15 November 2023

IDP Joint submission on the Commerce Commission Draft report: "Review of Fonterra's 2023/24 Milk Price Manual" (issued 16.10.23)

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Attention: Louise Stephenson (Head of Fuel and Dairy)
Subject Line: Milk Price Manual 2023/24
Submitted by: Independent Dairy Processors (IDPs): Miraka, Open Country Dairy, Synlait Milk and Westland Milk Products

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Contents

Abbreviations and other references

BMP: Base Milk Price (defined and regulated by the DIRA)
DIRA: Dairy Industry Restructuring Act 2001
DIRA Amendment Act 2022: Dairy Industry Restructuring (Fonterra Capital Restructuring) Amendment Act 2022
Draft Report: Review of Fonterra's 2023/24 Milk Price Manual (published 16 Oct 2023)
FMP: Fonterra's "**F**armgate **M**ilk **P**rice" (not a statutory measure but referred to by Fonterra to be the same as the BMP); abbreviated as "FMP" to distinguish from the DIRA defined "**F**arm **G**ate **M**ilk **P**rice"
IDPs: Independent Dairy Processors (Miraka, Open Country Dairy, Synlait Milk, Westland Milk Products)
Manual: Farmgate Milk Price Manual
NP: Notional Processor
RCP: Reference Commodity Product

Summary

1. The Commission is prioritising the completion of its review of the amended S 150B permitted assumptions within the 2023/24 Calculations review and the review of the 2024/25 Manual review. That means recommendations of the review are unlikely to be included in the Manual and implemented in full until the 2025/26 BMP calculations. Noting the significance of the S 150B assumptions to the overall BMP calculation the IDPs request the Commission further increase priority of this work to ensure review of S 150B is completed in its entirety for the 2023/24 BMP calculations review. The IDPs also request the Commission require any recommendations from this review be implemented as soon as feasible and not be delayed by Fonterra's administrative calendar for its review of the Manual.

2. For the review of the S 150B assumptions, the IDPs submit that:

   a) S 150B (1) (d) – practically feasible yields: yields are not demonstrably practically feasible because they rely on a commercially infeasible product mix and product volumes. The IDPs consider the amended S 150B now requires yields to be commercially feasible and to be consistent with a commercially feasible production scheme.

   b) S 150B (1) (c) – NP conversion rate:

      - An appropriate interpretation of this section results in the NP conversion rate being largely the same as the NP conversion rate. While previously understood to be the case, it is apparent from the recently released S 150QA disclosures that the NP rate might be substantially different to the Fonterra rate. The IDPs request this be clarified.
      - the IDPs consider ongoing disclosures (within the season) of the NP conversion rate are required to meet the contestability requirement of S 150A as it now relates to S 150B (1) (c). The IDPs describe the disclosures they consider necessary and appropriate. The IDPs consider these ongoing disclosures should be made at a minimum each time Fonterra updates the forecast FMP.
      - The IDPs note that Fonterra FMP forecasts and farm gate milk price statutory declarations are not consistent with Fonterra forecasts of the BMP and request the Commission to consider if this is appropriate.

c) S 150B (1) (a) – network of facilities – It is evident that the NP “network of facilities” have diverged from the Fonterra actual network of facilities. The IDPs consider that reliance on S 150B (1) (a) to assume the NP network of facilities is the same as the Fonterra network actually requires that to be the case; thus related NP assumptions must be consistent with that assumption. That is not currently the case. Fonterra could alternatively recast the NP network of facilities in a manner which is directly consistent with S 150A and put aside the optional assumption of S 150 (1) (a).

3. Fonterra has included a new definition of Standard Product Offerings in the Manual. The IDPs consider the definition is not compatible with the DIRA definition of dairy commodities and is otherwise open ended and not able to be objectively interpreted. The IDPs continue to submit that the hierarchy of products in the Manual is unnecessarily complex, including definitions that are incoherent, inconsistent and open ended, relying on subjective and secretive Fonterra decisions and processes. As has consistently been their position, the IDPs consider that much of the complexity and controversy around the BMP calculations and reviews would be removed if the NP selling prices were simply based on GDT. This position is apparently consistent with Fonterra’s own view that GDT properly discovers commodity prices for NZ dairy commodities.

Compliance with amended DIRA S 150B

4. The DIRA Amendment Act 2022 changed the manner by which the four S 150 B permitted assumptions can be used, now making them explicitly subject to the efficiency and contestability limbs of S. 150A. This had the effect of removing the previous “safe harbour” status of the assumptions and has brought them within full oversight of the Commission reviews.

5. The IDPs consider this requires a fundamental reassessment of the way the S 150B assumptions are used in the calculation of the BMP. In their submission on the Commission’s Focus Areas Paper (22/23 BMP Calculations) the IDPs requested the Commission review all the S 150B assumptions[1] when reviewing the 2022/23 BMP calculations (the Commission had proposed to review only assumption (c) concerning the NP USD conversion rate), the others to be reviewed at a later time.

6. In the event, the Commission did limit the 2022/23 Calculations review to the USD conversion rate assumption. In this latest Draft Report, the Commission has turned to consider if the 2023/24 Manual properly reflects the amendment as it affects S 150B (1) (c). [2] Noting the timetable for the BMP review processes, to the extent the Commission recommends any change to the Manual on this matter, Fonterra will not actually change the Manual (and is unlikely to comply with that change) before the 2024/25 Season.

7. In the Draft Report, the Commission has acknowledged the importance of the other three S 150B assumptions and that they apply to a wide range of interrelated rules in the Manual. The Commission confirms however that it has not examined those rules in the review of the 2023/24 Manual[3].

8. The Commission has indicated the review of the remaining S150B assumptions and associated aspects of the Manual is a matter of priority which will proceed across the 2023/24 Calculations review and the

[1] IDP Submission 22/23 Focus Areas, para 25
[2] Refer para 14 ff below
[3] Draft Report, para 30

2024/25 Manual review.[4] Again based on current form, Fonterra will not make any changes to the Manual (and is unlikely to implement those changes) until the 2025/26 Season at the earliest. The IDPs have previously raised concerns that the BMP review timetable can unreasonably defer implementation of Commission recommendations. Correction of statutory non-compliance should not be unnecessarily deferred by administrative procedures. Further, to the extent that the S 150B assumptions are not reviewed in the 2023/24 Calculation review the Commission will not be in a position to confirm compliance of the 2023/24 BMP with the DIRA (as was the case for the 2022/23 BMP).

