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Review of Fonterra's 2018/19 Milk Price Manual:

Dairy Industry Restructuring Act 2001

Final report

The Commission: Sue Begg

John Crawford

Dr Stephen Gale

Elisabeth Welson

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15 August 2017	ISBN 978-1-869455-28-6	Our approach to reviewing Fonterra's Milk Price Manual and base milk price calculation

Commerce Commission

Wellington, New Zealand

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Executive Summary

What this report covers

X1 This report sets out our final conclusions on our review of Fonterra's 2018/19 Milk Price Manual (**the Manual**). The Manual contains the methodology that will be used to calculate Fonterra's base milk price for the 2018/19 season.

About this review

X2 Our review of the Manual is required as part of the milk price monitoring regime (monitoring regime), which is contained in subpart 5A of the Dairy Industry Restructuring Act 2001 (the Act). More details of the intent of the monitoring regime along with an overview of our approach when reviewing the Manual can be found in our supporting paper "Our approach to reviewing Fonterra's Milk Price Manual and base milk price calculation" (15 August 2017).[1] This framework paper should be read together with, and as part of, this report. We did not make any changes to this framework paper for the purposes of this Manual review.

X3 Our review considers the 'efficiency' and 'contestability' dimensions of the s 150A purpose as required by the Act. These focus on whether the methodology used in the Manual:

X3.1 provides an incentive for Fonterra to operate efficiently (the 'efficiency dimension'); and

X3.2 adopts assumptions, inputs and processes that would be practically feasible for an efficient processor (the 'contestability dimension').[2]

X4 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.

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1 Commerce Commission "Our approach to reviewing Fonterra's Milk Price Manual and base milk price calculation" (15 August 2017). This paper provides an overview of the approach we have taken in reviewing the Manual. It outlines how we conduct our annual reviews of Fonterra's Milk Price Manual and each season's base milk price calculation. It includes our interpretation of key legislative provisions, our practical approach to the statutory reviews, an overview of how Fonterra sets its base milk price, assumptions of the notional processor, and internal and external controls surrounding the integrity of the milk price calculation.

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

Our conclusions

X5 Our final conclusions are that:

X5.1 the amendments to the Manual from last season's Manual are either reasonable, of low materiality or improve transparency;

X5.1 in the context of the safe harbour provisions in 150B of the Act, the Manual's approach to asset stranding is reasonable.

X6 However, as outlined in previous calculation reviews and Manual reviews, there are two aspects of the Manual that we consider to be inconsistent with the purpose in s 150A or we would like to see more disclosure in the Manual:

X6.1 farmer support; and

X6.2 capacity of standard plants.

X7 We do not, however, consider that either matter is sufficiently material to render this season's Manual inconsistent with the s 150A purpose as a whole.

X8 Accordingly, our overall final conclusion is that this season's Manual is largely consistent with the statutory purpose set out in s 150A of the Act.[3]

X9 There remain recommendations from previous reviews that we considered would better promote the purpose of the Act and provide greater confidence to interested parties through additional transparency that have similarly not been addressed in the current Manual. These recommendations related to:

X9.1 consistency over time - disclosure requirement;

X9.2 actual FX rates assumed.

X10 We are pleased to see that recommendations from last season's Manual review requesting Fonterra to disclose the cost of milk in standard terms (prior to any adjustments) as well as increased clarity around additional sales criteria have been incorporated.

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[3] We are required by s 150I to make a report on the extent to which the Manual is consistent with the statutory purpose set out in s 150A. We note for completeness that we have previously observed that we are comfortable with the WACC methodology set out in the Manual. See for example para X26 of Commerce Commission "Final report – Review of Fonterra's 2015/16 base milk price calculation - 15 September 2016", footnote 15 of Commerce Commission "Final report – Review of Fonterra's 2016/17 Milk Price Manual – 14 December 2016", and paragraphs 2.24 to 2.27 of Commerce Commission "Final Report – Review of Fonterra's 2016/17 base milk price calculation – 15 September 2017".

Chapter 1 Introduction and scope of review

1. This report sets out our review of the extent to which Fonterra's 2018/19 Manual (**the Manual**) is consistent with the purpose of the monitoring regime, which is set out in s 150A of the Act.

How this report is structured

2. This chapter introduces our review of the Manual, including the scope of our review. It also discusses the key points raised in the submissions from stakeholders on our draft report on the Manual.

3. Our final conclusions on the key focus areas of our review are set out in Chapter 2.

4. Minor technical and drafting amendments to the Manual, and our final views on these are set out in Attachment A. These relate to definitions that Fonterra has included in line with previous commitments made in the 2017/18 Manual.

5. Manual amendments that we proposed to Fonterra in prior reviews and which we consider still outstanding have been summarised in Attachment B.

6. A glossary of key terms is provided in Attachment C.

7. This paper should be read with the paper "Our approach to reviewing Fonterra's Milk Price Manual and base milk price calculation" (15 August 2017) which we have applied in this Manual review and which forms part of this report.

