

Review of Fonterra's 2019/20 base milk price calculation: Dairy Industry Restructuring Act 2001

Draft report

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15 August 2017	Our approach to reviewing Fonterra's Milk Price Manual and base milk price calculation

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Chapter 1 Introduction

Purpose of this report

- 1.1 This report sets out our draft conclusions from our statutory review of the extent to which Fonterra's 2019/20 base milk price calculation (**the calculation**) is consistent with the purpose of the base milk price monitoring regime (**monitoring regime**) under subpart 5A of the Dairy Industry Restructuring Act 2001 (**the Act**).¹
- 1.2 We invite submissions on this draft report from interested parties which we will consider when preparing our final report.²
- 1.3 Submissions are due by **12 noon, 1 September 2020**.³
- 1.4 This report follows our review of Fonterra's Milk Price Manual (**Manual**) for the 2019/20 season and builds on the analysis and conclusions from our previous Manual and base milk price calculation reviews.⁴

Our review framework

- 1.5 This report should be read with the framework paper "Our approach to reviewing Fonterra's Milk Price Manual and base milk price calculation" (15 August 2017) which we have applied in this review and which forms part of this report. The framework paper provides an overview of the approach which we take in our Manual and base milk price calculation reviews and includes:⁵
 - 1.5.1 an overview of how the base milk price is set;
 - 1.5.2 our interpretation of key legislative provisions guiding our statutory reviews; and
 - 1.5.3 our practical approach to our statutory reviews.

¹ The term 'base milk price' used by the Act is the price per kilogram of milk solids set by Fonterra for a dairy season. This is currently forecast between \$7.10 - \$7.20 per kilogram of milk solids for the season ended on 31 July 2020 that is under review in this report.

² Our final report will be published on 15 September 2020.

³ More details on how you can provide your views can be found in Chapter 3.

⁴ For our report on the 2019/20 Manual review, see:

https://comcom.govt.nz/_data/assets/pdf_file/0028/195553/Final-report-Review-of-Fonterras-Milk-Price-Manual-12-December-2019.pdf

For our reports on our reviews for earlier seasons, see: <http://www.comcom.govt.nz/regulated-industries/dairy-industry/review-of-fonterra-s-farm-gate-milk-price-and-manual/statutory-review-of-milk-price-calculation-2/>.

⁵ Commerce Commission "Our approach to reviewing Fonterra's Milk Price Manual and base milk price calculation" (15 August 2017).

- 1.6 Our review approach has been endorsed by the High Court in *Open Country Dairy Limited v Commerce Commission*.⁶

Scope of our review of the 2019/20 calculation

- 1.7 Our review of the calculation builds on the conclusions from our previous reviews. Based on the information we gather, we determine the key areas to focus on for each calculation review.⁷ These constitute our ‘focus areas’ for review.
- 1.8 For the other revenue and cost components that are not part of the more-detailed analysis, we undertake a ‘fit for purpose’ review, which involves:⁸
- 1.8.1 an analytical verification of the values used in the component against our previous reviews of the same component; and
 - 1.8.2 a review of the consistency of the assumptions, inputs and processes related to the different components.
- 1.9 If any aspect of this ‘fit for purpose’ review identifies inconsistencies with our previous analysis or other components of the base milk price calculation model, we will consider whether more analysis of that component is required.^{9 10} See paragraphs 2.80 to 2.82 for further detail.
- 1.10 In our proposed focus areas paper, we stated that the proposed focus areas for this year's review were:¹¹
- 1.10.1 whether it is practically feasible for the Notional Processor plant, as configured, to manufacture the specified product range included in Fonterra’s Qualifying Materials (Focus Area 1);
 - 1.10.2 whether production efficiencies assumed for the Notional Processor are consistent with the range and scheduling of production for the full sales portfolio of Qualifying Materials (Focus Area 2);

⁶ [2020] NZHC 334.

⁷ Commerce Commission "Our approach to reviewing Fonterra's Milk Price Manual and base milk price calculation" (15 August 2017), paragraphs 71 and 72.

⁸ Commerce Commission "Our approach to reviewing Fonterra's Milk Price Manual and base milk price calculation" (15 August 2017), paragraph 73.

⁹ Commerce Commission "Our approach to reviewing Fonterra's Milk Price Manual and base milk price calculation" (15 August 2017), paragraph 74.

¹⁰ We are provided with the full model, its underlying models and documentation for purposes of our review. The public version of Fonterra’s milk price model is available at Fonterra’s website at <https://www.fonterra.com/nz/en/investors/farmgate-milk-prices/milk-price-methodology.html>.

¹¹ Commerce Commission "Proposed approach and focus areas for our review of Fonterra’s 2019/20 base milk price calculation – 22 April 2020" (22 April 2020), page 4.

- 1.10.3 whether it is practically feasible to attribute manufacturing costs to the Notional Processor using the Incremental Product Cost adjustments for products that are not Standard Specification Products (Focus Area 3);
 - 1.10.4 whether the selling costs for all the Qualifying Materials have been appropriately provided for (Focus Area 4); and
 - 1.10.5 whether the assumptions, inputs and processes, in particular Fonterra's cost allocation methodology, underlying the calculation of administration and other overhead costs, provide an appropriate incentive for Fonterra to operate efficiently (Focus Area 5).
- 1.11 We received submissions from Synlait and Miraka on these proposed focus areas. Overall, we do not consider that the submissions raised any matters that should be added to our focus areas of this year's review. Appendix A provides a summary of the matters raised in submissions that were not in our proposed focus areas and why we do not consider that we need to address these matters as part of this year's review. Where submitters raised points relevant to our focus areas, we have addressed these points in the body of the report, where appropriate.

Information considered in our review process

- 1.12 In reaching our draft conclusions we have considered:
- 1.12.1 submissions received on the proposed focus areas;
 - 1.12.2 Fonterra's reasons paper in support of the base milk price for the 2019/20 season;¹² and
 - 1.12.3 additional models and documentation that Fonterra provided to us in confidence during our review which shows the application of these assumptions, inputs and processes.

How this report is structured

- 1.13 Chapter 2 sets out our draft conclusions from our review of the focus areas and our fit for purpose review of the assumptions adopted, and inputs and processes used by Fonterra when calculating the base milk price.

¹² Fonterra "Reasons' Paper in Support of Fonterra's Base Milk Price for the 2019/20 Season – Public Version" (1 July 2020).

- 1.14 Chapter 3 outlines how you can provide your views on this draft report.
- 1.15 Appendix A provides a summary of submission points raised on our proposed focus areas that do not require focus area review.
- 1.16 Appendix B provides a simplified off-Global Dairy Trade (**GDT**) pricing 'decision tree'.
- 1.17 Appendix C provides a glossary of the key terms and abbreviations.

Chapter 2 Draft conclusions

Purpose of this chapter

- 2.1 In this chapter we outline our draft conclusions on the extent to which the assumptions, inputs and processes of the base milk price calculation are consistent with the section 150A purpose.
- 2.2 Specifically, we set out:
 - 2.2.1 a summary of our overall draft conclusions and draft conclusions on our focus area review and fit for purpose review;
 - 2.2.2 our detailed findings from the review of the key focus areas; and
 - 2.2.3 our detailed findings from the fit for purpose review.

