



'Reasons' Paper in Support of Fonterra's Milk Price Manual for the 2019/20 Season

1 August 2019

Glossary

F19 Final Manual Report	Commerce Commission, Final Report on the Review of Fonterra's 2018/19 Milk Price Manual, 14 December 2018, https://comcom.govt.nz/_data/assets/pdf_file/0021/110496/Final-report-Review-of-Fonterras-2018-19-milk-price-manual-14-December-2018.pdf
F19 Base Milk Price Reasons Paper	Fonterra, 'Reasons' Paper in support of Fonterra's base milk price for the 2018/19 Season, 1 July 2019, https://comcom.govt.nz/_data/assets/pdf_file/0032/159197/Fonterra-Reasons-paper-on-review-of-2018-19-base-milk-price-calculation-1-July-2019.pdf
MPG	The Milk Price Group, the independent unit responsible for determining and recommending to the Milk Price Panel the Farmgate Milk Price.
NMPB	Notional Milk Price Business, comprising the notional milk powder manufacturing business implied by Fonterra's Farmgate Milk Price Manual.
R&M	Repairs and maintenance.
RCP	Reference commodity product, comprising WMP, SMP, BMP, Butter and AMF.
F20 Season	The period commencing on 1 June 2019 and ending on 31 May 2020.

1 August 2019

To: The Commerce Commission

1. Fonterra Co-operative Group Limited ("Fonterra") certifies that:
 - a. in terms of section 150L(d) of the Dairy Industry Restructuring Act 2001 ("Act"), Fonterra considers that its milk price manual to be applied in calculating Fonterra's Farmgate milk price for the 2019/20 financial year is, in all material respects, consistent with the purpose of subpart 5A of the Act; and
 - b. none of the circumstances set out in section 150G(1) of the Act have occurred with respect to the milk price manual to be applied in calculating Fonterra's Farmgate milk price for the 2019/20 financial year.
2. This certification is based on our interpretation of subpart 5A, and the other relevant assumptions, views and qualifications set out in the accompanying reasons provided pursuant to s 150L(e).



Signed by

Andrew Cordner
Director Legal

1. Introduction

This paper provides the reasons in support of Fonterra's certification in respect of the Milk Price Manual to be applied in the calculation of Fonterra's Farmgate milk price in respect of Fonterra's 2019/20 financial year and the corresponding Season (the F20 Manual), as required under section 150L of the Dairy Industry Restructuring Act 2001 (DIRA). The paper has been prepared under the oversight of the Milk Price Panel, and where relevant reflects the Panel's views.

Section 150L provides that Fonterra must:

- Provide the Commission with the milk price manual for the current season (i.e., the season corresponding to Fonterra's 2019/20 financial year) (section 150L(a));
- Provide the Commission with any recommendations by the Milk Price Panel "in relation to the setting of the base milk price" (section 150L(b));¹
- Notify the Commission of any change in the economic and business environment that, in Fonterra's view, requires a change to the milk price manual (section 150L(c));
- Certify to the Commission the extent to which Fonterra considers that the milk price manual is consistent with the purpose of subpart 5A of DIRA (section 150L(d)); and
- Provide the Commission with reasons for the view expressed in its certificate (section 150L(e)).

In addition, section 150G sets out the steps that Fonterra is required to take if it does not amend the Manual in accordance with a recommendation by the Panel, if it amends the Manual contrary to a recommendation by the Panel, or if it amends the Manual without having received a relevant recommendation from the Panel. We advise that none of these circumstances has occurred with respect to the F20 Manual.

On 26 June 2019 the board of Fonterra approved a number of amendments to the Milk Price Manual, all of which were recommended by the Milk Price Panel. These amendments are set out in 'mark-up' form in the Milk Price Manual attached to this paper and, where relevant, we explain their rationale below. In all other respects, the F20 Manual is identical to the Manual applied by Fonterra in respect of the 2018/19 season (the F19 Manual), and in respect of which Fonterra submitted a certification and reasons paper on 1 August 2018. Consistent with that paper, we have confined our comments in this paper to areas where our views have changed subsequent to preparing previous reasons papers, or where we wish to provide additional information. In all other respects, we request that this paper be read in conjunction with our reasons papers submitted in respect of the 2012 – 2019 seasons.

We have also recently provided (in our 'reasons paper' in respect of the 2018/19 base milk price) the Commission with our views on the appropriate interpretation of section 150A of DIRA (the purpose provision), and have not repeated these views in this paper.

