27 April 2023

IDP Joint submission on the Commerce Commission process paper: "Proposed focus areas for our review of Fonterra's 2022/23 base milk price calculation Review of Fonterra's 2022/23 Milk Price Manual" (issued 30.3.23)

Submitted by email:	*market.regulation@comcom.govt.nz*
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Subject:	Proposed base milk price calculation focus areas paper 2022/23
Submitted by:	Miraka, Open Country Dairy, Synlait Milk and Westland Milk Products (the Independent Dairy Processors (the IDPs))

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Abbreviations and other references

Approaches Paper – Commerce Commission reference paper: "Our approach to reviewing Fonterra's milk price manual and base milk price calculation". The current paper was issued in 2021

Draft Approaches Paper – draft update of the Approaches Paper on which the Commission is currently consulting

BMP - Base Milk Price

DIRA - Dairy Industry Restructuring Act 2001

DIRA Amendment Act 2022 - Dairy Industry Restructuring (Fonterra Capital Restructuring) Amendment Act 2022

Focus Areas 22/23 – Commerce Commission paper issued 30 March 2023: "Proposed focus areas for our review of Fonterra's 2022/23 base milk price calculation"

IDPs – Independent Dairy Processors: Miraka, Open Country Dairy, Synlait Milk, Westland Milk Products

IPC - Incremental Product Cost

Manual – Fonterra's Farmgate Milk Price Manual

NP - Notional Processor

SPO – Standard Product Offering

Summary

1. The DIRA Amendment Act 2022 introduced substantial changes to the regulation of the BMP. Amendments relating to the s 150B assumptions have removed their safe harbour status. This has had the effect of now requiring a substantive part (by effect) of the BMP assumptions to be compliant with the s 150A purpose of the BMP. The assumptions will therefore be subject to review by the Commission for the first time in its 2022/23 BMP calculations review. At the same time, new requirements create obligations for Fonterra to make wide disclosures of information related to the BMP, and provide the Commission with powers to enforce that obligation.

2. Recognising these major changes to the DIRA regulation of the BMP, in this submission the IDPs request the Commission

    a. Change and widen its review of the s 150B assumptions by deferring its proposed review of the USD conversion rate (s 150B assumption (c)) and replacing that with a review of the remaining s 150B assumptions:
        - assumption (a): network of facilities
        - assumption (b): size of processing facilities
        - assumption (d): volume of milk processed and associated yields

    b. Consider including a new focus area addressing the DIRA disclosure requirements.

3. In addition the IDPs request the Commission

    a. Reconsider its decision to exclude a review of milk collection costs in the 2022/23 review

    b. Provide for the same level of scrutiny of cost inflation adjustments as it did in the 2021/22 review and expand that review to include all cash costs

c. Consider issues raised in the IDPs submission on the 2022/23 review of the Milk Price Manual and which the Commission had put aside because they were out of scope of the Manual review (but remain relevant to the BMP Calculations review) including
   - Qualifying reference sales meeting prevailing market prices
   - Substitution test for determining standard product offerings
   - Compliance with the DIRA "significant quantities" definition of diary commodities
   - Valuation of reference assets

DIRA Amendments

4. The primary purpose of the DIRA Amendment Act 2022 was to enable Fonterra to implement changes to its capital structure. The Government considered amendments were necessary because the proposed restructure might have otherwise been subject to legal challenge under the DIRA. At the same time the Government acknowledged the new Fonterra capital structure, enabled by the Amendment Act, was not consistent with the purpose of the DIRA. The new capital structure:

   "*could constrain entry into the market or expansion by potentially more innovative or efficient dairy processors*… [which over time] … *could reduce pressure on Fonterra to perform optimally or innovate*"[1]; and

   "*will make it less costly for new farmers to join Fonterra and will reduce incentives for existing farmers to switch their supply to other processors or pursue a land-use change away from dairy. This will help secure milk supply for Fonterra but may have negative implications for the wider dairy industry and alternative land use*"[2].

5. The IDPs opposed the amendments permitting the Fonterra capital restructure for much the same reasons as the Government's own reservations to the changes. The Government however proceeded with the amendments. At the same time, to mitigate the identified risks to competition, the Government introduced other amendments including changes to the regulation of the base milk price. The Amendment Bill described certain of these changes were made to "*strengthen the Commerce Commission's oversight of the base milk price-setting regime*"[3].