Summary of overall draft conclusions

- 2.3 With the exception of our conclusion on the asset beta adopted by Fonterra, which has been carried forward from our previous years' reviews, our draft conclusion is that the assumptions adopted, and the inputs and process used by Fonterra to calculate the 2019/20 base milk price are consistent with the contestability dimension of the section 150A purpose.
- 2.4 The asset beta adopted by Fonterra has not changed since we concluded in our 2017/18 review.¹³ Therefore we continue to conclude that that an efficient processor with a similar risk exposure to the Notional Processor is unlikely to have an asset beta as low as Fonterra's estimate of 0.38. On balance we consider that this asset beta estimate is therefore unlikely to be practically feasible for an efficient processor, as referred to in section 150A(2) of the Act. Accordingly, our draft conclusion is that we do not consider that this aspect of the base milk price calculation is consistent with the contestability dimension of the section 150A purpose.
- 2.5 We note that the Fonterra Board has recently approved amendments to the provisions of the Manual relating to the asset beta and specific risk premium with effect from the 2020/21 season, and will establish new values for the asset beta and the specific risk premium for the 2020/21 season under these new provisions.¹⁴ We will review this change as part of our 2020/21 Manual review.
- 2.6 We also note that the Act has recently been amended by the Dairy Industry Restructuring Amendment Act (No 3). The amendments to the Act will reduce

¹³ Fonterra's asset beta estimate of 0.38 has remained the same since the 2014/15 base milk price calculation. We were subsequently unable to conclude whether the asset beta was practically feasible for an efficient processor until our conclusion in the 2017/18 calculation review.

¹⁴ Fonterra "'Reasons' Paper in Support of Fonterra's Base Milk Price for the 2019/20 Season – Public Version" (1 July 2020), page 34.

Fonterra's discretion in setting the asset beta. This change does not affect this year's review.

- 2.7 Our draft conclusion is that the assumptions adopted, and the inputs and processes used by Fonterra to calculate the 2019/20 base milk price are consistent with the efficiency dimension of the section 150A purpose.

Focus areas review

- 2.8 Our draft conclusion is that the assumptions adopted, and the inputs and processes used by Fonterra that we reviewed as part of our focus area review, provide for contestability since:

- 2.8.1 the range of products assumed to have been sold off-GDT constitute Reference Commodity Products that could be sold by the Notional Processor at prices that are consistent with the reference prices (Focus Area 1);
- 2.8.2 the practical application of the exclusion rules gives rise to pricing that could be achieved by the Notional Processor selling Reference Commodity Products at arms-length in freely contestable global markets (Focus Area 1);
- 2.8.3 the Qualifying Materials can be manufactured on Standard Plant without material modifications (Focus Area 2);
- 2.8.4 the Incremental Product Costs are practically feasible as they are derived from Fonterra's costing system used to establish its actual costs (which are then subject to external audit) (Focus Area 3);
- 2.8.5 the sales costs are based on Fonterra's actual costs, as applicable to the Notional Milk Price Business and scaled accordingly (Focus Area 4); and
- 2.8.6 the administration and other overhead cost allowances have been based on Fonterra's budgeted costs (Focus Area 5).

- 2.9 Our draft conclusion is that the assumptions adopted, and the inputs and processes used by Fonterra that we reviewed as part of our focus area review are consistent with the efficiency dimension of the section 150A purpose since:

- 2.9.1 although calculation revenues have always been based on Fonterra's actual sales of Reference Commodity Products as provided for in section 150C(1)(a), using a GDT or off-GDT benchmark set independently of Fonterra's current year performance provides an incentive to Fonterra to operate efficiently (Focus Area 2);

- 2.9.2 Incremental Product Costs and overhead and administration costs are notional, based on Fonterra's financial forecast set independently of Fonterra's current year performance (Focus Areas 3 and 5); and
- 2.9.3 selling costs are based on budget costs plus an inflation allowance (Focus Area 4).

Fit for purpose review

- 2.10 In our fit for purpose review we identified significant variances for administration and other overhead costs and lactose costs. We did not identify any other significant inconsistencies with previous base milk price calculations.
- 2.11 We have concluded on the administration and other overhead costs as part as our focus areas review.
- 2.12 In terms of lactose costs:
 - 2.12.1 For the 2019/20 season Fonterra has used the competitor price series and actual costs for lactose landed in New Zealand. We therefore consider that the assumptions relating to lactose costs are practically feasible.
 - 2.12.2 Consistent with our 2013/14 view, we consider that using the lower of Fonterra's or its competitors' actual lactose and cost, insurance and freight costs in combination with notional lactose volume requirements that are significantly larger than Fonterra's actual volumes, incentivises Fonterra to reduce its actual lactose costs (ie, operate efficiently).¹⁵
- 2.13 Therefore, for the areas that we have analysed as part of the fit for purpose review (ie, not the focus areas), and on which we are required to reach a conclusion, our draft conclusions are as follows:
 - 2.13.1 the assumptions adopted, and the inputs and process used by Fonterra in calculating the 2019/20 base milk price are consistent with the efficiency dimension of the section 150A purpose; and
 - 2.13.2 the assumptions adopted, and the inputs and process used by Fonterra to calculate the 2019/20 base milk price are consistent with the contestability dimension of the section 150A purpose.
- 2.14 In its reasons paper for the 2019/20 price calculation, Fonterra has confirmed that it has not:
 - 2.14.1 made any substantive amendments to the Milk Price Manual for 2019/20 in respect of the revenue calculation; and

¹⁵ Commerce Commission "Review of Fonterra's 2013/14 base milk price calculation - Final report" (15 September 2014), page 100.

2.14.2 made any material changes to the calculation methodology.¹⁶

2.15 We confirm that we rely on our conclusions from previous years' reviews for those aspects of the Milk Price Manual and the calculation methodology that have not significantly changed from previous years.

Detailed findings from our focus areas review

Qualifying materials

2.16 Figure 2.1 below sets out the focus areas that are relevant to our examination of Qualifying Materials, as well as the individual matters that we have examined for each focus area (the sub-headings).

Figure 2.1 Focus areas addressed in the Qualifying Materials section

Focus area	Sub-heading
1. Whether it is practically feasible for the Notional Processor plant, as configured, to manufacture the specified product range included in Fonterra's Qualifying Materials.	<p>Do all qualifying materials constitute Reference Commodity Products?</p> <p>Is it practically feasible to manufacture all Qualifying Materials on Standard Plant?</p> <p>Does the process for filtering qualifying off-GDT sales give rise to pricing that could be achieved by a Notional Producer selling Reference Commodity Products at arms-length in freely contestable global markets?</p>
2. Whether production efficiencies assumed for the Notional Processor are consistent with the range and scheduling of production for the full sales portfolio of Qualifying Materials.	<p>Has appropriate provision been made for additional manufacturing costs of products that constitute qualifying materials but are not Standard Specification products manufactured on Standard Plant?</p>
3. Whether it is practically feasible to attribute manufacturing costs to the Notional Processor using the Incremental Product Cost adjustments for products that are not standard specification products.	
4. Whether the selling costs for all of the Qualifying Materials have been appropriately provided for.	<p>Have the selling costs for all of the Qualifying Materials have been appropriately provided for.</p>

Background

2.17 The base milk price is informed by sales of all Qualifying Materials, whether sold off-GDT or on-GDT.¹⁷ The criteria to select commodity sales for the inclusion in the

¹⁶ Fonterra "Reasons' Paper in Support of Fonterra's Base Milk Price for the 2019/20 Season – Public Version" (1 July 2020).

¹⁷ Fonterra "Farmgate milk price manual – Part A: overview" (1 August 2019), page 64.

base milk price calculation are set out in Part C of the Manual, in particular through the definitions of ‘Qualifying Material’, ‘Qualifying Reference Sale’ and ‘Benchmark Selling Price’.¹⁸ Fonterra changed its methodology to include off-GDT pricing for Whole Milk Powder, Skim Milk Powder and Anhydrous Milk Fat in 2016/17.

2.18 A Qualifying Material is defined by the Manual as:¹⁹

a product manufactured by Fonterra from milk supplied in New Zealand that can in the view of the Milk Price Group be reasonably regarded as being a relatively undifferentiated commodity product that in normal circumstances could be expected to transact at a comparable price to other products within the same Reference Commodity Product, after adjusting for any costs that are normally recoverable from purchasers of the product. A product can only be a Qualifying Material if:

- It is a Standard Product Offering
- Its packaging format is Standard Packaging, and
- Its manufacture does not require the use of Specialised Plant.

