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Our approach to reviewing Fonterra's Milk Price Manual:

Dairy Industry Restructuring Act 2001

Supporting Paper #1

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Chapter 1: Introduction

Purpose of this paper

1. This paper provides an overview of the approach taken to our review of Fonterra's Farmgate Milk Price Manual (the Manual).

2. This edition of this supporting paper is based on our review of the 2015/16 Manual. Our intention is to maintain and update this supporting paper for future Manual reviews. Any major changes in our approach will be signalled before our draft report on any Manual review is published.

Our Manual review is the first of two reviews that we complete each dairy season

3. Under section 150H and section 150O of the Dairy Industry Restructuring Act 2001 (the Act), we must complete two separate but related reviews of Fonterra's base milk price setting for each dairy season.

4. This paper supports the first phase: our Manual review, which considers Fonterra's methodology for calculating its base milk price each dairy season.

5. In the second phase, we are required to review Fonterra's base milk price calculation at the end of each dairy season.

6. We intend to publish a similar supplementary paper to support our base milk price calculation review, starting with the 2015/16 dairy season (Supporting paper #2).

Fonterra provided its Manual for the 2015/16 season on 1 August 2015

7. On 1 August 2015, Fonterra provided its Farmgate Milk Price Manual (the Manual) for the 2015/16 dairy season.[1] As required by section 150H of the Act, the Manual was accompanied by supporting reasons for why it meets the purpose of the Act set out in section 150A.[2]

8. Under the Act we are required to provide our final report of the dairy season's Manual by 15 December each year. The final report on our review of the Manual for the 2015/16 dairy season is due to be published by 15 December 2015.

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[1] This can be downloaded from the Commerce Commission website at: http://www.comcom.govt.nz/regulated-industries/dairy-industry/review-of-fonterra-s-farm-gate-milk-price-and-manual/statutory-review-of-milk-price-manual/201516-season/

[2] Fonterra "'Reasons' Paper in support of Fonterra's Milk Price Manual for the 2015/16 Season" (1 August 2015).

How this paper is structured

9. This paper sets out:

   9.1. our interpretation of key legislative provisions guiding our review of each dairy season's Manual; and

   9.2. our approach to the review.

10. We also provide an overview of how Fonterra sets its base milk price.

This paper supports our review of the 2015/16 Manual

11. This paper has been published alongside the draft report for our review of the 2015/16 Milk Price Manual. It provides context for the conclusions and reasoning in the draft report. We recommend reading the two papers together. They are both available on our website.[3]

[3] http://www.comcom.govt.nz/regulated-industries/dairy-industry/review-of-fonterra-s-farm-gate-milk-price-and-manual/statutory-review-of-milk-price-manual/201516-season/.

Chapter 2: Our interpretation of key legislative provisions

Purpose of this chapter

12. This chapter sets out our interpretation of the following key legislative provisions in the Act that guide the Manual review:

    12.1. The purpose of the milk price monitoring regime - section 150A;

    12.2. ‘Safe harbours’ - section 150B;

    12.3. ‘Mandatory assumptions’ – section 150C; and

    12.4. Our review and report – sections 150H, 150I and 150J.

Policy objectives of the milk price monitoring regime

13. The milk price monitoring regime is intended to promote greater transparency of Fonterra’s base milk price setting processes, and greater confidence in the consistency of Fonterra’s base milk price with contestable market outcomes. The regime monitors whether the base milk price that Fonterra chooses to set provides incentives for Fonterra to operate efficiently but does not preclude efficient processors from potentially competing.

The section 150A purpose

14. Section 150A sets out the purpose of Subpart 5A of the Act, which gives effect to the milk price monitoring regime:

    150A Purpose of this subpart

    (1) The purpose of this subpart is to promote the setting of a base milk price that provides an incentive to new co-op to operate efficiently while providing for contestability in the market for the purchase of milk from farmers.

