

30 May 2023

Stephen Langbridge
General Counsel
Westland Milk Products

By email

Dear Stephen,

Effect of section 150B(2) of the Dairy Industry Restructuring Act

1. Subpart 5A of the Dairy Industry Restructuring Act 2001 (**DIRA**) sets out the way in which Fonterra is required to calculate a base milk price (a price payable to farmers for raw milk) for each New Zealand dairy season. Subpart 5A also provides the Commerce Commission (the **NZCC**) with a review and oversight role. Subpart 5A's purpose is to promote the setting of a price that provides an incentive to Fonterra to operate efficiently while providing contestability in the raw milk market (the **s 150A purpose**).¹
2. Prior to January 2023, s 150B (now s 150B(1)) set out four "assumptions" that, if used by Fonterra, were deemed to be consistent with the s 150A purpose. That is, if Fonterra adopted an assumption of the type listed in s 150B(1), then that assumption and its application was deemed to be consistent with the s 150A purpose and therefore outside the scope of the NZCC's review function.
3. In January 2023, s 150B was amended to include a new s 150B(2), which provides that:

[Section 150B(1)] does not extend to the way in which new co-op uses an assumption in setting the base milk price.
4. You have asked, on behalf of Westland Milk Products, Miraka, Open Country Dairy, and Synlait, for my opinion on the impact of s 150B(2) on the calculation of the base milk price and the NZCC's review of the same. This letter sets out my views.

Summary of my opinion

5. The introduction of s 150B(2) means that, taken together, s 150B(1) and (2) provide that:
 - 5.1 an assumption of the broad type listed in s 150B(1)(a)-(d) is not inconsistent with the s 150A purpose when included in the base milk price calculation; but
 - 5.2 the way that assumption is used by Fonterra – i.e., applied – in calculating the base milk price including all inputs (costs, quantities etc) and subsidiary assumptions used, must be consistent with the s 150A purpose.
6. While the matters listed in s 150B(1) are described as "assumptions", they are better labelled as characteristics of Fonterra. Section 150B(1) allows those characteristics to form

¹ Dairy Industry Restructuring Act 2001, s 150A.

part of the way the base milk price is calculated. Put another way, these characteristics cannot be challenged as being inconsistent with the s 150A purpose.

7. What s 150B(2) does is to make clear that the way Fonterra uses (i.e., applies) that characteristic in calculating the base milk price must meet the s 150A purpose, i.e., the application of the assumption must be one which provides an incentive for Fonterra to operate efficiently while providing for contestability in the raw milk market.
8. It follows that Fonterra's particular application of the assumption (the characteristic) – including the inputs used or subsidiary assumptions made – must meet the contestability requirements in s 150B(2) in that they must “be practically feasible for an efficient processor”. The NZCC has indicated its view that:

... the base milk price setting is consistent with the contestability dimension if the assumptions adopted, and inputs and process used, are practically feasible for Fonterra, or another processor that is efficiently building and operating an incremental plant.²
9. The NZCC has also indicated its view that the term “practical feasibility” in s 150A(2) requires the assumption or input to be commercially feasible.³
10. To take the assumption in s 150B(1)(a) as an example of the way s 150B now works, my view is that:
 - 10.1 the NZCC could not review whether assuming “a national network of facilities for the collection and processing of milk” is consistent with the s 150A purpose; but
 - 10.2 the NZCC could review whether the inputs used, or subsidiary assumptions made when applying the s 150B(1) assumption meet the s 150A purpose, i.e., are they inputs or subsidiary assumptions that are practically feasible for an efficient processor with a national network of facilities for the collection and processing of milk.
11. Like all statutory provisions, s 150B(2) must be interpreted based on its text in light of its purpose.⁴ I explain below why my interpretation is consistent with the text of s 150B(2) and its purpose, as inferred from the statutory scheme and the legislative background.