2.19 We asked Fonterra to explain how the term "relatively undifferentiated commodity product" contained in this definition is consistent with the requirement in the Act that a commodity is characterised by uniform technical specifications.²⁰

2.20 Fonterra has explained that there are a number of separate commodities within each Reference Commodity Product category as sellers provide technical specifications at this ‘sub Reference Commodity Product’ level, and not at the Reference Commodity Product level. For SMP, these separate commodities include low heat SMP, medium heat SMP, and instantised SMP, among other specifications. Each seller of these separate commodities will comply with the same functionally common set of technical specifications. For example, Fonterra and Dairy Farmers of America both sell medium heat SMP on-GDT and their product specifications offer essentially identical technical specifications. The product specifications are publicly available on the GDT website.

2.21 We consider that this interpretation is consistent with the ‘uniform technical specification’ element of the commodity definition.²¹

2.22 As required by the Manual, the Milk Price Group (**MPG**) maintains a schedule of Qualifying Materials. Fonterra has explained that it adds new products and/or changes product descriptions and attributes throughout the year. All new products added, or descriptions changed, during a month are evaluated for inclusion or exclusion from the calculation of the base milk price by:

¹⁸ Commerce Commission “Review of Fonterra’s 2016/2017 Manual - Final report” (14 December 2016), paragraph 48.

¹⁹ Fonterra “Farmgate milk price manual – Part A: overview” (1 August 2019), page 64.

²⁰ Section 5 of the Act.

²¹ Section 5 of the Act.

- 2.22.1 running through the ‘decision tree’ as a check for whether a new material should or should not inform the base milk price. The decision tree is a summary of the rules which have been implemented in the underlying sales data extraction software; and²²
- 2.22.2 reviewing and agreeing (or otherwise) those results at the monthly:
- 2.22.2.1 management base milk price Steering Committee meeting; and
- 2.22.2.2 MPG and management base milk price meeting.
- 2.23 The base milk price is informed by Qualifying Reference Sales, which are sales of Qualifying Materials and, if sold off-GDT, satisfy the following criteria:
- The sale can reasonably be regarded as being on arm’s length terms at a price that reflects prevailing prices that could be achieved by the Farmgate Milk Price Commodity Business at the time the contract for the sale is entered into; and
 - The contract complies with the relevant Fonterra Risk Management Policy.²³
- 2.24 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 Reference Commodity Products at arms-length on globally contestable markets are used to inform the base milk price.
- 2.25 The key concern expressed by Miraka in its submission on our review of the 2019/20 Manual, which we said we would look at in this review, is the open-ended nature of the definition of Standard Product Offerings that are able to be produced on Standard Plant.²⁴ In particular, Miraka raised concern about the matters raised in paragraphs 1.10.1 to 1.10.4 above.
- 2.26 To address these matters, as part of this year’s review, we asked Fonterra the following questions relating to off-GDT inclusion in the base milk price:
- 2.26.1 do all Qualifying Materials constitute Reference Commodity Products?
- 2.26.2 is it practically feasible to manufacture all Qualifying Materials on Standard Plant?
- 2.26.3 does the process for filtering qualifying off-GDT sales give rise to pricing that could be achieved by a Notional Processor selling Reference Commodity Products at arms-length in freely contestable global markets?

²² For a simplified version of this decision tree, see appendix B.

²³ Fonterra “Farmgate milk price manual – Part A: overview” (1 August 2019), page 63.

²⁴ Commerce Commission “Review of Fonterra’s 2019/20 Manual - Final report” (12 December 2019), paragraph 41.

2.26.4 has appropriate provision been made for additional manufacturing costs of products that constitute Qualifying Materials but are not Standard Specification Products manufactured on Standard Plant?

2.26.5 have the selling costs for all of the Qualifying Materials been appropriately provided for?

2.27 We address each of these questions respectively below.

Do all Qualifying Materials constitute Reference Commodity Products?

2.28 In order to ascertain the range of Qualifying Materials and the extent to which new products have been added since 2016/17, we requested the schedule of Qualifying Materials by category (WMP, SMP, AMF, BMP and Butter) showing additions/deletions year by year from 2016/17 (inclusive). The schedule we were given also showed the number of products shipped in each year.

2.29 Synlait submitted on our proposed focus areas that the open-ended nature of Qualifying Material must play a role in increasing the range of Qualifying Materials that are being included in the base milk price.²⁵

2.30 Our analysis of the additions and deletions of Qualifying Materials by product category from 2016/17 to January 2019/20 revealed that there has been only a slight increase in the net number of products added. This suggests there has been no systematic inflation of off-GDT prices by simply increasing the range of Qualifying Materials.

2.31 Although calculation revenues have always been based on Fonterra's actual sales of Reference Commodity Products as provided for in section 150C(1)(a), using a GDT or off-GDT benchmark set independently of Fonterra's current year performance provides an incentive to Fonterra to operate efficiently.²⁶

2.32 We are satisfied that the range of products assumed to have been sold off-GDT constitute Reference Commodity Products and could be sold by the Notional Processor at prices that are consistent with the reference prices. Therefore, we consider that the use of these prices is practically feasible.

Is it practically feasible to manufacture all Qualifying Materials on Standard Plant?

2.33 Synlait submitted that it is not appropriate for the Notional Processor to allocate a higher fixed cost to non-Standard Specification Products that have not in reality been manufactured and sold.²⁷ Synlait also noted that even small changes in

²⁵ Synlait "Submission on proposed focus areas" (22 May 2020), page 1.

²⁶ Commerce Commission "Review of Fonterra's 2016/17 base milk price calculation - Final report" (15 September 2017), paragraphs 2.105 to 2.108.

²⁷ Synlait "Submission on proposed focus areas" (22 May 2020), page 3.

specifications change the production rates. This is particularly important in a plant assumed to be operating as efficiently as the Notional Processor plants.²⁸

- 2.34 Fonterra has explained that the range of Qualifying Materials have been manufactured on actual plants that are functionally equivalent to those of the Standard Plant, therefore the production efficiencies assumed are consistent with the actual production of the portfolio.
- 2.35 Fonterra has provided supporting volume analysis of Qualifying Materials that have been manufactured by Fonterra on plants that are functionally equivalent to the Milk Price Model's Standard Plants.
- 2.36 There are some materials that the volume analysis suggests have not been manufactured for the analysis period on Standard Plants. Fonterra has explained that some separate material numbers have been manufactured on non-standard plants. This is for operational management purposes, for example, separate material numbers are used for the same product (eg, Regular WMP) manufactured for sale into different markets, not because there is any qualitative difference in the product, but because there will generally be market-specific packaging and testing requirements.
- 2.37 We consider that the Qualifying Materials can be manufactured on Standard Plant without significant modifications and therefore their inclusion in the base milk price is practically feasible.
- 2.38 As above, these costs are based on Fonterra's financial forecast, derived from Fonterra's costing system, and so provide an appropriate notional benchmark to beat. Therefore, we consider that the efficiency dimension is met.

Does the process for filtering qualifying off-GDT sales give rise to pricing that could be achieved by a Notional Producer selling Reference Commodity Products at arms-length in freely contestable global markets?

- 2.39 We requested and reviewed a current version of the 'decision tree' as used by the MPG.²⁹ We have also briefly discussed this 'decision tree' in paragraph 2.22.³⁰
- 2.40 We reviewed a summary of the price-exclude and volume-exclude sales from the off-GDT sales data extracts for 2017 to 2020 to identify whether there had been any marked change in the application of the exclusion criteria. The data does not suggest the application of the exclusion rules (based on the decision tree) has resulted in a higher proportion of off-GDT sales since the introduction of off-GDT

²⁸ Synlait "Submission on proposed focus areas" (22 May 2020), page 2.

²⁹ The MPG meets with management each month to assess all new stock-keeping-units (SKUs), and to consider the extent to which each SKU should be considered a Qualifying Material (assessed against the decision tree).

