

Review of Fonterra's 2021/22 Milk Price Manual: Dairy Industry Restructuring Act 2001

Draft report

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Commerce Commission

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Chapter 1 Introduction and how you can provide your views

Purpose of this report

1. This report sets out our draft conclusions from our statutory review of the extent to which Fonterra's 2021/22 Milk Price Manual (**the 2021/22 Manual**) is consistent with the purposes of the base milk price monitoring regime (**monitoring regime**) under subpart 5A of the Dairy Industry Restructuring Act 2001 (**DIRA**).¹
2. The Manual contains the methodology that will be used to calculate Fonterra's base milk price for the 2021/22 season.

How this report is structured

3. Chapter 2 explains our review framework and the scope of our 2021/22 Manual review.
4. Chapter 3 sets out our draft conclusions.
5. Attachment A provides a glossary of the key terms and abbreviations used in this draft report.

How you can provide your views

Invitation to comment

6. As required under DIRA, we are consulting with Fonterra on this draft report.² We have also extended our consultation process to other interested parties.
7. We welcome views on any aspects of this draft report before we finalise our conclusions. Your views on our draft report will help inform the final conclusions of our review.

¹ DIRA, s 150A.

² Ibid, s 150U.

Deadline for submissions

8. We invite submissions on this draft report from interested parties which we will consider when preparing our final report.
9. To allow us time to consider your views, submissions on this draft report must be provided to us no later than **Monday 15 November 2021**.
10. Our final report on the 2021/22 Milk Price Manual will be published by 15 December 2021.

Format of submissions

11. Your submission should be provided as an electronic file in an accessible form (eg, PDF, Word or an unlocked spreadsheet).
12. You should address your response to:

Hristina Dantcheva (Principal Economist, Economic Regulation Branch)
c/o regulation.branch@comcom.govt.nz
Subject line: Milk Price Manual 2021/22
13. The protection of confidential information is something the Commission takes seriously. When including commercially sensitive or confidential information in your submission, we offer the following guidance.
14. Please provide a clearly labelled confidential version and a public version, and provide reasons why you consider information to be confidential or commercially sensitive. We intend to publish all public versions on our website.
15. 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.
16. If we consider disclosure of information in the confidential version to be in the public interest, we will consult with the party that provided the information before any such disclosure is made.

Chapter 2 Our review framework

Our framework for the Manual review

17. This draft report should be read with the framework paper "Our approach to reviewing Fonterra's Milk Price Manual and base milk price calculation - 2021" (**Approach paper**) which reflects the amendments made to DIRA in 2020.³ The Approach paper applied in this review forms part of this draft report. The Approach paper provides an overview of the approach which we take in our reviews of Fonterra's Manual and base milk price calculation, and includes:⁴
 - 17.1 an overview of how the base milk price is set;
 - 17.2 our interpretation of the key legislative provisions guiding our statutory reviews; and
 - 17.3 our practical approach to our statutory reviews.
18. The base milk price monitoring regime is intended to provide incentives for Fonterra to act efficiently, while providing for contestability in the market for the purchase of raw milk from farmers. The regime also promotes greater transparency of Fonterra's base milk price setting processes.⁵
19. We undertake a review of the Manual for each season. The Manual contains the methodology Fonterra uses to calculate its base milk price. As such, the Manual contains a set of definitions, rules and formulas specifying the inputs and process to be followed in calculating the base milk price.
20. We consider the extent to which the Manual is consistent with the purpose of subpart 5A of DIRA. In particular, our review considers the 'efficiency' and 'contestability' dimensions of the s 150A purpose as required by DIRA. Our review thus focuses on whether the methodology used in the Manual:
 - 20.1 provides an incentive for Fonterra to operate efficiently (the 'efficiency dimension'); and

³ See Dairy Industry Restructuring Amendment Act 2020.

⁴ Commerce Commission "[Our approach to reviewing Fonterra's Milk Price Manual and base milk price calculation - 2021](#)" (5 July 2021).

