

# **Review of Fonterra's 2023/24 Milk Price Manual: Dairy Industry Restructuring Act 2001**

**Final report**

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# Chapter 1 Introduction

## Purpose of this report

1. This report sets out our conclusions from our statutory review of the extent to which Fonterra's 2023/24 Milk Price Manual (the **2023/24 Manual**) is consistent with the purposes of the base milk price monitoring regime (**monitoring regime**) under subpart 5A of the Dairy Industry Restructuring Act 2001 (**DIRA**).<sup>1</sup>
2. The Manual contains the methodology that will be used to calculate Fonterra's base milk price for the 2023/24 season.

## How this report is structured

3. Chapter 2 explains our review framework and the scope of our 2023/24 Manual review.
4. Chapter 3 sets out our conclusions from the review and responds to submissions from stakeholders on our draft report.
5. Attachment A provides a glossary of the key terms and abbreviations used in this report.

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

## Chapter 2 Our review framework

### Our approach for the Manual review

6. This report should be read along with 'Our approach to reviewing Fonterra's Milk Price Manual and base milk price calculation' (our **Approach paper**), which we have applied in this review and which forms part of this report. The Approach paper provides an overview of the approach we take in our reviews of Fonterra's Manual and base milk price calculation and includes:<sup>2</sup>
  - 6.1 an overview of how the base milk price is set;
  - 6.2 our interpretation of the key legislative provisions guiding our statutory reviews; and
  - 6.3 our analytical and practical approach to our statutory reviews.
7. The base milk price monitoring regime is intended to provide incentives for Fonterra to act efficiently, while providing for contestability in the market for the purchase of raw milk from farmers. The regime also promotes greater transparency of Fonterra's base milk price setting processes.<sup>3</sup>
8. We undertake a review of the Manual for each season. The Manual contains the methodology Fonterra uses to calculate its base milk price. As such, the Manual contains a set of definitions, rules and formulas specifying the inputs and process to be followed in calculating the base milk price.
9. We consider the extent to which the Manual is consistent with the purpose of subpart 5A of DIRA. In particular, our review considers the 'efficiency' and 'contestability' dimensions of the s 150A purpose as required by DIRA. Our review therefore focuses on whether the methodology and rules used in the Manual:
  - 9.1 provide an incentive for Fonterra to operate efficiently (the 'efficiency dimension'); and
  - 9.2 adopt assumptions, inputs and processes that would be practically feasible for an efficient processor (the 'contestability dimension').<sup>4</sup>
10. As set out in the Approach paper, the efficiency dimension is met if Fonterra uses notional inputs in calculating the milk price (independent from Fonterra's actual data).

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<sup>2</sup> [Commerce Commission "Our approach to reviewing Fonterra's milk price manual and base milk price calculation" \(1 August 2023\).](#)

<sup>3</sup> Dairy Industry Restructuring Amendment Bill (Government Bill) 2012, at 2.

<sup>4</sup> We consider the same 'efficiency' and 'contestability' dimensions when we carry out our base milk price calculation review.

11. Contestability is considered to be provided for if any notional costs, revenues, or other assumptions taken into account in calculating the base milk price are practically feasible for an efficient processor.<sup>5</sup>
12. To satisfy the provisions in s 150A, our interpretation is that our statutory review must assess the extent to which the Manual is consistent with both dimensions. We attach equal weight to both dimensions in our reviews. Our analytical approach to the efficiency and contestability dimensions is described in chapter 4 of the Approach paper.<sup>6</sup>
13. In practice, we mostly focus our review each year on changes to the Manual from the previous year's Manual and on any unresolved issues carried over from our previous reviews.
14. We also take into account the amendments to DIRA that are relevant to our review functions when deciding where to focus our reviews.
15. As a result of the recent amendments to s 150B of DIRA,<sup>7</sup> we have also focused in particular on assessing the way in which Rule 10 of the Manual (FX conversion of USD revenue to NZD) incorporates the s 150B(1)(c) assumption on foreign exchange conversion rates and the extent to which Rule 10 is consistent with the statutory purpose set out in s 150A.<sup>8</sup> Paragraph 22 outlines our planned consideration of the other s 150B(1) assumptions.

### Scope of this review

16. DIRA requires Fonterra to provide us with the following information for consideration in our Manual review:<sup>9</sup>
  - 16.1 the Manual for the current season;
  - 16.2 any recommendations by the Milk Price Panel (**MPP**)<sup>10</sup> in relation to the milk price manual;<sup>11</sup>

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<sup>5</sup> DIRA, s 150A(2).