6. These changes included
   - <u>Safe harbours</u>: amendment to the s 150B "safe harbour" assumptions making them subject to s 150A (thereby removing their "safe harbour" status and making bringing them within the full oversight of the Commission reviews)
   - <u>Disclosure</u>: requiring Fonterra to disclose non-sensitive information it provides as part of the Commission reviews of the manual and the BMP, and granting the Commission powers to overrule Fonterra decisions to withhold information

[1] Dairy Industry Restructuring (Fonterra Capital Restructuring) Amendment Bill, Explanatory note
[2] ibid
[3] Dairy Industry Restructuring (Fonterra Capital Restructuring) Amendment Bill, Explanatory note

- Direction: powers to direct Fonterra on matters arising from the Commission's reviews of the milk price manual and the BMP calculations (including the above noted power to overrule Fonterra decisions to withhold information)

7. The IDPs consider the first two amendments (safe harbours, and disclosure) require substantial changes to the way the BMP is calculated and reviewed. The powers to "direct" are expected to have a longer term impact on Fonterra responses to the Commission reviews). The IDPs are concerned these substantial changes are not recognised in the limited plan of work indicated in the draft Focus Areas paper. The Commission plays the key role ensuring the amendments achieve the objective of mitigating the increased risks to competition resulting from the new Fonterra capital structure. This is the first review following the DIRA Amendment Act 2022**; the IDPs request the Commission** consider giving a stronger signal of its intention to use the powers now available, by expanding the proposed focus areas for the 2022/23 review.

Section 150B assumptions (removal of "safe harbour" status)

8. While self-evident, a crucial characteristic of the BMP is that it sets a unit benchmark price for raw milk ($/kg MS) derived from a residual of revenues and costs. The unit measure can be considered to comprise three over-arching model elements:

   - The "unit" denominator: Total Milk solids processed into five commodities
   - The "unit" numerator comprising the residual of:
     - Costs (and yields) of converting the milk solids into five dairy commodities
     - Revenue/selling prices derived from sales and marketing of the five commodities

9. As calculated, these individual elements are not practically (commercially) feasible. The NP is attributed exceptional operating efficiencies (high yields and low unit costs) as a result of the scale attributed to the NP, while at the same time generating selling prices that can only be achieved on lower volumes and the higher cost of a more sophisticated business model. For example, it is not commercially feasible to process an equivalent of total Fonterra milk purchases into five commodities and deliver the revenue attributed to the NP: the volume produced is much larger than Fonterra actually produces, and that higher volume would result in substantially lower selling prices than is attributed to the NP. Because the BMP is a unit measure of a residual or surplus income, this would not be important if the NP model elements were determined in a consistent manner. Most importantly, the measures of costs and yields should be determined in a manner consistent with a commercial environment that is able to deliver the unit NP selling prices. The IDPs have long considered (and submitted) that this is not the case[4].

10. This inconsistency has been entrenched in the NP model because of what until now have been the s 150B safe harbour assumptions. It is important to note these assumptions are not mandatory – they are applied at Fonterra's discretion. The inconsistency related to costs and

[4] For example, submitters have previously pointed out that dairy solids in NP end product is almost certainly lower (and moisture and yield therefore higher) than Fonterra represents to buyers in its product bulletins ("typical compositions") published on the GDT web-site. There has never been a satisfactory explanation for this difference.

yields arises directly from the s 150B assumption (d) and the way in which Fonterra then interprets s 150B assumptions (a) and (b). S 150B assumption (d) states:

> *"all milk collected by new co-op is processed into commodities at yields that are practically feasible"*

11. Curiously, while the s 150B assumptions were sanctioned regardless of compliance with the s 150A purpose, assumption (d) ostensibly applies the s 150A "practically feasible" test for contestability. However in practice, assumption (d) has been interpreted to mean the NP yields are only required to be technically or theoretically feasible in relation to the volume of commodities assumed to be produced in accordance with assumption (d) – i.e. that all Fonterra milk is processed into just five unique products:
    - Regular Wholemilk Powder
    - Medium Heat Skimmilk Powder
    - Unsalted butter
    - 210 kg premium Anhydrous Milkfat
    - UHT Buttermilk Powder

12. This results in production yields that are higher than can be achieved in real world factories producing multiple products, or Fonterra's lower actual production of the relevant dairy commodities. The technical or theoretical feasibility test applied to s 150(B) assumption (d) had been allowed to stand in place of a proper s 150A "practically feasible" test as a result of the safe harbour status of the s 150B assumptions.

