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**IDP Joint submission on the Commerce Commission process paper:  
“Proposed focus areas for our review of Fonterra’s 2023/24 base milk price  
calculation” (issued 18.4.24)**

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

Submitted by: Miraka, Open Country Dairy, Synlait Milk and Westland Milk Products  
(the Independent Dairy Processors – IDPs)

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## Abbreviations and other references

- Approaches Paper – Commerce Commission reference paper: “Our approach to reviewing Fonterra’s milk price manual and base milk price calculation” (issued in 2021)
- BMP - Base Milk Price
- Codex - International food standards set by the Codex Alimentarius Commission and with which NZ dairy processors must comply (both under NZ regulation and to market dairy products in international markets)
- DIRA - Dairy Industry Restructuring Act 2001
- DIRA Amendment Act 2022 - Dairy Industry Restructuring (Fonterra Capital Restructuring) Amendment Act 2022
- Focus Areas 23/24 – Commerce Commission paper issued 18 April and subject of this submission: “Proposed focus areas for our review of Fonterra’s 2022/23 base milk price calculation”
- IDPs –Miraka, Open Country Dairy, Synlait Milk, and Westland Milk Products jointly referred to in this submission as the Independent Dairy Processors (IDPs)
- IPC - Incremental Product Cost (an adjustment which is intended to restate the selling price of a product to an equivalence with its relevant SSP)
- Manual – Fonterra’s Farmgate Milk Price Manual
- NP - Notional Processor
- RCP – Reference Commodity Product (wholemilk powder, skim milk powder, Butter, Anhydrous Milkfat, Buttermilk Powder); the RCPs comprise a range of SSP and non-SSP products
- SSP – Standard Specification Product - the 5 unique products the NP is assumed to manufacture and which represent the RCPs in the BMP model:
- RWMP (Regular Wholemilk Powder)
  - MH SMP (Medium Heat Skim milk Powder)
  - Unsalted Butter
  - AMF (Premium Anhydrous Milkfat 210 Kg)
  - BMPwdr (UHT Buttermilk Powder)

## Introduction and Summary

1. The Commission has proposed the following focus areas for its review of the 2023/24 BMP calculations:
  - a. Continue the review of the DIRA S.150B assumptions, with a special focus on compliance with the amendment that came into effect on 1 January 2023<sup>1</sup>. The amendment brings the use of the (optional) S.150B assumptions within the purview of the S.150A purpose of the BMP:
    - i. to incentivise Fonterra efficiency
    - ii. while providing for contestability in the NZ raw milk market.The S.150BN assumptions were previously exempt from S.150A and considered to be “safe harbours”.
  - b. Review NP repairs and maintenance assumptions.

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<sup>1</sup> DIRA S.150B (2), which was introduced by the DIRA Amendment Act 2022

- c. Review NP sustainability cost assumptions.
2. This submission addresses the first of the proposed focus areas (review of S.150B). In summary:
    - a. The NP is not a commercially feasible business that could operate in New Zealand. Yields which are optimised based on the assumptions in S.150B (a), (b), and (d) will not be commercially feasible for any commodity dairy processor that can foreseeably operate in New Zealand:
      - i. A commercially feasible small processor would not be able to access the NP economies of scale;
      - ii. A commercially feasible large processor would need to diversify beyond the simplified NP business model. The NP optimised production assumptions are not consistent with the need to optimise revenue of that large processor.
    - b. Overall Fonterra yields provide the best available benchmark for the most efficient commodity yields that can be achieved by a commercially feasible dairy processor operating in New Zealand. The IDPs consider that a comparison with Fonterra actual overall yields is an important test of the commercial feasibility of the NP yield assumptions. A high standard of evidence is required for the NP to assume yields above those Fonterra achieves on an ongoing basis. That standard of evidence has not been apparent to date.
    - c. The Manual does not provide a coherent basis to confirm commercially feasible management of the NP production facilities or distribution of its facilities. To this extent at least, assumptions (a) and (b) of the S.150B (respectively, the NP Network of Facilities, and capacity of NP plants) need to be reviewed to confirm the NP yields either are or can be supported by a commercially feasible production plan. This will need to include:
      - i. A review of the NP production plan to determine it is commercially feasible
      - ii. A review of milk losses which have previously been based on the performance of factories that are not representative of the NP facilities.
    - d. Production to support non-SSP sales is not directly provided for in the NP production plan. This is on the basis that the IPC procedure (which adjusts selling prices) has the same effect as though the non-SSPs had been directly provided for in the NP production calculations including all consequential yield impacts. The Commission has previously concluded the IPCs are practically feasible including for adjusting yields. It is difficult to draw that conclusion from available information. Included in the review of the NP yields, the IDPs consider the way in which the IPCs adjust for yields should be made transparent. This includes disclosure of the way in which the “current” value is determined for the milk portion of the IPCs.
3. This submission also proposes the focus areas be expanded to include:
    - a. Attribution of Fonterra long term cost saving targets to the NP costs. The IDPs consider long term savings should only be assumed by the NP when those savings have been shown to be achievable with certainty.
    - b. Maximising predictability of the BMP calculations. This is to mitigate the competitive disadvantage and risk the BMP calculation process creates for the IDPs as compared to Fonterra. This includes:

- i. S.150 QA disclosures:
  - NP assumptions that do not disclose Fonterra commercial performance (e.g. NP product compositions and lactose ingredient cost assumptions) should be disclosed maximally.
  - Assumptions, procedures and the associated chain of calculations for determining NP assumptions that directly depend on Fonterra commercial performance (e.g. NP selling prices) should remain transparent even where the underlying data is not disclosed.
- ii. There should be timely disclosure of any substantive changes intended to be made in the approach to calculating the BMP.