<sup>6</sup> [Commerce Commission "Our approach to reviewing Fonterra's milk price manual and base milk price calculation" \(1 August 2023\).](#)

<sup>7</sup> Section 150B(2) was inserted on 1 January 2023, by section 14 of the Dairy Industry Restructuring (Fonterra Capital Restructuring) Amendment Act 2022.

<sup>8</sup> DIRA, s 150B and s 150A

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

<sup>10</sup> The MPP is a committee that Fonterra is required to establish and maintain under s 150D of DIRA. Each season the MPP is required to supervise the calculation of the base milk price; advise Fonterra on the application of the Manual; and recommend the base milk price to Fonterra. See also [Fonterra "Base Milk Price Manual for the 2023/24 season \(marked up version\) - 1 August 2023" \(23 August 2023\), at page 27.](#)

- 16.3 notification of any change in the economic and business environment that, in Fonterra's view, requires a change to the Manual;
- 16.4 certification on the extent to which Fonterra considers that the Manual is consistent with the s 150A purpose; and
- 16.5 the reasoning behind the views expressed in Fonterra's certification.
17. The above information, where relevant, has been provided by Fonterra and has been considered as part of our review. Specifically, Fonterra has provided us with: the Base Milk Price Manual for the 2023/24 season (marked-up version);<sup>12</sup>
- 17.2 a Reasons paper in support of Fonterra's Milk Price Manual for the 2023/24 season (**Fonterra's Reasons paper**), which contains the information noted in paragraphs 16.3, 16.4, and 16.5;<sup>13</sup> and
- 17.3 the MPP recommendations to Fonterra's Board with respect to amendments to the 2023/24 Manual.
18. We published our draft report on 16 October 2023.<sup>14</sup> We received a joint submission on our draft report from Miraka, Open Country Dairy, Synlait Milk and Westland Milk Products.<sup>15</sup> Fonterra did not make a substantive submission on the draft report.<sup>16</sup> We invited Fonterra to respond to the joint submission from the IDPs. Fonterra provided a response to the Commission.<sup>17</sup>
19. The 'marked up' version of the 2023/24 Manual shows the changes that have been made to the previous season's version of the Manual. Fonterra has stated in its Reasons paper that the 'marked up' version of the 2023/24 Manual identifies all amendments to the Manual.<sup>18</sup> In addition, we have reviewed the MPP

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

<sup>12</sup> [Fonterra "Attachment 1 – Base Milk Price Manual for the 2023/24 season \(marked up version\) - 1 August 2023" \(23 August 2023\)](#).

<sup>13</sup> [Fonterra "Reasons Paper in support of Fonterra's Milk Price Manual for the 2023/24 season - 1 August 2023" \(23 August 2023\)](#).

<sup>14</sup> Commerce Commission "[Review of Fonterra's 2023-24 Milk Price Manual: Dairy Industry Restructuring Act 2001 – Draft report](#)" (16 October 2023).

<sup>15</sup> [Miraka, Open Country Dairy, Synlait Milk, Westland Milk Products "IDP join submission on the draft manual review 2023/24" \(15 November 2023\)](#).

<sup>16</sup> [Fonterra "Submission on Draft Report on Farmgate Milk Price Manual" \(15 November 2023\)](#).

<sup>17</sup> [Fonterra "Response to IDP submission on Draft Report on Farmgate Milk Price Manual" \(21 November 2023\)](#).

<sup>18</sup> [Fonterra "Reasons Paper in support of Fonterra's Milk Price Manual for the 2023/24 season - 1 August 2023" \(23 August 2023\)](#), at page 3.

recommendations to Fonterra's Board and confirmed that all recommended amendments are reflected in the 2023/24 Manual.

20. We have focused on the amendments Fonterra has made to the Manual for the 2023/24 season. This season, the only substantive change to the Manual was the definition of Standard Product Offering.
21. In addition to the change referred to in paragraph 20, for this review, we have focused in particular on assessing how the s 150B(1)(c) assumption relating to foreign currency gains and losses is incorporated into the Manual rules, focusing specifically on Rule 10. This follows from the amendment to s 150B which now expressly provides that we can assess the way in which Fonterra uses the assumptions in s 150B(1)(a) to (d) in setting the base milk price.<sup>19</sup>
22. The remaining s 150B assumptions (s 150B(1)(a), (b) and (d)) apply to a wide range of interrelated rules. While we have not examined these rules as part of this review, we are conscious of the importance of these assumptions to the operation of the price setting methodology and stakeholders' confidence in the process. We will begin the process of reviewing these rules in light of the amendments to s 150B as a matter of priority in advance of the 2023/24 Calculation and 2024/25 Manual reviews. We anticipate engaging with Fonterra and interested parties on these rules in the new year to ensure we are able to address them fully as part of our 2023/24 Calculation and/or 2024/25 Manual reviews as appropriate.
23. The IDPs raised several points in their submission on the draft report, including on the assumptions relating to yields and the national network. As noted above, we are undertaking the process of reviewing these rules as a matter of priority and expect to engage with interested parties in the new year.
24. Fonterra has also made amendments to the description of the Milk Price Group, and the addition of text relating to Fonterra's mandatory information disclosures under s 150JA and s 150QA. These amendments do not directly affect efficiency or contestability in terms of s 150A. They have come about due to the changes to DIRA. We discuss these changes in paragraphs 63 to 76 and suggest Fonterra makes some further amendments to better reflect the disclosure requirements. Fonterra confirmed in its submission on the draft report that it will consider these amendments as part of its 2024/25 Manual review process.

