

Proposed focus areas for our review of Fonterra's 2023/24 base milk price calculation

Process paper

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Associated documents

Publication date	Reference	Title
1 August 2023	ISBN 978-1-99-101282-1	Our approach to reviewing Fonterra's Milk Price Manual and base milk price calculation 2023
15 September 2023	ISBN 978-1-99-101226-5	Review of Fonterra's 2022/23 base milk price calculation: Dairy Industry Restructuring Act 2001
15 December 2023	ISSN 2382-1779	Review of Fonterra's 2023/24 Milk Price Manual: Dairy Industry Restructuring Act 2001

Introduction

1. This paper provides interested parties with details of our proposed focus areas for our review of Fonterra’s base milk price calculation for the 2023/24 season (**the Calculation**) under the Dairy Industry Restructuring Act 2001 (**DIRA or the Act**). This paper also invites feedback on those focus areas and seeks relevant information on those focus areas.
2. Our primary role under the Act is to publicly report on the extent to which Fonterra’s milk price setting processes and calculations provide incentives for Fonterra to operate efficiently and are consistent with contestability in the market for purchasing farmers’ milk.
3. We undertake two separate reviews in relation to each dairy season:¹
 - 3.1 The first review concerns Fonterra's milk price manual (**the Manual**). The Manual contains the specific methodology Fonterra uses to calculate its base milk price. This review assesses whether the rules and principles in the Manual for that season provide an incentive for Fonterra to operate efficiently and are practically feasible for an efficient milk processor, and as such are consistent with the purposes of subpart 5A of the Act.
 - 3.2 The second annual review we undertake is of Fonterra's base milk price calculation at the end of each dairy season (**Calculation review**). The Calculation review assesses whether the costs, revenue and other assumptions used in the base milk price calculation for the previous season are consistent with the purposes of subpart 5A of DIRA.
4. The framework for our reviews is contained in our **Approach paper**.²

We are reviewing Fonterra’s 2023/24 base milk price calculation

5. This Calculation review is the second of the reviews that we are required to complete under the Act in relation to the base milk price for the 2023/24 dairy season.
6. The first review for the 2023/24 season looked at the Manual. We published the final report on our review of the Manual for the 2023/24 season on 15 December 2023.³

¹ For a more detailed explanation of our monitoring role under DIRA see our [website](#).

² Commerce Commission “[Our approach to reviewing Fonterra’s Milk Price Manual and base milk price calculation](#)” (1 August 2023).

³ Commerce Commission “[Review of Fonterra’s 2022/23 Milk Price Manual: Dairy Industry Restructuring Act 2001 – final report](#)” (15 December 2023).

We note that the Manual requires periodic reviews of various inputs to the base milk price calculation, normally on a four-yearly cycle.⁴

7. Each Calculation review includes key areas of focus for the review. We determine the focus areas for each Calculation review based on a number of considerations. We explain in the next section the basis for the focus areas for this year's review.
8. For each proposed focus area in the Calculation review, we conclude on both the contestability and efficiency limbs within section 150A of subpart 5A (as we are required to do for the inputs, assumptions and processes underlying the calculation of the base milk price).
9. In addition to the specific focus areas, our Calculation review includes a 'fit for purpose' review of all revenue and cost components of the base milk price calculation. The fit for purpose review compares the component values against our previous reviews and relevant benchmark data of the same components, and reviews the assumptions, inputs and processes used for each of the components.
10. As required by the Act, we produce a draft report of our review of Fonterra's base milk price calculation for each season by **1 August** and a final report by **15 September**.⁵

Indicative timeline

Indicative date	Publication/event
18 April 2024	Proposed Focus Areas published
Midday, 9 May 2024	Submissions on Proposed Focus Areas due
1 August 2024	Draft report on the review of base milk price calculation published by
15 August 2024	Submissions on draft report due
16 September 2024	Final report on the review of base milk price calculation published by

⁴ Fonterra "[Farmgate Milk Price Manual](#)" (1 August 2023).

⁵ However, if either of these dates falls on a non-working day, the date may be extended to the next working day – see section 55 of the Legislation Act 2019.

Our proposed focus areas

11. Our process for selecting proposed focus areas is informed by:
 - 11.1 outstanding issues from previous Calculation and Manual reviews;
 - 11.2 Fonterra’s review of assumptions and components in accordance with its Manual;⁶
 - 11.3 Fonterra’s amendments to the current season’s Manual or any amendments to Fonterra’s approach to calculating the components that do not require a Manual amendment;
 - 11.4 any changes to DIRA; and
 - 11.5 any new information/evidence which suggests that matters may have changed substantively since our previous reviews.