9. The IDPs request the Commission give increased priority to fully completing the review of the S 150B assumptions during 2023/24 and to include that review In the compliance assessment of the 2023/24 BMP. This could include additional ad hoc review processes to ensure the review can be completed on time. Where appropriate, the IDPs are willing to assist in this review.

10. The IDPs also request the Commission make clear that any required changes to BMP calculation procedures arising from that review should be implemented as soon as feasible and not be subjected to delays associated with the artificial timetable for updating the Manual.

11. In paragraphs 12 to 31 below, the IDPs make initial observations for the review of the S 150B assumptions.

S 150B (1) (d) – Practically feasible yields for Fonterra equivalent milk volume

12. This milk volume assumption is the most problematic of the S 150B assumptions. It is self-contradictory. It is not commercially feasible to process the Fonterra milk volume into the 5 RCPs (which by practice is the 5 SKUs that comprise the standard specification products): the consequent volume produced far exceeds Fonterra actual volume and would cause commodity prices to fall or collapse. Despite this, the NP has been assumed to enjoy economies of scale that arise from the highly simplified production scheme that would result from this production volume: i.e. long periods of continuous production, and square curved production plants. The resulting yields are only theoretically feasible and cannot be commercially feasible because the simplified production scheme would never occur in practice.

13. This view has been presented repeatedly by the IDPs[5]. Until now it has not gained traction because of the incontestable safe harbour status of the S 150B assumptions. That has now changed, and the IDPs look forward to the NP yields being restated on a commercially feasible basis consistent with a commercially feasible production scheme.

S 150B (1) (c) – NP Conversion Rate

14. As noted in paragraph 6 above, the Commission included a review of the NP conversion rate in the 2022/23 Calculations review and concluded the conversion rate is consistent with S150B (1) (c).

15. In the Draft Report, the Commission now largely concludes the Manual is consistent with S 150A (efficiency and practical feasibility). The Commission has however drawn attention to the possible need for further disclosures regarding the Fonterra hedging strategy. The Commission's draft view is that

[4] Draft report para 30

[5] Most recently for example in

- IDP Joint Submission (dated 27 April 23) on the proposed focus areas for review of Fonterra's 2022/23 BMP calculations, at paras 8 to 15; and
- IDP Joint Submission (dated 15 August 2023) on the review of Fonterra's 2022/23 base milk price calculation, at paras 21 to 32.

additional disclosures would better promote transparency and therefore contestability but are not a necessary requirement for compliance with the contestability limb of S 150A.[6]

Compliance with S 150B (1) (c)

16. At this time, the IDPs are unclear whether the NP conversion rate is consistent with S 150B (1) (c). That section permits the inclusion of Fonterra currency management gains and losses to be "incorporated in the base milk price". A plain interpretation means the NP would adopt the same nominal gains and losses as Fonterra. This would be problematic because the NP business model is different to Fonterra (Fonterra for example has gains and losses for currencies other than USD). The closest next interpretation is that the NP would adopt the same overall USD conversion rate for revenue exposures as Fonterra. This would mean relative gains and losses for the NP USD denominated business would be the same as achieved by Fonterra through its active management of USD exposures. The NP however adopts a different procedure which has the effect of weighting Fonterra achieved monthly USD conversion rates (from actual Fonterra currency management of exposures from an actual sales programme) with the different NP sales programme. The resulting annual conversion rate is a lottery outcome, which is not demonstrably able to be linked to a commercially feasible currency management programme for the NP USD exposure.

17. The IDPs had however understood that in fact the NP overall conversion rate is almost identical to the overall Fonterra USD conversion rate and had accordingly considered the issue did not need to be further pursued.

18. That understanding position has been upended by the S150QA disclosures for the 2022/23 BMP. Those disclosures include confusing correspondence between Fonterra and the Commission that suggests there might be large differences (up to 588 b.p.) between the NP and the Fonterra annual USD conversion rate. While the correspondence suggest there may have been interpretation errors it also includes an explanation from Fonterra that

    "*there is no obviously practical way to calculate Fonterra's "annual average" exchange rate which makes sense for application in the Milk Price calculation*"[7].

    It is difficult to determine what the correspondence means or how it was concluded (begging the question why it was issued in this confusing manner). In any event it seems that in fact there is no available comparison between a Fonterra actual average USD conversion rate and the NP average conversion rate. The scale of the lottery implied in the NP conversion rate procedure is therefore apparently unknown. This is not satisfactory to the IDPs and it is surprising it is satisfactory to Fonterra.

19. **The IDPs request the Commission** obtain a meaningful comparison between Fonterra's actual USD conversion rate and the NP annual conversion rate. The IDPs consider this should be readily available at a materially correct level, and should be reported each year.

Compliance with S 150A (contestability): Transparency and Disclosure

20. IDPs mitigate exposure to milk cost by forecasting the BMP as the season progresses. Forecasts are based on publicly available information (eg GDT), previous season BMP models, and other information provided by Fonterra (e.g. the ongoing disclosure of the contribution to the BMP from off-GDT sales). The only major parameter in the BMP calculation which remains largely unknowable to the IDPs is the NP conversion rate. By contrast Fonterra retains exclusive knowledge of the NP conversion rate as a result of its role in setting the BMP. In the absence of ongoing disclosure of the conversion rate, this

[6] Draft Report, paras 52 to 55.
[7] Fonterra S150QA Disclosures – 2022/23 Season: "Emails" at pg 101

creates a competitive disadvantage for the IDPs (and an advantage for Fonterra) which cannot be consistent with the intent of S 150A (contestability).

21. In the annual milk price statements published in September, Fonterra provides an estimated conversion rate for the proceeding season established as at the previous 31 July. On its own this information has limited value for maintaining a forecast conversion rate for the season. This is due to the timing of the estimate (as at July, just two months into the season), uncertain (volatile) commodity prices (and USD exposure), optionality in the Fonterra hedging programme, and Fonterra active management of its hedge book.