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<sup>19</sup> DIRA, s 150B(2).



## Chapter 3 Conclusions

25. This chapter sets out our conclusions on the extent to which the 2023/24 Manual is consistent with the s 150A purpose.

### Our conclusions

26. Based on the assessment we have undertaken:
- 26.1 Our overall conclusion is that the Manual is consistent with the statutory purpose set out in s 150A.
  - 26.2 Regarding Fonterra's amendment to the Manual since last year's review, our conclusion is that the amendment is consistent with the statutory purpose set out in s 150A.
  - 26.3 Regarding our assessment of Rule 10 (including its incorporation of s 150B(1)(c)), our conclusion is that Rule 10 is consistent with the statutory purpose set out in s 150A.

### Fonterra's amendments to the 2023/24 Manual

27. Fonterra has made the following amendment to the 2023/24 Manual:
- 27.1 revised wording to clarify the description of Standard Product Offering.

#### *Clarification in the Manual of Standard Product Offering*

28. In our 2022/23 Manual review, we suggested that Fonterra consider whether the definition of Standard Product Offering in the Manual can be clarified, particularly with respect to the cascading product rule, or the application of the definition explained more clearly in the Calculation Reasons paper.<sup>20</sup> We also noted this in our 2021/22 Calculation review.<sup>21</sup>
29. As a result, Fonterra has amended the text in Part C, 1.2 to the below:

A Reference Commodity Product specification which:

- 1. Is a Standard Specification Product, or
- 2. Is sold on GDT, or
- 3. Is otherwise a product which:

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<sup>20</sup> [Commerce Commission "Review of Fonterra's 2022/23 Milk Price Manual: Final report" \(15 December 2022\), at page 13, paragraph 48.](#)

<sup>21</sup> [Commerce Commission "Review of Fonterra's 2021/22 Milk Price Calculation: Final report" \(15 September 2022\), at page 11, paragraph 3.6.3.](#)

- Is traded in significant quantities in globally contested markets, and
- Is characterised by uniform technical specifications.

When determining whether a specific product specification satisfies the conditions specified in paragraph (3) the MPG will disregard any element of the product specification which it can reasonably be expected would not give rise to a requirement for consultation with a customer if that product was used to fulfil an order for a similar product.

When determining whether a product is traded in significant quantities in globally contested markets, the MPG will have regard to the quantity of functionally equivalent products traded in globally contested markets, and not to the quantity of an individual product specification.

30. Fonterra has extended the definition to include ‘functionally equivalent products traded in globally contested markets’. This is more specific and relevant than the previous text which specified ‘multiple regions’ and ‘to multiple customers’. A product can be sold to multiple regions and to multiple customers without also being sold in globally contested markets. Furthermore, it is not limited only to Fonterra’s sales channels as it was previously. The definition of ‘globally contested’ is more appropriate than the previous text, as Reference Commodity Products (RCPs) are expected to be sold in a global market.<sup>22</sup>
31. In Fonterra’s 2022/23 Calculation Reasons paper, it noted that milk price revenue-informing inclusions are cascading, in that [the product] “...can be used to satisfy an order for a standard product offering... without any prima facie reason to believe prior consultation is needed with the customer”.<sup>23</sup> The revised Manual text gives effect to this.
32. Furthermore, in its 2022/23 Calculation Reasons paper, Fonterra provided a table of Standard Product Offering categories and Standard Packaging formats. Fonterra noted that products which do not fall within these categories are excluded from the schedule of Qualifying Materials.<sup>24</sup> This further outlines what Fonterra considers to be a Standard Product Offering.

*Submissions on the draft report regarding the definition of Standard Product Offering*

33. The IDPs discussed this amendment in their joint submission on the draft report. Their view is that while the definition of standard product offering has been amended to explicitly include the DIRA definition of dairy commodities, the hierarchy

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<sup>22</sup> A “commodity” is defined in s 5 of DIRA as “a product made by processing of milk that is – (a) traded in significant quantities in globally contested markets; and (b) characterised by uniform technical specifications”.