12. For the 2023/24 Calculation review, we are proposing the following focus areas:
 - 12.1 The commercial feasibility⁷ of yields, in respect of the way in which section 150B(1)(d) is used in the base milk price calculation, including but not limited to:
 - 12.1.1 Notional operating capacity of near 100% and squaring the production curve;
 - 12.1.2 The use of newer efficient plants for testing yield assumptions;
 - 12.1.3 Average peak processing capacity of the plants; and
 - 12.1.4 Average specification product mix.
 - 12.2 Repairs and maintenance (falling under fixed manufacturing costs), as this is a review year for fixed manufacturing costs and Fonterra has indicated some significant maintenance spend as part of its sustainability initiatives.
 - 12.3 Sustainability costs, which is a non-routine Fonterra review item but an item which Fonterra has indicated is being reviewed for the first time in the

⁶ The summary calculation of the base milk price is broken down into various revenue and cost components. The Manual provides a timeline for Fonterra to review certain assumptions, revenue and cost components every four years (or when the Milk Price Panel chooses to complete a review).

⁷ We interpret practical feasibility as including commercial feasibility, in the sense that it must be possible for an efficient processor operating in New Zealand to replicate or achieve the component being assessed. Commerce Commission “[Our approach to reviewing Fonterra’s Milk Price Manual and base milk price calculation](#)” (1 August 2023), at paragraph 51.

context of the base milk price due to rapid changes in sustainability initiatives.

13. According to the Manual, this year is a review year for fixed manufacturing costs (rule 13), sales costs (rule 17), site overheads, general overhead costs and research and development costs (rule 18), and certain supply chain costs (rule 20).
14. For the other review year items (ie, excluding repairs and maintenance under fixed manufacturing costs), we will review these costs, considering any significant changes in approach, and consider whether these are reasonable costs an efficient processor would expect to incur. We are not proposing these as focus areas.
15. Fonterra has indicated it will make several updates to inputs into the base milk price model, with a change in approach to some inputs anticipated. We will review these updates as part of our fit for purpose review, but they are not focus areas.
16. This scope is not necessarily exhaustive and does not limit our ability to evaluate other relevant factors.

Assessment of section 150B assumptions

17. On 1 January 2023, section 150B(2) was inserted into DIRA:

Subsection (1) does not extend to the way in which new co-op uses an assumption in setting the base milk price.
18. There are four assumptions outlined in section 150B (1) of DIRA:
 - (a) that new co-op operates a national network of facilities for the collection and processing of milk;
 - (b) that the size of new co-op's assumed units of processing capacity approximates to the average size of new co-op's actual units of processing capacity;
 - (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; and
 - (d) that all milk collected by new co-op is processed into commodities at yields that are practically feasible.
19. We reviewed section 150B(1)(c) in both the 2022/23 Calculation review and the 2023/24 Manual review.⁸

⁸ Commerce Commission "[Review of Fonterra's base milk price calculation for the 2022/23 season](#)" (15 September 2023), and Commerce Commission "[Review of Fonterra's milk price Manual for the 2023/24 season](#)" (15 December 2023)

20. We noted in our 2023/24 Manual review report that sections 150B(1)(a), (b), and (d) apply to a wide range of interrelated rules. We stated that we expected to begin the process of reviewing the rules in light of the amendments to section 150B as a matter of priority in advance of the 2023/24 Calculation and 2024/25 Manual reviews.
21. We have completed the early part of this process, which included consideration of issues arising during our previous reviews, engagement with Fonterra and the Independent Dairy Processors (IDPs)⁹ on potential areas of concern, and carrying out our own analysis. We are now shifting our section 150B related analysis into the 2023/24 Calculation review (this review).
22. We identified three potential substantive issues in our initial review process, though there are sub-issues within each one. The three potential substantive issues identified were:
 - 22.1 the commercial feasibility of yields;
 - 22.2 the practical feasibility of an expanded product mix; and
 - 22.3 the internal consistency of the use of the national network and processing capacity assumptions.
23. Following our analysis of these issues we propose to examine the commercial feasibility of yields further as a focus area for this year's Calculation review. We do not propose to examine the practical feasibility of an expanded product mix or the internal consistency of the use of the national network and processing capacity assumptions as focus areas. Each of these issues are outlined in more detail below.

