

15 November 2022

**Joint Submission to the Commerce Commission:  
Review of Fonterra’s 2022/23 Milk Price Manual, Draft Report (14 October  
2022)**

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Attention: Keston Ruxton (Manager, Fuel and Dairy)

Subject: Milk Price Manual 2022/23

Submitted by: Miraka, Open Country Dairy, Synlait Milk and Westland Milk Products  
(the Companies)

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## Abbreviations and other references

AMF - Anhydrous Milkfat

BMP - Base Milk Price

Bmp – Buttermilk Powder

DIRA - Dairy Industry Restructuring Act 2001

IPC - Incremental Product Cost

JS1 – Joint Submission (30 Aug 22): Miraka, Open Country Dairy, Westland Milk Products, Synlait Milk to the Commerce Commission on the 21/22 Review of the BMP Calculations (draft report)<sup>1</sup>

JS2 – Joint Submission (1 Sept 22): Miraka, Westland Milk Products, Synlait Milk to the Commerce Commission on the 21/22 Review of the BMP Calculations (report)<sup>2</sup>

Manual – Fonterra Farmgate Milk Price Manual

MPG – Milk Price Group

NP - Notional Processor

RCP – Reference Commodity Product

SKU – Stock keeping unit (i.e. an individual product, the lowest level of the product classification hierarchy)

SMP - Skimmilk Powder

SPO – Standard Product Offering

SSP – Standard Specification Product

WMP - Wholemilk Powder

## Summary

1. **The Companies request** the Commission reconsider its draft opinion that the 2022/23 Manual complies with DIRA section 150A.
2. The Companies consider the Manual does not comply with the DIRA because:
  - The Manual does not provide assurance that the NP revenue is based on commodity prices. Evidence provided by Fonterra indicates qualifying reference sales include sales explicitly transacted at prices which exceed prevailing market prices. This caused an overstatement of the 2021/22 BMP of up to 12 c/kg MS. To prevent this occurring, the Manual needs to include an explicit prevailing market price test to provide an objective filter in identifying qualifying reference sales (refer paragraphs 9 to 20)
  - The Manual does not provide assurance that only sales of commodity products are included in the calculations of NP revenues. The Manual needs to be amended so that the hierarchy of product definitions is consistent and coherent, and only products traded in significant quantities are classified as commodities (refer paragraphs 21 to 50)
  - The Manual includes unnecessary complexity which creates unjustifiable opacity and risks in the process of determining the BMP (refer paragraphs 51 to 53)
  - The Manual introduces unjustified discretion in setting the NP asset beta (refer paragraphs 54 to 57)

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<sup>1</sup> [https://comcom.govt.nz/\\_data/assets/pdf\\_file/0022/291721/Miraka2C-Open-Country2C-Westland-Milk-Products-and-Synlait-Joint-submission-on-draft-report-for-base-milk-price-calculation-2021-22-Attachment.pdf](https://comcom.govt.nz/_data/assets/pdf_file/0022/291721/Miraka2C-Open-Country2C-Westland-Milk-Products-and-Synlait-Joint-submission-on-draft-report-for-base-milk-price-calculation-2021-22-Attachment.pdf)

<sup>2</sup> [https://comcom.govt.nz/\\_data/assets/pdf\\_file/0023/291722/Miraka2C-Westland-Milk-Products-and-Synlait-Milk-Joint-submission-on-draft-report-for-base-milk-price-calculation-2021-22-1-September-2022.pdf](https://comcom.govt.nz/_data/assets/pdf_file/0023/291722/Miraka2C-Westland-Milk-Products-and-Synlait-Milk-Joint-submission-on-draft-report-for-base-milk-price-calculation-2021-22-1-September-2022.pdf)

- The Manual allows Fonterra unacceptably wide discretion with assumptions rules and procedures based on undefined materiality benchmarks (refer paragraphs 58 to 63)
3. The Companies also seek increased transparency in the changes over time of the value of reference assets. They request the Commission support them in this matter by recommending Fonterra provide an annual statement of changes in reference assets starting with the current season BMP calculations (refer paragraphs 64 to 69)

