1 September 2017

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REVIEW OF FONTERRA'S 2016/17 BASE MILK PRICE CALCULATION

We set out in this letter Fonterra's response to the Commission's draft report on its review of Fonterra's 2016 / 17 base milk price, released on 15 August 2017 ("Draft Report").

The attachments to this letter address the Commission's comments on the asset beta, and on transparency of sales information in the context of the inclusion of off-GDT sales of WMP, SMP and AMF in the milk price in the Draft Report.

Please contact me if you have any questions or would like further information.

Yours sincerely

Andrew Cordner

Director Legal

Attachment 1 – Asset Beta

Executive Summary

Our previous submissions to the Commission in support of our selected asset beta of 0.38 have included analysis of an extended set of 'comparator' businesses, either with dairy operations or which undertake activities that are otherwise analogous to dairy businesses. The average asset beta for our comparator set is 0.51.

We have previously explained the reasons why we consider the difference between the sample mean of 0.51 and our selected asset beta of 0.38 is supportable. Most recently we have argued that whereas the notional milk price business (NMPB) is a 'pure' commodity business, all the comparators have substantial non-commodity operations. We therefore consider it necessary to decompose the asset betas observed for the comparators into the asset betas applicable to their non-commodity and commodity operations. If the average asset betas applicable to the comparators' non-commodity businesses are generally be higher than the commodity business equivalents, this decomposition will imply lower average asset betas for the comparators commodity operations.

The Commission has responded to our position by noting they do not consider we have demonstrated that the average asset betas attributable to the comparators non-commodity businesses will in fact be higher than the average asset betas for their commodity businesses, on the basis that we have not provided sufficient evidence that dairy processors generally have less ability to pass systematic risk in respect of their non-commodity businesses through to suppliers of raw milk. The Commission has therefore requested further information on this point.

This attachment addresses the Commission's request for further information by identifying the conditions that would have to hold for the comparators to be able to fully pass their exposure to systematic risk, either in full or with respect to specific parts of their businesses, onto suppliers of raw milk. These conditions include:

- Raw milk comprising a sufficiently large share of a comparator's inputs for raw milk suppliers to in fact be able to absorb the comparator's systematic risk. Raw milk constitutes a significantly smaller proportion of total inputs for all other comparators for which information is readily available than it does for Fonterra or Synlait.
- There would have to be no regulatory constraints on passing systematic risk through into milk prices. A number of the comparators operate in markets in which milk prices are highly regulated.
- Where a number of processors compete for milk in a market, it will only be feasible for most of them to pass systematic risk onto suppliers if they also compete in largely the same markets for their output. This condition does not appear to hold for a number of the comparators.
- More generally, there are a number of other aspects of market structure that would have to be present for most processors in a market to be able to pass on their exposure to systematic risk. We identify a number of instances where these aspects do not appear to be present.
- We also explain that the transfer pricing mechanisms that are prevalent in vertically integrated dairy businesses are also not conducive to the pass through of non-commodity systematic risk into milk prices.

Based on this analysis, we conclude most of the comparators will have limited ability to pass their exposure to systematic risk onto their suppliers, supporting our position that the asset betas attaching to the comparator's non-commodity businesses should generally be higher than the asset betas for their commodity businesses (and more specifically, to the asset beta for either the notional milk price business (NMPB) or Fonterra's commodity business).

Introduction

1. We provide in this attachment our response to the Commission's observations on asset beta in the draft report and in the Commission's paper titled 'Emerging views on asset beta', released on 20 July 2017. In brief, the Commission has explained that:
   - "Looking at the market evidence, we cannot conclude that Fonterra's point estimate [of 0.38] is not practically feasible … but at the same time we consider that a 0.38 estimate is a substantial departure from the sample mean of 0.48 to 0.52" (paras 2.60 – 2.61).
   - While the Commission has undertaken some limited further analysis of its own, it considers "this evidence is not sufficiently robust to positively conclude that Fonterra's point estimate of 0.38 is practically feasible" (para 2.68).
   - "In order to … be confident that the departure from the sample mean based on differences in systematic risk is justified, we need better information on the extent to which the comparators pass on systematic risk [including from non-commodity sales] in the way they set milk prices paid to farmers" (para 2.73).