We are fulfilling our statutory requirements

8. We are required to review the Manual for each dairy season and make a report on the extent to which the Manual is consistent with the purpose statement set out in subpart 5A of the Act.[4]

9. The Act requires Fonterra to provide us with the following information for consideration in our review:

   9.1 Fonterra's Manual for the current season;

   9.2 Any recommendations by the Milk Price Panel in relation to the setting of the base milk price;

   9.3 Notification of any change in the economic and business environment that, in Fonterra's view, requires a change to the Manual;

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4 As required under s 150H and s 150J of the Act.

9.4 Certification on the extent to which Fonterra considers that the Manual is consistent with the purpose of s 150A; and

9.5 Reasoning behind the views expressed in Fonterra's certification.

10. The above information has been provided by Fonterra in the 'Reasons' Paper in support of Fonterra's Manual for the 2018/19 season and has been considered as part of our review. Fonterra’s Manual and the Reasons Paper can be found on our website.[5]

Scope of this review

11. We have focused our review on:

11.1 Fonterra's amendments to the Manual;

11.2 issues arising from our 2017/18 base milk price calculation review;[6]

11.3 outstanding issues from previous Manual reviews; and

11.4 relevant points from submissions received on our draft report.

12. For those parts of the Manual that have remained unchanged we have relied on our previous conclusions save where new information and/or changing circumstances have caused us to reconsider our previous conclusions. In this regard:

12.1 Lower than expected milk volumes over the last two seasons raise the possibility that milk volumes may be stabilising and/or could experience decline. As we signalled during the review of the 2017/18 Milk Price Calculation, this Manual review relooks at the Manual rules that relate to the issue of asset stranding and mothballing of plants should the volumes of milk collected and processed by Fonterra remain stable or decline over time.

12.2 We are not aware of any other new information which would warrant reconsideration of our previous conclusions.

13. In this report we have grouped issues in the following order:

13.1 The areas of the Manual that are most likely to have an impact on the extent to which the Manual is consistent with s 150A taking account of new information and changes to the Manual.

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5 Fonterra "Fonterra's Reasons Paper in support of Milk Price Manual for the 2018/10 season" (2018) at https://comcom.govt.nz/regulated-industries/dairy/milk-price-manual-and-calculation/milk-price-manual

6 Commerce Commission "Final Report Base Milk Price Calculation Review 2017/18" (14 September 2018).

13.2 Minor amendments to the Manual of a technical or drafting nature (Attachment A).

13.3 A summary of the Manual amendments we have proposed to Fonterra over the course of our milk price reviews which have not been adopted. Given the ongoing nature of our reviews we consider these issues to be of continuing relevance (Attachment B).

Matters raised in submissions on our draft report

14. We received submissions on the draft manual report from Open Country Dairy, Fonterra, Miraka and TDB advisory.[7] We would like to thank these stakeholders for their submissions. Large parts of the submissions were on matters we consider to be outside of the scope of the review of the Manual. However, these provided useful comments that we will consider in our milk price calculation review later in the season.

Off-GDT reference sale inclusion and transparency

15. Open Country Dairy and Miraka are concerned the additional definitions included in this year's Manual do not add any further clarity. Whilst we believe the new definitions are fit for purpose we agree further clarity could be provided by using the language Miraka has suggested for 'standard plant'.

> Standard plant should simply be defined as the NP plant which is designed to produce the GDT product range. Any product able to be made on this plant (not requiring other equipment) can be deemed to be standard product for purposes of determining "qualifying material".[8]

16. In our calculation review we will also seek clarification of what "qualifying outlier sales" comprise or are likely to comprise and will identify whether they have had an impact on the selling prices of the notional producer (NP).

17. Open Country and Miraka also remain concerned about a lack of transparency within the regime, particularly around the inclusion of off-GDT sales.

18. In our last review of the milk price calculation we retained the view that Fonterra's inclusion of off-GDT sales was consistent with the efficiency and contestability dimensions of the Act.

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[7] Submissions are available on our website at https://comcom.govt.nz/regulated-industries/dairy/milk-price-manual-and-calculation/milk-price-manual/milk-price-manual-201819-season

[8] Miraka 'Submission on draft report on review of Fonterra's 2018/19 draft milk price manual', 15 November 2018, para 1.6.3.

19. We will consider whether there is a need to further examine the adequacy of Fonterra's committed disclosures in this regard in our forthcoming 2018/19 review of the farm milk gate price calculation.

20. As noted in our final report on the 2017/18 milk price calculation review, Fonterra has not consistently met its commitment to publish quarterly forecasts of the cents per kgMS impact from the inclusion of off-GDT sales of WMP, SMP and AMF in the Milk Price calculation. The Commission expects Fonterra to meet the commitments it has made and therefore encourages this quarterly forecast information to be published going forward.[9]

21. While we continue to encourage Fonterra to meet its transparency commitments, we do not consider that these issues have limited our ability to perform our review to an appropriate standard or hindered our ability to conclude on the extent to which the Manual is consistent with the s 150A purpose. Accordingly, we do not consider those matters to be material to our overall conclusion on s 150A.