    (2) For the purposes of this subpart, the setting of a base milk price provides for contestability in the market for the purchase of milk from farmers if any notional costs, revenues, or other assumptions taken into account in calculating the base milk price are practically feasible for an efficient processor.

15. Our review of the Manual considers the ‘efficiency’ and ‘contestability’ dimensions of the Manual. It focuses on whether the Manual provides:

    15.1. an incentive for Fonterra to operate efficiently (the ‘efficiency dimension’); and

    15.2. for contestability in the market for the purchase of milk from farmers (the ‘contestability dimension’).

16. These two dimensions form the section 150A purpose under Subpart 5A of the Act.

17. We consider that the efficiency and contestability dimensions within section 150A are interlinked. To satisfy the provisions in section 150A, our interpretation is that the Manual must be consistent with both dimensions, independently.

Interpretation of the 'efficiency' dimension

18. Section 150A(1) refers to incentives to Fonterra to "operate efficiently". There are many factors which can, and do, provide efficiency incentives to Fonterra. Our review of the Manual against the efficiency dimension requires us to focus on only one of these possible factors (i.e. whether the Manual is consistent with promoting the setting of a base milk price that incentivises Fonterra to operate efficiently).

19. We have interpreted the primary focus of the efficiency dimension to be providing incentives for Fonterra to drive cost efficiencies (i.e. productive and dynamic efficiency).[4]

20. Our view is that the Manual would be expected to provide an incentive for Fonterra to operate efficiently where the Manual uses independent notional benchmarks for the revenue and cost inputs in the base milk price calculation. This is consistent with the Act, which envisages the use of notional values, and involves the assumption of a notional milk processing and collecting business (the 'notional producer').

Interpretation of the 'contestability' dimension

21. Section 150A(2) explains that the 'contestability' dimension is a function of whether any notional costs, revenues, or other assumptions taken into account in the base milk price calculation are 'practically feasible' for an efficient processor. Our review of the Manual therefore considers whether the assumptions adopted, and inputs and process used in the Manual are practically feasible for Fonterra or another efficient processor.

'Safe harbours' - section 150B

22. Section 150B lists certain assumptions that, if used in the Manual, are considered to not detract from the achievement of the purpose set out in section 150A. We interpret section 150B as being intended to create 'safe harbours', where Fonterra can use these assumptions without affecting the conclusions of our review.

[4] Productive efficiency is present when producers use inputs in such a manner as to minimise costs, subject to technological constraints. Dynamic efficiency relates to decisions made over time which result in improvements in productive efficiency. We are primarily concerned with productive and dynamic efficiencies when reviewing Fonterra's costs. For revenue items (such as the selection of reference commodity products and sales prices), where productive efficiency is not relevant, we necessarily focus on allocative efficiency. Allocative efficiency occurs when there is an optimal distribution of goods and services, and involves taking into account consumers' preferences.

‘Mandatory assumptions’ – section 150C

23. Section 150C of the Act sets out certain assumptions that Fonterra is required to make in setting the base milk price if the setting of that price is to be consistent with section 150A. In particular, the revenues and costs taken into account by Fonterra in calculating the base milk price must be determined from the prices of a portfolio of ‘Reference Commodity Products’.[5]

24. We consider our Manual review in this respect as being limited to examining whether the Manual contains the assumptions in section 150C.

Our review and report – sections 150H, 150I and 150J

25. Section 150H of the Act requires us to review the Manual for each dairy season.

26. Sections 150I and 150J of the Act require us to publish a report on the extent to which the Manual for a dairy season is consistent with the section 150A purpose.

[5] This portfolio of commodities is referred to in section 150C (2), and the setting of the base milk price must include the costs of processing milk into the same portfolio of RCPs.