<sup>23</sup> [Fonterra “Reasons Paper in support of Fonterra’s Milk Price Calculation for the 2022/23 season – 15 June 2023” at page 49.](#)

<sup>24</sup> [Fonterra “Reasons Paper in support of Fonterra’s Milk Price Calculation for the 2022/23 season – 15 June 2023” at page 50.](#)

is not consistent with the DIRA legal definition. In their view the DIRA definition should be overarching, rather than subservient as point three.

34. The IDPs also submitted that “it is less clear (and remains unexplained) why all other products sold on GDT are simply assumed to meet the DIRA commodity definition.”<sup>25</sup> They submitted that the definition steps beyond GDT to include any other product that meets “loosely defined” descriptions of the DIRA “uniform technical specifications” and “significant quantities” criteria. The IDPs also noted that they remain of the view that NP revenues should simply be derived from GDT.

#### *Response to submissions*

35. Rule 2 of the Manual sets out that the reference basket will comprise standard specification commodity product manufactured from four ‘base’ milk powder streams, comprising four combinations of WMP or SMP, Butter or AMF, and BMP. These are the RCPs.<sup>26</sup>
36. An RCP must also be a Standard Specification Product to be considered as part of the base milk price calculation. Standard Specification Product comprises part of the revised Standard Product Offering definition, and is defined as:<sup>27</sup>

...a product specification from Fonterra’s Specification Management System (or its successor system) which can reasonably be regarded as being representative of an undifferentiated commodity product and which Fonterra manufactures in material quantities. Standard Specification Products currently comprise the following products sold by Fonterra on GDT:

- AMF Premium 210kg drum – NZ
- BMP UHT – NZ
- Butter Unsalted – NZ
- SMP Medium Heat – NZ
- WMP Regular – NZ.

37. A Standard Product Offering must either meet the definition above; or be otherwise sold on GDT; or meet the broader DIRA definition, being a product which is traded in significant quantities in globally contested markets and is characterised by uniform technical specifications. These sales must still be of RCPs, and they must also meet the definitions of Qualifying Material and Qualifying Reference Sales.

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<sup>25</sup> [Miraka, Open Country Dairy, Synlait Milk, Westland Milk Products “IDP join submission on the draft manual review 2023/24” \(15 November 2023\), at paragraph 37.](#)

<sup>26</sup> [Fonterra “Attachment 1 – Base Milk Price Manual for the 2023/24 season \(marked up version\) - 1 August 2023” \(23 August 2023\) at page 35.](#)

<sup>27</sup> [Fonterra “Attachment 1 – Base Milk Price Manual for the 2023/24 season \(marked up version\) - 1 August 2023” \(23 August 2023\) at page 62.](#)

38. During the 2019/20 base milk price calculation review, we considered which products can be selected as a Qualifying Material.<sup>28</sup> Qualifying Material utilises 'Standard Product Offering' within its definition and links the definitions. Sales of Qualifying Materials also inform the base milk price.
39. In the 2019/20 calculation review, we stated that the criteria for Qualifying Materials and Qualifying Reference Sales are intended to ensure that only off-GDT prices that could be achieved by an efficient processor selling the RCPs at arms-length on globally contestable markets are used to inform the base milk price.<sup>29</sup>
40. The inclusion of the DIRA commodity definition in the revised Manual definition of Standard Product Offering allows any dairy commodity product that may not have been covered by the other parts of the definition to be captured. This qualifies such a product to be included in the calculation of the base milk price, as long as it also meets the other definitions outlined above in paragraphs 36 to 38.
41. Our view is that the definition captures the ways in which a reference commodity product may be sold and the specific products that are included in the calculation of the base milk price. As part of a calculation review, we may still assess whether the products included are commodities as defined in the DIRA.

#### *Conclusion*

42. We consider the revised wording adequately clarifies what Fonterra considers a Standard Product Offering is under the Manual, and is consistent with the s 150A purpose.