22. Miraka provided its analysis of the effect of inclusion of off-GDT sales on the milk price. The premium calculated by Fonterra for its off-GDT sales relative to GDT reference sales does not look unreasonable to us overall.[10]

23. For our 2018/19 milk price calculation review we would welcome information from stakeholders that demonstrates that the premium incorporated for off-GDT sales is not practically feasible if they consider this to be the case.

Asset stranding

24. We had a broad range of submissions relating to the topic of asset stranding.

25. After consideration of these submissions, we believe the best course of action is to monitor the asset stranding rules against real world behaviours for the time being and conduct a more substantive review in the 2020/21 season when Fonterra reviews the specific risk premium.

26. Fonterra continues to make the case that under the regime the oldest relevant assets will always be the lowest value assets of the NP.

> As explained in our submission on the Commission's draft report on the 2017/18 base milk price "CEPA's argument overlooks the homogeneity of the NP's assets: because its material

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[9] Commerce Commission "Final report – Review of Fonterra's 2017/18 base milk price calculation", 14 September 2018, para 2.46.

[10] Miraka 'Submission on draft report on review of Fonterra's 2018/19 draft milk price manual', 15 November 2018, page 10.

> manufacturing assets are SMP and WMP plants, and because each SMP and WMP plant can manufacture the same products, it follows that the oldest plants (which are assumed both to have higher operating costs and which by definition have the shortest remaining useful lives) will also be the assets that are forecast to generate the least value."[11]

27. We disagree with this view as there remain other costs, such as collection costs, that will vary from plant to plant regardless of the ages of the assets. We retain the view that the lowest returning asset might not always be the oldest asset.

Specific risk premium

28. TDB Advisory submitted that the specific risk premium appears to result in double counting the cost of equity:

> …In recent seasons, Fonterra has set a specific risk premium of 0.15% per annum. That cost of equity adjustment makes little sense to us given the cost of equity is estimated by comparing similar commodity businesses – all of which presumably risk asset stranding. Adding a specific risk premium in that case seems to be double counting.[12]

29. TDB's argument appears to be that the specific risk premium is doubling up on the risk allowance for the equity beta in some way. However, Rule 43 specifically carves out any compensation to equity owners in the specific risk premium where such additional risk has otherwise been provided for in the milk price calculation methodology. This means that where the risk has already been covered by either the equity beta or in some other cost element in the calculation building blocks, it would not also be provided for in the specific risk premium.

30. Miraka submitted that in the current environment of expected flattening and even declining milk supply, the asset stranding risk is increasing and is likely to be higher than would have been perceived at the time the current specific risk premium was determined.[13]

31. Fonterra pointed out that the specific risk premium allowance was last reviewed in April 2016 where the current value of 0.15 was implemented. It also highlighted,

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11 Fonterra 'Submission on draft report on review of Fonterra's 2018/19 draft milk price manual', 15 November 2018, page 1.

12 TDB Advisory 'Submission on draft report on review of Fonterra's 2018/19 draft milk price manual', 15 November 2018, page 3.

13 Miraka 'Submission on draft report on review of Fonterra's 2018/19 draft milk price manual', 15 November 2018, para 3.1.

correctly, that under the Manual the next review is scheduled for the 2020/21 season.[14]

32. Having reviewed submissions, we are comfortable with the specific risk premium remaining at 0.15 and for the next review to occur as scheduled by the Manual. We agree with Miraka that that any pressure on this premium is more likely to be upwards rather than downwards.

Materiality

33. Miraka submitted that we have not provided an objective or transparent measure of materiality. It is therefore concerned about our use of the term.[15]

34. We believe it is appropriate to consider this issue as part of the 2018/19 milk price calculation review and intend to engage with interested stakeholders ahead of producing our draft report in the calculation review.

Foreign exchange

35. We note the submission from TDB Advisory on Fonterra's foreign exchange calculations and the practical feasibility of a derived yield. This is outside the scope of the review of the Manual, but the information contained in the submission will be considered in our forthcoming review of the milk price calculation.[16]

Mothballing

36. While noting submissions on the Manual we retain the view that the current approach to mothballing undertaken as part of the milk price calculation meets both the efficiency and contestability dimensions.

37. We note Fonterra's commitment to providing more transparency around its mothballing decisions. We agree the milk price statement, published each September would be an appropriate place to deliver this information.[17]

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14 Fonterra 'Submission on draft report on review of Fonterra's 2018/19 draft milk price manual', 15 November 2018, page 1.

15 Miraka 'Submission on draft report on review of Fonterra's 2018/19 draft milk price manual', 15 November 2018, para 5.0.

16 TDB Advisory 'Submission on draft report on review of Fonterra's 2018/19 draft milk price manual', 15 November 2018, page 2.

17 Fonterra 'Submission on draft report on review of Fonterra's 2018/19 draft milk price manual', 15 November 2018, page 2.

38. Miraka highlighted in its submission that for the purposes of the milk price calculation, mothballing decisions cannot be made solely at a national milk supply level but require a regional review of supply volumes.[18] We agree that mothballing decisions on the specific plants of the NP cannot be made at a national milk supply level and it is logical that Fonterra would provide us with regional analyses in support of its mothballing decisions for each coming season in the milk price statement for the preceding season.

[18] Miraka 'Submission on draft report on review of Fonterra's 2018/19 draft milk price manual', 15 November 2018, para 4.3.