13. The theoretical yields have been supercharged by the application of the s 150B assumptions (a) and (b):

    S 150B assumption (a): *"new co-op operates a national network of facilities for the collection and processing of milk"*; Fonterra interprets this to mean the NP operates the same network of facilities with relevant factories scaled (using assumption (b)) to meet the volume produced in accordance with assumption (d)[5]

    S 150B assumption (b): the size of the NP "*assumed units of processing capacity approximates to the average size of new co-op's actual units of processing capacity*"

14. Assumption (a) has been interpreted by Fonterra to mean the NP can maximise square curved production (operate plants at full capacity over the season shoulders as well as the peak). Square curved plants operate more efficiently than plants that process milk in accordance with the seasonal milk curve. Processing efficiency is further enhanced by the large scale and number of Fonterra plants. That large processing capacity is a unique feature of Fonterra reflecting its dominant market share (around 80% of the raw milk market) and thus unavailable to any real world or potential Fonterra competitor for a supply of raw milk in New Zealand.

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[5] The s 150B assumptions are problematic, failing to distinguish between Fonterra and the NP. Fonterra and the Commission have interpreted "new co-op" to mean both Fonterra and the NP. At least in the case of assumptions (a) and (b), these are not Fonterra assumptions (they are real world descriptions). They become NP assumptions when the Fonterra characteristics are applied to the NP. This key distinction is important for considering the amendment making s 150B subject to the s 150A purpose.

Underpinning the efficiency is the commercially unrealistic assumption that only the five unique dairy commodities are manufactured by the NP.

15. On the other hand, NP selling prices are generated from a restricted volume of products (relative to the NP) and of a wider range of products. These service both commodity customers as well as customers that Fonterra nurtures through customer tailored supply of the wider range of products than actually "manufactured" by the NP[6].

16. The Commission approach to the safe harbour assumptions prior to the latest amendments is explained in its Approaches Paper as follows:

    "*Where revenue or cost components of the [BMP] calculation apply the "safe harbour" provisions of s 150B <u>they are excluded</u> from our assessment against the s150A purpose*"[7].

17. In relation to its assessment of practical feasibility 'in aggregate" the Commission approach has been to consider:

    "*whether the Manual provides for assumptions that are individually practically feasible for Fonterra due to features unique to Fonterra, and which do not relate to Fonterra acting efficiently … and which may not be "practically feasible for another efficient processor*"[8].

    This "in aggregate" review of practical feasibility explicitly excludes any features unique to Fonterra which are subject to the safe harbour provisions of s 150B[9].

18. Taken in the round, it can be concluded that a substantive part (by effect) of the BMP assumptions have to date not been reviewed for compliance with the s 150A purpose of BMP.

19. Under the DIRA Amendment 2022, the s 150B assumptions have lost their "safe harbour" status. The Commission recognises this in its Draft Approaches Paper which removes all references to "safe harbours" in relation to s 150B. The IDPs however consider the proposed revised treatment of s 150B is not sufficiently clear; the IDPs comment on this in a separate submission on the draft update. The NP will no longer be able to rely on the s 150B assumptions to justify theoretical advantages which are not achievable in a commercially feasible environment (for Fonterra or any actual or potential competitor).

20. The Commission indicates that amendments to the DIRA are an important factor for determining focus areas for the BMP calculations reviews[10]. The latest DIRA amendments have a major impact on the review of the BMP calculations noting the substantive assumptions which will now come within the s 150A purpose of the BMP (efficiency and contestability).

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[6] Fonterra claims the costs (including costs of reduced efficiency) of the wider range of products is accounted for through a procedure of adjusting selling prices for incremental production costs. This process remains opaque to external parties. Based on the limited information available, the IDPs are not confident that these incremental product costs and the process of adjusting selling prices is "fit for purpose".