⁵ Dairy Industry Restructuring Amendment Bill (Government Bill) 2012, p. 2

- 20.2 adopts assumptions, inputs and processes that would be practically feasible for an efficient processor (the 'contestability dimension').⁶
21. As set out in the Approach paper, the efficiency dimension is met if Fonterra uses notional inputs in calculating the milk price (independent from Fonterra's actual data).
 22. Contestability is considered to be provided for if any notional costs, revenues, or other assumptions taken into account in calculating the base milk price are practically feasible for an efficient processor.⁷
 23. To satisfy the provisions in s 150A, our interpretation is that our statutory reviews must assess the extent to which the Manual is consistent with both dimensions. We attach equal weight to both dimensions in our reviews. Our analytical approach to the efficiency and contestability dimensions is described in chapter 4 of the Approach paper.⁸
 24. In practice, we focus our review each year on changes to the Manual from the previous year's Manual and on any unresolved issues carried over from our previous reviews.

⁶ We consider the same 'efficiency' and 'contestability' dimensions when we carry out our base milk price calculation review.

⁷ DIRA, s 150A(2).

⁸ Commerce Commission "[Our approach to reviewing Fonterra's Milk Price Manual and base milk price calculation - 2021](#)" (5 July 2021).

Scope of this review

25. DIRA requires Fonterra to provide us with the following information for consideration in our Manual review:⁹
 - 25.1 the Manual for the current season;
 - 25.2 any recommendations by the Milk Price Panel (**MPP**)¹⁰ in relation to the setting of the base milk price;¹¹
 - 25.3 notification of any change in the economic and business environment that, in Fonterra's view, requires a change to the Manual;
 - 25.4 certification on the extent to which Fonterra considers that the Manual is consistent with the s 150A purpose; and
 - 25.5 the reasoning behind the views expressed in Fonterra's certification.
26. The above information, where relevant, has been provided by Fonterra and has been considered as part of our review. Specifically, Fonterra has provided us with:
 - 26.1 the Base Milk Price Manual for the 2021/22 season (marked-up version);¹²
 - 26.2 a Reasons paper in support of Fonterra's Milk Price Manual for the 2021/22 season (**Fonterra's Reasons paper**);¹³ and
 - 26.3 the MPP recommendations to Fonterra's Board with respect to amendments to the 2021/22 Manual.

⁹ DIRA, s 150L.

¹⁰ The MPP is a committee that Fonterra is required to establish and maintain under s 150D of DIRA. The MPP is required, for each season, to supervise the calculation of the base milk price; advise Fonterra on the application of the Manual; and recommend the base milk price to Fonterra. See also Fonterra "[Attachment 1 – Base Milk Price Manual for the 2021-22 season \(marked up version\) – 30 July 2021](#)" (18 August 2021), page 26.

¹¹ Fonterra has "interpreted this provision as in fact relating to recommendations by the Milk Price Panel in relation to amendments to the Milk Price Manual." (See Fonterra "[Reasons paper in support of Fonterra's Base Milk Price Manual for the 2021-22 season – 30 July 2021](#)" (18 August 2021), footnote 1). We agree with this interpretation.

¹² Fonterra "[Attachment 1 – Base Milk Price Manual for the 2021-22 season \(marked up version\) – 30 July 2021](#)" (18 August 2021).

¹³ Fonterra "[Reasons paper in support of Fonterra's Base Milk Price Manual for the 2021-22 season – 30 July 2021](#)" (18 August 2021).

27. The 'marked up' version of the 2021/22 Manual shows the changes that have been made to the previous season's version of the Manual. Fonterra has stated in its Reasons paper that the 'marked up' version of the 2021/22 Manual identifies all amendments to the Manual.¹⁴ In addition, we have reviewed the MPP recommendations to Fonterra's Board and confirmed that all recommended amendments are reflected in the 2021/22 Manual.
28. In reaching our draft conclusions we have applied DIRA as amended by the Dairy Industry Restructuring Amendment Act 2020. We have focused on the amendments Fonterra has made to the Manual for the 2021/22 season and matters carried forward from previous reviews. We have also considered whether the amendments to DIRA should give rise to any other changes in the Manual.
29. For those parts of the Manual that have remained unchanged we have continued to rely on our previous conclusions. We are not aware of any other new information which would warrant reconsideration of our conclusions in previous Manual reviews, but welcome submissions in that regard.