Background

2. In our follow-up comments to the Commission on the 2016/17 base milk price calculation review workshop, we:[1]
   - Provided additional information on the milk pricing mechanisms employed by the companies in our comparator company set with dairy operations (23 of the 40 companies).
   - Restated and expanded on the argument we have made previously, to the effect that it is in our view necessary to decompose the asset betas of the comparator companies into the asset betas applicable to their commodity processing operations and the asset betas applicable to their other operations.
   - Explained that all the companies in our comparator set have extensive non-commodity businesses, which in most cases are significantly larger than their commodity operations.

3. In its 'emerging views' paper, the Commission responded to our follow-up comments by noting that:
   - The Commission is not yet convinced that we have provided as much information as is potentially available on the comparators ability to pass on systematic risk in the way they set milk prices paid to farmers (para 50).
   - As a related matter, the Commission is not convinced that the systematic risk attaching to the comparator companies' non-dairy-commodity related businesses is necessarily different to the systematic risk attaching to their commodity businesses. In particular, the Commission in effect considers we have not provided evidence that the comparator

[1] The cover letter and attachments A (responses prepared by the MPG) and B (supplementary report by Dr Alastair Marsden) dated 13 June 2017, http://comcom.govt.nz/regulated-industries/dairy-industry/review-of-fonterra-s-farm-gate-milk-price-and-manual/statutory-review-of-milk-price-calculation-2/review-of-milk-price-calculation-201617-season/

companies have less ability to transfer-price variations in returns to their non-commodity businesses onto suppliers of milk than to transfer price variations in returns to their commodity businesses through to suppliers of milk.

4. Our comparator set includes 23 companies with significant dairy operations, and the discussion in this attachment focuses on just these companies. (Our comparator set also included 17 other companies generally regarded as comparable to companies with varying forms of dairy operations.) If, as the Commission, recommends in para 2.45.2, we exclude Bright Dairy & Food, our set of dairy comparators reduces to 22. Our average estimated asset betas calculated using weekly observations over four two year periods and four-weekly observations over four five year periods for the remaining dairy comparators are summarised in the table below.[2]

Dairy comparator	weekly estimates	4 weekly estimates	Average
Savencia	0.08	0.18	0.13
Fonterra	0.10	0.29	0.20
Want Want China Holdings	0.25	0.19	0.22
China Mengniu	0.29	0.41	0.35
Dean Foods	0.37	0.36	0.37
Parmalat SpA	0.20	0.54	0.37
MGC	0.39	-	0.39
Synlait	0.33	0.52	0.43
Dairy Crest	0.47	0.50	0.49
Saputo	0.44	0.58	0.51
Glanbia	0.55	0.49	0.52
Kerry Group	0.53	0.52	0.53
Danone	0.62	0.52	0.57
Grupo Lala	0.77	0.62	0.70
Inner Mongolia Yili	0.82	0.66	0.74
Bega	0.87	0.65	0.76
Yakult	0.88	0.74	0.81
Nestle S.A.	0.74	0.66	0.70
Mead Johnson	0.88	0.78	0.83
Chr. Hansen	0.70	0.54	0.62
Kraft Heinz	0.58	0.19	0.43
Unilever	0.73	0.72	0.73
Average	**0.53**	**0.51**	**0.52**
Adjusted average (1)	**0.48**	**0.50**	**0.49**
Adjusted average (2)	**0.47**	**0.49**	**0.47**

5. The average calculated asset betas for this subsample are 0.53 and 0.51, with an overall average of 0.52, compared to the average of 0.51 for our original sample. We also report two 'adjusted averages':

[2] Per the Commission's suggestion in para 2.45.3 we have excluded the Murray Goulburn estimates calculated using 5 years of data.