[7] Approaches Paper – para 95

[8] Ibid – para 93

[9] Ibid

[10] Focus Areas 22/3 – para 11.4 ff

21. The Commission is proposing just one focus area for the 2022/23 calculations review – i.e. a review of the NP USD conversion rate[11]. The IDPs request the Commission change and widen the focus areas noting the substantive impact of the 2022 DIRA amendments.

22. A review of the USD conversion rate is a lower priority compared to the removal of safe harbour status of the assumptions in s 150B (1) (a), (b) and (d). This is not because the USD conversion rate is unimportant. It is instead because a review is unlikely to provide anything not already known. The IDPs have previously submitted the USD conversion rate did not comply with s 150B (c) regardless of its then safe haven status. They have also previously submitted that the NP conversion rate is not demonstrably practically feasible: the NP conversion rate is calculated by weighting an actual Fonterra monthly conversion rate arising from currency risk management of Fonterra actual cash flows, by the different notional cash flows of the NP. The "lottery" outcome of that procedure cannot in principle be practically feasible. The Commission has previously rejected both these IDP concerns.

23. The Commission has also previously indicated that while the NP conversion rate is different to Fonterra's own conversion rate, the Commission "did not consider these gave rise to significant differences"[12]. The Commission has not indicated what it considered to be "significant differences"[13]. Regardless of any difference, Fonterra actual conversion rate is undeniably practically feasible (for its own cash flows) and more demonstrably aligns to s 150B(1) assumption c. This is especially if there is no "significant difference" between the Fonterra actual conversion rate and the lottery based calculation for the NP. These conclusions are self-evident and can be drawn without a detailed review of the NP calculation process. The detailed review the Commission proposes might result in a different lottery result or draw the same conclusions it has previously drawn. The IDPs therefore consider the review as proposed by the Commission is a lower priority at this time.

24. The IDPs also point out that at least equally important in relation to the NP conversion rate is the need for increased transparency and disclosure. This is further addressed in paragraphs 33 ff below.

25. The IDPs **request the Commission** change the proposed focus area to instead provide for a review of the other three s 150B (1) assumptions (assumption (a), (b) and (d)). It is acknowledged that this is a more substantial review than that proposed by the Commission relating to the NP conversion rate. This however seems unavoidable so that the Commission can complete its review following the removal of safe harbour status of the s 150B assumptions. If it is not practical for the Commission to review these assumptions in their entirety, the IDPs consider that the focus areas should include a work plan to achieve that outcome over the current and next review, and to identify the part of the work plan which will be included in the 2022/23 review.

[11] Focus Areas 22/3 – para 12 ff

[12] See for example Appendix B of the Commission's final report on the 2019/20 BMP calculations review

[13] Very small differences in the conversion rate have a large impact on the BMP. For example, a difference of 60 bp on the 2021/22 BMP conversion rate would have changed the 2021/22 BMP by 10 cents (or some 20% of the NP EBITDA).

Section 150QA: Disclosure of Information

26. Under new section 150QA, Fonterra is required to make all non-sensitive information related to the BMP calculations publicly available within 20 working days after the Commission issues its final report (no later than 15 September 2023)[14]. If the Commission considers any information withheld by Fonterra is not in fact "sensitive information", it may direct Fonterra to make the information publicly available[15]. The effect of this amendment will be first crystallised after the Commission completes its review and reports on the 2022/23 BMP calculations. The Commission might therefore consider it falls outside the scope of the 22/23 calculations review. In any event the Focus Areas 2022/23 paper is silent on the new disclosure requirements.

27. The IDPs nevertheless **request the Commission** consider including a new focus area addressing the new DIRA disclosure requirements. Since the introduction of the current BMP framework under sub-part 5A of the DIRA in 2012, Fonterra has shown it is very reluctant to disclose meaningful information. The BMP model remains opaque. Fonterra maintains a privileged and unique position and knowledge enabling it to manage milk cost risk throughout the Season. At the same time Fonterra extracts a competitive advantage by ensuring opacity of the BMP model. This undermines the management of milk cost risk for its competitors. Milk cost is only known with certainty by Fonterra competitors when Fonterra releases the final BMP almost four months after the end of the season (typically in the last week of September). The new DIRA disclosure requirements should help to neutralise that inappropriate competitive advantage.

