

## **Review of Fonterra's 2022/23 Milk Price Manual:**

### **Dairy Industry Restructuring Act 2001**

#### **Draft report**

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## Associated documents

Publication date	Reference	Title
15 September 2022	ISBN 978-1-99-101230-2	<a href="#">Final report – Review of Fonterra’s 2021/22 Base Milk Price Calculation: Dairy Industry Restructuring Act 2001</a>
15 December 2021	ISSN 2382-1779	<a href="#">Final report – Review of Fonterra’s 2021/22 Milk Price Manual: Dairy Industry Restructuring Act 2001</a>
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# Chapter 1 Introduction and how you can provide your views

## Purpose of this report

1. This report sets out our draft conclusions from our statutory review of the extent to which Fonterra's 2022/23 Milk Price Manual (the **2022/23 Manual**) is consistent with the purposes of the base milk price monitoring regime (**monitoring regime**) under subpart 5A of the Dairy Industry Restructuring Act 2001 (**DIRA**).<sup>1</sup>
2. The Manual contains the methodology that will be used to calculate Fonterra's base milk price for the 2022/23 season.

## How this report is structured

3. Chapter 2 explains our review framework and the scope of our 2022/23 Manual review.
4. Chapter 3 sets out our draft conclusions.
5. Attachment A provides a glossary of the key terms and abbreviations used in this draft report.

## How you can provide your views

### Invitation to comment

6. As required under DIRA, we are consulting with Fonterra on this draft report.<sup>2</sup> We have also extended our consultation process to other interested parties.
7. We welcome stakeholder views on any aspects of this draft report before we finalise our conclusions. Your views on our draft report will help inform our final conclusions for our review.<sup>3</sup>

### Deadline for submissions

8. We invite submissions on this draft report from interested parties which we will consider when preparing our final report.
9. To allow us time to consider your views, submissions on this draft report must be provided to us no later than **12 noon, Tuesday 15 November 2022**.

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<sup>1</sup> DIRA, s 150A.

<sup>2</sup> DIRA, s 150U.

<sup>3</sup> DIRA, s 150U.

10. Our final report on the 2022/23 Milk Price Manual will be published on 15 December 2022.

### **Format of submissions**

11. Please address all submissions to:

Keston Ruxton, (Manager, Fuel and Dairy)

c/o [market.regulation@comcom.govt.nz](mailto:market.regulation@comcom.govt.nz)

Subject line: Milk Price Manual 2022/23

12. We prefer submissions in both a format suitable for word processing (such as a Microsoft Word doc), and a 'locked' format (such as a PDF) for publication on our website.
13. The protection of confidential information is something the Commission takes seriously. The process requires you to provide (if necessary) both a confidential and public version of your submission and to clearly identify the confidential and public versions.
14. When including commercially sensitive or confidential information in your submission, we offer the following guidance:
  - 14.1 Please provide a clearly labelled confidential version and public version of your submission. We intend to publish all public versions on our website.
  - 14.2 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.
15. Please note that all submissions we receive, including any parts that we do not publish, can be requested under the Official Information Act 1982. This means we would be required to release material that we do not publish unless good reason existed under the Official Information Act 1982 to withhold it. We would normally consult with the party that provided the information before any disclosure is made.