³⁰ For a simplified version of this decision tree, see appendix B.

pricing for WMP, SMP and AMF in 2016/17. In fact, there is a declining trend in the percentage of sales included.

2.41 In our 2019/20 Manual review we stated that, although not matters affecting our conclusion, we consider that further disclosure of the following matters would better promote the purpose of subpart 5A:³¹

2.41.1 a clearer specification in the Manual of what is a Standard Product Offering, and in particular the range of products that constitute 'Generic product specifications';³²

2.41.2 clarification of what 'tender and formulaic sales' constitute;

2.41.3 clarification regarding what conditions apply to sales that are not considered to be transacted on freely contestable markets; and

2.41.4 clarification of what 'prevailing prices' means.

2.42 We also stated that we would review how these rules have been interpreted in practice.³³ The application of these rules forms part of the process that filters off-GDT sales. We therefore asked Fonterra to provide a detailed description of the:

2.42.1 applied criteria by which sales constitute tender sales;

2.42.2 applied criteria by which sales constitute formulaic sales;

2.42.3 applied criteria by which sales are not considered to be transacted on freely contestable global markets; and

2.42.4 a detailed description of the circumstances in which a sale is considered not to have been conducted at prevailing prices.

2.43 Fonterra's explanations of these are as follows:

Tender sales

All government purchasing agencies are identified as restricted customers, and sales to them are excluded for price inform purposes. Principle 2 of the Milk Price Principles provides that the Milk Price is to be calculated by reference to the prices achieved on the sale of commodity products on freely-contested global markets. Characteristics of government tenders that indicate they are not 'freely-contested global markets' include:

³¹ Commerce Commission "Review of Fonterra's 2019/20 Manual - Final report" (12 December 2019), page X10.

³² We may follow up on this matter during our 2020/21 Manual review.

³³ Commerce Commission "Review of Fonterra's 2019/20 Manual - Final report" (12 December 2019), page 64.

- They are generally for large volumes, and therefore there are generally a small number of suppliers that can fulfil such orders. In most instances due to our size, Fonterra is the only NZ processor which can do so.
- The conditions imposed by the government purchasing agencies including requirements for consistency of product quality and specification, and often for non-standard payment terms, may also result in Fonterra being the supplier that is awarded the majority of volume.

Formulaic sales

'Formulaic sales' excluded from both the 'price inform' and 'volume inform' series are sales priced against multiple reference points (e.g., the average GDT C2 price over the past three months, or Fonterra's overall average price over a prior period) for which it is not possible to identify a unique pricing date. These sales are identified by reference to a relevant attribute flag in SAP.

The Milk Price Principles require that we only take into account sales on markets which are freely contested, not contestable. In applying this criterion we mainly focus on whether there is any evidence that other NZ processors participate in the relevant markets. The primary exclusions under this test are government tender sales, as discussed above, and sales to certain 'global account' customers, on the basis that the volume requirements of these customers are typically such that other NZ processors are not able to supply to them. It can also be argued that the nature of ancillary services we provide to global accounts means that the associated pricing does not solely represent payment for a commodity product but instead also includes "returns from specialised value-add business activities" (per principle 2 in the Manual).

Sales not transacted on freely contestable markets

Sales that are considered not to be transacted on freely contested markets include sales of products with non-standard characteristics, and are identified through the material description. These may still be included for volume inform if they meet certain criteria for standard specification, or may be excluded for both volume and price inform purposes. Examples can include:

- Non-standard or non-cascadable product offerings, such as trial products, fortified powders, non-GMO materials, feedstock, etc
- Products that are sold in non-industry standard packaging, such as bulk bags or small packaging
- Products that are sold to customers for further processing and sold back to Fonterra as a different product

Circumstances in which a sale is considered not to have been conducted at prevailing prices

Fonterra's policies and procedures require that all 'spot' sales be priced by reference to the relevant current market price, [REDACTED]. Those policies and procedures allow for exceptions but restrict the ability to authorise exceptions to senior management and require that they only be exercised where doing so can be expected to increase total returns to Fonterra. The MPG therefore deems all sales which satisfy the relevant policies as having been undertaken at a 'prevailing market price' on the basis that if it were to exclude the small subset of sales which senior management agree to proceed with at prices that do not achieve the target margin, the resulting price series used in the Milk Price would arguably not be achievable for a real-world dairy processor (i.e., would not be practically feasible).

Fonterra does however undertake some sales under longer term agreements which are designed to generate average prices that are higher than expected spot prices, but which result in Fonterra facing the risk of under or over achievement relative to spot market prices. These sales, which may be characterised as either formulaic or under long-term fixed price contracts, are excluded under the principle that the consequences of risks which Fonterra's management choose to take on should fall to earnings rather than the Milk Price.

- 2.44 We consider that the latest version of the decision tree provides an appropriate basis on which to make decisions about whether SKUs constitute Qualifying Materials.
- 2.45 We consider that the practical application of the exclusion rules, as explained by Fonterra and set out above, does give rise to pricing that could be achieved by the Notional Processor selling Reference Commodity Products at arms-length in freely contestable global markets. Therefore, they are practically feasible.
- 2.46 Although calculation revenues have always been based on Fonterra's actual sales as provided for in section 150C(1)(a), we continue to consider that using a GDT or off-GDT benchmark set independently of Fonterra's current year performance provides an incentive to Fonterra to operate efficiently.
- 2.47 Synlait submitted on our proposed focus areas, that its ability to engage in the submission process relies on increased transparency of the off-GDT sales.³⁴ We have previously encouraged Fonterra to provide quarterly information on off-GDT sales in its quarterly Global Dairy Update. We welcome views from interested parties regarding what further information is required to facilitate meaningful stakeholder engagement on this matter.

³⁴ Synlait "Submission on proposed focus areas" (22 May 2020), page 1.

Has appropriate provision been made for additional manufacturing costs of products that constitute Qualifying Materials but are not Standard Specification Products manufactured on Standard Plant?

- 2.48 An Incremental Product Cost in the Manual is, for a product that is a Qualifying Material but not a Standard Specification Product, the net difference between the manufacturing cost of the Qualifying Material and a Standard Specification Product. We have reviewed Fonterra's schedule of Incremental Product Costs for the 2019/20 season and can confirm that provision has been made for all of the costs specified in the definition of Incremental Product Cost in the Manual.³⁵
- 2.49 The Incremental Product Costs are extracted from Fonterra's product costing system. The Fonterra product costing process covers costs from the farm to New Zealand ports, both inventoriable (eg, overheads and storage) and non-inventoriable (eg, WACC). A costing team takes Fonterra's financial forecast and allocates it to products using a product costing tool. The tool uses activity-based costing to allocate site level costs to product costs. Non product-specific costs (eg, labour and depreciation) are allocated to products based on resource drivers (eg, operating hours) and process activity (eg, evaporation drying or packing). Product specific costs (eg, ingredients or downgrade) are allocated based on a bill of materials and product specification requirements e.tc.
- 2.50 Fonterra considers that the Incremental Product Costs therefore capture the full range of costs incurred as part of the manufacturing process (eg, operating costs, lab testing and ingredients to meet the composition requirements of Qualifying Materials that are not Standard Specification Products). The depreciation component and a WACC charge relating to any incremental capital required to manufacture the material that is above that of the Standard Plant configuration is also included, if applicable (eg, vitamin tanks for powders and salt addition tanks for butter and AMF bulk packing lines are provided for).
- 2.51 Fonterra's external auditors examine Fonterra's inventory, which involves examining the standard costs that have been historically developed to value inventory. The external auditors also examine the accuracy of the under/over recovery of actual expenditure charged to inventory through the standard costing process. Fonterra has explained that the base milk price uses a subset of this information to calculate the Incremental Product Costs.
- 2.52 We consider that the costs are practically feasible as they are derived from Fonterra's costing system used to establish its actual costs (which are then subject to external audit).
- 2.53 The costs are based on Fonterra's financial forecast, and so provide an appropriate notional benchmark to beat. Therefore, we consider that the efficiency dimension is met.