#### **Assessment of Manual rules relating to s 150B**

43. For this Manual review we have focused our assessment on Rule 10 of the Manual in consideration of its relation to the s 150B(1)(c) assumption on foreign currency gains and losses.<sup>30</sup>
44. As part of our review of Rule 10, we have examined the following matters:
- 44.1 How does Rule 10 incorporate, engage or reference the s 150B(1)(c) assumption? (paragraphs 45 to 51)

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<sup>28</sup> [Commerce Commission "Review of Fonterra's 2019/20 base milk price calculation: Dairy Industry Restructuring Act 2001" \(15 September 2020\).](#)

<sup>29</sup> [Commerce Commission "Review of Fonterra's 2019/20 base milk price calculation: Dairy Industry Restructuring Act 2001" \(15 September 2020\) at paragraph 2.25.](#)

<sup>30</sup> [Fonterra "Attachment 1 – Base Milk Price Manual for the 2023/24 season \(marked up version\) - 1 August 2023" \(23 August 2023\) at page 39.](#)

- 44.2 Does the use of the s 150B(1)(c) assumption in Rule 10 correctly apply the s 150B(1)(c) assumption? Or as the Approach paper puts it, has Fonterra correctly interpreted the meaning of s 150B(1)(c)?<sup>31</sup> (paragraph 52)
- 44.3 To what extent is the way in which the s 150B(1)(c) assumption is used in Rule 10 consistent with s 150A (but leaving out an examination of the s 150B assumption in itself)? (paragraphs 57 to 62)

*Use of the s 150B assumption in the Manual*

45. Section 150B(1)(c) reads:

- (1) It does not detract from the achievement of the purpose set out in section 150A that new co-op sets the base milk price using assumptions that include any of the following:

...

- (c) that gains and losses experienced by new co-op resulting from foreign currency fluctuations, including from new co-op's foreign currency risk-management strategies, are incorporated in the base milk price.

46. Rule 10 of the Manual, Conversion of USD revenue to NZD,<sup>32</sup> reads:

	Application
Because the management and execution of Fonterra's actual hedging activities are governed by an established Financial Risk Management framework, it is appropriate to convert Farmgate Milk Price USD Receipts to NZD at Fonterra's actual average economic conversion rate.	<p>The process for converting USD revenue in respect of a Season to NZD shall reflect the following process:</p> <ul style="list-style-type: none"> <li>• Farmgate Milk Price USD Receipts for each month will be calculated by reference to Farmgate Milk Price US Dollar Commodity Revenue and Farmgate Milk Price Revenue Days</li> <li>• Farmgate Milk Price NZD Receipts for the month will be calculated by multiplying Farmgate Milk Price USD Receipts by the Benchmark FX Conversion Rate for the month.</li> </ul> <p>The Benchmark FX Conversion Rate for a month is the average rate at which Fonterra actually converts net receipts denominated in any currency other than NZD to NZD in the month, specified as a ratio of USD to NZD and calculated with regard to all costs and benefits of Fonterra's hedging activities in respect of amounts converted in that month.</p>

47. Rule 10 is consistent with s 150B(1)(c) in that it provides for the application of an actual average conversion rate to the Notional Producer's business and the conversion rate is calculated with regard to all of Fonterra's costs and benefits of hedging activities.
48. Fonterra in its Reasons Paper for the 2022/23 season base milk price calculation explains that "Fonterra's actual average conversion rates" are applied "without any

<sup>31</sup> [Commerce Commission "Our approach to reviewing Fonterra's milk price manual and base milk price calculation" \(1 August 2023\) at paragraph 59.](#)

<sup>32</sup> [Fonterra "Attachment 1 – Base Milk Price Manual for the 2023/24 season \(marked up version\) - 1 August 2023" \(23 August 2023\) at page 39.](#)

further adjustments to the NMPB’s notional monthly USD cash receipts.”<sup>33</sup> In our 2022/23 Calculation report we discussed the approach Fonterra uses when calculating and applying its monthly average conversion rate and noted that there is more than one way to calculate an average conversion rate, for example using Fonterra’s annual average conversion rate. We concluded that the way in which Fonterra used the assumption in section 150B(1)(c) in calculating and applying a monthly average conversion rate was consistent with s 150A.

49. Fonterra also references foreign exchange in other places in the Manual though Rule 10 explains how Fonterra actually applies the methodology in the base milk price calculation.
- 49.1 In the Executive Summary, referring to how the Aggregate Farmgate Milk Price is calculated: “...Prices primarily reflect US dollar prices achieved by Fonterra on the twice-monthly Global Dairy Trade trading events, converted to New Zealand dollars at Fonterra’s actual average monthly foreign-exchange conversion rate.”<sup>34</sup>
- 49.2 Principle 2: the Farmgate Milk Price should be the maximum amount which Fonterra could pay for milk supplied to it in a season including if “Fonterra was appropriately encouraged to make investment, production and sales decisions (including foreign exchange hedging decisions) that maximise the Farmgate Milk Price, both now and in the future.”<sup>35</sup>
- 49.3 Principle 3: “the Farmgate Milk Price Methodology broadly provides for costs and risks, such as changes in international Commodity Product prices and changes in foreign currency exchange rates, to pass through to the Farmgate Milk Price (as suppliers have better incentives and capabilities to manage these types of risks, in the short run by altering feed and milking practice, and in the long run by substituting alternative land uses)...”<sup>36</sup>
- 49.4 Part A, section 4.3: Farmgate Milk Price Revenue: “FX conversion: That USD Farmgate Milk Price Revenue will then need to be converted to NZD, giving a NZD Farmgate Milk Price Revenue. The conversion rate used for Farmgate Milk Price Revenue in a month will be Fonterra’s volume-weighted average conversion rate for the month, based on foreign exchange hedging