22. The IDPs submit that to meet the DIRA contestability requirement, Fonterra must provide ongoing updates of the estimated conversion rate. This would be in the same manner as provided in the annual FGMP statement and would additionally confirm the underlying forecast FMP (a single point forecast rather than the typical Fonterra forecast range), the method for evaluating open options in the hedge book, and the proportion of options in the open hedge contracts included in the "to date" forecast conversion rate. These should be provided no less frequently than with each update of the Fonterra FMP forecast.

23. Appendix 1 attached reviews the information that was made available for the 2022/23 NP conversion rate. It illustrates why the final outcome conversion rate was unpredictable, and further explains the ongoing disclosures required to provide minimum transparency of the conversion rate.

24. On a related note, IDPs do not consider Fonterra forecast FMP a reliable basis for forecasting the BMP during the season. Fonterra represents the FMP to be the same in principle as the BMP. The IDPs have previously submitted this creates ambiguity and can be misleading. This is now evidenced by the recently provided S 150QA documents for the 2022/23 Season. Table 1 below compares the myriad different "versions of the truth" that are now apparent. It compares Fonterra progressive updates of the BMP forecast (the "Milk Price Reporting Models" newly provided by the S 150QA disclosures), Fonterra forecast FMP updates across the comparable period, and a comparable statutory declaration of the forecast "Farm Gate Milk Price"[8].

25. The table shows that:

- The Fonterra forecast BMP remained within 2 c/kg MS of the final BMP ($8.22) from January 2023.
- The Fonterra forecast FMP update closest to the January 2023 forecast BMP (FMP update of 24 February 23) indicated a significantly higher milk price (mid-point $8.50). At the same time the comparable statutory declaration of the forecast farm gate milk price (6 March 23) of $8.58 seems similarly based on the then prevailing FMP mid-point ($8.50 – refer note 7 of Table 1). The forecast FMP is not a statutory declaration but Fonterra represents the FMP is the same as the BMP. The table suggests the forecast FMP was inflated by comparison to Fonterra's forecast of the BMP. The farm gate milk price is a statutory declaration and it is disturbing that it also now seems to be inflated by comparison with the then best available information.
- Fonterra next forecast FMP update (3 April 23, mid-point $8.30) was again inflated by comparison with the then latest forecast BMP ($8.20).
- Fonterra forecast FMP mid-point did not come close to the forecast BMP (largely unchanged since January 2023), until 25 May 2023. Even then, the forecast FMP included a range of $8.10 to $8.30

[8] The Farm Gate Milk Price (a DIRA statutory measure) is distinct from the FMP (and the BMP). It is a measure of the "true" actual average price Fonterra pays its milk suppliers. By comparison the FMP (and the BMP) is a normalised average milk price calculated in accordance with the Manual. The farm gate milk price is different to the FMP for example because of Fonterra's fixed milk price scheme and winter milk premiums.

when the forecast BMP since January 2023 had varied by no more than 4 cents above the $8.20 mid-point, and had not strayed below $8.20 in that period.

Table 1: Varying milk price forecasts – 2022/23 Season

Base Milk Price (1)		Forecast Farmgate Milk Price (FMP)			Forecast Farm Gate Milk Price (6)	
$/kg MS	As at (2)	Range	Mid-point	As at	$/kg MS	Date Issued
$ 8.23	Jan-23 (3)	$8.20 to $8.80	$ 8.50	24-Feb-23	$ 8.58	6-Mar-23 (7)
$ 8.20	Apr-23 (4)	$8.00 to $8.60	$ 8.30	3-Apr-23		
$ 8.24	May-23 (4)	$8.10 to $8.30	$ 8.20	25-May-23		
$ 8.21	Jun-23 (5)	No update				
$ 8.22	Jul-23 (5)	No update				
$ 8.22	Final 21-Sep-23	Final	$ 8.22	21-Sep-23	$ 8.32	Final: 5-Oct-23

(1) Fonterra refers to the BMP as the Farmgate Milk Pirce. The IDPs consider this creates ambiguity and is misleading.
(2) Included in the S150QA disclsoures (not available until after the final milk price is announced).
(3) S 150QA disclsoures: "F23 January Milk Price Reporting Model"
(4) S 150QA disclsoures: "F23 May Milk Price Reporting Model"
(5) S 150QA disclsoures: "F23 July Milk Price Reporting Model"
(6) This forecast of the Farm Gate Milk Price is a declaration made in accordance with the Dairy Industry (Raw Milk) Regulations. The Farm Gate Milk Price is the average overall price that Fonterra pays for milk. It differs from the FMP (a normlaised price based on the milk price manual) for example because of the Fonterra fixed milk price scheme, and winter milk premiums.
(7) Noting the final Farm Gate Milk Pirce was $0.10/kg MS higher than the final BMP, it is reasoanable to assume the underlying BMP to this statutory declaration was $8.48, similar to the then prevailing Fonterra FGMP forecast mid-point of $8.50 but inflated by comparion with the then forecast BMP.

26. Taken in the round, it seems the Fonterra forecast FMP is serving purposes other than to report on a DIRA compliant BMP and cannot be relied on for managing milk cost risk. As noted above, IDPs must depend on their own forecasting processes to mitigate that risk. Those forecasts remain unjustifiably compromised by the obscured NP conversion rate.

27. The IDPs consider that when Fonterra is performing its statutory role of setting the regulatory milk price, it should be required to use the correct statutory term: “base milk price”. It should not be able to create the impression the forecast FMP is the same in principle as the statutory BMP unless it can demonstrate compliance of those forecasts with the Manual.

28. The IDPs further consider that Fonterra should be required to substantiate and support the forecast farm gate milk price statutory declarations, and there should be independent oversight to assure the forecasts are consistent with the Manual. Noting a process exists for progressively updating the forecast BMP (the “Milk Price Reporting Models” now included in the S 150QA disclosures) consistent with the Manual, it seems reasonable to expect the statutory declarations of the farm gate milk price should be based on those “Milk Price Reporting Models”.