³⁵ Fonterra "Farmgate milk price manual – Part A: overview" (1 August 2019), page 65.

Have the selling costs for all of the Qualifying Materials have been appropriately provided for?

- 2.54 In our 2019/20 review of the Manual, Miraka raised concerns regarding the practical feasibility of Notional Processor selling costs. In particular Miraka does not agree there is evidence to support the conclusion that Fonterra has included the necessary sales costs for the Notional Processor as a result of including off-GDT sales for WMP, SMP and AMF.³⁶
- 2.55 A review of selling costs was included in Fonterra's 2019/20 scheduled review of the overhead and other administration costs, discussed at 2.63 to 2.79 below.
- 2.56 We have reviewed the Independent Reviewer's report and the methodology set out in Fonterra's Milk Price Overheads Reset Review Report. In general, the Notional Milk Price Business (**NMPB**) sales costs have been derived from Fonterra's GDT and off-GDT costs, with costs not relevant to the NMPB removed. Where appropriate, certain costs have been adjusted to reflect the sales volume (both GDT and off-GDT), size, scale or complexity of the NMPB operation compared to Fonterra.
- 2.57 In its submission on our 2019/20 Manual review, Miraka asked why Notional Processor selling costs had fallen to \$0.07/KgMS in 2018/19 despite the significant increase in off-GDT sales from 2016/17.³⁷ Furthermore, Synlait submitted on our proposed focus areas paper, that in its experience commodity selling costs have been increasing over time.³⁸
- 2.58 Fonterra has explained that a significant portion of the decrease in sales costs between F15 and F19 is explained by changes between F15 and F16 (noting that our final report in 2015/16 referenced the per KgMS cost from 2014/15).³⁹ The decrease in sales costs (particularly NZ fixed costs and other fixed sales costs) in F15 and F16 was a result of a more detailed review of sales costs in the FY15/16 overhead reset. The decrease in sales cost was mainly driven by the removal of duplicate costs and reduction in IT depreciation.
- 2.59 Fonterra's supporting data shows that from F15 to F16 fixed sales costs fell by [REDACTED] as a result of the above explanation and then rose again by [REDACTED] in 2019. At the same time GDT commission costs reduced from F15 to F19 by around [REDACTED], based on the reduced volumes assumed to have been sold on-GDT.

³⁶ Miraka "Miraka submission to the Commerce Commission: Draft report (15 October 2019): Review of Fonterra 2019/20 Milk Price Manual" (15 November 2019), page 8 – 9. This same point was cited by Synlait in "Submission on proposed focus areas" (22 May 2020), page 4.

³⁷ Miraka "Miraka submission to the Commerce Commission: Draft report (15 October 2019): Review of Fonterra 2019/20 Milk Price Manual" (15 November 2019), paragraph 26.3.

³⁸ Synlait "Submission on proposed focus areas" (22 May 2020), page 3.

³⁹ Commerce Commission "Review of Fonterra's 2015/16 base milk price calculation - Final report" (15 September 2016), paragraph A2.

- 2.60 Based on our review of the methodology and the Independent Reviewer’s report, we consider that the selling costs are practically feasible.
- 2.61 Sales costs are based on the F19 budget costs plus 2.35% inflation allowance. This is a notional figure which Fonterra has an incentive to beat and therefore provides an appropriate incentive for efficiency.

Administration and other overhead costs

- 2.62 Figure 2.2 below sets out the focus areas that are relevant to our examination of administration and other overhead costs, as well as the individual matters that we have examined for the focus area (the sub-headings).

Figure 2.2 Focus areas addressed in the administration and other overhead costs section

Focus area	Sub-heading
5. Whether the assumptions, inputs and processes, in particular Fonterra’s cost allocation methodology, underlying the calculation of administration and other overhead costs, provide an appropriate incentive for Fonterra to operate efficiently.	Application of rule 19 (non-recurring costs)
	Notional vs. actual costs and whether there was a failure to achieve efficiencies or errors in the allocation process
	Allocation methodology

Introduction

- 2.63 A review of the provisions for administration and other overhead costs was carried out in 2018/19 in preparation for the 2019/20 season review of general overhead costs as required by the Manual. A review of sales costs was also conducted at the same time.⁴⁰ Approximately \$45m out of around \$90m of additional costs arising from that review were immediately included in the 2018/19 milk price calculation because of concerns the existing costs might not be considered to be practically feasible for that year. The remainder has now been added into the 2019/20 milk price calculation.
- 2.64 In our 2018/19 review, we concluded that since we had previously concluded that the assumptions, inputs and process associated with administration and other overhead costs were practically feasible, we considered that an increased level of costs, absent any significant change in other assumptions or in the operating environment, must also be practically feasible and therefore consistent with the contestability dimension of the section 150A purpose.
- 2.65 In our 2018/19 review, we were unable to reach a conclusion on whether the assumptions, inputs and process underlying the calculation of administration and other overhead costs provided an appropriate incentive for Fonterra to operate

⁴⁰ Fonterra “Farmgate milk price manual” (1 August 2019), page 89.

efficiently under section 150A(1) of the Act as, due to its late provision, we did not have sufficient time to consider the relevant material before the publication of our 2018/19 draft paper.

- 2.66 Nonetheless, we made the following observations in our 2018/19 report:⁴¹
- 2.66.1 On the face of it, the application of Rule 19 (non-recurring costs) in 2018/19 may not be appropriate for all of these costs given that some appear to relate to ongoing changes to administration and other overhead costs.⁴²
- 2.66.2 It is not clear that the use of actual costs instead of notional costs is reasonable.
- 2.66.3 Around \$20m of costs allocated to each of the 2018/19 and 2019/20 seasons (\$40m total) relates either to the failure to achieve efficiencies provided for in the 2015/16 setting of provisions for administrative and other overhead costs or to errors in the allocation process at that time between Fonterra's costs and the costs of the NMPB.
- 2.67 As part of this year's review, we have reviewed the provision of administration and other overhead costs to address these concerns. We also reviewed whether there have been key changes in the allocation of Fonterra costs to the NMPB.
- 2.68 Based on our review, the main increases contributing to the approximately \$90m of net additional costs initially allocated relate to:
- 2.68.1 the removal of Velocity and Stretch savings \$40m (See 2.72 to 2.74 below);
- 2.68.2 [REDACTED] increase in Information Systems costs (See 2.76.3 below);
- 2.68.3 [REDACTED] increase in FMS cost (Food Safety, Quality and Regulatory and Farmer Engagement);
- 2.68.4 [REDACTED] increase in NZ Manufacturing overhead;
- 2.68.5 [REDACTED] increase in corporate overheads including Global Business services (See 2.76.1 below); and

⁴¹ Commerce Commission "Review of Fonterra's 2018/19 base milk price calculation - Final report" (15 September 2016), page 15 - 16.

⁴² In our 2015/16 base milk price review, we expressed the view that costs related to the Velocity adjustment (a one-off adjustment to staff numbers assumed in the NMPB for 2015/16) could be included in the non-recurring costs line item to provide greater transparency. It appears that up to \$20m of the costs being reinstated relates to the original Velocity adjustments. See below para 2.72 to 2.74 for further information.

- 2.68.6 [REDACTED] increase in fixed and variable supply chain costs.
- 2.69 In the course of allocating the F20 reset provision for overhead costs, provisions for certain costs were updated resulting in a reduction of the additional costs to \$82.8m.⁴³ The main amendments were:
- 2.69.1 [REDACTED] decrease in relation to Commodity, Risk & Trading overheads that had effectively been double counted in the total overheads provision;
- 2.69.2 [REDACTED] decrease due to revised non-staff overheads for energy and environmental costs, and the removal of innovation-related cost since an allowance had already been made in R&D costs;
- 2.69.3 [REDACTED] increase in non-significant complaints costs following an additional analysis on actuals data and a change in approach to more accurately reflect that the value of product is a key factor in settling complaints (See 2.76.4 below); and
- 2.69.4 [REDACTED] decrease due to an update on staff costs for management roles.