## Proposed Focus Area: Review of S.150B Assumptions

4. The primary purpose and effect of the DIRA Amendment Act 2022 was to eliminate certain legal risks for Fonterra resulting from changes it planned to make to its capital structure. At the same time the Government recognised the change in the Fonterra capital structure was not consistent with the purpose of the DIRA because it:

*“could constrain entry into the market or expansion by potentially more innovative or efficient dairy processors... [which over time] ... could reduce pressure on Fonterra to perform optimally or innovate”<sup>2</sup>.*

5. The Amendment to S.150B was one of several amendments to help redress this increased risk to efficiency and contestability. These amendments should be given full effect in a timely manner to mitigate those risks. In their submission on the proposed focus areas for the 2022/23 BMP calculations review, the IDPs explained the importance of the S.150B amendment and submitted the following assumptions should be prioritised in the review<sup>3</sup>:
  - a. network of facilities (assumption (a))
  - b. capacity of processing units (assumption (b))
  - c. commercially feasible yields (assumption (d))
6. In the event the Commission limited its review to the assumption concerning gains and losses from foreign currency risk management (assumption (c)). The IDPs understand the limited scope of the 2022/23 review was because a full scope review could not be completed in the available time. The IDPs submit the remaining S.150B assumptions should now be reviewed as fully as possible in the 2023/24 review.
7. The Commission is proposing to only consider assumption (d) of S.150B (commercially feasible yields) in the 2023/24 review. It will nevertheless still consider the way the use of assumptions (a) and (b) bare on the assessment of commercial feasibility of the NP yields<sup>4</sup>.

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<sup>2</sup> DIRA Amendment Act 2022, Explanatory note

<sup>3</sup> IDP Joint Submission on Proposed Focus Areas 2022/23 BMP Calculations (27 April 2023), para 4 to 25

<sup>4</sup> Focus Areas 2023/24, para 12.1

## Review of S.150 (1) (d) – commercially feasible yields

8. The IDPs request the Commission consider the following issues when reviewing the commercial feasibility of the NP yields:
  - a. Meaning of commercial feasibility
  - b. Production plan – network of facilities, and capacity of processing facilities
  - c. Impact on yields of non SSPs included in NP revenues.

### Meaning of commercial feasibility

9. S.150B (2) now requires all S.150B assumptions to be used in a way which complies with S.150A. This means the assumptions must be used in a manner which

*“provide for contestability in the market” ... by being practically feasible for an efficient processor<sup>5</sup>*

10. In the proposed focus areas, the Commission explains that they:

*“interpret practical feasibility as including commercial feasibility, in the sense that it must be possible for an efficient processor operating in New Zealand to replicate or achieve the component being assessed”<sup>6</sup> [emphasis not in the original]*

11. The IDPs agree that practical feasibility must include commercial feasibility. The IDPs have previously submitted the NP yields are only theoretically feasible. They may be technically feasible in advantageous or optimal production conditions which may occur from time to time. Those conditions will not though be sustainable across time for a commercial operation the scale of the NP. The Commission interprets commercial feasibility to be determined with reference to the possible performance of “an efficient processor operating in New Zealand”. This means contestability is correctly measured by reference to the actual commercial processing environment in New Zealand - i.e. contestability cannot be confirmed by reference to a commercial environment that does not or cannot foreseeably exist in New Zealand.
12. It is not sufficient that yields be technically feasible for the theoretical business model of the NP. Yields must also be commercially feasible for a dairy processor that can feasibly operate in New Zealand (which the NP can not). Consistent with the efficiency dimension of S. 150A, it can be argued that yields should be set with reference to the best yields that can be achieved within the NZ commercial processing environment. They should not however reflect yields that no commercially feasible processor (large or small) can achieve in New Zealand.
13. The analysis in the attached Appendix compares underlying NP yields for WMP with comparable Fonterra yields for WMP. The NP yields are derived from Codex minimum compositions, spec offsets and milk losses. Fonterra yields are deduced from Fonterra product typical composition. This is intended to compare NP yields with the yields of a highly efficient processor of dairy commodities in New Zealand. The analysis suggests NP WMP yields deliver a premium of at

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<sup>5</sup> DIRA S.150A

<sup>6</sup> Focus Areas 23/24, note 7 (quoted from the Commission’s Approaches Paper)

least \$0.07/kg MS by comparison with Fonterra yields. The IDPs submit the analysis raises doubts that the NP yields are commercially feasible.

14. The typical composition of Fonterra products (dairy fat, protein, lactose, etc) is represented to its customers in the Fonterra product bulletins<sup>7</sup>. These bulletins confirm product minimum and maximum dairy solids by composition (a range complying with Codex) as well as typical compositions. The typical compositions inform customers of the usual composition, falling within the Codex range, that can be expected by customers of Fonterra's products. <sup>8</sup> Fonterra advises that instead of basing NP yields on its own achievable (typical) product compositions, NP yields are based on Codex minimums, plus specification offsets of 0.63% and milk losses of 0.38% (both being averages across the full NP product mix)<sup>9</sup>. Losses are based on loss tests from selected Fonterra factories operating under ideal operating conditions (refer para 39 ff) . These are extrapolated across the full NP Network of Facilities. The analysis in the Appendix indicates the NP yields are significantly better than Fonterra yields to achieve typical compositions.
15. The NP yields contribute a \$0.07/kg MS premium to the NP compared to comparable Fonterra yields for WMP. This assumes Fonterra milk losses are the same as the NP. However, because NP losses are based on ideal operating conditions including optimised square curving (and dependent on the simplified production plan for the five SSPs) Fonterra losses will be higher than the NP. For example, if Fonterra milk losses are twice the level of the NP (i.e. 0.76%) the NP premium compared to Fonterra yields would increase to \$0.10/kg MS.