29. It is also relevant to note that Manual based forecasts of the FMP and of the farm gate milk price are important for the efficient operation of the NZX/SGX milk price futures contracts (which settle on the Manual based final Fonterra FMP).

S 150B (1) (a) – Network of Facilities

30. It is understood that this section is used by Fonterra to assume the NP capacity and location of processing facilities are the same as Fonterra. This assumption will permeate the NP production costs, logistics costs (raw materials, intermediary products and materials, and finished goods) and processing efficiency/yields. Other NP assumptions will need to be consistent and compatible with that "network of facilities" assumption. This does not appear to be the case as illustrated in the following:
    a) The location of the NP replacement production facilities are apparently not aligned to the Fonterra network of production facilities. For example (highlighting not in original):
        - *"F22 Milk Supply and Price Asset Base …. The old plants scheduled for closure in F21, have been replaced by the equivalent capacity of new plants which will commence production in F22. This replacement capacity has been assumed to be located in the SI, regardless of the location of the F21 capacity that will close, given that the previous peak milk forecast indicated a surplus of capacity in the NI and a small shortfall in the SI"*[9]; and
        - *"F23 Milk Supply and Milk Price Asset Base … The 1.35 old plants that are scheduled for closure by the end of F22, will operate at Peak and then be replaced by the equivalent capacity of new plants which will commence production in F23. As there is slight capacity shortfall forecasted in the NI for F22, all replacement plants have been assumed to be installed in the NI regardless of location of the F22 capacity that will close"*[10].
        - It goes without saying that it is not commercially feasible to "close" 1.35 plants as noted above for "F23". This modelling assumption might be made for convenience but underlines why the NP network of facilities is not in fact the same as Fonterra actual network of facilities.
        - The Manual refers to "regions" in relation to the location of the NP production facilities. Regions are defined in the Manual as meaning either the North Island or the South Island. While "regions" as defined is again presumably a simplification, this means that production costs and production performance assumptions are not determined consistently across the BMP model. Rather, it seems that Fonterra selectively applies the network of facilities assumption and does not ensure consistency across related assumptions.

       These serve to illustrate the NP network of facilities are unlikely to match the Fonterra network of facilities in the North and in the South Island. They will not therefore match Fonterra facilities in line with Fonterra management of milk catchment zones. Yet that assumption seems to have been made in determining the NP milk collection costs (or "milk diversion costs") as was addressed in the 2022/23 BMP Calculations review.
    b) The IDPs acknowledge Fonterra may wish to simplify assumptions. But if Fonterra wishes to rely on the (optional) S 150B (1) (a) assumption, other NP assumptions must still be consistent with that assumption and must be commercially feasible. On the face of it, that is not the case.

31. The IDPs submit that the review of the BMP rules and procedures that rely on S 150B (1) (a) needs to provide assurance of consistency of all related assumptions between the NP and the Fonterra actual network of facilities. Alternatively, Fonterra could choose to recast the NP network of facilities in a manner which is directly consistent with S 150A (efficiency and commercial feasibility) and put aside the optional S 150B (1) (a).

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[9] S150QA Disclosures 2022/23 Season – "Documents"
[10] Ibid

Definition of Dairy Commodities – Standard Product Offering

32. Fonterra has amended the definition of standard product offerings to as follows:

> A Reference Commodity Product specification which:
> 1. Is a Standard Specification Product, or
> 2. Is sold on GDT, or
> 3. Is otherwise a product which:
> - Is traded in significant quantities in globally contested markets, and
> - Is characterised by uniform technical specifications.
>
> When determining whether a specific product specification satisfies the conditions specified in paragraph (3), the MPG will disregard any element of the product specification which it can reasonably be expected would not give rise to a requirement for consultation with a customer if that product was used to fulfil an order for a similar product.
>
> When determining whether a product is traded in significant quantities in globally contested markets, the MPG will have regard to the quantity of functionally-equivalent products traded in globally contested markets, and not to the quantity of an individual product specification.

33. The Commission considers the new wording provides clarity and is consistent with DIRA S150A[11].

34. The definition of standard product offerings has been amended to explicitly include the DIRA definition of dairy commodities (the two bullet points of item 3 in the revised definition). The hierarchy of the definition is however not consistent with the DIRA legal definition. As presented in the Manual, the DIRA definition is subservient as point 3, with points 1 and 2 implicitly not subject to the statutory definition. The DIRA definition however must be over-arching. Points 1 and 2, and the further text in point 3 are in fact the Manuals interpretation of the DIRA definition and are subject in their entirety to the DIRA definition. The hierarchy in the definition needs to be changed to make this clear.

35. Fonterra states that it has explicitly included the Standard Specification Products in the definition to address "a source of apparent confusion on the part of submitters in previous years, who have argued that only Standard Specification Products should be used in the Farmgate Milk Price [sic] calculation"[12]. The IDPS have not been confused on this point. Rather, the IDPs have submitted that the Standard Product Offerings are not defined in manner that is cognisant of the definition and role of the Standard Specification Products.

36. A Standard Specification Products is identified for each RCP and is defined as

> *"a product specification … which can **reasonably** be regarded as being **representative** of an undifferentiated commodity product"*[13]

"Reasonably regarded" is interpreted by the IDPs to mean by general agreement of the industry. This "reasonable regard" arises from broad experience within the industry. A commodity is identified by the way it performs in markets; "commodity" it is not intrinsic to the product itself and thus for example products can become "commoditised" by the function of the market.

"Representative" is understood by the IDPs to mean the product is a benchmark ("representative") for identifying commodities for each RCP – i.e. Standard Specification Products are not necessarily the only "Standard Product Offering" but the characteristics of the Standard Specification Products must

[11] Draft Report, para 41
[12] Fonterra Reasons, 2023/24 Milk Price Manual, pg 4
[13] 2023/24 Manual Part C, 1.1 Definitions (highlighting not in original)

necessarily provide a benchmark for identifying Standard Product Offerings (otherwise they would not be "representative'). While this is self-evident, Fonterra has simply ignored the benchmarking role of the Standard Specification Products in this aspect of the Manual.