Application of rule 19 (non-recurring costs)

- 2.70 We consider that the application of Rule 19 to overhead and other admin costs is no longer an issue as the additional allowances previously provided for under Rule 19 (non-recurring costs) for the 2018/19 season have now been provided for under the provisions of the Manual relating to overhead costs (primarily Rule 18).
- 2.71 We note that in its Reasons Paper Fonterra has not identified any significant COVID-19 financial impacts relevant to the base milk price which requires recognition under Rule 19.⁴⁴

Notional vs. actual costs and whether there was a failure to achieve efficiencies or errors in the allocation process

- 2.72 We have further considered whether the increase in the overhead and other expenditure allowances across 2018/19 and 2019/20 provides for any recovery of previous cost over-runs due to the failure to achieve budgeted efficiencies, thereby undermining the incentive value of using a notional benchmark to establish those costs.

⁴³ FX and volume movements up to 31 May have given rise to a further increase of \$2.6m, giving a final movement between May 2019 and May 2020 of \$85.4m.

⁴⁴ Fonterra "Reasons' Paper in Support of Fonterra's Base Milk Price for the 2019/20 Season – Public Version" (1 July 2020), page 31.

- 2.73 To determine whether any portion of the increase in costs was attributable to a failure to achieve targeted efficiency gains from the Velocity programme, it would have been necessary to restate F19 actuals / F20 budget under the hypothetical counter-factual where the Velocity programme had not been undertaken. Fonterra management have not undertaken such an exercise, and do not consider it would be feasible. Consequently, it is not possible to determine whether any part of the increase in costs reflects a failure to achieve Velocity efficiency targets.
- 2.74 The allowances have been based on Fonterra's budgeted costs and have been subject to review by Fonterra's Independent Reviewer and external auditor. We have reviewed the Independent Reviewer's report and have not identified any matters that give rise to concern about the reasonableness of the allowances. Given they have been set independently of Fonterra's current year performance and there is no evidence of over-recovery, we consider that the allowances provide an appropriate incentive for Fonterra to beat.

Allocation methodology

- 2.75 Fonterra has confirmed that its methodology for allocating costs (including selling costs) has not changed since the previous reset in 2015/16, except for some refinements. Fonterra noted that the majority of overhead costs are fixed and therefore do not require scaling for volume. However, certain costs such as sales support costs and supply chain costs are scaled with the milk price volume.
- 2.76 In summary, the following refinements have been made to the cost allocation methodology:
- 2.76.1 The previous reset estimated the relevant costs for Fonterra's business unit 'Global Business Services' at a service level and applied relevant scaling to each service (eg, number of staff). A detailed recharge model has been developed that allocates GBS costs at a business unit level. Relevant business units were scaled based on their relevance to the base milk price using a reasonable driver for the business unit (eg, estimated Milk Price FTE for Group functions).
- 2.76.2 The previous approach involved an allowance for R&D related activities which were assumed to be outsourced by the NMPB given the smaller scope of the NMPB in the last reset. The approach in the F19 reset was refined and a costing model which allocates costs to relevant business units by activity was available to allocate costs to the NMPB. Certain activities were scaled to reflect the NMPB's simpler products relative to Fonterra.

- 2.76.3 Previously Fonterra's IS were apportioned at a business unit level on the basis of FTE and device numbers. For the F19 reset, this approach was refined as a more detailed Fonterra IS cost model was available. Costs relating to Global Operations, Global Ingredients and Group were reviewed by category and subcategory and assessed as to whether the NMPB business would incur these costs entirely, partially or not at all. The scaling is based on a reasonable driver for each business unit (eg, number of staff).
- 2.76.4 Non-significant complaints costs were reviewed as part of the F19 overhead reset work. Following a review of the approach, the complaint costs calculation basis was changed from NZ\$/MT to percentage of product sales value (ie, revenue). This more accurately reflects that the value of the product is a key factor in settling complaints.
- 2.76.5 MPG and DIRA costs were part of the previous reset but were excluded in the latest reset. The four-yearly reset is designed to apply only to costs that can reasonably be expected to change. On reviewing costs for items that potentially do not fit this category, Fonterra identified MPG and DIRA-related costs. These two cost items will be updated annually, rather than in reset years, using budget and actuals data.
- 2.77 The allocation of costs was subject to review by the Independent Reviewer and Fonterra's external auditor. We have reviewed the basis of allocations and are satisfied the underlying methodology is reasonable.
- 2.78 The assumptions adopted, and inputs and processes used in calculating the administration and other overhead expenses are based on budget information. Therefore, we consider they provide an incentive for Fonterra to operate efficiently.
- 2.79 The costs are based on Fonterra's actual costs, as applicable to the NMPB and scaled accordingly. We therefore consider they are practically feasible.

Detailed findings from our fit for purpose review

- 2.80 We received and reviewed Fonterra's base milk price calculation model, as well as supporting models for each of the key inputs. We requested and obtained further information on a confidential basis where we considered it necessary.
- 2.81 With the exception of administration and other overhead costs (discussed in our focus areas review above) and lactose costs (discussed below) we did not identify any significant inconsistencies with previous base milk price calculations. We

therefore confirm our reliance on the conclusions from previous years' reviews for those aspects of the base milk price calculation that have not significantly changed.

- 2.82 As part of the analysis set out above, we have also examined any changes in the following assumptions that have a high potential for impacting the base milk price:
- 2.82.1 changes in costs;
 - 2.82.2 changes in pricing assumptions, including reference to GDT and off-GDT sales data;⁴⁵
 - 2.82.3 changes in sales phasing;
 - 2.82.4 changes in timing or volume of milk collected; and
 - 2.82.5 yield and loss calculations.⁴⁶
- 2.83 Our draft conclusion is that we consider that the inputs and assumptions and processes covered in our fit for purpose review are consistent with the efficiency and contestability dimensions of section 150A.

Changes in costs

- 2.84 There has been an \$85.4m increase in the provision for administration and other overhead costs for the 2019/20 season.⁴⁷
- 2.85 Lactose costs have increased by \$83.5m for the 2019/20 season. The increase is driven by changes in international lactose prices applied to the notional milk price volumes.
- 2.86 Prior to the beginning of a season, it is decided whether Fonterra's or other processors' lactose price series will be used in the base milk price. For the 2019/20 season, Fonterra has used the competitor price series and actual costs for lactose landed in New Zealand. We therefore consider that the assumptions relating to lactose costs are practically feasible.
- 2.87 Consistent with our 2013/14 view, we consider that using the lower of Fonterra's or its competitors' actual lactose and cost, insurance and freight costs in combination with notional lactose volume requirements that are significantly larger than

⁴⁵ Fonterra has confirmed that it has not made any amendments to the process for identifying off-GDT 'price include' sales, see Fonterra "Reasons' Paper in Support of Fonterra's Base Milk Price for the 2019/20 Season – Public Version" (1 July 2020), page 48.

⁴⁶ For a full description of Fonterra's process to update the loss assumptions, see Fonterra "Reasons' Paper in Support of Fonterra's Base Milk Price for the 2019/20 Season – Public Version" (1 July 2020), page 13.

⁴⁷ As noted in paragraphs 2.66 to 2.67, this consists of final allocations of \$82.8m plus FX and volume movements of \$2.6m. The total increase is allocated across the admin costs, fixed supply chain costs, variable supply chain costs and commission categories in the milk price model.

Fonterra's actual volumes, incentivises Fonterra to reduce its actual lactose costs (ie, operate efficiently).⁴⁸

- 2.88 Therefore, our draft conclusion is that we consider the lactose cost assumptions are consistent with the efficiency and contestability limbs of section 150A.