Chapter 2 Conclusions

39. This chapter summarises our final conclusions on the extent to which the 2018/19 Manual is consistent with the s 150A purpose. Our overall final conclusion, which has not changed from the draft, is that the 2018/19 Manual is largely consistent with the s 150A purpose.

Conclusions on previous matters raised

40. Although not material to our overall conclusion, as outlined in previous calculation reviews and Manual reviews, we consider the following aspects of the Manual to be inconsistent with the purpose in s 150A or to require more disclosure:

    40.1 farmer support - We previously concluded that Fonterra should include the costs of providing shareholder support to ensure continued supply to be consistent with the contestability dimension; and

    40.2 capacity of standard plants – We previously recommended Fonterra considers disclosing its plant capacity for both primary and secondary plants in the Manual early in each season to provide certainty of the NP's assumed capacity for the related season. We consider this would improve the ability of interested parties to assess the practical feasibility of the assumed production volumes.

41. As there is no new information which warrants us revisiting our previous conclusions on farmer support and capacity of standard plants, we maintain and adopt the conclusions in our previous calculation reviews and Manual reviews on these matters. Further detail on these points can be found in Attachment B.

42. In line with previous Manual reviews we consider that to better promote the purpose of the Act and provide greater confidence to interested parties, it would also be desirable for Fonterra to provide additional transparency in the following areas, which are discussed in more detail in Attachment B:

    42.1 consistency over time - disclosure requirement; and

    42.2 actual FX rates assumed.

Final conclusions on Fonterra's amendments

43. Table 3.1 summarises Fonterra's changes to the 2018/19 Manual, Fonterra's specific commentary in its 2018/19 Reasons paper, and our final conclusions on the changes.

Table 2.1 Summary of our conclusions on the impact of Fonterra's amendments on consistency with the s 150A purpose[19]

Manual reference	Amendment	Fonterra comment	ComCom final conclusion
pp.5-6	Rearrangement of existing text & introduction of new 'Aggregate Farmgate milk Price' and 'Farmgate Milk Price' definitions.	No substantive impact, other than to align text with defined terms.	No impact on consistency.
p.32	Addition of requirement for the annual Milk Price Statement to explain how the Farmgate Milk Price has been determined and how it ties back to the aggregate amount calculated under the manual	Consistent with both past practice and a key purpose of these changes, which are intended to enable better alignment of the Milk Price Statement and Manual to other supplier Milk-Price related communications.	This rule improves clarity and has no impact on consistency.
p.56 Rule 44	Aggregate amount available to pay for milk which is calculated under the Manual now defined as 'Aggregate Commodity Milk Payments' rather than 'Farmgate Milk Price'.	New terminology: • Reflects fact that a portion of the aggregate amount calculated under the Manual is not applied to the payment of the Farmgate Milk Price as that term is commonly understood. • Highlights that payments for milk that are not related to the generation of commodity related returns are not funded from the aggregate amount calculated under the Manual	This rule is consistent with new rule 45 and 46 and does not impact consistency.
p.56 New rule 45	Payments for milk not supplied on standard terms will only be funded from the aggregate amount calculated under the Manual if the Panel determines that it would be 'commercially appropriate' for an RCP-only commodity processor business to make those payments.	Consistent with past practice but not previously made explicit in the Manual.	This rule is consistent with past practice and the change does not impact consistency. We accept that the Panel must make decisions in this regard in a commercially appropriate way. We have considered whether there is a benefit to further codifying this requirement and have concluded it does not justify a more prescriptive approach.

[19] See also Attachment A which outlines the amendments of a minor or drafting nature.

Manual reference	Amendment	Fonterra comment	ComCom final conclusion
p.56 New rule 46	Adjustments to payments for milk supplied on standard terms (e.g. demerits deductions) will be added back to / deducted from the Aggregate Farmgate Milk Price.	Consistent with past practice but not previously made explicit in the Manual.	This rule is consistent with past practice and has no impact on consistency. The 2018 milk price statement demonstrates how this adjustment is included. [20]
p.57 new Rule 47	Aggregate Farmgate Milk Price (for payment for valued components in milk supplied on standard terms) to be calculated as the total aggregate amount calculated under the Manual, less the amounts calculated under the new Rules 45 and 46.	Calculation method is consistent with past practice, but term 'farmgate milk price' now applies specifically to payments for milk supplied on standard terms.	This rule improves clarity and has no impact on consistency.
p.58, new Rule 48	Defines the Farmgate Milk Price as the total amount available to pay for valued components (milk fat and protein) supplied on standard terms divided by total kgMS supplied to Fonterra.	The average Milk Price paid for milk supplied on standard terms is the amount that is most commonly reported to Fonterra's suppliers, but has not previously been separately defined in the Manual.	This rule change does not impact consistency.
p.58, new Rule 49	Provides that payments for milk sourced for value-add purposes will not be funded from the Aggregate Farmgate Milk Price if a Reference Commodity Product (RCP)-only processor would not have made those payments.	This rule is technically not necessary, given the new Rule 45. However, we consider it useful for communication purposes to make it explicit that certain 'value-add' type payments for milk are not funded from the aggregate amount calculated under the Manual (on the basis that the related value-add returns are also not included in the calculation).	This rule improves clarity and has no impact on consistency.