#### Commercially Feasible Processors

16. The IDPs understand that for purposes of commercial feasibility, "operating in New Zealand" refers to commercially feasible processors that can foreseeably operate in New Zealand. In the current and foreseeable future, commercially feasible processors are either very large (Fonterra – close to 80% share of NZ milk) or small (all other processors including the IDPs, dividing up the remaining 20%).

#### A commercially feasible small processor operating in New Zealand

17. A commercially feasible small commodity processor will necessarily:
  - a. be limited in scale relative to Fonterra due to Fonterra dominant share of milk supply
  - b. operate smaller plants to achieve the flexibility required to produce a commercially feasible range of commodity products

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<sup>7</sup> Relevant Product Bulletins (including for all the SSPs) are posted to the GDT web-site at <https://www.globaldairytrade.info/en/gdt-events/gdt-events-sellers-and-products/nzmp/>

<sup>8</sup> It has been suggested that "typical compositions" are not representative of Fonterra actual or average product compositions. Fonterra has not explained why it nevertheless continues to represent these typical compositions in its commercial arrangements (described unambiguously in the RWMP product bulletin as "typical as measured on an "as is" basis"). In the absence of other information, it is reasonable to compare underlying NP yields to underlying yields based on Fonterra typical composition with the latter as a proxy for commercially feasible yields Fonterra is prepared to stand by.

<sup>9</sup> Fonterra Reasons Paper, 2022/23 BMP Calculations, pg. 14 ff

- c. have reduced opportunity for very long and efficient production runs (square curved plants) compared to Fonterra and certainly compared to the NP as currently formulated.
18. The commercially feasible but still efficient small processor would be expected overall to achieve lower yields than compared to the scale opportunities available to Fonterra, and certainly compared to the technically feasible yields attributed to the NP.
19. The DIRA requires the BMP to incentivise Fonterra efficiency. Yields of the commercially feasible small processor would likely be lower than Fonterra can achieve. They would correctly be dismissed by Fonterra as not appropriate for determining NP yields. In this respect the smaller processors operate at a disadvantage to Fonterra, but that is a normal commercial risk in contestable markets.

A commercially feasible large processor operating in New Zealand

20. Fonterra scale represents the only commercially feasible large processor operating in NZ. It has diversified business activity by comparison to the limited range of dairy commodities attributed to the NP. It is not commercially feasible for Fonterra to match the NP product mix. The NP production of the five RCPs exceeds Fonterra actual volume. Production of those volumes is not commercially feasible because international prices would be undermined. The representative commercially feasible large processor in NZ cannot therefore feasibly operate with the same simplified and streamlined product mix attributed to the NP. It is then unreasonable to conclude that yields which could theoretically be achieved by the NP (which itself is not commercially feasible), could be commercially feasible for a large efficient processor operating in NZ.
21. The IDPs submit that Fonterra actual ongoing yields are an appropriate benchmark for commercially feasible yields for the NP. Fonterra actual yields reflect its scale, considerable investment in efficient production processes and capital, and in production optimisation. At the same time Fonterra yields reflect the sub-optimal production outcome which occurs when balancing production optimisation with revenue optimisation. Fonterra argues that its actual yields include production complexity and disruption derived from business activity not consistent with the NP notional revenues<sup>10</sup>. That may be so, but the assumptions currently adopted for the NP cannot be achieved by any small or large processor feasibly operating in New Zealand. In the absence of an alternative, Fonterra actual yields should overall be the highest yields that can be achieved by a feasible processor operating in New Zealand and are thus the appropriate benchmark for the NP yields.
22. While the NP is not a commercially feasible business, S.150B (1) (d) nevertheless permits the NP to assume a scale of milk processing equivalent to Fonterra (which is a commercially feasible business). The IDPs submit that this does not mean the NP can assume yields that are not in themselves commercially feasible for any processor that could operate in New Zealand in the foreseeable future. Rather than providing for contestability, the BMP would then undermine contestability in the New Zealand raw milk market.

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<sup>10</sup> Fonterra Reasons Paper, 2022/23 BMP Calculations, Attachment 3 (for example)

23. The IDPs submit that Fonterra actual yields should be the benchmark for NP yields and a high standard of evidence would be needed to justify higher NP yields. That standard of evidence is not currently apparent.

#### Production plan – plant capacity assumptions and impact on NP yields

24. The Commission has indicated it is not proposing to review the S.150B (a) and (b) assumptions (network of facilities, and average processing capacity of NP plants) on the basis it has previously reviewed these items<sup>11</sup>. At the same time it has confirmed it will review certain aspects of those assumptions as they affect the review of the NP yields including<sup>12</sup>:
- The use of newer efficient plants for testing yield assumptions (it is assumed this refers to the selection of plants that are used to determine processing losses)
  - Operating capacity of near 100% and squaring the production curve
  - Average peak processing capacity of the plants (combined with (b) above it is assumed this refers to the commercial feasibility of consolidating milk at selected plants to maximise capacity utilisation of those plants).
25. The IDPs consider S.150B assumptions (a) and (b) in their entirety are relevant to considering commercial feasibility of the NP yields. While certain aspects of those assumptions may have previously been reviewed, these were not carried out under the new required compliance with S.150A. The IDPs agree however the selected areas for review noted above are central to considering the commercial feasibility of the NP yields.