¹⁴ Fonterra "[Reasons paper in support of Fonterra's Base Milk Price Manual for the 2021-22 season – 30 July 2021](#)" (18 August 2021), page 1.

Chapter 3 Draft conclusions

30. This chapter summarises our draft conclusions on the extent to which the 2021/22 Manual is consistent with the s 150A purpose.

Our draft conclusions

31. Regarding Fonterra’s amendments to the Manual since last year’s review, our draft conclusions are that the amendments made are consistent with s 150A of DIRA.
32. Our overall draft conclusion is that:
- 32.1 Rule 42 of the 2021/22 Manual is inconsistent with the new requirements set out in s 150C and thus inconsistent, with the statutory purpose set out in s 150A; and
- 32.2 based on the information we have before us, all other rules of the 2021/22 Manual are consistent with the s 150A purpose of DIRA.¹⁵

Amendments to DIRA

33. The relevant amendments to DIRA enacted by the Dairy Industry Restructuring Amendment Act 2020 came into force on 1 June 2021. We considered whether the DIRA amendments have been appropriately reflected in the 2021/22 Manual, where relevant. Our draft conclusion is that the only rule affected by the DIRA amendments is Rule 42 on the asset beta.

Asset beta

34. We have reviewed Rule 42 (Asset beta) in light of the amendments to the asset beta calculation requirements in s 150C. Our draft conclusion is that Rule 42, as currently worded, is inconsistent with section 150C(4) and is therefore inconsistent with the statutory purpose set out in s 150A of DIRA.

¹⁵ See paragraph 55 for a discussion on the review of the definition of “commodity”.

35. Rule 42 in the 2021/22 Manual states that:¹⁶

The MPG will determine an updated Asset Beta in a Review Year. In calculating the Asset Beta, the MPG will have regard to:

- Fonterra’s exposure to systematic earnings risk with respect to the portion of its business corresponding to the Farmgate Milk Price Business, as implied by the allocation of risks between Fonterra and suppliers under the Farmgate Milk Price Methodology.
- Any relevant requirements under DIRA.

36. We consider that the first bullet point is not consistent with the new section 150C(4) of the DIRA requirements and should be deleted.

37. Section 150C(4) states that the asset beta used in the calculation of the base milk price must be “consistent with the estimated asset betas of other processors of dairy and other food products...”. We consider that the asset beta would not be “consistent with the estimated asset betas of other processors of dairy and other food products...” if the matters in the first bullet point were taken into account when calculating the asset beta.

38. We note, for completeness, our view that section 150C(4) necessarily requires the adoption of the average asset beta from the comparator set.¹⁷

39. We also consider the statement “...the MPG will have regard to...” does not accurately reflect the legal obligation Fonterra has to comply with the s 150C(4) requirements. Fonterra must apply (not merely have regard to) the requirements for the calculation of asset beta in section 150C(4).

40. We therefore recommend that the Manual clarifies that Fonterra is required to apply the section 150C(4) requirements for the calculation of asset beta. Alternatively, the Manual could remove this requirement from Rule 42 entirely as DIRA requires the application of section 150C(4) in any event.

¹⁶ Fonterra “[Attachment 1 – Base Milk Price Manual for the 2021-22 season \(marked up version\) – 30 July 2021](#)” (18 August 2021), page 55.

¹⁷ Commerce Commission “[Review of Fonterra’s 2020/21 base milk price calculation: Dairy Industry Restructuring Act 2001 Final report](#)” (15 September 2021), paragraph 3.26.

