prevailing’ is used in eight instances in the Manual, and that:</p>

- It is arguably redundant in one instance, where we have deleted the term (p.68, in the definition of Lactose Payable Days).
  - In two instances the term 'normal' (e.g., 'normal commercial terms') better reflects the Manual's intent (p.19, reference to selling prices, Rule 8, p.36, definition of Benchmark Selling Prices).
  - The remaining references are all to 'prevailing', or current, market prices, and while we consider this meaning generally appears clear in context we have inserted 'market' in front of 'prices' in three instances (in the Part C definitions of Benchmark Selling Price, Qualifying Reference Sales, and Qualifying Outlier Sale).
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### 3. Other Matters

For completeness, we note that we have not changed our position on the following matters summarised in the Commission's F21 Final Manual Report, and again summarise our reasons in the table below.

Proposal	Response
<p>We consider that the disclosure of what constitutes a 'material change', when considering whether a change to the Manual should be made, will provide greater transparency.</p>	<p>As previously explained we do not consider it possible to codify in the Manual the full range of circumstances where we would consider it appropriate to amend the Manual, noting that most changes to the Milk Price methodology, including changes which result in a material change to the Milk Price (which would be publicly disclosed) do not require an amendment to the Manual.</p>
<p>We have also carried forward our conclusion from previous reviews that disclosure in the Manual of the capacity for both primary and secondary plants would better promote the purpose in s 150A.</p>	<p>We have previously explained, including in our submission on the 2020/21 Manual, our position that the Manual is not the appropriate vehicle for disclosures about the specific values of inputs into the Milk Price, and that we will continue to disclose this information for the following season in our 1 July base milk price Reasons Paper each year (noting this is published before the next year's Manual). We made these disclosures (noting also that assumed plant capacities would remain unchanged for the next four years) on p.9 of our F21 Base Milk Price Reasons Paper.</p>
<p>The publication of the list of all products that constitute 'Generic product specifications' in the Manual would greatly assist clarity of what is a standard product offering;</p>	<p>The Manual sets out the criteria used to determine which products are Qualifying Materials, and therefore potentially used in the Milk Price calculation. A Qualifying Material must, among other things, be a 'generic product specification' defined as a specification sold in multiple regions, to multiple customers, through Fonterra's standard sales channels, and which can be substituted for other Qualifying Materials.</p> <p>These criteria are in our view comprehensive, but the Commission is requesting that we include in the Manual the results from the application of the criteria. As noted above, we do not consider it appropriate as a matter of general principle to include in the Manual the outcomes from the application of the Manual's rules and processes, but we will continue to look for other means of providing additional information about the range of product specifications included in the Milk Price calculation, noting however the need to take into account Fonterra's legitimate commercial interests. (SKU level information, for example, often contains commercially sensitive details on Fonterra's customers.)</p>

## 4. 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 F22 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.