#### Consistency of use of S 150B assumptions (a) and b) – capacity of NP Plants

26. Amongst other things, the Manual variously defines the NP Standard Plant for each of the RCPs in terms of processing capacity. It is understood these definitions rely on the S.150B assumptions (a) and (b). These assumptions will be relevant to allocation of plants across the NP Network of Facilities and determining plant yield efficiency (including opportunities to consolidate milk to square curve production).
27. Unfortunately the definitions and procedures in the Manual are not clear. In general the Standard Plants are defined as incremental plants (for example to replace retired plants). Accordingly there are no Standard Plants for the NP as such, and the NP has a portfolio combining varying “old” plants and Standard (replacement) Plants. At other times however the Manual seems to conflate Standard Plants with all NP Plants or with their average capacity.
28. Rules 25 and 26<sup>13</sup> define a Standard Plant as a new or replacement plant (i.e. an incremental plant). The capacity of the Standard Plant is calculated for each RCP so that its addition to the NP Fixed Asset Base (to replace retired plants or to meet milk growth) will continue to leave the average plant processing capacity the same as Fonterra current average plant capacity. In the case of the SMP and WMP plants, the average daily capacity of NP plants (and thus Fonterra

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<sup>11</sup> Focus Areas 2023/24, para 23 and 38 ff

<sup>12</sup> Ibid: para 12.1

<sup>13</sup> The “Rules” are included in Part B of the Farmgate Milk Price Manual.



average plants) is 2,000 M3 litre<sup>14</sup>. In its Farmgate Milk Price Statements (for example for 2022/23) Fonterra explains new plants acquired by the NP since 2013 have a daily capacity of 2,500 M3 litres. This is presumably the daily capacity of the “Standard Plant” for WMP and SMP.

29. The cost of acquiring and installing a Standard Plant is determined in a review year (Rule 25). As above, the capacity of the WMP and SMP Standard Plant is 2,500 M3 litre per day. This is then presumably the specification for the capital cost of a powder plant costed in a review year.
30. Where it adds new plants the NP will be assumed to acquire a “Standard Plant” (Rule 29 and 34). Plants are thus added in pre-determined “chunks” of capacity (of 2,500 M3 litres per day for powder plants). This could exceed the incremental or replacement capacity requirement (as can be the case for any commercially feasible processor).
31. Rule 7 requires that NP yields are based on production that is

*“consistent with efficient manufacture of the products and the configuration of the Standard Plants”*

This is at best ambiguous. The Standard Plants for WMP and SMP have a daily capacity of 2,500 M3 litres while the average NP powder plant has a daily capacity of 2,000 M3 litres. The Standard Plant cannot therefore be the basis as such for determining yields of the NP plants.

32. NP factory fixed and variable costs are determined by reference to the operation and size of the Standard Plants (required variously but for example Part C Definitions, section 1.3 Milk Price Cash Costs). This again cannot be the case for the reasons outlined in paragraph 31 above.
33. The NP factory costs are informed by costs at all Fonterra sites. These have a range of ages, scale, and technology, all of which would impact production costs. It is unclear how Fonterra adjusts resource cost rates from its diverse range of sites into the resource rates for the NP (Standard Plant or otherwise). The Commission is asked to consider this as a focus area for the 2024/25 review.
34. Standard Plants are allocated to regions (Rule 27). Region here means either the North Island or the South Island (Glossary). This is explicitly to determine if the NP plants have sufficient capacity to meet processing demand (Rules 33 and 34). This procedure is unclear. Standard Plants are incremental plants but the procedure would require all plants to be allocated (i.e. Standard Plants and plants previously extant). At least in the case of “surplus capacity” (Rule 33) the reference to “Standard Plant” must then refer to all NP plant (surplus capacity must be determined with reference to all plants, not just incremental plants (Standard Plants)). Of further concern the capacity surplus or shortfall is confirmed at a regional (Island) level (i.e. without reference to capacity requirement to process milk in each catchment area). This suggests the NP plants might levitate around each Island to respond to changing processing requirements. While an elegant solution to investment in long life assets, it might take some time for commercially feasible technology to catch up.
35. At the same time, Rule 35 states the NP is assumed to have a network of processing facilities located on the same geographic footprint as Fonterra sites which process commodity products.

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<sup>14</sup> Fonterra Reasons Paper, 2022/23 BMP Calculations: pg. 45

The processing capacity at each NP site is materially aligned to Fonterra actual processing capacity at each relevant site (although the factory mix will of course be different). This is not consistent with Rule 27 (plants allocated by Region) and could result in a different allocation of plants by Region. For example where Fonterra has surplus capacity at a site, Rule 35 would require the NP to also hold surplus capacity while Rule 27 would permit that surplus to be balanced across other sites.

36. The Commission has indicated that S.150B assumptions (a) and (b) might appear to be used in an inconsistent manner as regards plant processing capacity.<sup>15</sup> The Commission has concluded that is not the case and this is not an issue which it is considering in the 2023/24 Focus Areas. The IDPs are unclear why the Commission has drawn that conclusion. The above review of the Manual indicates the capacity assumptions are not coherent, yet they are central to determining the NP yields.
37. Plant capacity issues which will need to be considered in the review of the NP yields are addressed below.