Fonterra's amendments to the 2021/22 Manual

41. Fonterra has made the following amendments to the 2021/22 Manual.¹⁸
- 41.1 Rule 23 (within period reviews) has been amended to make it explicit that “where feasible, the amended value should be calculated in a manner that does not result in an actual outcome to Fonterra being passed in full through into the Farmgate Milk Price” in any instance where a within-period review determines an input should be revised outside of a four-yearly ‘reset’ cycle.
 - 41.2 Rule 8 (benchmark selling prices) has been amended to include a reference to ‘freely-contested global markets’ (consistent with Principle 2 of the Manual)¹⁹ and a definition of ‘freely-contested global market’ has been added to the Glossary in Part C of the 2021/22 Manual.
 - 41.3 The term ‘prevailing’ used in different contexts relating to commercial or contract terms has been clarified.
 - 41.4 A review year for the post-tax market risk premium has been added for the 2021/22 and the 2024/25 seasons into the Glossary in Part C of the 2021/22 Manual.
42. Our draft conclusion is that we consider these changes provide greater transparency and are consistent with the efficiency and contestability dimensions of the s 150A purpose. In particular, we consider:
- 42.1 the amendment to the within-period reviews is consistent with the efficiency dimension; and
 - 42.2 the amendment to the benchmark selling price and the clarification of the term prevailing are consistent with the contestability dimension of the s 150A purpose.

¹⁸ Fonterra [“Reasons paper in support of Fonterra’s Base Milk Price Manual for the 2021-22 season – 30 July 2021”](#) (18 August 2021), pages 3-4; and Fonterra [“Attachment 1 – Base Milk Price Manual for the 2021-22 season \(marked up version\) – 30 July 2021”](#) (18 August 2021), page 89.

¹⁹ Principle 2 states that the base milk price “should be the maximum amount which Fonterra, reflecting its status as a properly-managed and efficiently-run, sustainable co-operative, could pay for the Milk supplied to it in a Season”. See Fonterra [“Attachment 1 – Base Milk Price Manual for the 2021-22 season \(marked up version\) – 30 July 2021”](#) (18 August 2021), page 9.

Issues carried forward from previous reviews

43. We have also considered the following issues carried forward from previous reviews:
- 43.1 materiality;
 - 43.2 capacity for primary and secondary plants; and
 - 43.3 how the Manual gives effect to the definition of commodity.

Materiality

44. We suggested Fonterra should disclose what constitutes a ‘material change’, when considering whether a change to the Manual should be made.²⁰
45. In response, Fonterra explained they do not consider it possible to codify in the Manual the full range of circumstances where they would consider it appropriate to amend the Manual. Fonterra noted that most changes to the Milk Price methodology, including changes which result in a material change to the base milk price (which would be publicly disclosed) do not require an amendment to the Manual.²¹
46. We still consider that the disclosure of a material change threshold, whether stated as a number or key qualitative considerations that are relevant to change decisions other than simple clarifications or corrections, will provide greater transparency. However, while improved transparency might be helpful for interested parties to assess whether the changes to the Manual meet the purpose at s 150A of DIRA, we do not consider that the absence of this information renders the Manual inconsistent with the s 150A purpose.

Capacity for primary and secondary plants

47. We have previously stated that the disclosure of the capacity for both primary and secondary plants in the Manual would better promote the purpose in s 150A.²²

²⁰ Commerce Commission “[Review of Fonterra’s 2019/20 Milk Price Manual: Dairy Industry Restructuring Act 2001 Final report](#)” (12 December 2019), paragraph 80.

²¹ Fonterra “[Reasons paper in support of Fonterra’s Base Milk Price Manual for the 2021-22 season – 30 July 2021](#)” (18 August 2021), page 5.

²² Commerce Commission “[Review of Fonterra’s 2020/21 Milk Price Manual: Dairy Industry Restructuring Act 2001 Final report](#)” (15 December 2020), paragraph X9.