Commercial feasibility of yields

24. For our 2023/24 Calculation review, we are proposing the commercial feasibility of yields as a focus area.
25. Rule 7: Product Yields, in the Manual is described as:¹⁰

The yield factors used to convert Milk Supply into the Farmgate Milk Price Production Plan will reflect the composition of standard specification commodity product and a target level of losses that is consistent with the efficient manufacture of the products included in the Farmgate Milk Price Production Plan and the configuration of the Standard Plants.

⁹ The Independent Dairy Processors (IDPs) currently comprise Open Country Dairy, Synlait Milk, Westland Milk Products, and Miraka.

¹⁰ Fonterra "[Milk Price Manual for the 2023-24 season](#)" (1 August 2023)

26. The Manual describes the application of yields:¹¹

The yield assumptions used to determine the Farmgate Milk Price Production Plan for a Season will reflect:

- The Composition Target for each Reference Commodity Product; and
- The Allowable Yield Losses for each Reference Commodity Product.
- The yield assumptions will be subject to review in each Review Year.

27. The scope of this review will likely include:

27.1 Consideration of how the Notional Processor's Farmgate Milk Price Production Plan is incorporated and how the assumption under section 150B(1)(d) is applied.

27.2 Whether the Farmgate Milk Price Production Plan properly accounts for the operational conditions required by the approach to measurement of yields. That is, does the production plan align with the production facilities, milk collection, and sales plan, including time-based constraints (eg, seasonal milk curve) and geographic constraints (eg, milk catchment areas)?

28. This scope is not necessarily exhaustive and does not limit our ability to evaluate other relevant factors.

Practical feasibility of an expanded product mix

29. We are not proposing to include the practical feasibility of an expanded product mix as a focus area.

30. This issue has two aspects: the practical feasibility of costs, included as part of the Incremental Product Costs (**IPCs**), and the practical feasibility of the bucket of milk calculations.

31. We reviewed the practical feasibility of these costs as part of our 2021/22 Calculation review.¹² We considered the IPCs generated by Fonterra's internal costing system to be achievable by Fonterra and an efficient processor.

32. Regarding the practical feasibility of the bucket of milk calculations, the issue is that the IPCs do not adequately account for volume differences associated with a change in product mix compared to standard specification products (**SSPs**). There was some

¹¹ Fonterra "[Milk Price Manual for the 2023-24 season](#)" (1 August 2023)

¹² Commerce Commission "[Review of Fonterra's base milk price calculation for the 2021/22 season](#)" (15 September 2022)

consideration in the 2021/22 Calculation review¹³ of whether the calculation adjusts for a reduction in the total volume available to the Notional Processor of butter, anhydrous milkfat (**AMF**) and buttermilk powder (**BMP**) when non-SSPs have been manufactured. This is due to a higher volume of milk components consumed by non-SSP production (for example, the higher volume of milk fat consumed by instant whole milk powder (**WMP**) than regular WMP) leaving less by-product available.

33. There are two alternative approaches to ensuring that all milk and all costs are accounted for within the base milk price calculation: either by making changes to assumed volumes in the product mix used in the calculations which determine weighted average selling prices, or by making component value adjustments through the IPCs.
34. Fonterra has explained that the value component (milk solid) costs within the IPC cost calculation allow for composition/loss adjustment differences relative to SSPs. This effectively adjusts for the volume difference between SSPs and non-SSPs. We reviewed this calculation in the 2021/22 Calculation review.¹⁴
35. As long as incremental milk components are priced at their current values, the net impact on the milk price of the two alternative approaches should provide the same cost outcome. Furthermore, in previous reviews, we found that the values ascribed to the milk components for product costing purposes reflect the current values of those components based on current prices. Therefore, we consider that the IPCs properly account for the component values associated with volume differences.
36. In 2021/22 we concluded that the IPCs generated by Fonterra's internal costing system are achievable by Fonterra or an efficient processor, and that they are practically feasible. We also considered the efficiency dimension to be met as IPCs are forecast costs and so provide an appropriate notional benchmark. We do not consider there have been any changes that require further review since 2021/22.
37. As such, we do not consider that a detailed re-examination of the practical feasibility of an expanded product mix as part of our 2023/24 Calculation review is warranted. Our current view is that there is no evidence that anything has changed since our previous assessments.

¹³ Commerce Commission "[Review of Fonterra's base milk price calculation for the 2021/22 season](#)" (15 September 2022), pages 28-35.

¹⁴ Commerce Commission "[Review of Fonterra's base milk price calculation for the 2021/22 season](#)" (15 September 2022).