*Milk Price Manual Rule 7: NP Yields based on Standard Plants*

38. Rule 7 states that NP yields are based on Standard Plants. However just 30% of the NP WMP and SMP plants in the 2022/23 Season were Standard Plants (i.e. new plants acquired since 2012) - refer Table 1. The overall average daily capacity was 2,000 M3 litres. Commercial feasibility would require the NP yields reflect the range of plants the NP operates which is clearly not the same as the Standard Plant.
39. Fonterra assesses NP milk losses based on test results at certain of its plants while they operate in ideal conditions: uninterrupted full capacity processing as for example occurs when plants are square curved. At least in recent seasons (including the 2022/23 Season) Fonterra has based and updated this assessment on test results from its WMP dryers at Darfield (D1 and D2)<sup>16</sup>. It is understood these dryers have a capacity of 2,500 M3 litres per day and 4,500 M3 litres per day respectively. At the time it was commissioned in 2013 Darfield D2 was claimed to be the largest in the world. While D1 is likely to be consistent with losses from Standard Plants operating in ideal conditions D2 does not match any of the NP facilities and should not inform the NP yields. Neither D1 nor D2 matches the average capacity of the NP Powder plants.
40. Fonterra states that its technical adviser on NP yields:

*“explicitly considered and where appropriate adjusted the loss audit results for the impact of assumed [NP] plant operation at partial capacity ... and for the identifiable impact of differences between the technology, operation and products of Fonterra plants and the [NP]”<sup>17</sup>.*

This explanation is insufficient considering the source data for the loss assessment in one case is from a plant that matches no more than 30% of the NP plants, and in the other case is unrelated to any of the NP plants. A more complete explanation is needed to justify using

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<sup>15</sup> Proposed Focus Areas, review of 2023/24 BMP calculations, para 38 ff

<sup>16</sup> Fonterra Reasons Paper, 2022/23 BMP Calculations, pg. 15.

<sup>17</sup> *ibid*

larger and more efficient plants to determine the NP losses and yields, and of the adjustments that are made to align to the actual NP factories. The Commission has confirmed it will consider this issue in its review of the NP yields.

41. Fonterra’s technical adviser on NP yields is also credited with concluding:

*“the loss allowances represent “achievable, but challenging, targets for the [NP], given the size, technology and operating parameters assumed for this business”<sup>18</sup>.*

42. This is a technical feasibility assessment. The technical adviser is not shown to be aware of the commercial feasibility requirement or to have given that consideration.

*Part B Rules 33 and 34 (Capacity assessed at a Regional Level), and Rule 35 (Standard Plants allocated to align to Fonterra geographic footprint – by processing capacity)*

43. The NP is assumed to be able to

*“move milk from its collection areas to maximise the length of time some factories remain full”<sup>19</sup>.*

44. This is achieved by consolidating milk at certain sites (while plants at other sites will operate at reduced capacity). Based on an analysis it performed for the 2013/14 Season, Fonterra advises that this “square curving” of certain plants means the NP plants operate at peak capacity for 85-90% of their operating days<sup>20</sup>. This suggests that the NP would need to process different quantities of milk at its processing sites compared to the “mirror” site in the Fonterra actual production plan. It appears Fonterra has not previously maintained an NP production plan that can confirm this.

45. Assumed square curving of NP plants reduces milk losses and will have a significant impact on product yields. To demonstrate the scope of square curving for the NP is commercially feasible the NP would require (at least) a monthly production plan by site based on the geographic footprint (Fonterra aligned) of its manufacturing facilities. The plan would also need to deal separately with milk processing over the season peak days. This plan would confirm the location of feasible square curving (matching wider catchment area milk with aligned processing capacity), associated costs of moving milk, and varying costs of operating some plants at peak capacity and others at reduced capacity. This requires explicit allocation of each NP plant (“pre-2012” and incremental plants) to that site footprint. To be commercially feasible those plants would of course be permanently fixed to those sites.

46. The above review of the Manual suggests a production plan at this level of disaggregation has not previously existed or is not a commercially feasible plan. The Fonterra review exercise in the 2013/14 Season might have been based on a fully disaggregated production plan but Fonterra provides no details of that exercise. In any event Table 1 below shows that since the 2014/15 Season (the first season Fonterra disclosed NP plant numbers), the NP plant configuration has substantially changed.

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<sup>18</sup> Fonterra Reasons Paper, 2022/23 BMP Calculations, pg. 15

<sup>19</sup> Fonterra Reasons Paper, 2022/23 BMP Calculations, Attachment 3

<sup>20</sup> *ibid*

Table 1: NP Powder Plants

	Notional Producer WMP and SMP Powder Plants (1)		
	2022/23	Change 2015 to 2023	2014/15 (3)
Pre 2012 Plants (excluding BMPwdr (2))	30	-12	42
New (Standard Plants)	13	8	5
Total Powder Plants	43	-4	47

(1) Fonterra Reasons Papers in Support of the BMP Calculations.  
(2) BMPwdr plants are understood to be "pre-2012" plants  
(3) Fonterra first published this information for the 2014/15 Season

47. To confirm capacity utilisation assumptions of NP plants remain commercially feasible, the production plan at the level of disaggregation above needs to be maintained on an ongoing basis. This same plan is needed to confirm commercially feasible milk transport costs, plant operating costs (full capacity vs partial capacity processing), and to confirm that processing capacity remains aligned to the commercially feasible manufacturing footprint (matches Fonterra capacity footprint).
48. The IDPs consider the disaggregated production plan as described should be sought and reviewed by the Commission as the basis for its review of the NP yields. It is also noted that this production plan should in principle provide for the disruption to SSP production and yields that would arise from the wider product range (the non-SSP sales) unless it can be shown that is given effect by the IPC procedure (see below).