Inclusion of off-GDT sales as a reference for calculating commodity prices

- 2.89 In our 2017/18 and 2018/19 calculation fit for purpose reviews we looked at the off-GDT prices and volumes against the previous season to obtain comfort in what was being used as a reference for prices used for the Notional Processor.
- 2.90 We obtained the same information for the 2019/20 season. This shows that the overall impact of off-GDT pricing for WMP, SMP and AMF was ██████████ compared with ██████████ in 2018/19, a change of 0.5c. We do not consider this to be significant.
- 2.91 Therefore, given also the results of our review of the application of the exclusion rules, discussed in the Qualifying Materials section above, we continue to consider that the use of off-GDT sales pricing is practically feasible.
- 2.92 Also, as discussed in the Qualifying Materials section above, since prices continue to be independently set, we continue to consider that the prices provide an incentive for efficiency.

Changes in sales phasing

- 2.93 Fonterra's approach to sales phasing has not changed from previous years' reviews. We note that sales were contracted slightly earlier in 2019/20 and therefore shipped earlier. The revenue was recognised in the base milk price model based on the contracted prices, and the use of total phasing is consistent with the production profile of the notional business, therefore our draft conclusion is that we consider the phasing is practically feasible.
- 2.94 While the incentive to operate efficiently is potentially weaker than if notional data had been used, we continue to consider the current approach to sales phasing using Fonterra's actual data to be consistent with the efficiency dimension of the purpose because:
- 2.94.1 there is insufficient data to develop a reasonable notional figure; and
- 2.94.2 Fonterra only has limited discretion over its sales phasing.⁴⁹

⁴⁸ Commerce Commission "Review of Fonterra's 2013/14 base milk price calculation - Final report" (15 September 2014), page 100.

Changes in volumes of milk collected

- 2.95 The 2019/20 volume of milk collected (1,517,000 KgMS) reduced slightly, by 0.38%, from 2018/19. As a result, there are no new asset stranding or mothballing issues to consider.
- 2.96 In our 2018/19 review of the Manual, we concluded that in respect of issues raised by static or declining volumes of milk collected by Fonterra, our best course of action would be to monitor the asset stranding rules against real world behaviours for the time being with a more substantive review to be included in the 2020/21 season alongside Fonterra's review of the specific risk premium. Accordingly, we will address the issue of asset stranding at that time.

Yield and loss calculations

- 2.97 A full description of Fonterra's process to update the loss assumptions can be found in its 2019/20 reasons paper.⁵⁰
- 2.98 The 2019/20 losses are in line with the losses achieved in the 2018/19 season.
- 2.99 We confirmed the calculated yield by performing a 'mass balance' calculation to verify that loss assumptions have been properly taken into account. This reconciles the milk solids in the total volume of raw milk purchased by the Notional Processor with the fat and protein milk solids components of the Reference Commodity Products together with associated losses.
- 2.100 Synlait has raised concerns in its submission on our proposed focus areas regarding whether appropriate provision has been made for unstandardised product.⁵¹ The yield calculation we performed accounts for the effect on yield of unstandardised production. The achieved yield fully reconciles with the volumes collected, processing capacity, and composition targets after having taken into account the unstandardised volumes.
- 2.101 Having reviewed the information provided by Fonterra, and performing our own analysis on the calculated yield, we are satisfied that the yields can be achieved by Fonterra and that they are therefore practically feasible for an efficient processor.
- 2.102 The process for setting the yield and loss calculation inputs is in line with that used in the 2018/19 base milk price calculation review, therefore our draft conclusion is that the yield and loss calculations are consistent with the efficiency dimension of the section 150A purpose.

⁴⁹ Commerce Commission "Review of Fonterra's 2014/15 base milk price calculation - Final report" (15 September 2015), paragraphs 7.94 to 7.106.

⁵⁰ Fonterra "'Reasons' Paper in Support of Fonterra's Base Milk Price for the 2019/20 Season – Public Version" (1 July 2020), page 13.

⁵¹ Synlait "Submission on proposed focus areas" (22 May 2020), page 5.

Chapter 3 How you can provide your views

Invitation to comment

- 3.1 As required under the Act, we are consulting with Fonterra on this draft report.⁵² We have also extended our consultation process to other interested parties.
- 3.2 This chapter outlines how you can provide your views on our draft report.
- 3.3 We welcome views on any aspects of this draft report before we finalise our conclusions. Your views on our draft report will help inform our final conclusions for our review.

Format of submissions

- 3.4 Submissions must be provided electronically in a format suitable for word processing and publication on our website.
- 3.5 We intend to publish all submissions on our website. If you would like the published electronic copy to be 'locked' (eg, in PDF), we ask that you provide multiple versions of your submission. At least one version should be provided in a file format which is suitable for word processing

Deadline for submissions

- 3.6 To allow us time to consider your views, submissions must be provided to us by no later than **12 noon, Tuesday 1 September 2020**.
- 3.7 Please address your submission to:
Matthew Lewer, Regulation Development Manager
regulation.branch@comcom.govt.nz
- 3.8 We will consider submissions and publish our final report by **Tuesday 15 September 2020**.

Requests for confidentiality

- 3.9 We encourage full disclosure of submissions so that all information can be tested in an open manner. However, we offer the following guidance where you wish to provide information in confidence:
- 3.9.1 If you include confidential material in a submission, both confidential and public versions of the submission should be provided; and

⁵² Section 150U of the Act.

3.9.2 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.

3.10 You can also request a confidentiality order under section 100 of the Commerce Act 1986. Any request for a section 100 order must be made at the time the relevant information is supplied to us, outlining the reasons why the relevant information should not be made public. We will provide further information on section 100 orders if requested.⁵³

⁵³ A key benefit of such orders is to enable confidential information to be shared with specified parties on a restricted basis for the purpose of making submissions. However, any section 100 orders will apply for a limited time only as specified in the order. Once an order expires, we will follow our usual process in response to any request for information under the Official Information Act 1982.

Appendix A **Submission points raised in proposed focus areas that do not require focus area review**

Submitter	Key points	Our response
Synlait	Whether section 150B(a) of the Act (safe harbour provision) has the effect of geographically un-anchoring the Notional Processor manufacturing foot print. Regardless of the interpretation of 150B(a) we do not believe that this two island capacity match could be considered practically feasible. The dairy environment has changed materially since 2012/13 with continuous season on season milk pool growth no longer existing.	We have previously concluded that the North Island/South Island milk allocation assumption is consistent with section 150B(a) and is practically feasible. ⁵⁴ We do not understand why changes to the dairy environment gives rise to the need to reconsider this conclusion.
	We believe there would be benefit in the Commerce Commission providing more detail around the assessment of processing capacity vs raw milk production each season. It is difficult to discern the costs associated with mothballing a plant in the milk price calculation.	Our work on this is summarised in paragraph 2.99 to 2.101 above. We determined that costs of existing mothballed plants were appropriately accounted for in our 2018/19 review. No additional plants were mothballed in the 2019/20 base milk price calculation.
	We continue to believe the regime would be improved through further transparency around foreign exchange (FX) achieved by the Notional Processor.	We continue to encourage further transparency by Fonterra around FX rates. ⁵⁵
	We request confirmation that the midpoint of any announced range represents the Notional Producer Model derived farmgate milk price.	Our focus of the base milk price review is reviewing the extent to which the assumptions adopted and the inputs and processes used in calculating the base milk price are consistent with section 150A. We consider that confirming the midpoint of any announced range represents the Notional Producer Model derived farmgate milk price is outside of our role.

⁵⁴ Commerce Commission “Review of Fonterra’s 2012/13 Manual – Final report” (14 December 2012), paragraphs 3.36 to 3.40 and Commerce Commission “Review of Fonterra’s 2012/13 base milk price calculation – Final report” (16 September 2013), paragraphs J15 to J18.