Chapter 3: Our approach to the Manual review

Purpose of this chapter

27. This chapter describes our analytical and practical approach to carrying out the review of the Manual.

28. Chapter 2 identified the two key elements of our review:

    28.1. The 'efficiency dimension'; and

    28.2. The 'contestability dimension'.

29. We cover our analytical approach to each dimension in turn, followed by our practical approach to the Manual review as a whole.

Our approach to the efficiency dimension

30. As noted in Chapter 2, there are many factors which can, and do, provide efficiency incentives to Fonterra. Improvements in efficiency may be passed through into a higher base milk price or a higher Fonterra dividend (i.e. profit).

31. This review only concerns whether the Manual is consistent with promoting the setting of a base milk price that incentivises Fonterra to operate efficiently. In doing this, we focus on:

    31.1. the use of notional inputs in the calculation of the base milk price; and

    31.2. instances when it may be reasonable to use actual data in setting the base milk price.

The use of notional inputs in the base milk price

32. Our view is that Fonterra will have a stronger incentive to operate efficiently where the base milk price is set independently of Fonterra's actual performance (i.e. the calculation uses notional data). The efficiency incentive provided by setting the base milk price works because of the effect it has on Fonterra's actual profitability. For a given level of revenue, any improvements in actual cost efficiency relative to the notional values used in setting the base milk price will result in higher profits.

33. Using notional data provides Fonterra with a benchmark to beat.[6] This increases transparency to shareholders about whether Fonterra is achieving efficiency gains relative to the alternative of using data on Fonterra's actual performance to set the base milk price. An independent benchmark provides a target and means that any improvements in efficiencies will always result in higher profits, all things being equal.[7]

34. The Manual requires, in some cases, that the notional data used in the base milk price calculation should be based on Fonterra's actual data in a previous year. Therefore, efficiency savings achieved in one year (which result in a reduction in actual costs) may lead to a higher base milk price in a later year.

35. Subpart 5A of the Act is consistent with this approach. It envisages the use of notional values and involves the assumption of a notional milk processing and collecting business (the 'notional producer'). There is no unique price that needs to be ascertained to provide incentives for Fonterra to improve its efficiency.[8]

Instances when it may be reasonable to use actual data in setting the base milk price

36. Notwithstanding the efficiency dimension of section 150A, there are instances where it may be reasonable to use actual data in setting the base milk price, such as when:

    36.1. there is insufficient information to know what an appropriate notional value would be, or it would be unreasonably costly to obtain this information; or

    36.2. Fonterra has very limited control over the actual costs used for the benchmark.

37. Where the Manual requires the use of actual data, we explore whether notional data could reasonably have been used instead and we assess whether the use of this data distorts or weakens incentives to operate efficiently. For example, whether it provides Fonterra with an opportunity to earn higher profits without achieving efficiencies.[9]

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6 Ideally the benchmark should be stable over time in order to provide an incentive to operate efficiently over time and to provide transparency to shareholders on efficiency gains achieved.

7 This means that using a notional cost assumption that is less than the average across all of Fonterra's plants is still consistent with the efficiency dimension.

8 An infographic that shows what the notional producer looks like for the purposes of calculating Fonterra's base milk price can be found at http://www.comcom.govt.nz/regulated-industries/dairy-industry/review-of-fonterra-s-farm-gate-milk-price-and-manual/statutory-review-of-milk-price-calculation-2/review-of-milk-price-calculation-201415-season/

9 For example, through a combination of using actual and notional values in the base milk price calculation.

How the trading among farmers (TAF) regime impacts our approach to efficiency

38. We consider that Fonterra has an incentive to maximise its overall payments to farmers and to shareholders, including unitholders in the publicly listed Fonterra Shareholders Fund, which was created as part of the trading among farmers (TAF) regime. Improvements in efficiency may be passed through into a higher base milk price or a higher dividend (i.e. profit).