48. Fonterra responded that the Manual is not the appropriate vehicle for disclosures about the specific values of inputs into the base milk price, and that they will continue to disclose this information for the following season in the 1 July Reasons paper supporting the base milk price calculation each year.²³
49. We accept that the plant capacity disclosures in Fonterra's Reasons paper for the 2020/21 base milk price calculation have now included both the primary and secondary plant capacity along with a statement that the secondary plant capacity will be maintained for the next four years.²⁴ Fonterra's Reasons paper therefore provides the plant capacity assumptions for both primary and secondary plant on an ex ante basis so as to enable interested parties to assess the practical feasibility of the assumed production volumes.
50. Based on Fonterra's continued ex ante reporting of capacity for both primary and secondary plant in its Reasons papers in support of the base milk price calculation, we consider this issue to be resolved.

How the Manual gives effect to the definition of commodity

51. In our 2019/20 base milk price calculation review, we asked Fonterra to provide a detailed description of 'Standard Product Offering' as we made recommendations regarding these matters in our 2019/20 Manual review.²⁵
52. In our 2020/21 base milk price calculation review, we further recommended that Fonterra clarifies the definition of standard packaging and clarifies its application of the "cascadable product" rule in the Manual.²⁶

²³ Fonterra "[Reasons paper in support of Fonterra's Base Milk Price Manual for the 2021-22 season – 30 July 2021](#)" (18 August 2021), page 5.

²⁴ Fonterra "[Reasons paper on review of 2020/21 base milk price calculation – 1 July 2021](#)" (8 July 2021), page 9.

²⁵ Commerce Commission "[Review of Fonterra's 2019/20 Milk Price Manual: Dairy Industry Restructuring Act 2001 Final report](#)" (12 December 2019), paragraph X10.

²⁶ Commerce Commission "[Review of Fonterra's 2020/21 base milk price calculation: Dairy Industry Restructuring Act 2001 Final report](#)" (15 September 2021), page 39.

53. Fonterra does not consider it appropriate as a matter of general principle to include in the Manual the outcomes from the application of the Manual’s rules and processes, but they indicated they will continue to look for other means of providing additional information about the range of product specifications included in the base milk price calculation.²⁷
54. We consider that the publication of the list of all products that meet the criteria for ‘Generic product specifications’ in the Manual, or the accompanying Reasons paper, would greatly assist transparency of what is a standard product offering.
55. We also noted in our 2020/21 base milk price calculation review that given the submissions related to the inclusion of Instantised Skim Milk Powder as a qualifying material, we intend to examine how the Manual gives effect to the DIRA definition of “commodity” more closely in a future Manual review. This will likely involve engaging an expert to review the list of qualifying materials and incremental product cost adjustments made to account for differences in product specifications and manufacturing processes.²⁸ We will consider engaging an expert to review the list in advance of the 2022/23 Manual review. We welcome submissions from interested parties on specific questions and issues that should be considered by the independent expert when conducting this review.
56. Based on the information we have before us, we do not consider that these matters render this season’s Manual inconsistent with the s 150A purpose as a whole. Once we have conducted our review of how the Manual gives effect to the DIRA definition of “commodity” and have more information available to us, we will revisit this conclusion in a future Manual review.

²⁷ Fonterra [“Reasons paper in support of Fonterra’s Base Milk Price Manual for the 2021-22 season – 30 July 2021”](#) (18 August 2021), page 5.

²⁸ Fonterra [“Attachment 1 – Base Milk Price Manual for the 2021-22 season \(marked up version\) – 30 July 2021”](#) (18 August 2021), page 64.

Attachment A Glossary

Term/Abbreviation	Definition
DIRA	Dairy Industry Restructuring Act 2001
Base milk price	Base milk price, in relation to a season, means the price per kilogram of milk solids (kgMS) that is set by Fonterra for that season
Calculation review	Commission's review of Fonterra's base milk price calculation for the prior season
Manual review	Commission's review of Fonterra's Milk Price Manual for the current season
Dairy season	1 June to 31 May annually
MPG	Milk Price Group
Milk Price Manual or the Manual	Fonterra's Milk Price Manual
MPP	Milk Price Panel
Notional processor	The notional commodity business that is used to calculate the base milk price (in its Reasons paper Fonterra uses the term notional producer).
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)