28. The milk price manual already requires Fonterra to

    "*make publicly available, modified where necessary to protect the disclosure of information that would be prejudicial to Fonterra's legitimate commercial interests, the Reports prepared for a year by Fonterra under Section 150L of the DIRA and section 150T* (i.e. the information Fonterra provides the Commission in support of the Manual and of the BMP calculations reviews)"[16]

29. Fonterra is thus likely to claim it is already compliant with the new s 150QA. In the absence of intervention by the Commission, there is a risk that s 150QA will have no meaningful impact on improving transparency of the BMP.

30. At the most basic level, as part of the 2022/23 review the Commission will need to consider how the review process itself will inform its view on whether specific information can be considered to be "sensitive information". Fonterra has already made it clear what it considers to be "sensitive information" through the information it already withholds in accordance with its interpretation of the Milk Price Manual Part A, sections 6.4[17]. After over a decade in which

[14] New section 150JA mirrors 150QA but deals with disclosures relating to information concerning the Milk Price Manual. It will first be effective in relation to the 2023/24 Milk Price Manual and so is outside the scope the 2022/23 reviews.

[15] DIRA s 150UA (1) (b) and 150UB (3)

[16] Fonterra Milk Price Manual Part A, Section 6.4

[17] Refer for example Attachment 2, Fonterra 'Reasons' Paper in Support of Fonterra's Base Milk Price for the 2021/22 Season (1.07.22), and the redactions made in the "Reasons" paper itself (e.g. assumed processing losses and specification offsets are redacted at pages 14 and 15 despite the fact that, as also stated on those

the BMP has remained opaque, the objective now must be to ensure information is publicly accessible in as timely a manner as possible, whether voluntarily by Fonterra or as a result of directions by the Commission.

31. The Commission has previously recommended Fonterra increase disclosures and transparency of the BMP. Until now it has been unable to enforce those recommendations and Fonterra has often failed to implement them. The Commission is now able to and should consider if it will direct Fonterra to comply with these recommendations. Recent examples are:

- Detailed disclosures (presented in a way that is meaningful to interested parties) relating to NP cash costs, selling prices and volumes, the methodology for determining weighted average selling prices (including the impact of phasing), and detailed information relating to off-GDT sales and inputs.[18]

- On several occasions the Commission has encouraged Fonterra to provide greater transparency around the USD conversion rate.[19]

32. The IDPs **request the Commission** consider including the new DIRA disclosure requirements of section 150QA as a focus area for the review of the 22/23 BMP calculations. This could include

- a review of the material submitted with the Fonterra Reasons Papers BMP calculations which Fonterra has previously withheld from public disclosure and consider any Fonterra explanation for any continued withholding of that information

- a review of previous disclosure recommendations made by the Commission and whether those disclosures (to the extent Fonterra has not complied) might now be required under new s 150QA or an associated direction from the Commission

- a consideration of disclosures concerning the NP USD conversion rate so that the market is as informed as Fonterra of the likely NP conversion rate

USD Conversion rate

33. Disclosures concerning the USD conversion rate warrant further consideration. The NP conversion rate is the most opaque (to all but Fonterra) assumption underlying the BMP when measured by its ability to cause estimation error. While it is correct that earlier in the season the uncertainty of commodity selling prices will typically have a bigger impact on estimation error, that uncertainty is common to all parties[20].

34. The NP conversion rate depends entirely on Fonterra treasury policy, its selection of hedging instruments, and its ability to accurately estimate future commodity prices. Overlaid by the

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pages, the assumptions are different to Fonterra actual yields and thus not commercially sensitive in any obvious manner.

[18] Para 3.139, Final Report on the 2021/22 BMP Calculations Review (15.09.22). Previous reports have raise related issues (for example, paras 2.67 and 2.71, Final Report on the 2019/20 BMP Calculations Review (15.09.20)

[19] For example, Appendix B, page 38 Final Report on the 2019/20 BMP Calculations Review (15.09.20)

[20] This difficulty is for example reflected in Fonterra's FGMP forecasts to date for the 2022/23 season. Mid-points of those forecasts have been: $9.00 (26 May 22), $9.50 (23 June 22), $9.25 (26 Aug 22), $9.00 (8 Dec 22), $8.50 (24 Feb 23), $8.30 (3 April 23).