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<sup>33</sup> [Fonterra “Reasons Paper in support of Fonterra’s Milk Price Calculation for the 2022/23 season – 15 June 2023” at page 10.](#)

<sup>34</sup> [Fonterra “Attachment 1 – Base Milk Price Manual for the 2023/24 season \(marked up version\) - 1 August 2023” \(23 August 2023\) at page 7.](#)

<sup>35</sup> [Fonterra “Attachment 1 – Base Milk Price Manual for the 2023/24 season \(marked up version\) - 1 August 2023” \(23 August 2023\) at page 10.](#)

<sup>36</sup> [Fonterra “Attachment 1 – Base Milk Price Manual for the 2023/24 season \(marked up version\) - 1 August 2023” \(23 August 2023\) at pages 10 and 11.](#)

contracts Fonterra has in place under its financial risk management policies.”<sup>37</sup>

50. Rule 10 enables Fonterra to implement the Principles and references described in paragraphs 49.1 to 49.4 above. All gains and losses in relation to foreign currency are incorporated by using the average rate at which Fonterra actually converts net receipts in any other currency into NZD.
51. Hedging activities are included in the conversion, thus the gains and losses from foreign currency risk management are incorporated, providing for costs and risks related to foreign exchange to pass through into the base milk price.

*Does Rule 10 apply the s150B(1)(c) assumption correctly?*

52. Rule 10 allows Fonterra’s gains and losses (including resulting from the application of a foreign currency risk management strategy) to be incorporated into the base milk price. While the rule provides no detail in relation to the hedging strategy Fonterra (and thus the Notional Producer) adopts, and effectively allows Fonterra to adopt any strategy with respect to managing foreign currency exposure, we consider the rule reflects a correct interpretation of the s 150B(1)(c) assumption and that there is nothing in the rule that is inconsistent with the assumption.

*Submissions on the draft report regarding FX*

53. In their joint submission, the IDPs:
  - 53.1 Submitted that within season on-going disclosure of the notional processor (NP) conversion rate is required to meet the contestability requirement of s 150A. While most key parameters of the base milk price are visible in the public domain as they unfold, they said that the USD conversion rate is a major exception. Within their submission they included some detail of what, in their view, should be included in any on-going disclosure. This included the actual hedged portion of exposure, the conversion rate on which the unhedged exposure has been valued, the single point farmgate milk price on which the forecast conversion rate is based, and the relative portion of open option contracts in the actual hedged position.<sup>38</sup>
  - 53.2 The IDPs also submitted that the NP hedging strategy is unlikely to be passive, as claimed. The hedging policy needs to be reassessed and any

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<sup>37</sup> [Fonterra “Attachment 1 – Base Milk Price Manual for the 2023/24 season \(marked up version\) - 1 August 2023” \(23 August 2023\) at page 20.](#)

<sup>38</sup> [Miraka, Open Country Dairy, Synlait Milk, Westland Milk Products “IDP join submission on the draft manual review 2023/24” \(15 November 2023\), at pages 2, 5-6, and 13-14.](#)

consequences addressed, resulting in use of a modelled notional conversion rate.<sup>39</sup>

54. We sought a response from Fonterra on some of the issues raised by the IDPs.
55. Fonterra said in their response to the IDPs' submission that their "programme to hedge FX is largely passive or mechanistic, involving the progressive build-up of a hedge portfolio of forward FX contracts and FX options in accordance with benchmarks defined by reference to forecast monthly USD cash flows. Options provide more flexibility in scenarios which may lead to downward revisions in forecast exposures, such as declining commodity prices or reduced milk supply, and so require a reduction in the level of FX hedges." Fonterra states that it seeks to meet "the requirements for the application of hedge accounting treatment for the entire FX hedge book and would [therefore] be precluded [under the relevant accounting standard] from undertaking hedging activity that could be construed as speculative in nature."<sup>40</sup>
56. Fonterra also committed to providing additional information regarding in-season FX related disclosures, by:<sup>41</sup>

...releasing the following information as soon as practicable in the monthly Global Dairy Update subsequent to each forecast Farmgate Milk Price announcement:<sup>42</sup>

- The percentage of the forecast full-year exposure which is hedged.
- The forecast full-season average conversion rate if the spot rate was to remain at the announcement date rate for the balance of the season.
- The percentage of option cover included in the hedged amount.