- The first adjusted average, averaging 0.49 across the two approaches, is obtained by excluding Mead Johnson, Chr. Hansen, Kraft Heinz and Unilever, on the basis that none of these companies purchases material volumes of raw milk, and therefore they do not have any ability to pass exposure to systematic risk through to farmers. (Another reason for exclusion is that none of these businesses bear any resemblance to a commodity dairy processor.)
- The second adjusted average, averaging 0.47 across the two approaches, also excludes Nestle, on the basis that dairy comprises just 18 percent of Nestle's revenue, and that its asset beta will therefore primarily reflect its non-dairy operations.[3]

Comparator companies' ability to pass non-commodity risk through to milk suppliers

6. As noted above, the Commission has discounted the weight placed by us on the differences between the non-commodity / commodity mix of companies in the comparator set relative to either the NMPB or Fonterra or Synlait, on the basis that we have not demonstrated that there is any difference in the extent to which commodity and non-commodity-related price risk is passed through to farmers through the relevant companies' milk price mechanisms. (The reason we made this distinction is that we believe dairy businesses generally do not have any greater ability than any other supplier of finished or non-commoditised intermediate goods to downstream purchasers to pass their exposure to systematic risk onto a subset of their suppliers. The Commission is in effect arguing that we have not provided sufficient support for this belief.)

7. A difficulty we face in addressing the Commission's request is that the information required to definitively determine the extent to which individual comparator companies can (and, more importantly, do) pass the consequences of their exposure to systematic risk in their non-commodity businesses onto milk suppliers is in large part information that is not in the public domain (and much of it will be commercially confidential to the relevant companies). In some markets – most obviously Europe – we can observe prices paid by individual processors, but even for these markets we do not have any information on the internal processes employed by processors to set prices.

8. It follows that we must therefore resort to an alternative approach to address the Commission's request for further information. The approach we have adopted involves identifying the conditions we consider would have to obtain for businesses in our comparator set to be able to transfer the systematic portion of variability in returns to their non-commodity businesses through to suppliers of raw milk, and then evaluating the comparators against these conditions.

9. The conditions we consider would have to obtain for the dairy companies in our comparator set to be able to transfer their exposure to systematic risk in their non-commodity businesses onto suppliers of raw milk are summarised in the italicised headings below.

[3] Further, while Nestle purchases in absolute terms a significant volume of raw milk in a number of markets, it also obtains a very substantial portion of its dairy inputs from other dairy processors, including Fonterra.

Raw milk would have to be a substantial input of the company in question

10. As noted above, four of the companies with dairy operations in our comparator set (Chr. Hansen, Mead Johnson, Kraft Heinz and Unilever) do not purchase raw milk, while others purchase a significant proportion of their dairy inputs from other processors (and therefore at market commodity prices), though it is not possible to get precise information on their splits between raw milk and processed dairy inputs. Companies falling in this latter category include Want Want, Kerry and Nestle. We are also aware that some comparators operating in developing markets switch, at least at the margin, between buying local fresh milk and milk powder as inputs into UHT products.

11. In addition, it appears plausible to assume that a processor's ability to pass its exposure to systematic risk onto its suppliers will depend on the relative significance of raw milk as an input. In turn, the value of raw milk as a proportion of a processor's total input costs varies systematically with the extent to which the processor's output comprises commoditised products or products involving higher levels of processing or (for example) marketing. This point is demonstrated in the following graphic.[4]