## Chapter 2 Our review framework

### Our approach for the Manual review

16. This report should be read along with, Our approach to reviewing Fonterra's Milk Price Manual and base milk price calculation (our **Approach paper**), which we have applied in this review and which forms part of this report. The Approach paper provides an overview of the approach we take in our reviews of Fonterra's Manual and base milk price calculation and includes:<sup>4</sup>
  - 16.1 an overview of how the base milk price is set;
  - 16.2 our interpretation of the key legislative provisions guiding our statutory reviews; and
  - 16.3 our analytical and practical approach to our statutory reviews.
17. The base milk price monitoring regime is intended to provide incentives for Fonterra to act efficiently, while providing for contestability in the market for the purchase of raw milk from farmers. The regime also promotes greater transparency of Fonterra's base milk price setting processes.<sup>5</sup>
18. We undertake a review of the Manual for each season. The Manual contains the methodology Fonterra uses to calculate its base milk price. As such, the Manual contains a set of definitions, rules and formulas specifying the inputs and process to be followed in calculating the base milk price.
19. We consider the extent to which the Manual is consistent with the purpose of subpart 5A of DIRA. In particular, our review considers the 'efficiency' and 'contestability' dimensions of the s 150A purpose as required by DIRA. Our review therefore focuses on whether the methodology used in the Manual:
  - 19.1 provides an incentive for Fonterra to operate efficiently (the 'efficiency dimension'); and
  - 19.2 adopts assumptions, inputs and processes that would be practically feasible for an efficient processor (the 'contestability dimension').<sup>6</sup>
20. As set out in the Approach paper, the efficiency dimension is met if Fonterra uses notional inputs in calculating the milk price (independent from Fonterra's actual data).

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<sup>4</sup> [Commerce Commission "Our approach to reviewing Fonterra's Milk Price Manual and base milk price calculation - 2021" \(5 July 2021\).](#)

<sup>5</sup> Dairy Industry Restructuring Amendment Bill (Government Bill) 2012, at 2.

<sup>6</sup> We consider the same 'efficiency' and 'contestability' dimensions when we carry out our base milk price calculation review.

21. Contestability is considered to be provided for if any notional costs, revenues, or other assumptions taken into account in calculating the base milk price are practically feasible for an efficient processor.<sup>7</sup>
22. To satisfy the provisions in s 150A, our interpretation is that our statutory review must assess the extent to which the Manual is consistent with both dimensions. We attach equal weight to both dimensions in our reviews. Our analytical approach to the efficiency and contestability dimensions is described in chapter 4 of the Approach paper.<sup>8</sup>
23. In practice, we focus our review each year on changes to the Manual from the previous year's Manual and on any unresolved issues carried over from our previous reviews.

### Scope of this review

24. DIRA requires Fonterra to provide us with the following information for consideration in our Manual review:<sup>9</sup>
  - 24.1 the Manual for the current season;
  - 24.2 any recommendations by the Milk Price Panel (**MPP**)<sup>10</sup> in relation to the setting of the base milk price;<sup>11</sup>
  - 24.3 notification of any change in the economic and business environment that, in Fonterra's view, requires a change to the Manual;
  - 24.4 certification on the extent to which Fonterra considers that the Manual is consistent with the s 150A purpose; and
  - 24.5 the reasoning behind the views expressed in Fonterra's certification.

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<sup>7</sup> DIRA, s 150A(2).

<sup>8</sup> [Commerce Commission "Our approach to reviewing Fonterra's Milk Price Manual and base milk price calculation – 2021" \(5 July 2021\).](#)

<sup>9</sup> DIRA, s 150L.

<sup>10</sup> The MPP is a committee that Fonterra is required to establish and maintain under s 150D of DIRA. The MPP is required, for each season, to supervise the calculation of the base milk price; advise Fonterra on the application of the Manual; and recommend the base milk price to Fonterra. See also [Fonterra "Attachment 1 – Base Milk Price Manual for the 2022/23 season \(marked up version\) - 1 August 2022" \(23 August 2022\), at 26.](#)

<sup>11</sup> Fonterra has "interpreted this provision as in fact relating to recommendations by the Milk Price Panel in relation to amendments to the Milk Price Manual." (See [Fonterra "Reasons Paper in support of Fonterra's Milk Price Manual for the 2022/23 season - 1 August 2022" \(23 August 2022\), at footnote 1.](#) We agree with this interpretation.