## Commodity Products and Prices

4. The Manual uses a web of loosely defined and at times open ended product and price concepts to attribute Fonterra sales volume and prices to the NP. Taken in the round, this provides wide discretion to classify Fonterra sales as dairy commodities. It is not possible to independently validate the resulting NP sales revenues align to broadly accepted pricing of dairy commodities. The underlying issues are not new, and many were addressed in the review of the 2021/22 BMP Calculations. This included issues raised by the Companies in their two submissions on that review (JS1 and JS2). The Commission did not agree with many of the concerns raised by those submissions. The Companies however consider those issues warrant further consideration by the Commission and that this is directly relevant to an assessment of compliance of the 2022/23 Manual to the DIRA.
5. The Commission did nevertheless make a number of recommendations concerning the definition of dairy commodities in their final report (review of the 2021/22 BMP calculations). No changes have been made to the Manual in response to those recommendations. Fonterra will claim this is because the issues were too late to be included in the latest update of the Manual. While that might be so, there is no reason why the implementation of Commission recommendations should be precluded from prompt action simply because of the timing of the Manual.
6. **The Companies request** that the Commission confirm an expectation that their recommendations will be addressed promptly by Fonterra. Other than good reason to the contrary, the recommendations should be implemented in the season current to the date of the relevant final report.
7. Section 150C (1) (a) of the DIRA requires that the BMP revenue is
 

*“determined from prices of a portfolio of commodities at the time those commodities are contracted to be sold by [Fonterra]”*
8. The Companies do not consider the Manual assures that processes to determine the NP revenues meet this DIRA requirement and the Manual is accordingly not compliant with the DIRA in this respect.

### Prevailing market price test for qualifying reference sales

9. Qualifying references sales are defined amongst other things as those where the price
 

*“reflects prevailing market prices that could be achieved by the Farmgate Milk Price Commodity Business at a time the contract for the sale is entered into”<sup>3</sup>*

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<sup>3</sup> Manual Part C 1.2 Definitions – Milk Price Revenue

10. Despite this definition, Fonterra does not actually demonstrate that qualifying reference sales meet prevailing market prices for the simple reason that price is not considered when filtering for qualifying reference sales. Rather, Fonterra relies on internal controls the purpose of which is to ensure off-GDT sales are sold at prices which are no less than comparable GDT prices.
11. The Companies have submitted that an explicit prevailing market price test based on GDT prices should be included in decision criteria for filtering qualifying reference sales<sup>4</sup>. The Commission continues to consider an explicit test is not required and that the Companies have not provided evidence that would lead the Commission to change their view<sup>5</sup>. The Companies are not in a position to provide that evidence because Fonterra does not disclose disaggregated sales price information. Only Fonterra is in a position to provide that evidence, and it has now indirectly done so.
12. In their draft report on the 2021/22 BMP calculations, the Commission noted the impact of certain off-GDT sales (WMP, SMP and AMF) on the BMP had increased by 3.6 c/kg MS in the 2021/22 Season. Fonterra had attributed this increase to “favourable market conditions” and the Commission had requested further evidence from Fonterra to support that explanation<sup>6</sup>.
13. In their final report and based on the further evidence provided by Fonterra, the Commission did not further contest the Fonterra explanation that the increase (now recalculated as 3.2 c/kg MS) was due to “favourable market conditions”<sup>7</sup>.
14. To explain that prices have increased because of “favourable market conditions” is superficial. And in the context of the BMP calculations this is neither explanation nor justification.
15. In 2021/22, **both** on and off-GDT prices increased “because of favourable market conditions”. The point is that off-GDT prices increased by more than the increase in on-GDT prices, otherwise the measured variance of 3.2 c/kg MS would not have been apparent. “Favourable market conditions” then does not explain the increase. Fonterra has however provided evidence and even the right explanation to explain this increase – but it has drawn the wrong conclusion. The Commission appears to have overlooked this.
16. The Fonterra submission of 1 September 2022 to the Commission (Draft Report, 21/22 Milk Price Calculations Review) summarised as follows the further evidence it had supplied separately to the Commission to explain the “favourable market conditions”:

*“From December 2021 on, there was increasing evidence of lower near-term milk supply, relative to previous forecasts, both in New Zealand and in other major dairy exporting regions. In addition, lower returns to WMP relative to other dairy products provided an incentive for major manufacturers, including Fonterra, to divert milk away from WMP production. Fonterra’s primary off-GDT customers, which are all large multinational firms with significant capability to understand market dynamics, were consequently prepared to pay higher premiums over GDT to compensate Fonterra for supplying them RCPs (and WMP in particular) rather than diverting milk to other uses.”*

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<sup>4</sup> Submitted most recently in JS2, paragraph 10

<sup>5</sup> Commerce Commission Review, 2021/22 BMP calculation, Final Report (15 Sept 22), Attachment A (Prevailing Market Price Test).

<sup>6</sup> Commerce Commission Review, 2021/22 BMP calculation, Draft Report (15 Aug 22), paragraph 3.120 and 3.122

<sup>7</sup> Commerce Commission Review, 2021/22 BMP calculation, Final Report (15 Sept 22), paragraph 3.152

17. This Fonterra explanation is unambiguous. Off-GDT qualifying reference sales included price premiums that customers paid to secure supply which they would not otherwise have secured if they were only prepared to pay open market commodity prices. This premium is gained from a strategy of close partnering with customers. That is a valid sales strategy. It is however clear that prices achieved from that strategy are not commodity prices. They are explicitly intended to ensure supply over and above that which could be achieved through product allocation based on commodity prices and through commodity sales channels.
18. Fonterra thus concedes these off-GDT sales are sold at prices **above** “prevailing market prices”; the sales therefore do not meet the definition of qualifying reference sales. The Fonterra evidence is concerned with the 3.2 c/kg MS increase in the contribution from off-GDT sales (a “tip of the iceberg” analysis). However, the gross impact of those non-compliant sales will be a substantially larger portion of the total off-GDT sales impact (which amounted in total to 12 c/kg MS in 2021/22). It must then be concluded the 2021/22 BMP was overstated by up to 12 c/kg MS as a result of the incorrect classification of (an unknown quantity) of off-GDT sales. This would have been avoided if an explicit and objective prevailing market price test had been in place for purposes of filtering qualifying reference sales<sup>8</sup>.
19. **The Companies submit** that while the Manual requires that qualifying reference sales are transacted at prevailing market prices, the Manual does not provide a mechanism to ensure that is in fact the case. Based on the evidenced supplied by Fonterra, this has resulted in a significant overstatement of commodity prices and of the BMP. The failure to provide an explicit “prevailing market price” test therefore means the Manual does not provide assurance that NP revenue is based on commodity prices and the Manual does not comply with the DIRA in this crucial respect.
20. **The Companies also request** that the 22/23 milk price calculations review include a compliance review of off-GDT qualifying reference sales based on an appropriate and disclosed prevailing market price test.

#### Product classifications/definitions

21. The Companies consider that the way by which the Manual establishes criteria and definitions of dairy commodities does not provide assurance that only dairy commodities are included in the NP revenue calculations.
22. The review of the 2021/22 Milk Price Calculations included a review of qualifying materials and IPCs. The Commission concluded that all qualifying materials (with one possible exception) comply with the DIRA definition of commodities<sup>9</sup>. The Commission also concluded the IPCs are consistent with the DIRA<sup>10</sup>. **The Companies request** the Commission reconsider these conclusions.
23. The DIRA defines dairy commodities as being “characterised by uniform technical specifications”<sup>11</sup>. The Manual does not further define “uniform technical specifications”. Instead it identifies certain “standard specification products” (SSPs) which are generally accepted in global markets as representative of dairy commodities within each of the Reference Commodity

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<sup>8</sup> In JS2 paragraph 9 the Companies explain how an objective prevailing market price test could be established.

<sup>9</sup> Commerce Commission Review, 2021/22 BMP calculation, Final Report (15 Sept 22), paragraphs 3.57 and 3.59

<sup>10</sup> *ibid* paragraph 3.121

<sup>11</sup> DIRA section 5(1): Interpretation

Product groups. This is a pragmatic and uncontroversial approach. Unfortunately the Manual then proceeds to bend or ignore the **standards** implied by selecting the **standard** specification products. This is reflected in the way Standard Product Offerings are defined, and by the failure to include the SSP as a benchmark for excluding products that are not sold in significant quantities<sup>12</sup>.