volatility of the USD/NZD, it is very difficult to predict the NP conversion rate with any certainty. Fonterra provides some information on the conversion rate earlier in the season, in its annual Farmgate Milk Price Statement (published in September). In that statement, for the then current season, Fonterra advises its estimate of the portion of NP revenues that were already hedged at 31 July, and its estimated conversion rate assuming the remaining estimated unhedged cash flows were hedged at that same date. Fonterra discloses the latter metric correct to 2 decimal points. Fonterra provides no credible reason for this low level of accuracy. Given the sensitivity of the BMP to the conversion rate, it is typically represented correct to four decimal places (e.g. in Fonterra "after the event" reporting on the NP actual conversion rate).

35. The datapoints disclosed by Fonterra early in the season do however provide a basis for extrapolating possible NP conversion rates. The potential range of extrapolations is wide. By way of illustration, following the second auction in February 2023, third party estimates of the FGMP included:
    - NZX Milk Price Calculator[21]: estimated FGMP was $8.57 including an estimated conversion rate of 0.6325
    - TDB Advisory[22]: estimated FGMP was $8.24 including an estimated conversion rate of 0.6538

36. A substantial portion of the difference between the two FGMP estimates is explained by the 213 b.p. difference between the estimated conversion rates. This illustrates the uncertainty and associated risks to managing costs and revenues faced by Fonterra competitors and NZ dairy farmers generally. By comparison, Fonterra holds all the key parameters to determine the NP conversion rate with increasing accuracy as the season progresses. It does not currently share those parameters in a meaningful way and thus places its competitors (and all dairy farmers) at a disadvantage. The purpose of the DIRA is to mitigate the risks of Fonterra market power. Fonterra should not be able to exploit its DIRA role of determining the BMP to provide a competitive advantage.

37. The new DIRA disclosure requirements only require Fonterra to disclose information after the final BMP has been reported. However, given the intent of the requirements is to help level the playing field for Fonterra competition, the IDPs consider that Fonterra at least should be strongly encouraged to provide on-going disclosures of its estimate of the NP conversion rate: each time it updates its forecast FMGP, it should disclose the same information it currently provides once a year in the FGMP Statement. To be meaningful, the estimated conversion rate needs to be correct to four decimal places, and Fonterra needs to disclose a single point FGMP forecast (presumably its forecast mid-point) on which the estimate is based.

Other Focus Areas

Milk Collection Costs

38. In its final report on the 2021/22 BMP calculations, the Commission indicated it would consider including a review of milk collection costs as a focus area in its review of the 2022/23 BMP

[21] The NZX Milk Price calculator is available online at https://dairy-tools.nzx.com/fgmp.
[22] TDB Advisory "Dairy Matters" commentary issued to clients and partners.

calculations[23]. This was in response to previous submissions on the 2020/21 and 2021/22 BMP reviews. In its submission on the 2021/22 proposed focus areas, Miraka pointed out[24]:

- the Commission had last reviewed milk collection costs for the 2012/13 BMP
- the implied NP business model had since become more complex including because:
  - the implied production model is more complex because of the expanded use of off-GDT sales since the 2016/17 season
  - four NP plants have been "mothballed" and subsequently "closed"; this is likely to have a direct impact on milk collection costs

39. The Commission has now decided it will not include milk collection costs as a focus area for the 2022/23 BMP review[25]. The Commission explains this is because:

- There is insufficient evidence to justify a detailed review
- The NP model does not allocate milk to NP processing sites and it is therefore difficult to test milk collection cost assumptions (thus elaborating on why there is insufficient evidence to enable a detailed review)
- The Commission accepts that the use of Fonterra's actual milk collection costs is consistent with the efficiency dimension of s 150A
- An efficient processor, locating an incremental plant close to it source of milk can achieve milk collection costs that are lower than the NP and accordingly the milk collection costs of the NP are practically feasible.

40. The IDPs disagree that this justifies excluding milk collection costs from the focus areas for the 2022/23 BMP review. Rather, it indicates that Fonterra has not provided sufficient information to determine that the milk collection costs are practically feasible in a way which reflects the advantages of scale attributed to the NP.