*Does Rule 10 provide for consistency with section 150A?*

57. Rule 10 allows an appropriate risk management framework to be used for managing foreign currency exposure and allows certainty in relation to the foreign exchange impacts on the base milk price. Our view is that both aspects incentivise efficiency with respect to the foreign exchange translation process, irrespective of the degree to which it could be described as a passive or active process.

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<sup>39</sup> [Miraka, Open Country Dairy, Synlait Milk, Westland Milk Products "IDP joint submission on the draft manual review 2023/24" \(15 November 2023\), at pages 16-17.](#)

<sup>40</sup> [Fonterra "Response to IDP submission on Draft Report on Farmgate Milk Price Manual" \(21 November 2023\), at page 2.](#)

<sup>41</sup> [Fonterra "Response to IDP submission on Draft Report on Farmgate Milk Price Manual" \(21 November 2023\), at page 2.](#)

<sup>42</sup> "This will ordinarily be in the first Global Dairy Update (GDU) published after a Farmgate Milk Price announcement, but there may be instances where an announcement occurs after the close-off for GDU content but prior to publication of the GDU." ([Fonterra "Response to IDP submission on Draft Report on Farmgate Milk Price Manual" \(21 November 2023\), at page 2.](#))



58. With regard to contestability, our view is that it is practically feasible for an efficient processor to use a process that is consistent with Rule 10 to achieve similar results in relation to gains or losses from foreign currency fluctuations.
59. We also considered whether further information about Fonterra's hedging strategy was necessary for Rule 10 to be consistent with the contestability dimension of s 150A.<sup>43</sup>
60. We also note that while the inclusion within the Manual of an independent notional benchmark for FX would provide greater transparency, Fonterra is entitled to incorporate its actual gains and losses from currency fluctuations in the base milk price under s 150B(1)(c).
61. Our view is that no amendments to Rule 10 of the Manual are required to comply with the contestability dimension in s 150A.
62. We further recognise and support the additional disclosure Fonterra has committed to as a positive step towards providing greater transparency. We encourage Fonterra to make these disclosures as soon as practicable within the current season. We will continue to engage with Fonterra and the IDPs on the disclosures.

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<sup>43</sup> In this regard, we note the IDPs' stated concerns that the calculation process is "opaque", including in particular the NP conversion rate. See [Miraka, Open Country Dairy, Synlait Milk and Westland Milk Products "Submissions on the proposed focus areas for our review of Fonterra's 2022/23 base milk price calculation" \(27 April 2023\) at page 9.](#)

## Other amendments to the 2023/24 Manual due to DIRA changes

63. Fonterra has also made several amendments to reflect changes to DIRA.

64. In its Reasons paper, Fonterra explains the rationale for the changes:<sup>44</sup>

[The intent of the minor amendments is] principally to align the Manual to amendments to subpart 5A of DIRA in the Dairy Industry Restructuring (Fonterra Capital Restructuring) Amendment Act 2022.

65. The amendments do not affect efficiency or contestability in regard to s 150A. We consider they largely reflect DIRA.

### *Part A, 5.3 Milk Price Group*

66. Fonterra has amended the description of the Milk Price Group, which now reads:<sup>45</sup>

The day-to-day administration of the Manual will be carried out by an independent party (the Milk Price Group) appointed by the Board in accordance with subsection 150EA(1) of DIRA, who will be responsible for calculating the Farmgate Milk Price and otherwise undertaking the functions and responsibilities assigned to the Milk Price Group under the Manual. In making this appointment, the Board must comply with the requirements of subsections 150EA(2)-(4) of DIRA. The Milk Price Group will report to the Panel in relation to all matters, including matters relating to, or arising from, the administration, operation and application of the Manual and the performance of the Milk Price Group.

67. In addition, Fonterra has removed the below text from the Glossary, as it is no longer needed:<sup>46</sup>

MPG Head has the meaning set out in clause 4.3 of Part A of the Manual.

68. The revised description of the Milk Price Group aligns with DIRA s 150EA(1), which reads:

New co-op must engage 1 or more persons to calculate a base milk price that will enable the panel to perform its function under section 150D(3).<sup>47</sup>

69. The revised description of the Milk Price Group references the independence of the party (s 150EA(3)(a)) and for completeness could also reference operating at arm's length from Fonterra (s 150EA(3)(b)).