#### Impact on yields of non SSPs included in NP revenues

49. The NP yields are based on the production of five unique products (the SSPs). Because of the associated assumptions of scale permitted by S.150B (milk volume equivalent to Fonterra, network of facilities matching the Fonterra facilities, and average plant size equivalent to Fonterra), the SSPs yields reflect exceptional scale benefits which as discussed above are not available to any commercially feasible processor in New Zealand: a feasible small processor cannot access the scale opportunities; the feasible large processor needs to diversify to be sustainable.
50. The NP revenues are however based on a wider product range than the five SSPs. The NP yield assumptions are not adjusted directly for this wider product range. The impact of yield differences is apparently achieved indirectly as an outcome of the Incremental Product Costs (IPC) procedure<sup>21</sup>. This procedure discounts selling prices for non-SSP products by the amount of the IPC. Discounted prices are then included in the calculation of NP weighted average selling prices and revenues. The Commission reviewed IPCs in the 2021/22 calculations review. It concluded the IPCs were practically feasible and agreed with Fonterra that they have the same effect as if NP yields were adjusted directly. For this reason the Commission is not proposing to

<sup>21</sup> Incremental Product Costs (IPCs) are the difference between the cost of producing a non SSP compared to the cost of the relevant SSP. The cost difference is intended to be the difference in cost between the two products as if manufactured by NP but that becomes contradictory because the NP does not manufacture the non-SSP. The IPC is in fact determined from the Fonterra costing system including certain undisclosed adjustments.

include the full NP product range in its review of the commercial feasibility of the S1509B assumptions<sup>22</sup>.

51. The IPCs can be considered to consist of two components:
  - a. the difference between the conversion costs of the product and the related SSP. This cost difference is derived from the Fonterra product costing system. The principles of the costing system are not disclosed. The Commission does however note the IPCs (and therefore Fonterra costing system) are based on forecast costs<sup>23</sup>. To confirm commercial feasibility of the Fonterra costing system, those costs (which presumably refers to budget costs including efficiency targets) would need to be compared against Fonterra ongoing actual product costs.
  - b. the difference between the milk solids consumed by the product and the milk solids consumed by the related SSP. This again is derived from the Fonterra costing system and would similarly need to be shown to be commercially feasible by a comparison to Fonterra actual or typical product compositions. The difference in milk solids is attributed a cost based on an assessment of the “current” values of the milk solids (i.e. based on a “current” FGMP). “Current” is understood to refer to the time at which the product is sold. The Commission has confirmed the current FGMP is based on “current prices”; the process for determining the current FGMP has not otherwise been disclosed. A “current” FGMP would need to make other significant assumptions to match costs with current prices and to determine a \$/kg MS value for each milk component. The approach to determining the “current” FGMP should be made transparent.
52. Relative to the efficient production assumed by the NP, production of non-SSPs would affect NP yields in three ways (all of which are apparently accounted for by the IPC procedure):
  - a. The production plan to deliver the full product range would be more complex and would be less optimised compared to a production plan for the five SSPs. This more complex environment would affect the yield of ALL products **including the five SSPs**.
  - b. Non SSPs will have different yields to the SSPs due to different product composition, product complexity, and demand/length of feasible production runs. This is distinct from the non-SSP conversion costs which will also be different to the SSP conversion costs.
  - c. The production of the non-SSPs would affect the overall volume of the relevant RCP and of associated RCPs. Volumes for all RCPs would be different compared to the NP product mix which is calculated from the five SSPs.
53. In its 2021/22 review the Commission concluded the IPCs were practically feasible and accounted for yield differences.<sup>24</sup> The IPC procedure is however not transparent and it is not clear how the IPCs can account for all yield effects of non-SSP production.

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<sup>22</sup> Focus Areas 2023/24, para 29 ff

<sup>23</sup> Focus Areas 2023/24, para 36

<sup>24</sup> Focus Areas 2023/24, para 35 and 36

54. The IDPs request the focus areas for the 2023/24 review include an explanation (including with examples) to confirm how the IPCs adjust all yield differences noted in paragraph 52 above.
55. The IDPs also request that the focus areas consider how further disclosures could make transparent the process to determine the “current” FGMP, and costing principles underlying the conversion cost portion of the IPCs.

## Additional Focus Areas

56. The IDPs request the Commission consider two additional focus areas in its review:
  - a. Fonterra long term planned cost savings attributed to the NP
  - b. increasing predictability in the BMP calculations.