25. The above information, where relevant, has been provided by Fonterra and has been considered as part of our review. Specifically, Fonterra has provided us with: the Base Milk Price Manual for the 2022/23 season (marked-up version);<sup>12</sup>
- 25.2 a Reasons paper in support of Fonterra's Milk Price Manual for the 2022/23 season (**Fonterra's Reasons paper**);<sup>13</sup> and
  - 25.3 the MPP recommendations to Fonterra's Board with respect to amendments to the 2022/23 Manual.
26. The 'marked up' version of the 2022/23 Manual shows the changes that have been made to the previous season's version of the Manual. Fonterra has stated in its Reasons paper that the 'marked up' version of the 2022/23 Manual identifies all amendments to the Manual.<sup>14</sup> In addition, we have reviewed the MPP recommendations to Fonterra's Board and confirmed that all recommended amendments are reflected in the 2022/23 Manual.
27. We have focused on the amendments Fonterra has made to the Manual for the 2022/23 season and matters carried forward from previous reviews. This season, the only substantive change to the Manual was to Rule 42 on asset beta. The matters carried forward from previous reviews are:
- 27.1 materiality; and
  - 27.2 the DIRA definition of commodity.
28. For those parts of the Manual that have remained unchanged we have continued to rely on our previous conclusions. We are not aware of any other new information which would warrant reconsideration of our conclusions in previous Manual reviews, but welcome submissions in that regard.

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<sup>12</sup> [Fonterra "Attachment 1 – Base Milk Price Manual for the 2022/23 season \(marked up version\) - 1 August 2022" \(23 August 2022\).](#)

<sup>13</sup> [Fonterra "Reasons Paper in support of Fonterra's Milk Price Manual for the 2022/23 season - 1 August 2022" \(23 August 2022\).](#)

<sup>14</sup> [Fonterra "Reasons Paper in support of Fonterra's Milk Price Manual for the 2022/23 season - 1 August 2022" \(23 August 2022\), at 5.](#)



## Chapter 3 Draft conclusions

29. This chapter summarises our draft conclusions on the extent to which the 2022/23 Manual is consistent with the s 150A purpose.

### Our draft conclusions

30. Based on the information we have before us, our draft conclusions are:
- 30.1 Regarding Fonterra's amendments to the Manual since last year's review, our draft conclusion is that the amendments made are consistent with s 150A of DIRA.
  - 30.2 Our overall draft conclusion is that, the Manual is consistent with the statutory purpose set out in s 150A.

### Fonterra's amendments to the 2022/23 Manual

31. Fonterra has made the following amendments to the 2022/23 Manual:
- 31.1 Rule 42 asset beta; and
  - 31.2 Minor changes in contemplation of future review years for inputs into the base milk price calculation. We do not consider these changes necessitate review.

#### *Rule 42: asset beta*

#### This season's Manual change and reasons

32. Fonterra has amended Manual Rule 42 on asset beta for the 2022/23 season, which now reads:<sup>15</sup>

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.

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<sup>15</sup> [Fonterra "Attachment 1 – Base Milk Price Manual for the 2022/23 season \(marked up version\) - 1 August 2022" \(23 August 2022\) at 56.](#)

33. In its Reasons paper, Fonterra explains the rationale for this change:<sup>16</sup>

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.

Our review findings in last season’s Manual review

34. In our 2021/22 Manual review, we reached the following conclusion on the first limb of Rule 42 (asset beta):<sup>17</sup>

We consider that the first limb of Rule 42 is inconsistent with the s 150C(4) requirement for calculation of the asset beta and is therefore inconsistent with the s 150A purpose.

Section 150C(4) requires the use of an asset beta that is consistent with the comparator set asset betas. In our view, the use of an average from a set of comparators that meet the requirements of s 150(C)(4) would likely meet the legislative requirement, assuming the asset betas for the comparators have been appropriately estimated.

The first limb of Rule 42 enables the Milk Price Group (MPG) to have regard to Fonterra-specific systematic risk in calculating the asset beta. Our view is 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 s 150C(4).