37. It is less clear (and remains unexplained) why all other products sold on GDT are simply assumed to meet the DIRA commodity definition. By way of example, IWMP sales on GDT can extract substantial and even extreme price premiums over the RCP representative commodity product (RWMP). These are scarcity premiums, a characteristic contrary to the nature of commodities. In recent years IWMP premiums over RWMP have peaked as follows:
    - US$2,240/MT (Contract 2, GDT auction 3 May 2022)
    - US2,965/MT (Contract 3, GDT auction 19 April 2022)
    - US$1,520/MT (Contract 4, GDT auction 15 March 2022)
    - US$450/MT (Contract 5, GDT auction 5 May 2020)

38. IWMP product composition is also materially different to the representative RCP product (RWMP); it would not be considered to be "uniform" by comparison with RWMP.

39. These issues at least require consideration before simply assuming "carte blanch" that IWMP (and other products sold on GDT) are DIRA compliant dairy commodities.

40. The Manual definition of Standards Product Offerings then steps beyond GDT to include any other product that meet loosely defined descriptions of the DIRA "uniform technical specifications" and "significant quantities" criteria:

    a) A product (SKU) will in effect be deemed to meet the "uniform technical specifications" requirement provided there is just one other SKU for which it can be substituted.. There is no nexus in this definition with the technical specification of the representative product of the RCP and there is apparently no other requirement to confirm uniformity. The IDPs consider that the definition for Standard Product Offerings must be cognisant of the definition ("representative") of Standard Specification Products and must therefore show "sufficient uniformity" (to be objectively defined) with the relevant Standard Specification Product.

    b) The "significant quantities" requirement will be satisfied by reference to the overall volume of "functionally equivalent" products. "Functional equivalence" is not defined and therefore remains meaningless.

    c) A problem with the "significant quantities" criteria was further illustrated in Fonterra's earlier submission on the review of the 2022/23 BMP calculations. In that submission Fonterra explained that

    > "*there is not good data available on the traded volumes of various subcategories of dairy products … meaning we generally rely on indirect evidence that a particular product type is traded in significant quantities, including anecdotal evidence from purchasers of product manufactured by Fonterra*".

    Fonterra's explanation is provided in full in Appendix II attached. The explanation is important because it indicates that "significant quantities" will not ultimately be evidence based but will depend on Fonterra judgement.

41. None of the discussion on standard product offerings is new. In effect it summarises submissions made previously by the IDPs regarding off-GDT sales. The complexity reflected in the hierarchy of product definitions in the Manual largely came about as a result of the inclusion of off-GDT sales in the BMP calculations. The definitions are incoherent, inconsistent and open ended. They rely on subjective and

secretive Fonterra decision and processes. They cause the BMP to be unnecessarily complex and they undermine confidence in the BMP.

42. All of this is unnecessary. The IDPs remain of the view that a pragmatic solution has always been available and that the NP revenues should simply be derived from GDT. Indeed that was one of the purposes for establishing GDT in the first place. While it was discussed above that certain products sold on GDT might not meet the DIRA commodity definition, the advantages provided by GDT (including its transparency and the confidence created by its professional and independent governance) outweigh that concern. The most eloquent advocacy for using GDT as the basis for determining BMP commodity revenues has in fact been provided by Fonterra. An article published internally by Fonterra in December 2020 and subsequently included in the GDT 2020 Annual Report explained:

    a) that GDT was formed for two major reasons including that

       "Fonterra had a real need for a credible reference price to feed into the milk price calculation for dairy commodity prices"

    b) "*the GDT auction meant … the global dairy market could discover prices for core dairy products in a transparent way, which was not only beneficial for Fonterra and its shareholders, but for the dairy industry as a whole"*

    c) GDT is

       "a critical tool, not only for our Co-op, but farmers as well as it provides an accurate reading on where dairy prices are globally"

    d) the article also extolled the role of auctions noting

       "*auctions were recognised in the 2020 Nobel Economics prize, which was awarded for improvement to auction theory and inventions of new auction formats. Nobel prizes are awarded to those who have conferred the greatest benefit to mankind"*.

43. The article is copied in full in Appendix III.

44. Compared to the observations in the article, the determination of BMP revenues in accordance with the Manual is inferior and suspect. The IDPs fully agree with the view presented by Fonterra in the article. Reversion to full reliance on GDT would remove much of the complexity and heat from the BMP review processes.

45. **<u>The IDPs commend this article to the Commission and request</u>** they reconsider full reliance on GDT as a pragmatic and superior alternative to the determination of the BMP revenues.

Authorisation

This submission is authorised by:

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Appendix 1 – Forecasting the NP Conversion Rate

1. The IDP submission on the proposed Focus Areas for the 2022/23 review of the BMP calculations requested the Commission strongly encourage Fonterra to provide on-going disclosures (at each update of the FGMP forecast) regarding the Notional Producer conversion rate[14]. This was to address an inappropriate competitive disadvantage to Fonterra competitors (and thus competitive advantage – privileged information - enjoyed by Fonterra) which arises as a direct result of Fonterra's designated role under the DIRA to set the BMP. The competitive advantage this gives Fonterra must be an unintended consequence given the purpose of the DIRA is to mitigate risks to competition arising from Fonterra market power.
2. The Explanatory note to the Dairy Industry Restructuring (Fonterra Capital Restructuring) Amendment Bill acknowledges that:

   > "*A **transparent, independent**, and **robust** base milk price-setting process is important, as **Fonterra's dominance in the market for Fonterra's milk means that Fonterra essentially sets the milk price for the whole dairy industry**. To attract and retain farmers' milk supply, other processors need to exceed Fonterra's milk price. The base milk price setting process promotes efficiency across the whole industry. The Act* [DIRA] *therefore includes provisions that govern calculation of the base milk price, including monitoring by the Commerce Commission*".

