

30 May 2023

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Attention: Louise Stephenson
Manager, Fuel and Dairy
Market Regulation Branch
Commerce Commission
WELLINGTON
By email: market.regulation@comcom.govt.nz

Dear Keston,

CROSS-SUBMISSION ON THE COMMERCE COMMISSION'S APPROACH TO REVIEWING FONTERRA'S MILK PRICE MANUAL AND BASE MILK PRICE CALCULATION AND PROPOSED FOCUS AREAS FOR OUR REVIEW OF FONTERRA'S 2022-23 BASE MILK PRICE CALCULATION, BOTH DATED 30 MARCH 2023

Thank you for the opportunity to provide cross-submissions on the Commerce Commission's *Approach to Reviewing Fonterra's Milk Price Manual and Base Milk Price Calculation* (the "Approach Paper") and *Proposed Focus Areas for our Review of the 2022-23 Base Milk Price Calculation* (the "Focus Areas Paper").

Attached as an Appendix to this letter are Fonterra's comments on the submissions prepared jointly by Miraka, Open Country Dairy, Synlait Milk and Westland Milk Processors (the Independent Dairy Processors, or IDPs), in response to the Approach Paper and the Focus Areas Paper.

Please do not hesitate to contact the writer if you have any questions on these comments.

Yours sincerely,

Andrew Cordner
Director of Legal

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Appendix

INTRODUCTION

This cross-submission sets out Fonterra's response to a number of matters raised in the submissions prepared jointly by Miraka, Open Country Dairy, Synlait Milk and Westland Milk Processors (the Independent Dairy Processors, or IDPs), in response to two papers released by the Commerce Commission on 30 March 2023, respectively titled 'Proposed focus areas for our review of Fonterra's 2022/23 base milk price calculation' and 'Our approach to reviewing Fonterra's Milk Price Manual and base milk price calculation'.¹

We have combined our cross-submissions on the matters raised in the two separate IDP submissions in a single cross-submission given the duplication and overlap of some of the points made in the IDP submissions. We have focused on the material assertions made by the IDPs. If we have not commented on particular statement(s) in the submissions from the IDPs, our submissions should not be considered to imply an agreement with such statement.

Our cross-submission is organised as follows:

- The section 150B amendments
- Other matters, comprising:
 - Notional data
 - Disclosure as a focus area
 - Conversion rate-related disclosure.

THE SECTION 150B AMENDMENTS

As noted by the Commission and the IDPs, s 150B has been amended to incorporate a new subsection 150B(2), with section 150B in its entirety now reading:

150B Certain assumptions do not detract from purpose of subpart

- (1) It does not detract from the achievement of the purpose set out in [section 150A](#) that new co-op sets the base milk price using assumptions that include any of the following:
 - (a) that new co-op operates a national network of facilities for the collection and processing of milk;
 - (b) that the size of new co-op's assumed units of processing capacity approximates to the average size of new co-op's actual units of processing capacity;
 - (c) that gains and losses experienced by new co-op resulting from foreign currency fluctuations, including from new co-op's foreign currency risk-management strategies, are incorporated in the base milk price;
 - (d) that all milk collected by new co-op is processed into commodities at yields that are practically feasible.

¹ The IDP submissions are available at https://comcom.govt.nz/_data/assets/pdf_file/0025/315619/Miraka2C-Open-Country-Dairy2C-Synlait-Milk-and-Westland-Milk-Products-Joint-submission-on-Proposed-focus-areas-27-April-2023.pdf (the IDP Focus Areas Submission) and https://comcom.govt.nz/_data/assets/pdf_file/0025/315619/Miraka2C-Open-Country-Dairy2C-Synlait-Milk-and-Westland-Milk-Products-to-Commerce-Commission-Joint-submission-on-our-Approach-Paper-2023-Update-27-April-2023.pdf (comcom.govt.nz) (the IDP Approach Submission), and the Commission's papers at https://comcom.govt.nz/_data/assets/pdf_file/0017/311435/Proposed-focus-areas-for-our-review-of-FonterraE28099s-2022-23-base-milk-price-calculation-30-March-2023.pdf (the Commission's Focus Areas Paper) and https://comcom.govt.nz/_data/assets/pdf_file/0017/311435/Our-approach-to-reviewing-Fonterra's-Milk-Price-Manual-and-base-milk-price-calculation-Draft-30-March-2023.pdf (comcom.govt.nz) (the Commission's Approach Paper).

- (2) Subsection (1) does not extend to the way in which new co-op uses an assumption in setting the base milk price.