41. The Commission explanation of its position also does not seem consistent with the way Fonterra calculates the NP milk collections costs. Referring to the Fonterra Reasons paper in support of the 2021/22 BMP calculations:

- "*The* [BMP] *model assumes the same number (and location) of commodity manufacturing sites as is actually maintained by Fonterra, and that total processing capacity by site is materially aligned to Fonterra's. The model also assumes that annual volumes of milk processed on each site are materially aligned to the volumes actually processed*"[26] [by Fonterra].
  Fonterra indicated this assumption relied on the s 150B assumption (a): that Fonterra, and therefore the NP "*operates a national network of facilities for the collection and processing of milk*". At the time, that assumption had "safe harbour" status. That is no longer the case, and going forward the assumption must comply with the s 150A purpose.

[23] Attachment A, Commission Final Report, BMP Calculations Review 2021/22 (15 September)
[24] Para 35, Miraka Submission (6 May 22), Proposed Focus Areas, 2021/22 BMP Calculations Review
[25] Paras 18 to 22, Commission Proposed focus areas, 2022/23 bmp calculation review (30.3.23)
[26] Fonterra "Reasons" Paper, BMP Calculations, 2021/22 Season (1.6.22) - Page 9

- The NP costs are based on "*Fonterra's actual costs, **excluding Fonterra's actual inter-factory diversion costs and inter-island milk transport costs***"[27] [highlighting not in the original]
- "*Diversion costs are modelled by reference to the assumed product mix (**and therefore surplus cream/buttermilk**) at each site, average transport cost per km, and for sites without cream or buttermilk processing capacity, the distance between the site and a designated site with cream and/or buttermilk processing capacity*"[28] [29].

42. Contrary to the Commissions view, an allocation of milk to geographic sites is implicit in the NP business model. That allocation is the same or virtually the same as Fonterra's own allocation (i.e. which are known metrics). Whether that allocation can support the extent to which the NP is assumed to square curve production facilities is a separate issue which needs to be considered in relation to paragraph 25 above. The fact remains that for purposes of milk collection costs, the NP is assumed to consolidate or allocate milk to the same geographic sites and of the same actual volume as Fonterra.

43. While the Commission is correct that the NP milk collection costs are based on Fonterra actual costs, the NP costs do not include all Fonterra costs. Diversion costs and inter-island milk transport costs are excluded. Those excluded costs however are the necessary costs of delivering milk in accordance with Fonterra actual processing of milk at each site (although also refer note 30 below). That is the same site allocation as assumed for the NP. It is not feasible on the one hand to assume milk allocation to the NP sites is the same in all material respects to Fonterra's own milk allocation while at the same time assuming without evidence the NP milk collection costs do not include all Fonterra costs. To the extent that it might have been arguable previously, the fact that the s 150B assumptions are no longer safe harbours means it is certainly no longer acceptable.

44. Fonterra separately models "diversion costs" for cream and buttermilk processed by the NP[30]. The description of this modelling procedure is contrary to the assertion that milk collection cost assumptions cannot be tested. The calculation as described depends on a detailed site by site allocation of NP milk, calculation of the NP primary production (WMP and SMP) at each site based on that milk allocation, calculation of resulting cream and buttermilk by-product streams, and allocation of those streams to either on-site NP cream and buttermilk processing facilities, or "closest site" production facilities taking into account closest site location, capacity, travel distances, and transport costs. In other words, there is a fully modelled geographic allocation of processing capacity (WMP, SMP, butter/AMF and BMP), allocation of milk volumes to primary processing sites, and allocation of cream and buttermilk to secondary processing sites. None of

[27] Ibid: Collection Costs, page 22
[28] Ibid
[29] "Diversion costs" refer to the transport of milk liquids beyond the typical or closest site within the relevant milk catchment, as for example might be required during the season peak or to aggregate milk at selected square curved facilities. Fonterra here is referring to the modelling of costs of transporting cream and buttermilk to a secondary processing site (where the Fonterra – and therefore NP - production configuration does not include cream or buttermilk processing at the primary production site).
[30] To the extent that this replaces transport costs included in Fonterra diversion costs, this justifies the exclusion of those actual Fonterra diversion costs from the NP costs.

this seems particularly onerous considering the simple (five product) nature of the assumed NP manufacturing model.

45. In summary, it is difficult to understand why Fonterra is unable to provide testable evidence to support the NP milk collection cost.