[footnotes omitted]

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<sup>16</sup> [Fonterra “Reasons Paper in support of Fonterra’s Milk Price Manual for the 2022/23 season - 1 August 2022” \(23 August 2022\), at 5.](#)

<sup>17</sup> [Commerce Commission “Review of Fonterra’s 2021/22 Milk Price Manual: Final report” \(15 December 2021\), at \[33-35\].](#)

We consider Rule 42 is consistent with the s 150A purpose

35. Our draft conclusion is that the amended Rule 42 on asset beta is consistent with the s 150A purpose.
36. Section 150C(4) of the DIRA requires Fonterra to use an asset beta that is consistent with the estimated asset betas of other processors of dairy and other food products that are both traded in significant quantities in globally contested markets and characterised by uniform technical specifications. Our draft conclusion is that Rule 42 complies with this requirement and is consistent with the DIRA.
37. The reason for this conclusion is that the rule requires, as a pre-requisite, that the asset beta estimate used in the base milk price calculation meets the s 150C(4) requirement. A choice is only available to Fonterra when each of the estimates available is consistent with s 150C(4) and “otherwise equally supportable”. If Fonterra were to select an asset beta, in any calculation, that was not consistent with this pre-requisite, and therefore was not consistent with s 150C(4) we would address this in the relevant calculation review.

**Issues carried forward from previous reviews**

38. We have also considered the following issues carried forward from previous reviews:
  - 38.1 materiality;<sup>18</sup> and
  - 38.2 how the Manual gives effect to the DIRA definition of commodity.<sup>19</sup>

*Materiality*

39. In our final report on our review of the 2019/20 Manual, we suggested Fonterra should disclose what constitutes a ‘material change’, when considering whether a change to the Manual should be made.<sup>20</sup>
40. Fonterra has explained that in various circumstances, which potentially give rise to a decision to amend the Manual, a materiality test is simply not relevant. That position remains the same whether the test is expressed as a number or a list of qualitative factors. Fonterra also provided examples of when changes have been made to the Manual, despite having minimal impact on the base milk price.<sup>21</sup>

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<sup>18</sup> [Commerce Commission “Review of Fonterra’s 2021/22 Milk Price Manual: Final report” \(15 December 2021\), at 15.](#)

<sup>19</sup> [Commerce Commission “Review of Fonterra’s 2021/22 Milk Price Manual: Final report” \(15 December 2021\), at 18.](#)

<sup>20</sup> [Commerce Commission “Review of Fonterra’s 2019/20 Milk Price Manual: Final report” \(15 December 2019\), at \[80\].](#)

<sup>21</sup> [Fonterra “Reasons Paper in support of Fonterra’s Milk Price Manual for the 2022/23 season - 1 August 2022” \(23 August 2022\), at 6.](#)

41. Based on Fonterra’s explanation and our review of past changes to the Manual, we are satisfied that materiality has not been a relevant consideration. As such, implementing a materiality test would be unlikely to provide any meaningful additional transparency or effect.

*How the Manual gives effect to the DIRA definition of commodity*

42. In our 2020/21 Calculation review, we said we intended to examine more closely how the Manual gives effect to the DIRA definition of commodity in a future Manual review.<sup>22</sup> In our 2021/22 Manual review, we expanded on this, noting 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.<sup>23</sup> This became a focus area in our 2021/22 Calculation review.<sup>24</sup>
43. Our 2020/21 Manual review recommended that publication of a list of all products constituting ‘generic product specifications’ would greatly assist clarity of what is a Standard Product Offering.<sup>25</sup> Responding to this, Fonterra indicated in its Reasons paper in support of the 2021/22 Manual that it did 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 would continue to look for other means of providing information about the range of price-informing products.<sup>26</sup>
44. In its Reasons paper in support of the 2021/22 Calculation, Fonterra provided a table of Standard Product Offering categories and Standard Packaging formats. Fonterra noted that products which do not fall within these categories are excluded from the schedule of Qualifying Materials.<sup>27</sup>
45. In our Approach Paper we note that the Manual rules are not always prescriptive. As a result, we are not always able to conclude on the efficiency and contestability dimensions of notional costs, revenues and assumptions in the Manual review.