#### Standard Product Offerings (SPOs)

24. Amongst other things, SPOs are defined in the Manual as “generic product specifications”. “Generic” is not otherwise defined other than by the requirement that an SPO

*“can be substituted for other SPOs”<sup>13</sup>*

This requirement for substitutability is a proxy test for “uniform technical specifications”. It is however applied by Fonterra in a manner which both makes it meaningless and does not comply with the Manual.

25. Attachment 5 of the Fonterra reasons paper 2021/22 Milk Price Calculations included a list of the “full range of Standard Product Offerings”. This list has not been previously disclosed. Fonterra provided the list in response to a recommendation from the Commission. **The Companies support** the Commission recommendation that Fonterra disclose this information on an ongoing basis<sup>14</sup>.
26. It is apparent that while the Manual defines SPOs as “commodity product specifications”<sup>15</sup> in practice they are groups of products with the same or very similar technical specifications. In JS1, the Companies submitted an analysis of the list of SPOs. That analysis identified that many of the SPOs do not meet the substitution test as defined in the Manual (“substituted for other SPOs”) and do not meet the DIRA requirement for “uniform technical specifications”<sup>16</sup>. The Commission has explained that in practice Fonterra applies the substitutability test by reference to products “within the same SPO”<sup>17</sup>. The Commission did not object to this failure to comply with the Manual. Rather, they recommended that Fonterra amend the Manual to include the cascading product rule as it is actually applied by Fonterra<sup>18</sup>. **The Companies submit** that this would leave the substitution test meaningless and gives Fonterra wide licence to add SPOs at its discretion. Fonterra would in effect be able to add any SPO simply on the basis that the SPO comprised more than one SKU assuring the substitutability test is met. There would accordingly be no actual requirement that products meet a “uniform technical specifications” requirement.
27. **The Companies request** that the Commission review their opinion on this matter. The Commission is also requested to reconsider the analysis provided in JS1 in their review of the 2022/23 Milk Price Calculations.

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<sup>12</sup> It is further reflected in the failure to establish a meaningful definition of standard packaging (the Companies will seek to have this unresolved issue addressed in the 2022/23 BMP calculations review).

<sup>13</sup> Manual Part C 1.2 Definitions – Milk Price Revenue

<sup>14</sup> Commerce Commission Review, 2022/23 Milk Price Manual, Draft report (14 Oct 22) paragraph 47

<sup>15</sup> Manual Part C 1.2 Definitions – Milk Price Revenue

<sup>16</sup> JS1 paragraphs 30 and 33

<sup>17</sup> Commerce Commission Review, 2021/22 BMP calculation, Final Report (15 Sept 22), paragraph 3.80

<sup>18</sup> Ibid paragraph 3.73

28. In the previously mentioned Attachment 5 of Fonterra Reasons 2021/22 Milk Price Calculations, Fonterra provided what it refers to as “additional detail” to explain how the substitution test (now renamed a “cascadability test”) is applied in practice. This included that:

*“Product specifications which are described to customers as having fat and protein content that falls materially outside the expected normal range for the relevant product, will be automatically excluded”* [emphasis not in original]

29. As written this description is ambiguous<sup>19</sup>. It does though suggest a pathway to a meaningful rule for assuring uniform technical specifications. In context it seems to describe a process for excluding certain products as commodities on the basis of their composition but it provides no certainty that it would in fact exclude any product. As the Commission has now confirmed (and in contradiction to the Manual) the cascade rule is applied within SPOs rather than between SPOs. The “product specifications” therefore presumably refer to individual products or SKUs, while the “normal range of the relevant product” possibly refers to (undefined) normal characteristics of an SPO. It should be self-evident that a product with a “materially” different fat and protein composition to that which is characteristic of a particular SPO would not be included in that SPO in the first place. That does not mean the product in question would be excluded from the list of products identified as commodities because it could simply be included in another SPO to which it is more closely aligned.