Other matters raised in our 2017/18 milk price calculation review

44. In our report on our review of the 2017/18 milk price calculation we signalled our intention to look at the issues of asset stranding[21] and mothballing[22] of processing plants in the Manual review.

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20 How rules 45 and 46 were included in the 2018 milk price calculation can be seen on page 4 of Fonterra's 2108 Milk price statement: https://www.nzx.com/files/attachments/266472.pdf

21 Stranding occurs when the reduction of milk supply results in the permanent removal of assets.

22 Mothballing occurs when the reduction of milk supply results in the temporary removal of assets to reduce variable costs.

45. Our focus is on how the Manual accounts for the capital costs of milk collection and processing in the event that the volumes of milk collected and processed by Fonterra were to remain static or permanently decline over time.

46. In our final report on the 2017/18 calculation we stated that:

> At this stage we see the milk volume forecasts as a key issue to be carried forward into the 2018/19 Manual and calculation reviews. Assessing how static or declining volumes are factored into the base milk price calculation will be a key consideration in next season's reviews. For example, whether further notional plant mothballing will be required and the impact on the cost of capital and depreciation as a result, and whether there is a sufficient allowance for the risk of asset stranding are all issues that will need to be considered.[23]

47. We have now concluded that the best course of action is 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.

48. The sections of our report below set out our assessment of the current Manual rules that are relevant to these matters. This material will act as a starting point for further consideration of this issue.

How the manual deals with asset stranding

49. There are three rules in the Farmgate Milk Price Manual relevant to the consideration of asset stranding:

    49.1 Rule 32 - Adjustments for amendments to Reference Commodity Products;

    49.2 Rule 33 - Surplus capacity; and

    49.3 Rule 43 - Specific risk premium.

50. Rule 32 and rule 33 identify two situations in which a standard plant may be stranded and provide differing rules as to how any such stranded plant should be treated when calculating the milk price. In essence:

    50.1 Rule 32 - If a plant becomes stranded due to a change in the portfolio of RCPs produced by the notional processor, then Fonterra can, subject to two exceptions, deduct the unrecovered cost of that plant from the milk price.[24]

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[23] Commerce Commission "Final Report Base Milk Price Calculation Review 2017/18" (14 September 2018).

[24] The exceptions are when (1) this would result in the Farmgate Milk Price being significantly less than the milk price Fonterra's competitors for milk in New Zealand are able to pay while still earning a reasonable risk-adjusted return on their invested capital; or where (2) Fonterra has previously been compensated for the risk of removal of the Reference Asset, whether under Rule 43 (Specific Risk Premium) or under any other provision of this Manual.

In short, when there is a change in RCPs, farmer suppliers to Fonterra will bear the cost of writing-off a plant through a lower milk price in that season. In this scenario the relevant plant with the shortest remaining assessed economic life is removed from the asset base first.

50.2 Rule 33 - If a plant becomes permanently stranded due to a decrease in the supply of milk to Fonterra in that region, then the unrecovered cost of that asset is a cost borne by Fonterra's shareholders. There is no adjustment to the milk price when a plant becomes stranded due to over capacity of processing plants. In this scenario the plant with the earliest deemed acquisition date will be removed from the asset base first.[25]

51. Rule 43 provides for a specific risk premium to compensate investors in the Farmgate Milk Price Commodity Business for risks that are not otherwise provided for in the Farmgate Milk Price calculation methodology, and which investors would seek compensation for. The specific risk premium is estimated on an ex ante basis, and added to the return on capital allowed, when estimating the price the NP can afford to pay for milk. In recent seasons, Fonterra has set a specific risk premium of 0.15% per annum.

52. Table 2.1 of the Manual (Allocation of Risks between Farmgate Milk Price (suppliers) and Earnings (Fonterra)) under Principle 3 also explains the position as follows:

52.1 Temporary supply risks - Both Fonterra and suppliers have the capability and incentives to respond to temporary reductions in milk supply; accordingly, costs of lower fixed-cost recoveries and temporarily stranded assets should 'lie where they fall'.

52.2 Permanent supply shocks - … costs associated with permanently stranded assets should fall on Fonterra.

Stranding risk

53. When the milk supply volumes are growing existing processors have the opportunity to keep their existing plants running with sufficient milk volumes even if other processors are growing their volumes. There is an increased risk of stranding however if industry milk volumes are in decline as one processor's growth can only come from another processor having less milk to put through its existing plants. Therefore, the risk of existing processors' plants becoming stranded would seem to increase materially if or when industry milk volumes are static or declining.

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25 Despite some differences in wording between rules 32 and 33, we assume that if stranding has occurred, in effect, rules 32 and 33 both result in the plant with lowest book value being written off first.

54. The current rules provide that Fonterra would write-off the value of its oldest plant in the event of asset stranding due to a change in RCPs or having too much processing capacity. In work carried out on the asset beta as part of the 2017/18 milk price calculation report, CEPA suggested, and we agreed, that a real-world producer would likely retire the assets of least value to the business, rather than the just the oldest plant. This would consider asset values within the context of the overall asset footprint and reflect more than just asset age and book value.