The statutory scheme prior to the enactment of s 150B(2)

12. Subpart 5A of DIRA was introduced in July 2012 to increase transparency and accountability for Fonterra in the setting of its raw milk price. Section 150A describes the purpose of subpart 5A as follows.
 - (1) The purpose of this subpart is to promote the setting of a base milk price that provides an incentive to [Fonterra] to operate efficiently while providing for contestability in the market for the purchase of milk from farmers.
 - (2) For the purposes of this subpart, the setting of a base milk price provides for contestability in the market for the purchase of milk from farmers if any notional costs, revenues, or other assumptions taken into account in calculating the base milk price are practically feasible for an efficient processor.
13. Section 150C specifies principles that the base milk price must comply with. Section 150B(1) provides:

² Commerce Commission “Our approach to reviewing Fonterra’s Milk Price Manual and base milk price calculation 2023”, at [55].

³ Above n 2, at [50].

⁴ Interpretation Act 1990, s 5 and *Commerce Commission v Fonterra Co-operative Group Ltd* [2007] NZSC 36

- (1) It does not detract from the achievement of the purpose set out in section 150A that [Fonterra] sets the base milk price using assumptions that include any of the following:
- (a) that [Fonterra] operates a national network of facilities for the collection and processing of milk:
 - (b) that the size of [Fonterra's] assumed units of processing capacity approximates to the average size of [Fonterra's] actual units of processing capacity:
 - (c) that gains and losses experienced by [Fonterra] resulting from foreign currency fluctuations, including from [Fonterra's] foreign currency risk-management strategies, are incorporated in the base milk price:
 - (d) that all milk collected by [Fonterra] is processed into commodities at yields that are practically feasible.

14. While described as “assumptions”, in my view, the matters listed in (a)-(c) are better described as characteristics of Fonterra which are permitted to form part of the base milk price calculation. That is, the base milk price calculation should not require Fonterra to assume away: the fact it operates a national network of collection facilities (sub-clause (a)), its actual processing capacity (subclause (b)), the fact that it sells products overseas and so will experience currency fluctuations (subclause (c)). Sub-clause (d) is slightly different but embodies an assumption that all milk collected is processed at realistic yield levels.
15. As I understand it, historically, s 150B(1) has been interpreted as a “safe harbour”. That is, if Fonterra adopted an assumption of the type listed in (a) to (d), then that assumption and its application was deemed to be consistent with s 150A.

The introduction of s 150B(2)

16. Section 150B(2) was introduced in January 2023 and provides:

Subsection (1) does not extend to the way in which [Fonterra] uses an assumption in setting the base milk price.

17. In addition to s 150B(2), two other relevant amendments were made to the NZCC's monitoring and review powers.

- 17.1 Section 150I – which requires the NZCC to report on the extent to which the milk price manual is consistent with the s 150A purpose – was amended to include a new subsection (1A):

To avoid doubt, a report under subsection (1) may include the extent to which the way new co-op uses an assumption described in section 150B(1) in relation to the milk price manual is consistent with the achievement of the purpose set out in section 150A.

- 17.2 Section 150P – which requires the NZCC to report on the extent to which the assumptions adopted and the inputs and process used by new co-op in calculating the base milk price are consistent with the s 150A purpose – was amended to include a new subsection (1A):

To avoid doubt, a report under subsection (1) may include the extent to which the way new co-op uses an assumption described in section 150B(1) in calculating the base milk price is consistent with the achievement of the purpose set out in section 150A.

18. On their face, these amendments subject the use (i.e., the application) of any of the s 150B(1) “assumptions” to scrutiny as against the s 150A purpose. This interpretation is consistent with the legislative background to the introduction of these amendments.

19. The amendments arose out of a consultation process MPI ran on the Government’s response to Fonterra’s capital restructuring plan.⁵ The application of the s 150B assumptions was not raised in MPI’s Consultation Document. Rather, in their joint submission on MPI’s Consultation Document, Miraka, Westland Milk Products, and Synlait Milk, submitted:

S150B safe havens provide a wide scope to artificially inflate the milk price. In effect, these trump and make toothless the “practically feasible” test of S150A (2). The Submitters consider that S150B should be repealed. This appropriately leaves the practical feasibility test of S 150A (2) as the correct basis for determining that the milk price provides contestability in the market.⁶

20. While MPI did not adopt the submitters’ suggestion to repeal s 150B, in its briefing to the Minister on 23 June 2022 seeking decisions on regulatory design, MPI recommended (emphasis added):