30. This “additional detail” is accordingly muddled if not misleading. Further, it fails to define what would trigger a product to be “excluded”: determining that a product is “materially outside the expected normal range” would require judgement on not one but two undefined standards: “materially outside” and “expected normal range”. Thus while seeming to refine the definition of commodities in reality Fonterra establishes for itself wide discretion to classify products as commodities.

31. The implied approach to identifying commodities on the basis of compositions by reference to a standard however has merit if properly defined. **The Companies consider** the correct approach to assure that selected products are properly classified as commodities is to retain internal consistency across the hierarchy of product classifications within the Manual.

- RCPs are identified in accordance with DIRA section 150C (2) (portfolio of products); there is currently wide agreement and acceptance that these comprise WMP, SMP, AMF, Butter and Bmp.
- An SSP is selected for each RCP; the Manual defines SSPs as

*“a product specification ... which can reasonably be regarded as being representative of an undifferentiated commodity product”<sup>20</sup>*

The currently selected SSPs are also widely accepted and uncontroversial as the appropriate representative products for the RCPs. This is reinforced by the fact that the GDT prices of these same SSPs are used to settle the SGX dairy commodity futures contracts.

- Other product specifications can then be included as SPOs where they are not “materially outside the expected normal range” of the standard specification product.
- “Materially outside” and “normal product range” would need to be defined.

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<sup>19</sup> It is not clear for example how the “product specifications” are distinguished from “the relevant product”

<sup>20</sup> Manual Part C 1.1.1 Definitions – Milk Price Commodity Business

- The cascade rule would exclude products with different functionality, customer specific unique packaging, or other special characteristics.
32. This is generally the approach the Companies took in reviewing the Fonterra list of SPOs and which identified that eight do not qualify as SPOs. The Commission largely dismissed concerns about products on that list including on the basis that an analysis provided by Fonterra concluded the SPOs did not have a material impact on the BMP<sup>21</sup>. One product (the exception - IWMP) contributed over 3 c/kg MS; the remaining 7 products contributed in total just over 1 c/kg MS<sup>22</sup>.
  33. The Companies would welcome the exclusion of those SPOs the Commission (and presumably Fonterra) has now determined are not material to the BMP. That would simplify the BMP procedures, help to reduce Fonterra discretion and thereby help to make the procedures more acceptable to all parties.
  34. **The Companies request** that the Commission encourages Fonterra to exclude the 7 SPOs which have been identified by the Commission (and presumably Fonterra) as not material to the BMP.
  35. In any event, to demonstrate materiality or otherwise, to the extent that these products remain SPOs, **the Companies request** ongoing disclosure of their impact on the BMP, along with the impact of any addition to the list of SPOs.
  36. In their report on the 2021/22 Milk Price Calculations, the Commission indicated in relation to the cascable product rule:
 

*“we have previously sought further clarification on ... the rule and with the benefit of the submissions received, we consider this matter warrants further consideration in our upcoming review of Fonterra’s Manual [and recommend that] Fonterra take this into account when considering any amendments to its Manual”<sup>23</sup>;*
  37. This was in addition to recommending that
 

*“the Manual be revised to include the requirements of the cascable product rule as it is applied”<sup>24</sup>*
  38. Fonterra has in fact made no changes to the Manual in this respect and did not address the issue in its Reasons paper. The Commission also appears not to have given further consideration to the matter.
  39. As the Manual currently stands, it does not provide reasonable assurance that NP revenue is based on the sale of products which can be classified as dairy commodities. This can be summarised as being due to a failure of the Manual to provide consistency in the hierarchy of product definitions.
  40. **The Companies request** the Commission reconsider their assessment of the Manual taking into account the issues raised above. **The Companies further request** that these issues be included in the review of the 2022/23 BMP calculations.