55. The effect of writing off the oldest plant has a number of implications for the calculated milk price.

    55.1 If there is a write-off due to change in RCPs, in the year of write-off there may be an additional cost included in the calculation of the milk price (subject to the exceptions in rule 32). Specifically, the write off will reduce the milk price in the season in which the write-off occurs. Writing off the oldest asset, which has the lowest book value, will therefore have a smaller impact on milk price in the year of write-off, than a methodology which required the write-off of an asset with a higher book value.

    55.2 Any write-off will also impact the milk price in subsequent seasons. Regardless of whether the asset stranding is due to a change in RCPs or excess capacity, any write-off will reduce the value of asset base, and therefore the size of the return on capital allowed in the milk price in subsequent seasons. Writing-off the oldest plant, which has the lowest book value, therefore has a smaller reduction on the milk price in subsequent seasons than would writing off a much newer asset with a higher book value. Fonterra’s approach to estimating the value of the stranded asset therefore is less likely to come into tension with the contestability limb of s 150A in those subsequent seasons than an alternate methodology which wrote off an asset with a higher book value.

Asset stranding considerations

56. We are comfortable the current rules around asset stranding are consistent with the efficiency dimension. The focus of our discussion below is therefore on the contestability dimension.

57. Both s 150A and s 150B of the DIRA are relevant when assessing asset stranding provisions in the Milk Price Manual.

58. Section 150A of DIRA sets out the purpose of subpart 5A. It follows the overriding scheme of the DIRA by promoting the efficient operation of New Zealand dairy markets through the setting of a base milk price that incentivises Fonterra to operate efficiently while providing for contestability in the market for the purchase of milk from farmers.

59. Section 150A also provides that "the setting of a base milk price provides for contestability if any notional costs, revenues, or other assumptions taken into account in calculating the base milk price are practically feasible for an efficient processor." As set out in our framework paper our interpretation of this requirement for the purposes of the Manual review is that the contestability dimension will be satisfied if the assumptions in the Manual used in setting the base milk price are practically feasible for an efficient processor. This requires us to consider the impact of the assumptions on an efficient processor's ability to enter the market for buying milk from farmers.

60. Our assessment of the extent to which the Manual meets the purposes of s 150A is subject to the 'safe harbours' in s 150B which provides that certain assumptions used by Fonterra in setting the base milk price do "not detract from the achievement of the purpose set out in s 150A."

61. We first assess whether the assumptions in the Manual are practically feasible for an efficient independent processor (ignoring s 150B) and then go on to consider the impact of the 'safe harbours' in s 150B.

62. In assessing the asset stranding rules, the Commission believes that consideration must be given to both a new independent processor looking to enter the market and existing independent processors who may or may not be building new plants.

63. A key question is whether Fonterra's current approach to the risk of asset stranding provides sufficient compensation for the risk that an efficient processor building a plant to process milk would face from asset stranding.

64. An efficient, competing IP would potentially face different asset stranding risks when competing with a single or much smaller number of processing plants than the NP. An allowance for stranding based on the remaining book value of an old NP plant seems intuitively to understate the asset stranding risk to an efficient processor building a new plant.

65. Fonterra's current or future competitors do not have the relative asset scale of Fonterra and would be more restricted when choosing which plant, or part of a plant, to strand as a result of lower milk volumes. When deciding whether or not to build a new plant, they therefore seem to face higher potential costs if that new plant was to become stranded.

66. On the other hand, s 150B of the DIRA includes a number of assumptions that do not detract from the purpose in s 150A. These include the assumption of a national network of facilities for the collection and processing of milk similar to Fonterra's and

that the size of assumed units of processing capacity approximates to the average size of Fonterra' actual units of processing capacity. [26]

67. One of the benefits of a processing footprint of this size and diversity is that it would provide the NP with a range of options in the event of an asset needing to be stranded. It would therefore be more likely to be able to close an older (or oldest), lower value plant and therefore face lower asset stranding costs than an entrant with a much smaller range of plants. This seems to be implied by s 150B even if there is no provision in that section which explicitly references asset stranding risks.

68. We recognise that the assumptions in rules 32 and 33 of the Manual may not always reflect the response of Fonterra when assets are stranded and consider the assumptions adopted as necessary simplifying assumptions which are reasonable in the circumstances.

69. As such, there appears to be a tension between s 150A and s 150B when it comes to the issue of providing for the risks of asset stranding.

69.1 If one only considered s 150A (without s 150B) the most appropriate lens to view the risk of asset stranding from is that of an efficient processor considering building a new plant to compete for farmer's milk. Viewed from this perspective, Fonterra's manual would seem to under-estimate the extent of asset stranding risk relevant to determining the milk price.

69.2 On the other hand, the 'safe harbour' provision in s 150B expressly allows a Fonterra – centric approach to asset stranding. From the NP's perspective, with its wide range and location of plants, of varying ages, the costs of asset stranding seem to be lower in magnitude than that of a processor building a new plant.