Internal consistency of the use of the national network and processing capacity assumptions

38. Section 150B(1)(b), relating to processing capacity, assumes that all plants are a uniform size. Section 150B(1)(a), relating to the national network, assumes that there is a national network of facilities with the same processing capacity footprint as Fonterra. On the face of it, the use of these two different s150B assumptions could be seen as inconsistent.
39. We are not proposing to make the difference between these two assumptions a focus area, because we have concluded that there is no inconsistency between them given the way that they are each used in the milk price model.
40. The processing capacity assumption is used to estimate capital costs, and the national network assumption is used as the basis for all other plant-related assumptions, including milk collection costs. The assumption that all plants are a uniform size is a simplification that allows a reasonable estimate to be made of the aggregate capital cost of a more diverse asset base, such as that assumed in the national network assumption.
41. This aspect of our analysis has focused on the consistency of the way these two section 150B assumptions are used in the model. Where we have residual areas to consider about the practical feasibility of costs that relate to the implementation of the national network assumption, such as the effect of squaring the production curve on yields, we will address these separately. Consideration of squaring the production curve is noted in paragraph 12.1.1 as within scope of the focus area on the commercial feasibility of yields.

We invite your views on our focus areas for this year's calculation review

42. We invite submissions on the following matters by **Midday, Thursday 9 May 2024**:
 - 42.1 whether the proposed focus areas should form part of our review, and whether there are further focus areas that should be included; and
 - 42.2 any relevant information about our proposed focus areas or any further proposed focus areas that should be included.
43. Receiving submissions on these matters will:
 - 43.1 assist us to decide what the focus areas should be for our Calculation review; and
 - 43.2 provide us with information relevant to the proposed focus areas, so that we may take this information into account when examining the focus areas as part of our Calculation review.

44. Please address all submissions to:

Andrew Harrison (Dairy Manager)

c/o market.regulation@comcom.govt.nz

Subject line: Proposed base milk price calculation focus areas paper 2023/24

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

Attachment A: Glossary of terms / abbreviations

Term / Abbreviation	Definition
AMF	Anhydrous milk fat
Approach Paper	Our approach to reviewing Fonterra's Milk Price Manual and Base Milk Price calculation
Base milk price	Price per kilogram of milk solids that is set by Fonterra for that season
BMP	Butter milk powder
Calculation	Fonterra's 2023/24 base milk price calculation
Calculation review	Review of Fonterra's base milk price calculation
Dairy season	1 June to 31 May
DIRA, or the Act	Dairy Industry Restructuring Act 2001
Farmgate Milk Price	<p>This term is used by Fonterra in the Manual and its annual Farmgate Milk Price Statement. Fonterra describes the Farmgate Milk Price as the average price paid by Fonterra for each kilogram of milk solids (kgMS) supplied by Fonterra's farmer-shareholders under Fonterra's standard terms of supply. It is calculated in accordance with the Manual unless Fonterra decides to make an adjustment.</p> <p>The price set by Fonterra as its <u>farmgate milk price equates to the statutory base milk price</u>.</p>
GDT	GlobalDairyTrade, online auction platform used to sell dairy commodities
IDPs	The Independent Dairy Processors (the IDPs); Miraka, Open Country Dairy, Synlait Milk and Westland Milk Products
IPC	Incremental product costs
kgMS	Kilogram of milk solids
Manual review	Commission's annual review of Fonterra's Milk Price Manual
MPG	Milk Price Group, the independent group responsible for calculating the base milk price
MPP	Milk Price Panel, the independent group which oversees the milk price calculation
Milk Price Manual or the Manual	Fonterra's Farm Gate Milk Price Manual generally referred to by the version relating to each dairy season

	(eg, 2022/23 Manual). The Manual contains the methodology used to calculate Fonterra's base milk price
MT	Metric tonne
Notional Processor, or NP	The notional commodity business that is used to calculate the base milk price
NMPB	Notional Milk Price Business, an alternative name given to the Notional Processor in Fonterra's Farmgate Milk Price Manual
RCP	Reference Commodity Product. These products, manufactured and sold by the Notional Processor, are in the Reference Basket. They are WMP, SMP, BMP, Butter and AMF.
Reasons paper	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)
Reference Basket	The RCPs used to calculate the base milk price
SMP	Skim milk powder
SSP	Standard specification product; comprising AMF premium 210kg drum, UHT BMP, unsalted butter, medium heat SMP and regular WMP.
WMP	Whole milk powder