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<sup>21</sup> Commerce Commission Review, 2021/22 BMP calculation, Final Report (15 Sept 22), paragraph 3.85

<sup>22</sup> Ibid paragraph 3.83 and Table 3.2

<sup>23</sup> Commerce Commission Review, 2021/22 BMP calculation, Final Report (15 Sept 22), para 3.88

<sup>24</sup> Ibid para 3.73



### Significant quantities

41. A further characteristic of dairy commodities as defined by the DIRA is that they are “traded in significant quantities”<sup>25</sup>. The Manual does not define “significant quantities”. The Commission has recommended that Fonterra amend the Manual to “include guidance on what constitutes significant quantities”<sup>26</sup>. Fonterra has not responded to that recommendation. **The Companies agree** with this recommendation and that it should be implemented and reviewed in the current season.
42. The “significant quantities” characteristic referred to in the DIRA in the first instance is directly relevant to determining the RCPs. It is uncontroversial that the selected RCPs on which the BMP is based are “traded in significant quantities”. However, drilling further down to individual products, volume criteria are required to prevent differentiated products (typified by small volumes) leaking into the selection of commodity products. Objective volume criteria also reduce discretion in the selection of SPOs and qualifying materials, and reduce unnecessary complexity in the BMP calculations.
43. Again consistent with the hierarchy of product definitions, volume criteria should be set relative to the SSPs (i.e. a minimum annual volume equivalent to x% of the annual SSP volume). That x% would in the first instance be informed by an analysis of products which Fonterra currently includes as qualifying materials and a benchmark set to “weed out” the products where relatively low volumes reflect some element of specialisation in the product. To create certainty at the start of the season, the compliance with this volume test could be confirmed by reference to the previous season traded volumes.
44. **The Companies request** the Commission confirm their expectation that Fonterra will respond to the recommendation to include volume criteria in the current season, and that this will be included in the 2022/23 review of the base milk price calculations.

### Price weighting of qualifying reference sales

45. DIRA Section 150C (1) (a) requires that NP revenue is  
*“determined from prices of a portfolio of commodities at the time that those commodities are contracted to be sold”*
46. The Companies have submitted that weighting of prices from “price include” sales with the volumes of the different “volume include” sales cannot be shown to be practically feasible<sup>27</sup>. The Companies further submit the volume include weighting is not consistent with S150C (1)(a) because the resulting weighted prices do not reflect the prices of products “at the time that those commodities are contracted to be sold”.
47. The Commission considered this issue in their review of the 2021/22 BMP Calculations. At Table 3.5 of their final report, they provided a Fonterra analysis that suggests the impact on the BMP of the mismatch between volume include and price include weighted average prices was less than 1 c/kg MS in four of the last 5 years. The Commission consequently advised “they do not consider the impact on the BMP warrants further detailed analysis”<sup>28</sup>. The Commission did not

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<sup>25</sup> DIRA S. 5(1): Interpretation

<sup>26</sup> Commerce Commission Review, 2021/22 BMP calculation, Final Report (15 Sept 22), paragraph 3.84

<sup>27</sup> Most recently in the JS2, paragraphs 13 to 20.

<sup>28</sup> Commerce Commission Review, 2021/22 BMP calculation, Final Report (15 Sept 22), paragraph 3.161

comment on whether the process was compliant with the DIRA, and did not confirm it would be subject to ongoing review.

49. Given the weighting procedure does not comply with S150C (1)(a), does not (in principle) produce prices that are practically feasible, and in any event has such a small impact on the BMP that it does not “warrant further detailed analysis”, there is no clear reason why this model complexity is justified.
50. Material or otherwise, the weighting of selling prices by volume include sales is not in principle consistent with the DIRA and creates unwarranted complexity in the model, obscuring compliance of commodity prices. **The Companies request** the Commission reconsider their opinion on this matter.

### Model Complexity

51. The analyses noted in paragraph 47 (distortion due to volume include weighting of prices) and paragraph 32 (BMP impact of 8 SPOs) were both provided to the Commission by Fonterra. They have not been previously disclosed by Fonterra. Both analyses are welcome and both should continue to be made available while the underlying procedures continue in place. Both however address long standing issues and it is disappointing it has taken years to obtain this basic level of information. In both cases, while Fonterra has defended the relevant procedures against criticism from submitters, Fonterra is now suggesting the issues raised by the Companies and other submitters are not relevant because they have only a trivial impact on the BMP.
52. **The Commission is requested** to consider the wider implications of these disclosures. The effects of complexity in the BMP model are manifold:
  - reduces understandability
  - increases cost of maintenance and review
  - increases the risk of errors
  - increases discretion and the opportunity to directly influence the model outcome
  - reduces trust in and acceptability of the BMP
53. **The Companies request** that in their approach to reviewing the Manual and the BMP calculations the Commission actively discourage model complexity which has no appreciable impact on the BMP. The Companies consider this is relevant to the latest review of the Manual because the Manual should not allow unnecessary complexity which creates the risk of obscuring compliance with the DIRA.