IFCN Top 20 Milk Processor by milk intake

Rank 2016	Company name	Origin & main operation countries	Milk intake in mill. t ME	Estimated turnover per kg milk, in USD	Market share in % of world milk production
1	Dairy Farmers of America	USA	28.1	0.5	3.6%
2	Fonterra	New Zealand/ others	22.1	0.6	2.8%
3	Groupe Lactalis	France/others	15.1	1.3	1.9%
4	Arla Foods	Denmark/Sweden/UK	14.2	0.8	1.8%
5	Nestlé	Switzerland/others	14.0*	1.9*	1.8%
6	FrieslandCampina	Netherlands/others	12.6*	1.0*	1.6%
7	Dean Foods	USA	10.3	0.8	1.3%
8	DMK (incl.DOC Kaas)	Germany/Netherlands	7.8	0.9	1.0%
9	Saputo	Canada/USA/others	7.7	1.1	1.0%
10	California Dairies	USA	7.7	0.5	1.0%
11	Danone	France/others	7.5	2.4	1.0%
12	Yili Group	China	6.8*	1.4*	0.9%
13	Amul (GCMMF)	India	6.5	0.8	0.8%
14	Müller	Germany/UK/others	6.3	1.2	0.8%
15	Glanbia Group	Ireland/USA/others	6.1	0.7	0.8%
16	Agropur	Canada/USA	5.8	1.0	0.7%
17	Land O' Lakes	USA	5.8*	0.7*	0.7%
18	Mengniu	China	5.8	1.4	0.7%
19	Groupe Sodiaal	France	5.2	1.1	0.7%
20	Schreiber foods	USA	4.5*	1.1*	0.6%
	Sum of Top 20		**200**	**1.0**	**25.4%**

Source: IFCN data collection, analysis and estimates (feedback to improve our estimations is always very welcome). Data represents in most cases the year 2015. * = IFCN estimation.

Explanation of variables: 1. Milk intake represents milk volume collected and dairy commodity purchases (in milk equivalent) for the main company and its subsidiaries. Milk intake figures in mill tons. In some cases recalculated from litre (1litre = 1033 kg). In the milk intake a double counting is possible once a processor sources milk from a collecting cooperative (e.g. DFA) or is sourcing milk in form of dairy products. This means that the total milk volume of the top 20 processors can be overestimated. **2. Turnover per kg milk**: Dairy turnover divided by milk intake. This indicator gives an indication of value creation per kg of milk processed. This figure shall be interpreted with care as the precise number is difficult to define and a direct comparability between companies is limited.

12. We note the following points with respect to the table above:

[4] http://www.dairyreporter.com/Manufacturers/Who-are-the-world-s-top-20-milk-processors, with data sourced from IFCN. Note in particular that 'milk intake' includes both raw milk and IFCN's estimates of dairy commodity purchases, in raw milk equivalents. Consequently, estimated USD revenue per kg of raw milk, rather than raw milk equivalents, will be materially higher for some of these companies.

- Eight of the processors listed in the table are included in our comparator set, with the remainder being either (unlisted) co-operatives or private companies.[5]
- Of the processors in our comparator set, Fonterra had by far the lowest estimated USD revenue per litre, at approximately US 60 cents. By way of comparison, the FY15 Farmgate Milk Price calculation assumed revenue of US 40 cents per litre, which is therefore a reasonable benchmark for 'commodity only' returns against which to compare the processors listed above.
- Glanbia Group is the next lowest, at US 70 cents, but includes Glanbia Ingredients as well as the listed comparator Glanbia plc (for much of the period over which our asset betas are estimated Glanbia plc had a 40% interest in Glanbia Ingredients). In 2015, Glanbia Ingredients had revenue of 871m Euro, or approximately USD 970m, and collected 2.03 billion litres of milk, implying Glanbia plc consumed approximately 4 billion litres on a raw milk equivalent basis, for average revenue of around USD 0.85, or 40 percent more than Fonterra.[6]
- While there was some variation in 2015 in both average milk prices in the countries in which the comparators operated, and in average returns per litre, these differences were much lower than the differences in average revenue per litre,[7] implying the other comparators had far higher non-milk costs per litre than both Fonterra and the notional milk price business, and therefore considerably less ability (holding other things equal) to pass systematic shocks in their non-milk costs through into their milk prices.