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<sup>44</sup> [Fonterra "Reasons Paper in support of Fonterra's Milk Price Manual for the 2023/24 season - 1 August 2023" \(23 August 2023\), at page 5.](#)

<sup>45</sup> [Fonterra "Attachment 1 – Base Milk Price Manual for the 2023/24 season \(marked up version\) - 1 August 2023" \(23 August 2023\) at page 28.](#)

<sup>46</sup> [Fonterra "Attachment 1 – Base Milk Price Manual for the 2023/24 season \(marked up version\) - 1 August 2023" \(23 August 2023\) at page 89.](#)

<sup>47</sup> DIRA s 150EA(1)

*Part A, 6.1 Disclosure*

70. Fonterra has added paragraph (e), which reads:<sup>48</sup>

The non-sensitive information (as defined in subsection 150JA(2) of DIRA) made publicly accessible by Fonterra in accordance with subsection 150JA(1) of DIRA.

71. Section 6.1 (e) of the Manual refers to the new information disclosure requirements. For completeness, it should also include a reference to s 150QA (calculation disclosure) in addition to s 150JA (Manual disclosure) in order to more fully reflect the disclosure requirements.

*Part A, 6.4 Information Disclosure relating to DIRA*

72. Fonterra has amended the title of this section to read:

Information Disclosure Relating to the Dairy Industry Restructuring Act 2001

73. Fonterra has also added the below paragraph:<sup>49</sup>

Fonterra will also make publicly available all information requested by or provided to the Commerce Commission in relation to the Commission's review of the base milk price for a Year, other than information which Fonterra reasonably considers is commercially sensitive, subject to legal professional privilege, or personal information.

74. Section 6.4 of the Manual refers to reports Fonterra must provide under DIRA<sup>50</sup> requiring all non-sensitive information requested by or provided to the Commission as part of the calculation review to be made publicly available, as well as the base milk price Manual itself. The new text includes the new information disclosure requirements. The edit is similar to that made to section 6.1. For completeness, it should also include a reference to section 150JA (the equivalent provision for the Manual).
75. The information required to be provided to the Commission under s 150L and s 150T would also be subject to the new disclosure rules, and the grounds for withholding under those rules would apply. The chapeau suggests a slightly different test to the test in the new rules ("modified where necessary to protect the disclosure of information that would be prejudicial to Fonterra's legitimate commercial interests" vs "commercially sensitive").

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<sup>48</sup> [Fonterra "Attachment 1 – Base Milk Price Manual for the 2023/24 season \(marked up version\) - 1 August 2023" \(23 August 2023\) at page 31.](#)

<sup>49</sup> [Fonterra "Attachment 1 – Base Milk Price Manual for the 2023/24 season \(marked up version\) - 1 August 2023" \(23 August 2023\) at page 33.](#)

<sup>50</sup> DIRA, s150L and 150T

76. We suggest Fonterra better aligns this text with the new disclosure regime. Fonterra confirmed in its submission on the draft report that it will consider the amendments suggested by the Commission as part of its 2024/25 Manual review process.

## Attachment A Glossary

Term/Abbreviation	Definition
<b>DIRA</b>	Dairy Industry Restructuring Act 2001
<b>Approach paper</b>	Commerce Commission's overview of the approach we take in our reviews of Fonterra's Manual and base milk price calculation.
<b>Base milk price</b>	Base milk price, in relation to a season, means the price per kilogram of milk solids (kgMS) that is set by Fonterra for that season.
<b>Calculation review</b>	Commission's review of Fonterra's base milk price calculation for the prior season.
<b>Dairy season</b>	1 June to 31 May annually
<b>GDT</b>	Global Dairy Trade, online auction platform used to sell dairy commodities
<b>GDU</b>	Global Dairy Update, Fonterra's monthly report in which it provides dairy market updates
<b>IDP</b>	Independent Dairy Processors
<b>Manual review</b>	Commission's review of Fonterra's Milk Price Manual for the current season.
<b>MPG</b>	Milk Price Group
<b>Milk Price Manual or the Manual</b>	Fonterra's Milk Price Manual
<b>MPP</b>	Milk Price Panel
<b>Notional processor or NP or NMPB</b>	The notional commodity business that is used to calculate the base milk price (in its Reasons paper Fonterra uses the term notional producer).
<b>Reasons paper</b>	Fonterra's Reasons paper which is provided alongside the Manual for each dairy season (this is also provided when Fonterra discloses its base milk price calculation at the end of each dairy season).
<b>RCP</b>	Reference Commodity Product, referring to the five commodities used in the base milk price calculation, being anhydrous milkfat (AMF), butter, buttermilk powder (BMP), skim milk powder (SMP) and whole milk powder (WMP).