46. The Commission also considers the NP milk collection costs based on Fonterra actual costs would be practically feasible because they would be a higher unit cost compared to an incremental plant located close to its milk supply. While that might be correct, the NP business model has elected for scale advantages over the advantages of a smaller operation. Scale advantages can carry incremental costs. In this case, the commodity plants and factories are sized to process an equivalent of the total of Fonterra milk. This will necessarily draw from a wider catchment than smaller plants and thus occur a higher unit cost for milk transport. The NP cannot claim scale advantages while avoiding incremental costs associated with scale.

47. **The IDPs request the Commission** reconsider including a review of milk collection costs in the 2022/23 BMP review.

Cost Inflation Adjustments

48. In response to submissions by OCD and Synlait, the Commission added a focus area for the 2021/22 BMP calculation review to include a review of adjustments for cost inflation. That review extended to adjustments for variable manufacturing costs and to update the cost of the capital asset base[31]. With inflation continuing at historically high levels, **the IDPs request the Commission** include the same level of scrutiny of NP inflation based cost adjustments for the 2022/23 BMP calculations review. It is requested that review extend to include all cash costs, not just the variable manufacturing costs.

Issues Raised in the IDP submission, draft report 2022/23 Manual Review

49. In the submission on the Commission's draft report on the 2022/23 manual review, the IDPs raised a number of issues arising from the final report on the 2021/22 calculations review. They considered these issues were relevant to the 2022/23 Manual review. The IDPs also requested consequential actions be taken in the 2022/23 calculations review. The Commission did not respond to a number of the issues raised in the IDPs submission. In its final report it advised that:

> The IDPS "*raised a range of other matters that are outside the scope of the Manual review as they relate to the application of the [Manual] rules in practice…. We review the implementation of the rules in the calculation review*"[32].

50. The IDPs accept the issues raised may have been outside the scope of the Manual review. However, the issues were raised to help retain a thread between the various phases of the BMP reviews, and to maintain momentum in the resolution of issues.

51. In its proposed Focus areas, the Commission has also not addressed the IDP issues which it had put aside for the Manual review. **The IDPs now request the Commission** to consider those

[31] Commission final report, 21/22 BMP Calculations Review, para 3.122 ff
[32] Commission final report, 22/23 Manual Review (15.12.22), para 22

issues for the 2022/23 BMP calculations review. A summary of the issues, and relevant references to the IDP submission of 15 November 2022 (IDP submission on the Commission draft report, 2022/23 manual review) is provided in the following sections.

Prevailing market price test for qualifying reference sales

52. This was addressed in paragraphs 9 to 20 of the IDP submission, 2022/23 Manual review. The IDPs submitted new evidence (based on information provided by Fonterra to the Commission) that 2021/22 qualifying reference sales included sales that were not consistent with prevailing market prices. The IDPs requested the Commission review that evidence and that compliance of the qualifying reference sales with prevailing market prices be further considered in the 2022/23 calculations review.

Standard Product Offerings (substitution test)

53. This was addressed in paragraphs 24 to 40 of the IDP submission, 2022/23 Manual review. The IDPs pointed to unresolved issues relating to the substitution test (also referred to as the cascadable product rule) including those raised by the Commission in its final report on the 2021/22 BMP calculations review. The IDPs consider that the substitution test as it is applied does not provide assurance that SPOs and qualifying reference sales are dairy commodities. The IDPs requested the Commission include this matter in the 2022/23 BMP calculations review.

Significant quantities

54. This was addressed in paragraphs 41 to 44 of the IDP submission, 2022/23 Manual review. The Manual does not define "significant quantities" for purposes of identifying dairy commodities. The IDPs requested the Commission review whether products included as qualifying reference sales in the 2022/23 BMP calculations review are compliant with the DIRA definition ("significant quantities") of dairy commodities.

Valuation of Reference Assets

55. This was addressed in paragraphs 64 to 69 of the IDP submission, 2022/23 Manual review. The IDPs explained that it is not possible to reconcile the limited available information regarding changes in the value of the reference assets with the changes in NP fixed assets each year. The IDPs requested that Fonterra make available an annual statement which explains the movements in the value of NP fixed assets. This can now also be considered to fall within the new DIRA disclosure requirements.

Authorisation

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