70. Our view is that the 'safe' harbours provisions in s 150B are applicable, and accordingly the contestability purpose in s 150A is met even though the stranding risk of the NP is lower than that independent processors, and in particular new entrants would be likely to face. We therefore consider that the Manual's approach to asset stranding is reasonable even though it may underestimate the sort of allowance for stranding risk that a new entrant may face, but this is a function of the safe harbours which is expressly permitted.[27]

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[26] The relevant assumptions in this context are (a) and (b) of s 150B.

[27] While there is likely a difference in stranding risks between the NP and another processor we don't consider this difference is of a quantum that would materially affect their respective betas. Also the relevant risks, a decline in milk supply for a region resulting in over-capacity in that region and a change in RCPs leading to overcapacity in a certain plant type, are not obviously systematic in nature.

Mothballing

71. For the purpose of calculating the milk price in the last two seasons, Fonterra has assumed the mothballing of some of the NP's plants as a result of lower than expected milk volumes. The assumed mothballing of plants, rather than showing them as permanently stranded assets, implies that the lower milk volumes caused a decrease in the requirement for processing capacity which is only temporary in nature. The impacts of mothballing were treated as temporary impacts on the milk price calculation. They were not treated as a cost borne by Fonterra's shareholders.

72. In our 2017/18 milk price calculation report we concluded that the assumed mothballing of some of the NP's plants in the 2017/18 season was consistent with the efficiency and contestability dimensions of the Act. We concluded that there was sufficient signalling of lower than expected peak volumes to warrant the mothballing of plants and we considered the actions assumed to be taken by the NP were consistent with real world outcomes.

73. In our draft report we encouraged Fonterra to continue to improve transparency of information around mothballing decisions that will be applied in the milk price calculation. We suggested the Global Dairy updates each month were an appropriate place for this to occur. We are pleased with Fonterra's commitment to provide further transparency and agree the milk price statement, published each September, would be an appropriate place to deliver this information.[28]

Next Steps – this seasons milk price calculation review

74. We aim to publish our draft report on the 2018/19 calculation review in August 2019.

75. Following from our review of the 2017/18 milk price calculation and the submissions on our draft report on the Manual, there are a number of matters we intend to include in the scope of our review of the 2018/19 milk price calculation.

    75.1 Off-GDT reference sales - we would welcome information from stakeholders that demonstrates that the premium incorporated for off-GDT sales is not practically feasible if they consider this to be the case.

    75.2 Materiality – We will revisit this issue as part of the 2018/19 milk price calculation review. We intend to engage with interested stakeholders ahead of producing our draft report into the calculation review to gain a range of views.

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[28] Fonterra 'Submission on draft report on review of Fonterra's 2018/19 draft milk price manual', 15 November 2018, page 2.

75.3 Costs associated with changing environmental considerations – We are keen to understand how costs associated with resource management requirements, or changes to the approvals, would be dealt with by the NP.

75.4 Energy costs - Fonterra is responding to changes in energy policy and the energy markets. The pace of change appears to be accelerating. We are interested in how the NP is likewise assumed to respond to these changes and how that response finds its way into the milk price calculation.

76. There does not appear to be any immediate need to do any further work on the asset stranding assumptions until the specific risk premium is reviewed in 2020/21. Assessing how static or declining volumes are factored into the base milk price calculation remains an important consideration however we believe there are good reasons for this to happen in the 2020/21 season.

77. The Government is currently conducting a review of DIRA, including the provisions that govern our reviews of the Manual and calculations. In the discussion document published in November 2018, it is indicated that any implementation of review outcomes will happen during 2019. We therefore expect that the terms of the Act under which we will carry out our review of the 2018/19 milk price calculation will remain unchanged.

Attachment A Conclusions on minor amendments

78. This attachment highlights minor technical and drafting changes made by Fonterra. All of these are amendments in respect of Fonterra's undertakings to the Commerce Commission.

Table A1 Summary of minor technical and drafting changes

Manual reference	Amendment	Fonterra comment
p.64	Definition of Qualifying Material amended to make explicit that a product can only be included in the Milk Price revenue calculation if has three commodity product related attributes (per definitions below).	In response to transparency-related concerns raised by the Commission we undertook in our submission on the 2017 base milk price report to provide further clarity around the attributes of product specifications which we consider to be commodity products and therefore eligible for inclusion in the Milk Price revenue calculation.
p.64	New defined term Standard Product Offering	Per above, clarifies that the only product specifications included in the Milk Price are specifications that are sold on GDT or which are generic products sold to multiple customers in multiple regions, and which are substitutable for the relevant base offerings.
p.64	New defined term Standard Packaging	Per above, clarifies that only products which are packaged in standard commodity-category packaging formats are included in the Milk Price revenue calculation.
p.64	New defined term Specialised Plant	Per above, clarifies that product that can only be manufactured in the plants with material differences to the standard reference plants included in the Milk Price asset base cannot be included in the Milk price revenue calculation.
p.82	New defined terms Standard Supply Milk Payments, Additional Commodity Milk Payments and Non-Commodity Milk Payments	Consequential on, and provide additional detail on, the new Part B Rules 45, 46 and 47.