In their submissions, the IDPs assert that the addition of s 150B(2) “has the effect of removing the “safe harbour” status of the [s 150B(1)] assumptions, bringing them within the full oversight of the Commission reviews,” that introduction of s 150B(2) means “the ‘safe harbour’ status of the S 150B assumptions has been expunged,” and “that the s 150B assumptions [now] have no preferential or unique status for determining compliance with s 150A.”² With respect to this final assertion, the IDPs have asked to the Commission to delete the underlined words in paragraph 101 of the Commission’s Approach Paper:

“We also examine whether our assessment is affected by unique features of Fonterra which are not subject to s 150B or 150C provisions. If the Manual provides for assumptions that are only practically feasible for Fonterra due to features unique to Fonterra, then such assumptions may not be practically feasible for another efficient processor.”

The IDPs’ position appears to be that so long as Fonterra collects more than 50% of milk supplied in New Zealand, the ‘scale’ assumptions reflected in the assumptions specified in paragraphs (a), (b), and (d) of ss 150B(1) are necessarily not practically feasible for any other processor, and that the Commission should therefore conclude that Fonterra’s reliance on those assumptions is not consistent with the s 150A purpose.

We do not believe the IDPs’ position regarding the purpose and effect of the new ss 150B(2) is correct. In particular, our understanding of the policy rationale for ss 150B(2) is consistent with the explanation set out in the briefing paper from MPI to the Minister of Agriculture dated 20 June 2022 and titled Fonterra Capital Structure: Decisions on Regulatory Design (the Regulatory Design Paper).³ In summary, the Regulatory Design Paper explains that:

“Providing for the use of [the s 150B(1)] assumptions to be applied in the base milk price calculation is appropriate, as it provides clarity and certainty for Fonterra, the Commission, and other stakeholders that Fonterra’s use of such assumptions is not up for debate.”⁴

The concern which s 150B(2) was intended to address was that “the drafting of [s 150B(1)] appears to make it possible for Fonterra to use the actuals simply as a starting point for translating them into notional inputs, while at the same time making it unclear the extent to which the Commission may review and comment on any such translations.”⁵

The Regulatory Design Paper also notes (in paragraph 53) that IDPs had sought the repeal of the s 150B safe harbour provisions, but that officials had rejected this request in favour of the ss 150B(2) amendment. It goes without saying that if Parliament had intended the ss150B(1) assumptions to be treated like any other inputs and assumptions in the Commission’s review process, then it would and could have simply repealed ss 150B(1). It did not do so.

The deliberate policy decision by Parliament not to repeal s150B must be given meaning in the interpretation of the Commission’s role in oversight of the Manual and milk price calculation.⁶ The

² See paragraphs 4 and 8 of the IDP Approach Submission.

³ <https://www.mpi.govt.nz/dmsdocument/53287-Fonterra-Capital-Restructure-Decisions-on-Regulatory-Design-Briefing-paper-B22-0295>. On our review of the relevant Parliamentary materials, this appears to be the most recent and relevant statement of the policy intent behind the reform.

⁴ Regulatory Design Paper, paragraph 50.

⁵ Regulatory Design Paper, paragraph 51.

⁶ We note the IDP Approach Submission is plainly incorrect in this respect. The IDP submission states (at para 9) “This is then no different to any other BMP assumption: they are all required to meet the purpose of s 150A”. The claim that the addition of s 150B(2) effectively “expunges” the safe harbour status of the s 150B(1) assumptions (para 8) fails to give

usual rules of statutory interpretation require that the text and purpose of the provision will determine the correct interpretation, and the objectives of the legislation (here, summarised in the officials' papers referenced above) will be relevant.⁷ Officials' explanation of the policy intent behind the retention of ss 150B(1) and the addition of ss 150B(2) is relatively clear. It simply means that:

- The assumptions listed in ss 150B(1) remain fundamental features of the Manual and milk price calculation. That is why they were identified by Parliament when ss150B(1) was first enacted in 2012, as assumptions that “do not detract” from the purpose of the subpart. The use of those assumptions, as a direct input into the calculation where that is appropriate, or as the starting point for the derivation of a notional input where that is appropriate, remains a fundamental feature of the calculation and ss150B(1) signals the policy intent to support key attributes of the Manual and base milk price calculation in the context of the oversight regime.
- If Fonterra simply imports one of the four assumptions listed in ss 150B(1) and, by its nature, there is no need for that assumption to be translated into a notional input (e.g., the assumption that the notional producer (NP) processes all milk collected by Fonterra), then the ‘safe harbour’ protection applies without any further enquiry being required.
- Where Fonterra transforms, or should properly transform, an actual input into a notional input, ss 150B(2) has simply clarified that the Commission can review that transformation to check that it results in a base milk price input which remains consistent with s 150A; i.e., that the transformation results in a notional input which is practically feasible for Fonterra and consistent with incentivising Fonterra to operate efficiently.