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<sup>22</sup> [Commerce Commission "Review of Fonterra's 2020/21 base milk price calculation: Final report" \(15 September 2021\), at \[3.7.4.2\].](#)

<sup>23</sup> [Commerce Commission "Review of Fonterra's 2021/22 Milk Price Manual: Final report" \(15 December 2021\), at \[74\].](#)

<sup>24</sup> [Commerce Commission "Review of Fonterra's 2021/22 base milk price calculation: Final report" \(12 September 2021\), at \[2.12.3\].](#)

<sup>25</sup> [Commerce Commission "Review of Fonterra's 2020/21 Milk Price Manual: Final report" \(15 December 2020\), at \[X16.1\].](#)

<sup>26</sup> [Commerce Commission "Review of Fonterra's 2021/22 Milk Price Manual: Final report" \(15 December 2021\), at 5.](#)

<sup>27</sup> [Fonterra "Reasons Paper in support of Fonterra's Milk Price Calculation for the 2021/22 season – 1 July 2022" at 49.](#)

Where this occurs, we will, to the extent possible, assess these dimensions during our review of the Calculation in the relevant season.<sup>28</sup>

46. Our 2021/22 Calculation review included a full review of the list of Qualifying materials to determine whether the products met the DIRA definition of commodity and whether they constituted Reference Commodity Products on a reasonable interpretation of the Manual. We concluded that we were satisfied the range of Qualifying Materials was appropriate and that the approach taken provided an incentive for Fonterra to operate efficiently and was practically feasible for an efficient Notional Processor.<sup>29</sup>
47. We consider that the approach taken by Fonterra to disclose information in relation to Standard Product Offerings and Standard Packaging formats in the Reasons paper in support of the Calculation is reasonable and provides additional transparency in relation to Qualifying Materials. We recommend that Fonterra continues to disclose this information.
48. We will continue to assess whether the implementation of the rules in relation to Qualifying Materials satisfy the contestability and efficiency dimensions of DIRA in future Calculation reviews. We use both publicly available and confidential information in this assessment. This is consistent with our stated approach to consider the outcomes of non-prescriptive rules in the Calculation review.
49. However, as we noted in the 2021/22 Calculation Review, we suggest that Fonterra considers whether the definition of Standard Product Offering in the Manual can be clarified, particularly with respect to the cascable product rule, or the application of the definition explained more clearly in the Calculation Reasons paper.<sup>30</sup>

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<sup>28</sup> [Commerce Commission "Our approach to reviewing Fonterra's Milk Price Manual and base milk price calculation – 2021" \(5 July 2021\), at \[99\].](#)

<sup>29</sup> [Commerce Commission "Review of Fonterra's 2021/22 Milk Price Calculation: Final report" \(15 September 2022\), at \[3.7.3\] and \[3.8.3\].](#)

<sup>30</sup> [Commerce Commission "Review of Fonterra's 2021/22 Milk Price Calculation: Final report" \(15 September 2022\), at \[3.6.3\].](#)

## Attachment A Glossary

Term/Abbreviation	Definition
<b>DIRA</b>	Dairy Industry Restructuring Act 2001
<b>Base milk price</b>	Base milk price, in relation to a season, means the price per kilogram of milk solids (kgMS) that is set by Fonterra for that season.
<b>Calculation review</b>	Commission's review of Fonterra's base milk price calculation for the prior season.
<b>Manual review</b>	Commission's review of Fonterra's Milk Price Manual for the current season.
<b>Dairy season</b>	1 June to 31 May annually
<b>MPG</b>	Milk Price Group
<b>Milk Price Manual or the Manual</b>	Fonterra's Milk Price Manual
<b>MPP</b>	Milk Price Panel
<b>Notional processor</b>	The notional commodity business that is used to calculate the base milk price (in its Reasons paper Fonterra uses the term notional producer).
<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).