### Asset Beta

54. Fonterra has amended Rule 42 (Asset Beta) in the Manual. Fonterra has indicated this was in response to findings of the Commission in their report on the 2021/22 Milk Price Manual. The Commission draft conclusion is that the amended Rule 42 is consistent with the DIRA<sup>29</sup>.
55. The amendment to Rule 42 now more clearly mandates how the NP asset beta is determined. However, the Rule also includes a new provision that the MPG (in effect, the Fonterra majority controlled Milk Price Panel) can select between different asset betas where “more than one estimate of asset beta is consistent with this mandatory requirement”. The MPG will make that selection on the basis of the estimate which the MPG considers “best reflects the exposure to

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<sup>29</sup> Commerce Commission Review, 2022/23 Milk Price Manual, Draft Report (14 Oct 22), paragraphs 35 and 36.

systematic risk of an efficient New Zealand-based manufacturer of reference commodity products”.

The rule does not provide insight into why there would be more than one estimate of asset beta<sup>30</sup>. It also does not state how one asset beta would be distinguished from another in terms of reflecting “systematic risk of an efficient New Zealand-based manufacturer”. That would seem contradictory since that is the purpose of a valid asset beta exercise – i.e. there would be no basis of distinguishing that one estimate is better than another. Where more than one valid estimate exists, the normal approach would be to choose the simple mathematical average and no discretion is required or should be permitted. Based on prior experience, it is difficult not to conclude that Fonterra will use this discretion to enable it to select the lowest possible asset beta.

56. The Commission seems comfortable they can detect and prevent any gaming of the asset beta<sup>31</sup>. The Companies however consider the provision invites a continuation of the seemingly endless saga of Fonterra establishing procedures to minimise the asset beta to achieve a lower cost of capital and higher BMP.
57. **The Companies submit** that the procedure for determining the asset beta should not entrench any opportunity for Fonterra to have discretion in selecting between different asset betas and that the procedure for determining the asset beta should result in a single point asset beta determined in accordance with expert professional standards. To the extent that the expert assessment of an asset beta includes calculations that deliver different valid outcomes, the asset beta should be the simple average of those valid outcomes.

## Materiality

58. References to materiality are littered throughout the milk price documents. The Manual contains 41 references to judgements that are made on the basis of materiality. The Fonterra Reasons papers frequently justify judgements on the basis of materiality<sup>32</sup>. No doubt in its confidential papers provided to the Commission judgements will also have been attributed to materiality. And each year, Fonterra is required to submit two certificates to the Commission under DIRA sections 150L (d) and 150T (b) to certify the extent to which the Manual and the BMP calculations comply with the DIRA. In both cases, Fonterra certifies compliance “in all material respects”. In all of these instances where materiality is claimed to justify Fonterra judgements in relation to DIRA compliance, the Manual does not include any definitions or standards of materiality.

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<sup>30</sup> At page 5 of the Fonterra Reasons Paper (2022/23 Manual) Fonterra suggests it is concerned that more than one valid asset beta arises from the asset beta analysis process itself. This results from “technical judgements ... with legitimate choices between approaches often generating slightly different answers”. However, to the extent that a suitably qualified professional expert calculating the asset beta considers legitimate choices are available, those choices would be analysed and the resulting calculated different outcomes (which Fonterra considers would only be “slightly different”) would simply be averaged. There is then no requirement for discretion where the suitably qualified professional expert is evaluating legitimate options.

<sup>31</sup> Commerce Commission Review, 2022/23 Milk Price Manual, Draft Report (14 Oct 22), paragraph 37

<sup>32</sup> The Fonterra Reasons Paper (2021/22 BMP calculations) included 23 references to judgements based on an undefined materiality standard.