## Fonterra Planned Long Term Cost Savings

57. In September 2023 Fonterra advised its shareholder suppliers of a new plan to deliver cost savings of \$1 billion over the seven years to 2030. Savings would be delivered through a range of projects to streamline operations. Fonterra signalled some cost reductions had already been delivered or are included in FY 23 and FY 24 business plans. The Fonterra initiative could be expected to lead to reductions in NP costs.
58. Anticipated savings from an earlier Fonterra initiative to reduce costs (“Velocity”) were used to justify a reduction in NP costs from 2015/16. The savings were banked by the NP (before they were achieved by Fonterra) on the basis they represented feasible cost reductions for an efficient processor. It is unclear what portion of those planned cost savings were achieved. However in the 2018/19 Season up to \$20M of the savings were reversed and up to a further \$20M was expected to be reversed in 2019/20<sup>25</sup>.
59. At that time, Miraka requested the Commission

*“assess whether it is appropriate (practically feasible) to reduce Notional Producer costs on the basis of specific Fonterra strategic plans before underlying targeted cost savings have been demonstrated to be achieved”*<sup>26</sup>
60. While Fonterra’s cost saving initiative is laudatory, organisations embark on such initiatives for a variety of reasons and with varying levels of success. Fonterra’s failure to realise its earlier planned “Velocity” savings is an apt example. The Fonterra Co-operative Council has also expressed dissatisfaction with the lack of Fonterra accountability to date concerning the cost savings target<sup>27</sup>. The IDPs consider cost savings planned to be achieved across a long period must be demonstrated to be achieved before they can be credited (or progressively credited) to

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<sup>25</sup> Commerce Commission Report on the 2018/19 BMP Calculations, para 2.36

<sup>26</sup> Miraka Submission, Commerce Commission Draft Report, Review of 2018.19 BMP calculations Para 3.2

<sup>27</sup> NZ Herald 6 May 2024: “Fonterra shareholders pull up dairy company over disclosure concerns”  
<https://www.nzherald.co.nz/business/fonterra-shareholders-pull-up-dairy-company-over-disclosure-concerns/33RPWOB7MZCRNEVNYTW2QZYGBY/>

the NP. The IDPs request the Commission include this issue in the focus areas for its 2023/24 review.

### Increasing Predictability of the BMP calculations

61. Cost of milk is the single largest cost of dairy processors. Milk price uncertainty is a significant business risk. DIRA S.150 A seeks to provide for contestability in the New Zealand raw milk market. In this respect the BMP setting process grants an advantage to Fonterra over other New Zealand milk processors: it substantially reduces Fonterra's exposure to milk price uncertainty. The IDPs consider S.150A requires the underlying imbalance in risk should be reduced wherever possible. Fonterra responded positively to this issue when it agreed last year to provide ongoing disclosure of the NP conversion rate.
62. New disclosure requirements came into effect in June 2023 requiring Fonterra to disclose all "non-sensitive" information relating to the BMP calculations (S.150QA). These disclosures can help further redress the imbalance in milk cost risk for the IDPs. Any increase in transparency of the procedures and assumptions reduces the IDP knowledge imbalance and better equips them to more effectively manage milk cost risk.
63. Fonterra information advantage is inevitable where assumptions and processes include "sensitive information" and which Fonterra can withhold. The contestability purpose of S.150A means discretion with disclosing "sensitive information" should err on the side of transparency.
64. Fonterra made its first disclosure of information under S.150QA for the 2022/23 BMP calculations. This will not have been a simple exercise for Fonterra, and there were gaps in the information disclosed. Moving forward IDPs seek wider disclosures and request the Commission consider this in its focus areas for the 2023/24 review.
65. Below discusses areas where the IDPs consider wider disclosures are needed.

### NP assumptions that do not disclose Fonterra commercial performance

66. Where the NP assumptions do not disclose Fonterra commercially sensitive information, the IDPs consider there should be maximum disclosures. Examples include:
  - a. The composition of the SSPs (as currently determined) are different to Fonterra product compositions and should not therefore be commercially sensitive. There is accordingly no reason for withholding them and they should be disclosed in full. In the Appendix to this submission an attempt has been made to approximate the NP composition of RWMP. This highlighted difficulties in interpreting the various information provided with regard to the NP yields and product composition (in this case, the NP specification offsets last advised as 0.63%<sup>28</sup>). The composition of the NP SSPs could be made more transparent by disaggregating and clearly defining the NP specification offsets and milk losses, or by simply disclosing the composition of the SSPs.
  - b. NP lactose ingredient cost is based on New Zealand import statistics for lactose imported by dairy processors (excluding Fonterra imports). The NP lactose cost is therefore not commercially sensitive for Fonterra. Lactose ingredient disclosures under S.150QA are

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<sup>28</sup> Fonterra Reasons Paper, 2022/23 BMP Calculations, pg. 16

however heavily redacted. The disclosures should be expanded so that the assumptions and chain of calculations to determine the NP lactose ingredient cost can be replicated. The IDPs would then be in the same position as Fonterra to manage lactose cost exposure in the milk price.

#### NP assumptions that depend directly on Fonterra commercial performance

67. Disclosure of data underlying certain NP assumptions is necessarily limited. A significant example is the data used to calculate the NP selling prices. In this and similar instances the IDPs expect the underlying procedure and chain of calculations for translating that sensitive data into NP outcomes should remain transparent. An example is the process for translating price Fonterra selling prices into NP selling prices. IDPs should as far as possible be able to replicate the Fonterra procedure at least as it relates to translating (public domain) GDT selling prices. The S.150QA disclosures in this respect not only redact the underlying sales price data, they also remove the tracks of the underlying procedure for translating those selling prices. The IDPs consider the chain of calculations should remain transparent either within the source calculations file or in an illustrative example.