There would have to be no substantive regulatory (or quasi regulatory) impediments to passing the consequences of exposure to systematic risk through to milk suppliers

13. Several of the comparators operate primarily in countries such as France, Canada and the US where the local regulatory framework constrains their ability to 'flex' the prices paid for raw milk. Others operate primarily in markets, like China, where the government sets more informal but nonetheless binding constraints on raw milk prices. In particular:
    - Several of our comparators procure significant volumes of raw milk in the US, including Dean Foods, Saputo, Nestle, Danone and Glanbia plc. In brief, US dairy processors are generally required to pay minimum prices that are set monthly by reference to a set of prevailing commodity prices. This system results in general commodity price risk (and, effectively, foreign exchange risk) being passed through to suppliers, but in individual processors having less ability to transfer to suppliers either processor-specific risk or systematic risk arising from sources other than variations in commodity prices
    - Saputo generates 36% of its revenue in the highly regulated Canadian market.

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[5] Dairy Farmers of America, Arla, Friesland Campina, DMK, California Dairies, Amul, Agropur, Land O'Lakes and Sodiaal are co-operatives. Muller and Schreiber Foods are private companies. Lactalis is also a private company, but owns 89% of Parmalat, which is included in our comparator set.

[6] Source: https://www.glanbiaconnect.com/medias/2015-Co-op-Annual-Report-lowres.pdf?context=bWFzdGVyfGltYWdlc3wzMjYwNzgwfGFwcGxpY2F0aW9uL3BkZnxpbWFnZXMvODgzMjc5NTUwODc2Ni5wZGZ8MzIxYTdhNjI3YzMyYzJjM2YxMGIzZmMzMGRiODEyN2VhN2Y0OTk5ZmExYzA3YzFhNzg4ZmQ4NDk0ZDk0N2ZiNQ

[7] The IFCN 2016 Dairy Report cited a 'world' milk price of US 28 cents for 2015, with average prices in Europe and the US of between US 30 – 40 cents per litre. Fonterra's FY15 Milk Price of NZD 4.40 was equivalent to approximately US 26 cents per standardised litre.

- Savencia procures most of its milk in France, where it acquired 2.9 billion litres in 2015, compared to Danone's 650 million litres.[8] The French milk price system "consists of a base price for standard milk … derived from the average base price applicable in the previous year, plus a monthly adjustment based on … selling prices achieved for dairy products in the previous period."[9] A higher weight is placed on selling prices in the domestic market, which are subject to less fluctuation, than more volatile export prices.

Homogeneity of processors competing for milk from the same pool

14. In countries where multiple processors are competing for raw milk, it will only be feasible for (all) those processors to pass their exposure to non-commodity price related systematic risk onto suppliers if most of those processors are in fact exposed to the same sources and level of systematic risk (i.e., if they also compete in largely the same markets for their output). (Consider for example a situation where there are only two processors in a country, one solely supplying the local market – and therefore exposed to local GDP fluctuations – and the other solely supplying an offshore market (say the China infant formula market), and where milk suppliers can switch between processors. It would not appear possible for both processors to be able to pass all their systematic risk back through into their milk prices.)

15. In evaluating our comparators against this criterion, we note:
    - The condition arguably holds for Fonterra and Synlait with respect to their commodity businesses, but not their non-commodity businesses. (Synlait's non-commodity business is mainly in the nutritionals powders segment, whereas Fonterra operates across a much broader range of segments, including the NZ, Australia and Chile liquid and chilled segments, consumer cheese in a range of markets, food service, etc.)
    - The comparators operating in the Australian market (Fonterra, Murray Goulburn, Saputo and Bega) have quite different levels of relative exposure to the domestic Australian market and to export markets.
    - Three of the comparators (Mengiu, Want Want and Yili) procure raw milk, and compete, in China, so this condition arguably holds for them. Want Want is more diversified, with only circa 50 percent of its revenue from dairy products. Mengiu and Yili derive circa 85 percent and 73 percent respectively of their revenue from the sale of UHT milk, but have very different average asset betas (0.35 vs 0.74).