3. That Bill proposed DIRA amendments (subsequently enacted) to improve transparency and independence of the BMP setting process. In the case of transparency the Bill provided for certain "after the event" disclosures. The Bill did not address "during the event" disclosures. This was possibly because most of the key parameters of the BMP are significantly visible (through data in the public domain) as they unfold. The USD conversion rate is the major exception. The IDPs submit this exception should be addressed through on-going disclosure of the conversion rate no less frequently than each time Fonterra updates its forecast FMGP. These ongoing disclosures would include:
   - The Fonterra estimate of the NP conversion rate in the same manner provided in the annual FGMP Statement I.e.
     - Forecast conversion rate based on the disclosed:
       - actual hedged portion of exposure as at the most recent available month end data (this would include the portion of hedged exposure that has already crystallised and for which hedging has already closed out)
       - the conversion rate on which the unhedged portion of exposure has been valued (to date hat has been the closing USD/NZD spot rate for the same most recent month end)
     - Fonterra would additionally need to disclose:
       - the single point FMP on which the forecast conversion rate is based, and
       - the relative portion of open option contracts in the actual hedged position (this is important for evaluating potential for variation in the final NP conversion rate)
4. The NP conversion rate is substantially an outcome of Fonterra management (rightfully private) of its own USD currency exposure including:
   - Fonterra assessment of gross USD exposure in the face of volatile dairy commodity prices

[14] IDP Joint Submission (27 April 23), Proposed Focus Areas for review of Fonterra's 2022/23 BMP Calculations", paras 33 to 37

- Fonterra Treasury policy and flexibility that policy provides for day to day management of currency exposure
- Fonterra choice of hedging instruments
- Fonterra ongoing decisions in managing its book of hedging instruments

5. Overlaid by volatile USD/NZD cross rates, it is not possible to predict with certainty the outcomes of those internal Fonterra policies, processes and decisions. However they have a profound impact on the NP conversion rate and the BMP.

6. An analysis of the 2022/23 Season conversion rate illustrates these issues. In September following the end of the previous season (June to May) Fonterra issues its Farmgate Milk Price Statement. In that statement, Fonterra also includes an estimate of the conversion rate for the coming season. In the 2021/22 Farmgate Milk Price Statement, Fonterra advised that for the 22/23 Season:

    - "*Fonterra had hedged approximately 65% of the forecast cash flows related to the 2023 season Farmgate Milk Price*";

    - "*If the remaining 35% of the forecast cash flows were to be hedged at the 29 July [2022] spot rate [0.6287], the average NZD/USD conversion rate would be around 65 cents*"

7. Fonterra's estimate of the NP hedged position as at 31 July 22 (65% of 2022/23 Season exposure) will have been based on the then Fonterra estimate of full year sales revenues and USD exposure. At that time (31 July 2022), Fonterra forecast FMP was range $8.25 to $10.75 with a mid-point of $9.50. Final FMP for the season was $8.22. It is understood the hedge position of 65% was based on the estimated revenues included in the then forecast FMP mid-point ($9.50). The hedged position as at 31 July 2022 must accordingly have been closer to 75% (of actual full year exposure) – refer Table 1 for calculations. The remaining then unhedged position was therefore closer to 25%, and the conversion rate achieved on that unhedged position is derived to have been 0.5569 (Table 2 below).

Table 1 Derived Notional Producer hedge book and hedged position as at 31 July 2022 [15]

		BMP: 22/23 Season		
		F'cast at 30 Jul 22	Actual	Delta
Gross Revenue	USDM	11,909	10,273	-1,636
Conversion Rate	NZD/USD	0.6500	0.6357	
Gross Revenue	NZD M	18,322	16,159	-2,163
Milk Price	NZ$	9.50	8.22	
Milk Solids	M kg MS	1,510	1,483	
Milk Cost	NZD M	14,345	12,182	-2,163
Hedge Book at 31 July 22	%	65%	75%	
	USD M	7,741	7,741	

Source:
- Fonterra Forecast as at 31 July 22
- 22/23 FGMP Statement
- 23/24 FGMP Statement
- Derived Value

Table 2 – Notional Producer Conversion Rate Analysis – 75% Hedged Position as at 31 July 2022

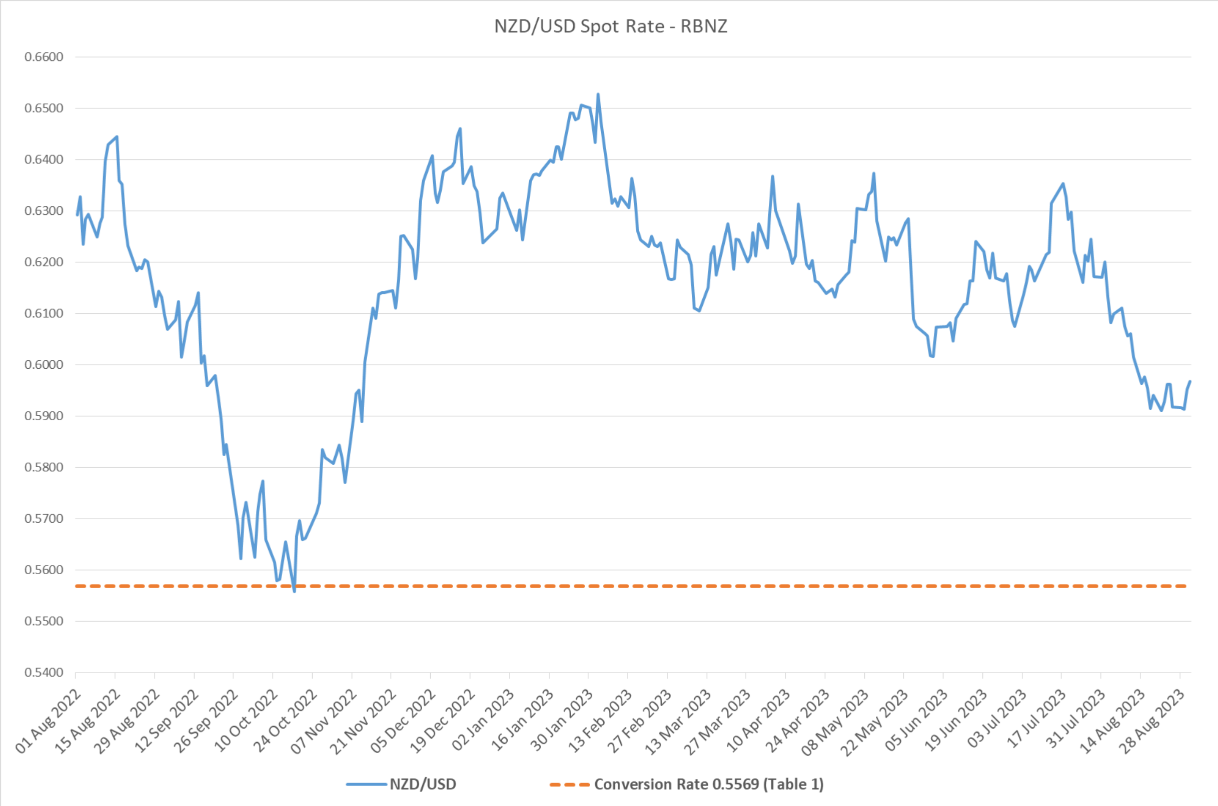
	Estimated as at 31.7.22			Full Season Actual		
	Exposure (USD M)	Hedged	Conversion Rate	Exposure (USD M)	Hedged	Conversion Rate
Hedged Exposure as at 31 July 22	7,741	65%	0.6615	7,741	75%	0.6615
Unhedged Exposure	4,168	35%	0.6287	2,532	25%	0.5569
Total	11,909	100%	0.6500	10,273	100%	0.6357