Attachment B Outstanding amendments proposed earlier to Fonterra

B1 This Attachment provides a summary of the amendments we have proposed to Fonterra over the course of our milk price reviews which have not been adopted.[29] For the continuity of our reviews and consideration of future submission points, we consider this to be a valuable summary for all interested parties.

B2 We do not consider these outstanding amendments to be material to our review. However, we consider these proposed amendments would better promote the setting of a base milk price that provides an incentive to Fonterra to operate efficiently while providing for contestability in the market for the purchase of milk from farmers.[30]

B3 Table B1 outlines Manual amendments, Fonterra's reasons and our brief comments.

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[29] Both the Manual and calculation reviews.

[30] s 150A of the Act.

Table B1 Summary of amendments proposed earlier to Fonterra

Manual reference	Detail	Category	First raised by the Commission	Previous Commission conclusion[31]	Description of issue	Fonterra reasoning
N/A	Fonterra decision for no change	Farmer support	2015/16 calculation review	Although, immaterial, we conclude that Fonterra should include the costs of providing shareholder support to ensure continued supply to be consistent with the contestability dimension.	Financing and associated administration costs of providing farmer support loans and costs of providing other mechanisms of farmer support.[32]	No change to our previous position that it is not appropriate to fund these costs from the Milk Price.
Part A, Section 2.6	Fonterra decision for no change	Consistency over time - disclosure requirement	2016/17 Manual review	No consistency issue; however, we consider such disclosure would provide greater transparency.	We consider the Manual should outline what is considered a 'material change' when considering a change to the Manual and specify the timeliness of making such a change in order to set a minimum level for disclosure of changes.[33]	No change, for reasons explained on page 5 of our submission on the Commission's F17 Draft Manual Report (a 'bright line' materiality threshold is likely to lead to less disclosure).

31 Our previous conclusions in these areas from prior reviews. These reports can be found at http://www.comcom.govt.nz/regulated-industries/dairy-industry/review-of-fonterra-s-farm-gate-milk-price-and-manual/.

32 We note Open Country Dairy's views on farmer support costs in its submission "Submission on Commerce Commission's Draft Report on the 2017/18 Milk Price Manual", p.2, at http://www.comcom.govt.nz/regulated-industries/dairy-industry/review-of-fonterra-s-farm-gate-milk-price-and-manual/statutory-review-of-milk-price-manual/review-of-milk-price-manual-201718-season/. However, we disagree that the amount of the loans is the relevant issue. We rather consider that the cost of funding the loans (and any loan forgiveness) is the more relevant issue for the base milk price calculation. We further note that a key focus of our role in reviewing the Manual is to assess the extent to which the Manual is consistent with the s 150A purpose as a whole. As stated in paragraph 26 we do not consider that any inconsistency with the s 150A purpose arising from farmer support costs is sufficiently material to render the Manual inconsistent with the s 150A purpose as a whole. We therefore remain of the view that the Manual is largely consistent with the s 150A purpose.

Manual reference	Detail	Category	First raised by the Commission	Previous Commission conclusion[31]	Description of issue	Fonterra reasoning
Part B, Rule 26	Fonterra decision for no change	Capacity of standard plants	2016/17 Manual review	We recommend Fonterra considers disclosing its plant capacity for both primary and secondary plants in the Manual early in each season to provide certainty of the notional processors assumed capacity for the related season. We consider this would improve the ability of interested parties to assess the practical feasibility of the assumed production volumes.	We recommend that Fonterra considers disclosing its plant capacity for both primary and secondary plants in the Manual. This earlier disclosure should provide increased transparency of the assumed capacity of the notional processor for the season. We consider Fonterra's latest amendment still allows a significant level of discretion.	We do not consider the Manual is the appropriate vehicle for these disclosures. We have previously put this information into the public domain, including in the F17 and F18 Base Milk Price Reasons Papers, and the relevant assumptions will not be revisited until F20.
N/A	Fonterra decision for no change	Actual FX rates assumed	2016/17 Manual review	We suggest there should be more transparency of information on the actual FXD rates assumed to be achieved by the notional processor.	We consider there should be more transparency of information on the actual foreign exchange rates assumed to be achieved by the notional processor. We suggest providing an average FX conversion rate assumed to be achieved by the notional processor throughout the season.	Outside scope of Manual.[34]

[34] Although outside of the scope of the Manual and a safe harbour under the Act, we consider the disclosure of the assumed rates would promote the purpose of the Act. We note this does not affect our ability to conclude on the Manual.

Attachment C Glossary

Term/Abbreviation	Definition
The Act	Dairy Industry Restructuring Act 2001
Base milk price	Farm gate milk price expressed per kilogram of milk solids
Calculation review	Review of Fonterra's base milk price calculation for the prior season
Dairy season	1 June to 31 May annually
FX	Foreign exchange
GDT	GlobalDairyTrade, Fonterra's online auction platform used to sell commodity products
kgMS	Kilogram of milk solids
Manual review	Review of Fonterra's Milk Price Manual for the current season
Milk Price Manual or the Manual	Fonterra's Milk Price Manual
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).
R&M	Repairs and maintenance
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)