Market structure

16. The 'processor homogeneity' issue considered in the preceding section is a subset of a more general market structure issue. Other things equal, we would expect individual processors' ability to pass systematic risk through to milk suppliers will be a function of market structure:
    - At one extreme, in a market such as New Zealand, where there is a single dominant processor, that processor will have considerable ability (absent regulatory constraints) to pass its full exposure to both systematic and non-systematic risk through to its suppliers. To the extent it chooses to act on that ability, and to the extent other processors compete in the same output markets, other processors will also be able to pass on their systematic risk.

[8] IFCN 2016 Dairy Report, p.119.
[9] LTO International comparison of producer prices for milk, http://milkprices.nl/Reports/MPV_REPORT_2016.pdf

- At another extreme, in a market where no individual processor has market power, but processors are sufficiently homogeneous as to face materially the same sources and level of systematic risk, we might expect to see that systematic risk (whether it is related to commodity or non-commodity products) passed through to suppliers. But where these processors specialised in different segments of the market (e.g. home brand white milk vs luxury ice cream), and therefore faced different levels of exposure to local GDP fluctuations, it would again not be possible for most individual processors to pass their full exposure to systematic risk onto their suppliers.
- The non-NZ comparators, in our view, all procure milk in markets that are somewhere between these extremes. While they may therefore be in a position to pass onto suppliers that portion of systematic risk that is common to all (or most) processors, most will not be able to pass through their full exposure to systematic risk.
- Individual processors ability to 'dictate' milk prices paid to their suppliers will also depend on a range of other factors, including the balance between supply of and demand for milk (e.g., whether or not dairy processors have excess capacity).

17. In considering comparator companies which have not otherwise been discussed extensively above in this context, we note:
    - Yakult does not rank in the top ten procurers of milk in Japan; the leading processor collects less than 20 percent of milk supplied;[10] and Yakult operates in a relatively specialised market segment (probiotic foods and beverages). Therefore, at face we might expect Yakult to face a higher exposure to systematic risk than processors operating in most other dairy segments. These observations are consistent with Yakult's average asset beta of 0.83.
    - At the end of 2015 Dairy Crest sold its fresh milk business to Muller, at which time it went from being the largest procurer of raw milk in the UK (circa 2.2 billion litres) to being outside the top six at circa 500 million litres.[11] The disposal of its fresh milk business meant Dairy Crest's product mix went from being heavily weighted toward fresh milk to a product mix of branded cheese and butter (and by-products). This change appears to have resulted in a structural decrease in Dairy Crest's asset beta: Dairy Crest's asset beta (calculated using weekly observations over a two year period) decreased from an average of 0.59 over the four quarters to 30 September 2015 to 0.47 over the four quarters to 31 March 2017. The change in average asset beta implies that the systematic risk faced by Dairy Crest's shareholders is a function of its product mix, and that the business was unable to pass through into its milk price a material portion of its exposure to systematic risk at least prior to 2016.
    - Kerry Group is the second largest procurer of milk in Ireland, behind Glanbia. Kerry competes primarily in branded segments, on a global basis, which are mainly quite distinct to the segments in which Glanbia (and the other larger Irish processors) compete.
    - Parmalat is the fifth largest procurer in Italy (but also procures raw milk in a number of other countries). Italian milk prices are more stable than elsewhere in Europe, and the top ten processors only collect 22 percent of milk.

[10] IFCN Dairy Report 2016, p.134.
[11] IFCN Dairy Report 2014, p.173 and http://www.dairycrest.co.uk

Other considerations

18. Most of our comparators which procure raw milk are vertically integrated businesses, where the downstream business units either actually purchase some of their dairy inputs from third parties or at least have the option to do so. Our experience is that such businesses will, for well-established reasons, transfer-price dairy inputs between divisions at arm's length market-based prices. Given the milk procurement functions in such businesses will normally be appropriately incentivised to maximise earnings, they can generally be expected to look to resist any pressure to pass the consequences of systematic risk in downstream business units through into the prices they pay for raw milk.[12]

19. We have anecdotal evidence on the transfer pricing arrangements of a number of the multi-division comparators, and are not aware of any that do not set transfer prices by reference to current market prices.