Source:
- 22/23 FGMP Statement
- 23/24 FGMP Statement
- Derived Value

8. Chart 1 below compares the derived conversion (0.5569) on then 25% unhedged exposure as at 31 July 2022 with USD/NZD spot rates from that date. On the face of it, the spot rate[16] has not fallen to levels which can explain the derived NP conversion rate. At a push, the conversion rate might be explained if there was substantial optionality in the opening (75%) hedge book. A heavy weighting of options in the hedge book further obscures the interpretation of the estimated conversion rate advised by Fonterra as at July '22. This is a necessary outcome of the estimation process, not a criticism of Fonterra.

[15] The calculations assume that with the exception of selling prices, milksolids and USD conversion rate, Fonterra's FGMP forecast mid-point as at 30 July 2022 was in line with the final BMP.
[16] Fx hedging points ranged negative and positive over the period but were not significant compared to spot rates.

Chart 1 – Notional Producer Conversion Rate (Derived) Compared to NZD/USD spot rate



9. Fonterra explains the NP currency risk management policy in its 2022/23 FGMP Statement as follows:

> *"The primary objectives of hedging are to increase the visibility and **certainty** of the forecast Farmgate Milk Price throughout the season by **reducing and smoothing the impacts from volatility in the NZD/USD spot exchange rate**… Fonterra enters into foreign exchange hedge contracts over an 18-month period to hedge forecast USD exposures… **The first 20% of hedges are entered into** **eighteen months out** from when USD sales proceeds are forecast to be received, and increased **progressively** to 100% two months out from the forecast USD cash receipt"*.

10. The Commission description of the NP risk management policy[17] is consistent with that Fonterra description:

> *"Fonterra's hedging strategy, that gives rise to Fonterra's gains and losses that are incorporated into the Benchmark Conversion Rate, is a **passive strategy**…* [including]*:*
>
> *A forecast sales cash flow hedging book, which hedges the forecast of sales receipts out up to 18 months on a **stepped profile**. The percentage of the exposure hedged **increases over time** to 100%..."*

11. Both descriptions are consistent with a passive hedging policy weighted towards forward exchange contracts (certainty), and with hedged exposures stepping up uniformly (or at least predictably) over time. In reality Fonterra can be expected to employ a mix of FECs and currency options, and will

[17] Commerce Commission final report, 2022/23 BMP Calculations Review, para 3.37.1 and 3.37.2

consider short term views on currency movements (and future commodity price expectations) when stepping up the portion of hedged exposure and managing the hedge book. The conversion rate achieved for 2022/23 provides strong evidence that the underlying hedging strategy is not passive and reflects Fonterra's sophisticated treasury function.

12. Based on the 75% hedged position (conversion rate 0.6615) as at 31 July 2022 and a passive and stepped hedging programme for the remainder of the exposure, it is estimated the 2022/23 NP full year conversion rate would have been above 0.65. This is over 143 b.p. higher than the actual NP conversion rate of 0.6357, equivalent to 24 cents/kg MS in the final BMP. Compared to the final BMP ($8.22) this demonstrates the disadvantage Fonterra competitors have in managing milk price risk; by comparison Fonterra knows the NP conversion rate and the final BMP with near certainty long before it is published. For the 2022/23 season for example, from as early as January 2023 Fonterra has already forecast a BMP that was within 2 cents of the final FMP; that is over 8 months before Fonterra finally disclosed the 22/23 BMP in late September 2023 (refer Table 1 in the main body of this submission).

13. While the NP 2022/23 Season conversion rate is difficult to validate, the Commission had already concluded the 2022/23 rate is consistent with the Manual; the IDPs are not here casting doubt on that conclusion. Rather the purpose is to demonstrate it is not possible to forecast the NP conversion rate on the basis of Fonterra's limited and incomplete disclosures. Given these circumstances, to comply with the S 150A contestability requirement, Fonterra should provide the ongoing disclosure as noted above. That disclosure should be no more commercially sensitive than the disclosure Fonterra already makes in the September FGMP Statement.

14. It is also noted that the NP conversion rate is likely to be inconsistent with the claimed passive currency risk management policy attributed to the NP. The NP hedging policy needs to be reassessed and any consequences addressed (including the ongoing disclosures identified in the submission).

15. In summary, the IDPs submit Fonterra should provide on-going disclosures to give transparency to the otherwise unpredictable NP conversion rate. In the event Fonterra is unwilling to provide these disclosures, it would be appropriate that the NP conversion rate be modelled separately on the basis of a passive hedging strategy consistent with Fonterra's description of the Treasury policy attributed to the NP. This would provide an appropriate independent measure against which to assess the performance of more active currency risk management strategies. As such it would be consistent with the standard approach the Commission takes in determining that the BMP incentivises Fonterra efficiency in accordance with DIRA s 150A. Crucially of course, there would also be no objection to ongoing disclosure of that modelled conversion rate throughout the season.