The paper is intended to satisfy the section 150L(e) requirement to provide the Commission with the reasons for the view expressed in our certificate. The paper is organised as follows:

- In section 2, we set out, and explain the rationale for, the amendments to the F20 Manual.
- In section 3, we summarise our reasons for not making certain amendments proposed by the Commission.
- In section 4, we summarise changes in the economic and business environment that are potentially of relevance to the calculation of the base milk price, and explain why we have not amended the Manual in response to these changes for the 2019/20 year.

The attachment to this paper comprises a 'marked up' version of the Milk Price Manual, identifying all amendments, and which satisfies the section 150L(a) requirement to provide the Commission with the Manual for the current season. Brief comments on the rationale for each amendment are also included in this attachment.

¹ As in our previous 'reasons papers' we have interpreted this provision as in fact relating to recommendations by the Milk Price Panel in relation to amendments to the Milk Price Manual.

2. Amendments to the F20 Manual

Apart from correcting some cross-referencing errors, the only changes we have made to the Manual for F20 are intended to address some minor matters raised previously by the Commerce Commission. The relevant amendments and their rationale are set out in the table below.

Manual Reference	Amendment	Comment
p.73	Amendment to definition of Standard Plant to provide that these are plants suitable for the manufacture of Standard Product Offerings.	In response to Miraka's proposal, endorsed by the Commission, that we define a 'standard plant' as "the [notional processor] plant which is designed to produce the GDT product range. The amended definition effectively defines a standard plant as one which can be used to manufacture: Reference Commodity Product specifications that are: 1. Sold on GDT, or 2. Generic product specifications which: <ul style="list-style-type: none"> • Are sold in multiple regions • Are sold to multiple customers • Are sold through Fonterra's standard sales channels • Can be manufactured in Standard Plants, and • Can be substituted for other Standard Product Offerings.
p.64	Definition of Standard Product Offering amended as above to remove the current reference to product that can be manufactured in Standard Plants.	Consequential on the proposed amendment to the definition of Standard Plant, to avoid what would otherwise be a circular reference.

The approach taken in practice to date to specifying standard plants and standard product offerings is consistent with the revised definitions, which will therefore not result in any change in the approach taken to calculating the base milk price or in its quantum.

3. Other Matters

For completeness, we note that we have not changed our position on the matters summarised in Table B1 of the Commission's F19 Final Manual Report, and again summarise our reasons in the table below.

Proposal	Response
Although immaterial we conclude that Fonterra should include the costs of providing shareholder support to ensure continued supply to be consistent with the contestability dimension.	No change to our position that it is not appropriate to fund these costs from the Milk Price.
We consider the Manual should outline what is considered a 'material change' when considering a change to the Manual and specify the timeliness of making such a change in order to set a minimum level for disclosure of changes.	No change in our position, for reasons explained on page 5 of our submission on the Commission's F17 Draft Manual Report (a 'bright line' materiality threshold is likely to lead to less disclosure).
We recommend that Fonterra considers disclosing its plant capacity for both primary and secondary plants in the Manual. This earlier disclosure should provide increased transparency of the assumed capacity of the notional producer for the season. We consider Fonterra's latest amendment still allows a significant level of discretion.	We do not consider the Manual is the appropriate vehicle for these disclosures. We have previously put this information into the public domain, including in the F19 Base Milk Price Reasons Paper, and the relevant assumptions will not be revisited until F20, with any changes not taking effect until F21.
We consider there should be more transparency of information on the actual foreign exchange rates assumed to be achieved by the notional producer. We suggest providing an average FX conversion rate assumed to be achieved by the notional producer throughout the season.	Outside scope of Manual.

4. Changes in the Economic and Business Environment

We confirm we are not aware of any changes in the economic or business environment that would in our view necessitate a change to the Milk Price Manual for the F20 Season. In arriving at this view, we have had regard to the following:

- None of the amendments to the Milk Price Manual set out in the attachments to this paper were prompted by changes in the economic or business environment.
- As a general matter, our view is that changes in the economic or business environment will in most circumstances not necessitate changes to the Manual, though they may result in changes in the approach taken to applying existing provisions of the Manual. Among other things, the existing provisions of the Manual could accommodate the changes in approach required to reflect the impact of changes in relative demand for (and profitability of) different product streams that affect industry-wide patterns of new investment, or of assets becoming 'stranded' due to a significant reduction in milk supply.