20. Finally, we note that while we have focused in this submission on addressing the Commission's request for further information, we remain of the view that the Commission's preferred approach to estimating asset beta is of limited usefulness in this instance, on the basis that:
    - As demonstrated above, the differences between most of the real world 'comparators' and the NMPB are sufficiently significant as to mean it is difficult to conclude that it is appropriate to place primary emphasis on the comparator set to determine an appropriate asset beta for the NMPB.
    - On the other hand, because Fonterra's Farmgate Milk Price is explicitly determined using a quasi-regulatory building blocks methodology, the level of systematic risk faced by other businesses subject to a similar regulatory framework is of direct relevance in determining an appropriate asset beta for the NPMB.

21. Consequently, we continue to consider it more appropriate in this instance to place primary emphasis on EDBs, and to use the assessment against the comparators as a cross-check for reasonableness.

[12] Incentives to set arm's length transfer prices will of course also be reinforced by the general requirement to do so by tax authorities for businesses transacting across borders.

Attachment 2

Transparency of sales information in the context of the inclusion of off-GDT sales of WMP, SMP and AMF in the milk price

1. We have noted the Commission's comments on transparency in reaction to concerns raised by the IPs and its suggestions for further disclosure by Fonterra. We address these below.

2. In paragraph 2.109 of its Draft Report, the Commission notes that we stated that we expected to publish periodic updates on both off-GDT margins and historic GDT prices but that we were still considering the format, precise content and timing of this information. We have carefully considered the most useful approach to publishing meaningful periodic updates on the impact of including off-GDT WMP, SMP and AMF prices in the Farmgate Milk Price. In doing so, we have considered the best way to do this without disclosing commercially sensitive information.

3. Based on this review, we have elected to regularly publish our current forecast of the cents per kgMS impact from the inclusion of off-GDT sales of WMP, SMP and AMF in the Milk Price calculation.

4. This commenced in the November 2016 Global Dairy Update ("GDU") for the quarter ended 31 October 2016, and has continued each quarter since then. Each GDU is released to the NZX and is available on Fonterra.com.

5. We also intend to disclose:

    a. the cents per kgMS impact from the inclusion of the additional off-GDT sales for the full year in the annual Milk Price Statement.

    b. the average full season GDT selling prices for each RCP in the annual Milk Price Statement.

6. We consider this information on Milk Price impact provides the most meaningful informational value for parties interested in understanding the impact of off-GDT WMP, SMP and AMF sales on the forecast Farmgate Milk Price. This is because it incorporates all the information available to Fonterra, run through Fonterra's Milk Price Model, and provides the most accurate view available of the end to end Milk Price impact of these off-GDT prices.

7. At the same time, this approach does not result in the publication of commercially sensitive pricing data.

8. In further considering the nature of the information to be provided on off-GDT sales, we determined that the disclosure of the margins for sales of off-GDT product included in the Milk Price calculation on a periodic basis during the year would not be helpful and would likely be misleading for interested parties. Even if these margins were disclosed on a periodic basis through the year, the disclosure would need to be significantly qualified given the level of variability of the margins and our knowledge of relevant (and obviously confidential) forward looking information throughout the year (with further potential for misinterpretation of the qualifications made).

9. We affirm that GDT remains the primary reference point for pricing informing the Milk Price for sales of RCPs made outside the GDT platform. Fonterra is therefore committed to maintaining the relevance and credibility of the GDT platform.