Appendix II – Extract: Fonterra Submission (15 August 2023) Review of 2022/23 BMP Calculations

Begins (part page 2 and 3)

We are happy, however, to provide the following observations on our interpretation of the phrase 'significant quantities' in the context of the DIRA definition of a commodity:

- There is not good data available on the traded volumes of various subcategories of dairy products – e.g., Instant vs UHT vs Regular WMP – meaning we generally rely on indirect evidence that a particular product type is traded in significant quantities, including anecdotal evidence from purchasers of product manufactured by Fonterra, the number of manufacturers promoting the availability of the product, and so forth. While Fonterra will generally be able to put forward informed estimates as to the internationally traded quantities of particular products it would often struggle to source authoritative supporting data.
- We therefore tend to focus on considering the availability of a product which can otherwise be considered to have the characteristics of a commodity, with a focus on whether the equivalent products offered by different sellers have identical technical characteristics, whether buyers consider them to be substitutable, our understanding of the size of the pool of actual or potential buyers, whether the product is widely offered by multiple sellers, on the quantity of the product sold by Fonterra, and on whether it is reasonable to assume the prices Fonterra realises on sale of the product are not systematically different to the prices achieved by other sellers of the same product manufactured to the same specification. The emphasis placed on each of these (and other) indicia will vary with circumstances and data availability, and we therefore do not believe it is feasible to draft a sensible formulaic test for inclusion in the Manual.
- Our amendment to the Manual for 2023/24 clarifies that we consider it appropriate to apply the 'significant quantities' test by reference to the quantity of functionally-equivalent products traded in globally-contested markets, and not by reference to the quantity traded of individual product specifications. This clarification is relevant to the assessment of the single product specification queried by the Commission in its detailed 2021/22 assessment of the qualifying materials included in the base milk price revenue calculation. That product was a standard specification AMF product sold in a specific 1250kg packaging format which is generally available for use by dairy processors, but which it appears not many processors offer. In the context of the amended definition, the relevant commodity category is standard specification AMF, and not standard specification AMF sold in a non-customer specific 1250kg packaging format, and the product specification therefore clearly satisfies the 'significant quantities' test.

Ends

[The IDPs make the further observation:

It is understood Fonterra provided the explanation in bullet point 3 above because the Commission had suggested the 1,250 Kg AMF product might be disqualified by the "significant quantities" test. The Fonterra explanation nevertheless convolutes issues concerning "standard product offerings" and "qualifying materials".

Packaging is not a characteristic of the Manual definition of "standard product offerings". It is the case that "premium AMF" products in whatever packaging are "functionally equivalent" (they share the same technical specification). "Packaging" only becomes an identifying further characteristic when determining whether a "standard product offering" is also a "qualifying material". The IDPs have previously submitted the 1,250 kg AMF was not a qualifying material because the packaging was unable to be considered “standard packaging” other than in a most liberal and meaningless definition of “standard packaging”. A definition of standard packaging does not in fact exist. In reality standard packaging is simply what Fonterra chooses it to be and multiple standard packaging can therefore apply to each RCP. **The IDPs consider the issue of standard packaging remains unresolved**. There is a failure to recognise that packaging in itself can differentiate a product to secure market advantage, including premiums over commodities or even delinking the product from commodity pricing (price maker versus price taker). The IDPs consider this is the case for the 1,250 kg AMF, and more particularly that a proper definition of standard packaging needs to include consideration of this issue.]

Appendix III: Extract - GDT Annual Report 2020

Article published internally by Fonterra, December 2020

The invention of cars, vending machines, the iPhone and online streaming service Netflix have all changed the way we travel, snack, connect with friends and even how we watch our favourite movies.

Every industry has an innovation that's known for being ahead of its time and changing the way we do things. Ours is Global Dairy Trade (GDT).

When it was first established in 2008, the GDT auction platform was a bold move for the dairy industry. It was the first time an online auction of its kind had been applied to international dairy trade and enabled buyers from around the world to participate in the auction at the same time – an incredibly sophisticated technology at the time.

Today, it's a critical tool, not only for our Co-op, but farmers as well as it provides an accurate reading on where dairy prices are at globally.

This year, auctions were recognised in the 2020 Nobel Economics prize, which was awarded for improvements to auction theory and inventions of new auction formats. Nobel prizes are awarded to those who have conferred the greatest benefit to humankind.

Reflecting back on how far we've come, Eric Hansen, Director of Global Dairy Trade says GDT was formed for two major reasons.

"Extreme uncertainty in the global markets made it hard for buyers and sellers to agree on prices for core dairy products, and Fonterra had a real need for a credible reference price to feed into the milk price calculation for dairy commodity prices.

The establishment of the GDT auction (known today as GDT Events) meant for the first time the global dairy market could discover prices for core dairy commodities in a transparent way, which was not only beneficial for Fonterra and its shareholders, but for the dairy industry as a whole."

The first Trading Events (auctions) were held once a month and launched with one seller, NZMP from Fonterra, who traded one product - whole milk powder - to just 100 buyers.

To become a multi-seller platform GDT developed a rulebook, known as the GDT Trading Event Rules, which has ensured the platform is managed and developed with objectives of independence, neutrality and transparency.

The platform was expanded in 2010 to enable other sellers to participate and a wider range of products to be sold.

It was a turning point when the likes of Arla Foods and Dairy America Inc. wanted to sell their products on GDT Events, proving that sellers other than Fonterra were welcome on GDT and were satisfied with the way it operated independently.

"It also enhanced GDT as a global platform, with supply coming from three of the largest dairy exporting regions New Zealand, Europe and the United States," says Eric.

Since then the team has continued to grow participation on the platform, with buyers from 88 countries and supply from eight countries participating in 24 auctions (two per month) every year.

There's no doubt that digital technology has changed in the last decade since the first GDT auction took place, but GDT has continued to build on the platform, investing annually to enhance attractiveness to buyers and sellers, such as offering up to 6 contract periods and reducing the duration of Trading Events.

Eric says they're now in the process of a total refresh "This will create a better user experience and it makes sense for GDT to harness modern technology to future proof the platform."

We want buyers to be able to bid using their mobile devices or switch between multiple devices when bidding, to make it more accessible to how they live their daily lives and do business.

GDT even has its own mobile friendly app, download here.