⁵⁵ Commerce Commission “Review of Fonterra’s 2019/20 milk price manual – Final report” (12 December 2019), paragraph 107.

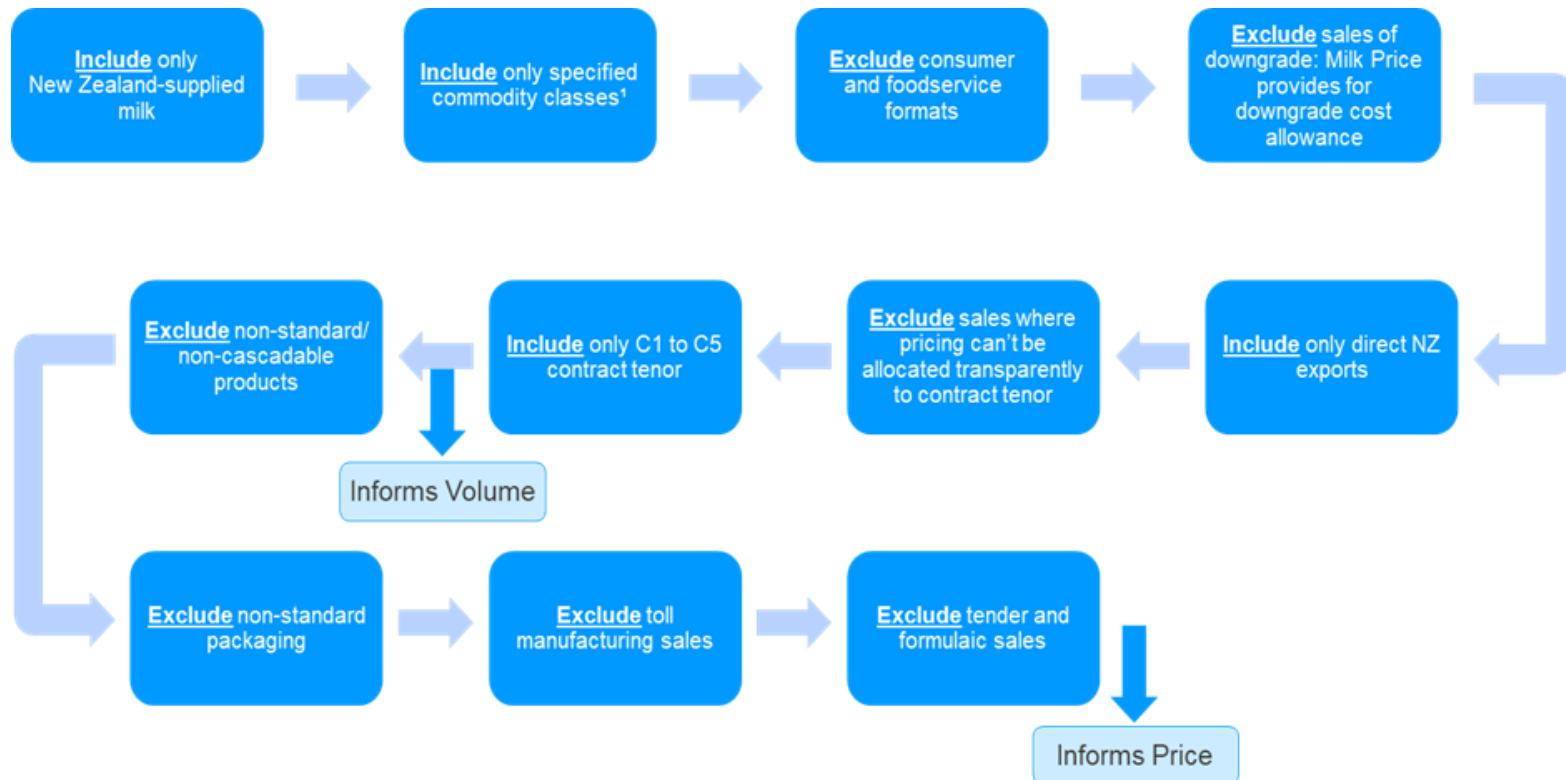
Submitter	Key points	Our response
Miraka	<p>Notional Processor FX conversion rate cannot be the same as Fonterra’s actual FX conversion rate. The Notional Processor is a construct which is materially different to Fonterra. There must be a significant and complex procedure to translate the Fonterra hedge book outcomes to determine a conversion rate for the Notional Processor. The translation process is unlikely to be demonstrably practically feasible, and the outcome of the process is a lottery.</p> <p>The Commission considers the section 150B “safe harbours” are in effect exceptions to the “practical feasibility” requirement of section 150A(2). However, Fonterra “gains and losses” are neither explicitly nor implicitly “incorporated in the base milk price”. Accordingly, the Notional Producer conversion rate is not sheltered by the section 150B(c) safe harbour.</p>	<p>Fonterra’s Reasons Paper describes the process for calculating the benchmark FX conversion rate.⁵⁶ In our 2012/13 base milk price calculation review final report we noted that there are differences between the actual conversion rates Fonterra achieves and the conversion rates used in the base milk price, but we did not consider that these gave rise to significant differences. We also reviewed the external audit reports and were satisfied that the calculation of the FX conversion rate used to calculate the revenue component of the base milk price calculation had been subject to appropriate independent verification. We accepted that using Fonterra’s average actual foreign exchange conversion rates for the purposes of the base milk price calculation is consistent with the ‘safe harbour’ provision in section 150B(c).⁵⁷</p> <p>We disagree with Miraka’s interpretation of section 150B(c) that only actual gains and losses are subject to the safe harbour provision. In the 2012/13 base milk price calculation review final report we accepted that using Fonterra’s average actual foreign exchange conversion rates for the purposes of the base milk price calculation is consistent with the ‘safe harbour’ provision in section 150B(c).⁵⁸ We continue to interpret section 150B(c) in this manner.</p>

⁵⁶ Fonterra “‘Reasons’ Paper in Support of Fonterra’s Base Milk Price for the 2019/20 Season – Public Version” (1 July 2020), page 19.

⁵⁷ Commerce Commission “Review of Fonterra’s 2012/13 base milk price calculation – Final report” (16 September 2013), page 79 & 80.

⁵⁸ Commerce Commission “Review of Fonterra’s 2012/13 base milk price calculation – Final report” (16 September 2013), page 79.

Appendix B Simplified off-GDT pricing decision tree



Appendix C **Glossary of terms**

Table C1 Glossary

Term/Abbreviation	Definition
AMF	Anhydrous milk fat
BCP	Base commodity price, or FAS-equivalent commodity price
Base milk price	Means the price per kilogram of milk solids that is set by Fonterra for that season
BMP	Butter milk powder
Calculation review	Review of Fonterra's base milk price calculation for the prior season
Dairy season	1 June to 31 May
FX	Foreign Exchange
GDT	Global dairy trade, Fonterra's online auction platform used to sell commodities
kgMS	Kilogram of milk solids
Manual review	Review of Fonterra's Milk Price Manual for the current season
MPG	Milk price group, the independent group responsible for calculating the base milk price
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, 2016/17 Manual). The Manual contains the methodology used to calculate Fonterra's base milk price
Notional Producer	The notional commodity business that is used to calculate the base milk price
NP	Notional producer
NMPB	Notional Milk Price Business, comprising the notional milk powder manufacturing business conducted by the Notional Producer as implied by Fonterra's Farmgate Milk Price Manual
RCP	Reference Commodity Product. These products, manufactured and sold by the Notional Producer, are in the Reference Basket. They currently include WMP, SMP, BMP, Butter and AMF
Reference Basket	The RCPs used to calculate the Base Milk Price
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)
SKU	Stock keeping unit, for inventory management
SMP	Skim milk powder
The Act, or DIRA	Dairy Industry Restructuring Act 2001
WACC	Weighted average cost of capital
WMP	Whole milk powder