10. In Table 2.3 in its Draft Report, the Commission also provided comments on the five specific requests from Independent Processors for additional information on off-GDT sales included in the Milk Price calculation. We address each of these five requests in the following table:

Area	***Additional transparency of off-GDT price information requested***	***Our suggested steps for Fonterra***	**Fonterra response**
Sales criteria	*IPs request greater transparency of off-GDT sales criteria.*	*We appreciate that Fonterra has attempted to provide greater clarity here with an Attachment in its Reasons paper outlining further detail on the approach applied in practice and on the product specifications included and excluded from the calculation. We invite Fonterra to consider defining "standard packaging", "specialised plant or technical resources", "standard product offerings" and "standard packaging' in its Milk Price Manual.*	We intend including definitions of these terms in the Milk Price Manual.
Selling prices	*IPs request monthly GDT selling prices of the reference commodity products (RCPs) expressed in standard specification product (SSP) price equivalents.*	*We note IPs concern but do not believe such disclosure is required for us to conclude on our review.*	We agree with the Commission's conclusion.
Sales phasing	*IPs request: - Monthly GDT actual sales phasing (shipment date) of sales from which the prices in (a) are derived (expressed as a percentage) - Monthly actual sales phasing (shipment date) of the RCP sales (GDT and off-GDT) from which the prices in (a) are derived (expressed as a percentage); and - Monthly Notional Producer sales phasing (shipment date) for the current milk price season (expressed as a percentage).*	*We note that increased use of off-GDT sales with limited transparency makes it difficult to assess whether there is potential for impacts on off-GDT sales by holding back or advancing the sales of inventory to achieve a better price (i.e., timing advantage). Therefore the assumed monthly Notional Producer sales phasing could be an issue and this would potentially be alleviated by more disclosure of the assumed sales phasing.*	Sales phasing assumptions have not changed as a result of including off-GDT sales of WMP, SMP and AMF in the Milk price. The phasing of sales is a tactical decision made by Fonterra to maximise value. The information available to Fonterra when making this decision is no different from that available to any of Fonterra's competitors. However Fonterra's strategy and tactical decisions about how to act based on that information are confidential to Fonterra and commercially sensitive. Actual and forecast sales phasings across the season are incorporated into the Milk Price forecasts provided by Fonterra under DIRA and in the information regarding the impact of including WMP, SMP and AMF off-GDT sales in the Milk Price across the year.

Selling prices	*IPs request monthly Notional Producer selling prices.*	*We agree that such disclosure would be informative to interested parties and that Fonterra should consider providing monthly off-GDT sales information on a comparative basis to that provided publicly from GDT.*	Fonterra publishes blended selling prices by quarter for each RCP in the Milk Price Statement after the end of each season. Monthly selling prices are highly commercially sensitive as they provide information about pricing decisions and activity to Fonterra's customers and competitors. Fonterra's regular Milk Price forecasts under DIRA, and quarterly disclosure of the impact of including off-GDT WMP, SMP and AMF sales in the Milk Price, provide the most complete and useful information value available to interested parties, whilst not compromising Fonterra's competitive position.
Volume	*The separate volumes of GDT and off-GDT sales for each RCP included in the milk price calculation.*	*We recommend that Fonterra discloses the percentage mix of off-GDT to on-GDT sales by RCP. Such disclosure would be more valuable to interested persons on a quarterly basis throughout the season rather than just annually on an ex-post basis.*	Fonterra's regular Milk Price forecasts under DIRA, and quarterly disclosure of the impact of including off-GDT WMP, SMP and AMF sales in the Milk Price, provide the most complete and useful information available to interested parties. Fonterra also considers that disclosure of the percentage mix of off-GDT sale and GDT sales will provide commercially sensitive information as to Fonterra's tactical sales strategies.

8. Fonterra does want to highlight and confirm that it provides the Commerce Commission with confidential access to revenue information (including information on off-GDT pricing and volumes) to the full extent requested by the Commission throughout the course of the Commission's Milk Price reviews, in order to enable the Commission to perform its functions required under DIRA.