#### Timely disclosure of substantive changes in the approach to calculating the BMP

68. The Commission has noted that Fonterra is changing the approach to determining certain inputs in the 2023/24 BMP<sup>29</sup>. The Commission has not elaborated on these changes and the IDPs do not know whether they might be significant.
69. The IDPs will be informed of these changes at the earliest when Fonterra issues its Reasons Paper in support of the 2023/24 BMP calculations which is not due until 15 June. This is after the Season has finished and the Financial Year is largely over. The IDPs consider they should have advance warning of any changes in Fonterra approaches which can materially affect the BMP. This is again needed to mitigate the disadvantage from the knowledge gap between the IDPs and Fonterra. The IDPs request the Commission consider this in its focus areas for the 2023/24 review.

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<sup>29</sup> Focus Areas 2023/24, para 15



## Authorisation

This submission is authorised by:

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## APPENDIX: WMP PRODUCT COMPOSITION AND YIELDS: A COMPARISON BETWEEN THE NOTIONAL PROCESSOR AND FONTERRA<sup>30</sup>

IMPORTANT NOTE: This analysis is derived from the incomplete information available to the IDPs. The conclusions in the analysis are based on an interpretation of that available information. The IDPs do not claim the analysis is conclusive. More complete information might draw different conclusions.

### A. An analysis of RWMP Compositions: NP vs Fonterra

#### RWMP (all compositions expressed as w/w)

Milk Components	Codex		NP WMP Composition Analysis			Fonterra RWMP Composition Analysis		Compare WMP Composition: NP vs Fonterra (5)	
	Range		Minimum (1)	NP Components Consumed (2)	NP WMP Composition (3)	Implied Spec offset (nominal) (3)	Typical Composition (4)		
	Min	Max	A	B	C = B minus NP Milk Losses	D	E	F	C vs. E
Protein			23.46%	24.19%			24.500%		
Fat	26.0%		26.00%	26.21%			26.300%		
P + F			49.46%	50.41%	50.21%	0.75%	50.800%	1.340%	98.8%
Lactose + Minerals			45.54%				46.100%		
TS			95.00%				96.900%		
Moisture		5.0%	5.00%				3.100%		
Total			100.00%				100.000%		
Total SNF			69.00%				70.600%		
P:SNF	34.0%		34.00%				34.703%		

#### Overall NP Loss assumptions (Fonterra Reasons Paper, 2022/23 FGMP Calculations, page 15 and 16)

Milk Losses (including pack over-weights)	0.38%
Specification Offset (6)	0.63%

#### Notes:

(1) Codex minimum (= zero specification offset):

Set to Codex minimum

Set to Codex maximum

(2) Fonterra "Version of 2022/23 Milk Price Model" (<https://www.fonterra.com/nz/en/investors/farmgate-milk-price/milk-price-methodology.html>)

(3) Milk solids (P + F) in product less nil Codex Minimum

(4) As advised to customers in Fonterra product bulletins (for example as published on GDT).

(5) NP product is over 1% lower in solids compared to Fonterra typical composition.

(6) The NP specification offset of 0.63% is defined by Fonterra as a measure of the lower NP production compared to a zero spec offset counterfactual. The metric is presumably calculated after milk losses but is otherwise difficult to interpret. The metric has not therefore been used in this analysis. This analysis instead derives the spec offset from the derived NP product composition (milk components consumed less raw milk losses). The derived spec offset is 0.75% nominal (Column D).

It may though be informative to compare this analysis with metrics derived from the NP spec offset of 0.63% advised by Fonterra. The derived metrics (below) do not appear credible. Nevertheless providing them here illustrates the difficulty interpreting and reconciling the incomplete information related to NP yields. This would be resolved if the NP product compositions are made transparent, as proposed in this submission (para 66).

Compare: Implied Metrics (NP Spec Offset Metric vs. this analysis)		
	NP Offset	This Analysis
NP Spec Offset (NP Production vs Codex Minimum counterfactual)	0.63%	
	P + F	P + F
NP WMP Composition (P + F)	50.21%	50.21%
Implied NP Spec Offset (nominal)	0.32%	0.75%
Implied Codex Minimum	49.90%	49.46%

<sup>30</sup> This analysis is contained in an excel file attached to this submission as Schedule 1

B. A high level calculation to illustrate the c/kg MS difference between WMP production based on NP yields and WMP production based on Fonterra yields  
(derived from typical composition)

		Milk losses: NP overall losses ==>			Milk Losses: What if Fonterra ==>		
		0.38%			0.76%		
		Yield Analysis 1			Yield Analysis 2		
		Notional Processor	Fonterra Typical Composition	NP Yield Premium	Notional Processor	Fonterra Typical Composition	NP Yield Premium
Total WMP Production - 22/23 Season	MT (000)	1,730	1,710	19.96	1,730	1,704	26.48
MS consumed (F+P only)	MT (000)	872	872		872	872	
Less Milk Losses (F+P)	MT (000)	3.3	3.31		3.3	6.6	
MS in Finished Goods (F+P)	MT (000)	869	869		869	866	
WMP Selling Price 22/23 Season	US\$/MT	3,392	3,392		3,392	3,392	
Revenue	US\$ (000)	5,868,611	5,800,923	67,688	5,868,611	5,778,795	89,815
Conversion Rate - 22/23 FGMP	USD:NZD	0.6357	0.6357		0.6357	0.6357	
Revenue	NZ\$ (000)	9,231,730	9,125,252	106,478	9,231,730	9,090,444	141,286
<b>Total</b> MS - 22/23 Season	Kgs (M)			1,483			1,483
Premium: NP WMP Yields vs Fonterra Yields	NZ\$/kg MS			<b>0.07</b>			<b>0.10</b>