To the extent that the IDPs' positions or assertions in their submissions rely on their incorrect interpretation of s150B(2) then those positions or assertions must be rejected.

We also note that we reject the IDPs claim (for example in paragraph 11 of the IDP Focus Areas Submission) that to date “the s 150B assumptions [have been] sanctioned regardless of compliance with the s 150A purpose”. Our experience has been that the Commission has routinely checked that our section 150B-related inputs are practically feasible for Fonterra, including by engaging an external expert to examine our yield assumptions.⁸

OTHER MATTERS

Notional data

Paragraphs 34 – 44 of the IDP Approach Submission are devoted to the proposition that the comment in paragraph 87 of the Commission's Approach Paper that “using notional data provides Fonterra with a benchmark to beat” (emphasis added by IDPs) implies Fonterra “uses notional data which represents stretch targets for Fonterra ... [and that] the consequence of such notional data is to increase the base milk price by comparison with what it would be using data based on ‘Fonterra's actual performance’.”

We note:

- Setting a notional input at any level relative to Fonterra's actual performance (below, equal to, or beyond) provides Fonterra with a ‘benchmark to beat’ and has the same impact on

any meaning to a key statutory provision deliberately retained and effectively seeks to relitigate before the Commission a policy argument that Parliament has already decided, against the IDPs.

⁷ *Commerce Commission v Fonterra* [2007] NZSC 36 at [22]; and as applied in the context of Part 5A in *Open Country Dairy Ltd v Commerce Commission* [2020] NZHC 334 at [34].

⁸ While our ‘base’ yield assumptions are based on the manufacture of the five products listed in paragraph 11 of the IDP Focus Areas Submission, additional allowances, both for incremental valued component usage and for incremental losses, are provided for in the Incremental Product Cost allowances, which the Commission has also regularly reviewed.

Fonterra's incentive to operate efficiently – it simply does not follow that notional inputs are necessarily 'stretch targets'.

- We are required to certify to the Commission that notional inputs used in the base milk price calculation are consistent with the s 150A purpose – i.e., that they are practically feasible – and much of the Commission's work revolves around testing this proposition.
- More generally, the Commission has indicated since the inception of the base milk price oversight regime that it favours the use of notional inputs (subject to their being demonstrably practically feasible for an efficient processor) on the basis that notional inputs are the most obviously consistent with the s 150A principles.

Disclosure as a focus area

We note the IDPs' request that the Commission consider:

“including the new DIRA disclosure requirements of section 150QA as a focus area for the review of the 22/23 BMP calculations. This could include

- a review of the material submitted with the Fonterra Reasons Papers BMP calculations which Fonterra has previously withheld from public disclosure and consider any Fonterra explanation for any continued withholding of that information
- a review of previous disclosure recommendations made by the Commission and whether those disclosures (to the extent Fonterra has not complied) might now be required under new s 150QA or an associated direction from the Commission
- a consideration of disclosures concerning the NP USD conversion rate so that the market is as informed as Fonterra of the likely NP conversion rate.”⁹

We simply note that we expect the Commission will devote considerable effort to disclosure matters in the course of the current review whether or not the new requirements are designated as a 'focus area' for the Commission's review, and that we are actively considering potential disclosures that are consistent with the intent of the new legislative provisions, while appropriately acknowledging Fonterra's legitimate commercial interests.

Conversion rate-related disclosures

In paragraph 37 their Focus Areas Submission, the IDPs write:

“The new DIRA disclosure requirements only require Fonterra to disclose information after the final BMP has been reported. However, given the intent of the requirements is to help level the playing field for Fonterra competition, the IDPs consider that Fonterra at least should be strongly encouraged to provide on-going disclosures of its estimate of the NP conversion rate: each time it updates its forecast FMGP, it should disclose the same information it currently provides once a year in the FGMP Statement.”

The IDPs assertion that “the intent of the [disclosure] requirements is to help level the playing field for Fonterra competition” does not reflect the stated policy objective, which is “to promote further transparency and confidence in the base milk price-setting processes ... [by addressing] a key concern relating to the current regime, which is often regarded as a 'black box' to the rest of the dairy

⁹ IDP Focus Areas Submission, paragraph 32.

processing industry.”¹⁰ Legislators explicitly recognised, as the IDPs note, that accomplishment of this goal only required the release of information after year-end.¹¹

¹⁰ Regulatory Design Paper, paragraph 9. Further explanation, consistent with the summary comments in paragraph 9, is provided in paragraphs 39 – 46 of the Regulatory Design Paper.

¹¹ While the new regime does not envisage the release of additional information in the course of a season, we are nonetheless considering voluntarily releasing additional non-commercially sensitive information periodically during a season.