59. Submitters have for some time requested that Fonterra include quantitative and qualitative materiality standards in the Manual<sup>33</sup>. The Commission have previously supported this request<sup>34</sup>. Fonterra has though resisted introducing materiality standards. In its latest Reasons Paper (2022/23 Manual update) Fonterra claims that in relation to decisions to amend the Manual:

*“a “materiality” test ... is simply not relevant in most of these circumstances”<sup>35</sup>*

60. In their draft report on the review of the 2022/23 Manual the Commission has signalled they now agree with Fonterra concluding that:

*“implementing a materiality test would be unlikely to provide any meaningful additional transparency or effect”<sup>36</sup>*

61. In its Reasons Paper Fonterra points out that many changes to the Manual are required to be made in response to compliance matters raised by the Commission and that these are made regardless of materiality<sup>37</sup>. This may be so, but it does not address those circumstances where substantive changes are made to the Manual. It also does not provide a basis for assessing those aspects of the Manual noted in paragraph 53 above which add unjustifiable complexity to the BMP model.

62. Equally it fails to address the fact that the Manual allows broad discretion to Fonterra on the grounds of assumptions rules and procedures which provide for judgement within undefined boundaries of materiality. As noted above, that is widespread throughout the Manual and should be addressed directly and replaced by objective standards.

63. **The Companies request** the Commission reconsider their draft opinion on this matter.

## Valuation of Reference Assets

64. The dairy industry faces increasing pressure to ensure efficient utilisation of production capacity in the face of declining milk volumes. The Companies are accordingly seeking increased assurance that the capital costs attributed to the NP reference assets remains practically feasible. The Companies seek transparency of the movements in the value of the NP reference assets each year. While this may be an issue more relevant to the BMP calculations review, by signalling it in this submission it is hoped the Commission will indicate their support and Fonterra will provide this further detail in its Reasons Paper for the 2022/23 Milk Price Calculations.

65. The need and scope for this request for increased transparency is illustrated by the incomplete information for the 2021/22 Season described below.

66. In their final report on the 2021/22 Milk Price Calculations, the Commission confirmed that

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<sup>33</sup> Most recently for example in the Miraka submission of 15.11.21 (Commerce Commission Review 2021/22 Milk Price Manual – Draft Report), paragraph 17.

<sup>34</sup> For example, Commerce Commission Review 2021/22 Milk Price Manual, Final Report (15 Dec 2021), paragraph 55

<sup>35</sup> Fonterra Reasons (2022/23 Manual) page 6

<sup>36</sup> Commerce Commission Review, 2022/23 Milk Price Manual, Draft Report (14 Oct 22), paragraph 41

<sup>37</sup> Fonterra Reasons (2022/23 Manual) page 6

*“the overall replacement cost of the asset base from 2021 to 2022 was 10.5%”<sup>38</sup>*

and that

*“the capital asset costs have been appropriately adjusted to take account of current inflationary effects”<sup>39</sup>*

67. Based on Attachment 3 in the Fonterra Reasons paper (2021/22 BMP Calculations) one NP powder plant was retired in the 2021/22 Season and one replacement powder plant was commissioned by the NP. It seems these changes were made in accordance with Rule 31 of the Manual although it would be useful if that were confirmed.
68. The only insight into the value attributed to the NP Reference Assets is the book value of NP fixed assets reported in Fonterra’s annual farmgate milk price statement. For the 2021/22 season, NP fixed assets were reported to be \$6,595 M compared to the prior year of \$6,532 M. This was a net increase of \$63M and a gross increase of \$346M after adding back depreciation. It is difficult to match these changes in value to the events described above.
69. **The Companies request** the Commission recommend, starting for the current season, that Fonterra make available an annual statement which explains the movements in the book value of NP fixed assets.

The Companies are available and would welcome any opportunity to assist the Commission further with any of the issues raised in this submission.

## Authorisation

This submission is authorised by:

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<sup>38</sup> Commerce Commission Review, 2021/22 BMP calculation, Final Report (15 Sept 22), paragraph 3.131

<sup>39</sup> Ibid paragraph 3.132