The use of the current “safe harbour” provisions in section 150B of Subpart 5A of the DIRA is clarified. These provisions list certain assumptions that may have a material impact on the base milk price calculation but as currently drafted cannot be reviewed by the Commission. We propose that the DIRA be amended to:

- i. retain Fonterra’s ability to adopt/use the assumptions listed in section 150B, but
- ii. ensure that the Commission's review and directions powers **may extend to consideration of whether Fonterra's method for applying the listed assumptions is consistent with the purpose of the base milk price-setting provisions in Subpart 5A, as set out in section 150A.**⁷

21. Subsequently, the Cabinet Paper seeking approval to introduce for Dairy Industry Restructuring (Fonterra Capital Restructuring) Amendment Bill stated (emphasis added):

The Bill also clarifies the scope of the Commission’s existing review functions, in relation to the boundaries of the “safe harbour” provisions in section 150B of subpart 5A of Part 2 (Subpart 5A). The “safe harbour” provisions are certain assumptions which, if used by Fonterra in the Manual or the calculation, are deemed consistent with the purpose of the base milk price regime and are therefore excluded from the Commission’s reviews.

However, the current drafting of the DIRA has limited the Commission’s ability to consider the way in which such assumptions are applied by Fonterra. This may have a material impact on the base milk price calculation but is not currently considered by the Commission. **The Bill addresses this issue by amending the DIRA to retain Fonterra’s ability to use the safe harbour assumptions, while explicitly stating that the way in which Fonterra applies those assumptions are subject to the Commission’s review and direction.**⁸

22. The Cabinet Economic Development Committee approved the introduction of the Dairy Industry Restructuring (Fonterra Capital Restructuring) Amendment Bill on 31 August 2022. The Bill was introduced on 13 September 2022. In relation to s 150B(2), the Explanatory Note to the Bill stated the purpose was to:

To strengthen the Commerce Commission’s oversight of the base milk price-setting regime, the Bill—

....

- clarifies the boundaries of the current safe harbour provisions that relate to the setting of the base milk price; and

⁵ See <https://www.mpi.govt.nz/consultations/the-governments-proposed-response-to-fonterras-capital-restructure/>

⁶ Miraka, Westland Milk Products, and Synlait Milk “Joint Submission to the Ministry for Primary Industries re: Fonterra Capital Restructuring: Proposed Government Response - Proposed Amendments to the Dairy Industry Restructuring Act 2001” (3 June 2022) at [28].

⁷ MPI “Briefing to the Minister of Agriculture” (20 June 2022) at [9(b)].

⁸ Cabinet Paper “Dairy Industry Restructuring (Fonterra Capital Restructuring) Amendment Bill: Approval for Introduction and Associated Increase in Appropriation”.

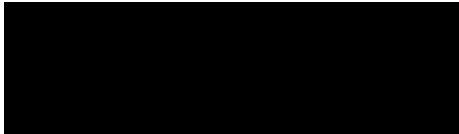
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23. Section 150B(2) received little attention during the parliamentary process. The bill passed its third reading in November 2022 and s 150(b) came into effect on 1 January 2023.
24. The legislative history shows that a decision was made not to repeal s 150B entirely. It can be inferred from this decision that s 150B(1) is intended to retain some effect. However, what is clear is that s 150B(2) was introduced to address the danger of Fonterra applying the s 150B(1) “assumptions” in a way that did not meet the s 150A purpose.
25. My view is that the interpretation that is both consistent with the words of s 150B and best reconciles s 150B(1) and (2) is that s150B in total means:
 - 25.1 the inclusion of an assumption of the type listed in s 150B(1)(a)-(d) in the base milk price calculation cannot be challenged as being inconsistent with the s 150A purpose; however,
 - 25.2 the way the assumption is used by Fonterra – i.e., its application –in calculating the base milk price including all inputs (costs, quantities etc and subsidiary assumptions) must be consistent with the s 150A purpose.

Concluding comments

26. As illustrated above, in making the changes to s 150B(2) it was acknowledged that the application of the s 150B(1) assumptions can have a “material impact” on the base milk price. The potential for a “material impact” is a factor that is relevant to the exercise of the NZCC’s discretion as to what areas to focus its review on.
27. I trust this letter addresses your questions.

Yours sincerely



David Blacktop
Partner