39. We consider Fonterra's management has a stronger incentive to maximise profits (which benefits both farmers and shareholders, including unit holders in the publicly listed Fonterra Shareholders Fund) relative to its incentive to increase the base milk price.[10] This incentive is reinforced by the transparency associated with the listing on the stock exchange of the non-voting units, and the importance to Fonterra of ensuring that its TAF regime works.

Our approach to the contestability dimension

40. Section 150A(2) of the Act states that:

> for the purposes of this subpart, the setting of the base milk price provides for contestability in the market for the purchase of milk from farmers if any notional costs, revenue, or other assumptions taken into account in calculating the base milk price are practically feasible for an efficient processor.

41. The 'contestability' dimension is therefore a function of whether any notional costs, revenues, or other assumptions taken into account in the base milk price calculation are 'practically feasible' for an efficient processor. The Manual review therefore considers whether the assumptions adopted, and inputs and process used in the Manual are practically feasible for Fonterra or another efficient processor.

What is an 'efficient processor'?

42. The term 'efficient processor' is not defined in the Act. It is our interpretation, within the context of the Act, including section 150A, that the term means a processor that is able to operate at least cost over time. This is consistent with our view that the primary focus of the efficiency dimension is on improving incentives for Fonterra to drive cost efficiencies over time (i.e. productive and dynamic efficiency).

43. We consider that expansion by an existing processor or the entry by a new processor into the New Zealand market for farmgate milk would be most likely to achieve least cost operation over time. That is because a newly built plant would be able to take advantage of the latest technology. This 'incremental' plant could be built at a capacity to take the best possible advantage of cost efficiencies in activities such as the collection and processing of milk.

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[10] The use of the term 'profits' throughout this report refers to the difference between Fonterra's revenues and costs (including the cost of raw milk) and includes dividends paid to shareholders (including farmers and unit holders in the publicly listed Fonterra Shareholders Fund).

44. Therefore, conceptually, we consider that the contestability dimension is satisfied if the Manual provides for the calculation of the base milk price to be practically feasible for Fonterra or another processor that is efficiently building an incremental plant.

Our practical approach to the review

45. Our 2015/16 Manual review has built on the conclusions from our previous reviews. We looked at:

45.1. Fonterra's amendments to the Manual for the dairy season;

45.2. issues arising from our 2014/15 Milk Price Calculation Review (including submissions), which was published on 15 September 2015;[11]

45.3. issues arising from comments made by stakeholders in response to our Process and Issues paper;[12] and

45.4. outstanding issues from previous Manual reviews.

46. Our review grouped issues by common themes and was particularly focused on the issues that are most likely to have a material impact on the 2015/16 base milk price calculation. Our approach involved:

46.1. assessing whether the Manual provides for assumptions that are individually practically feasible for Fonterra; and

46.2. performing cross-checks to ensure the Manual provides for assumptions that are practically feasible in aggregate.

Assessing whether the Manual's assumptions are individually practically feasible for Fonterra

47. We examine whether the Manual provides for the notional costs, revenues, and other assumptions taken into account in calculating the base milk price are practically feasible for Fonterra. This approach is appropriate because, more often than not, the Manual provides for the use of parameters that reflect Fonterra's 'average' plant rather than its most cost efficient plant(s). An efficient processor (building an incremental plant) should be able to achieve lower costs than this.

[11] Commerce Commission "Review of Fonterra's 2014/15 base milk price calculation: Final report" (15 September 2015).

[12] Commerce Commission "Process and Issues Paper - Review of the Milk Price Manual for the 2015/16 dairy season" (7 September 2015).

48. The Manual provides, for the most part, for the use of performance parameters that are based on the average across all relevant Fonterra notional RCP plants, rather than on any single recently built Fonterra plant. This is consistent with assuming that there is a national network of facilities for the collection and processing of milk (ie, the safe harbour provision in s 150B(a)). Also, the notional plants provided for in the Manual approximate the average capacity of Fonterra's actual plants, which is consistent with the safe harbour provision in s 150B(b).

Assessing whether the Manual provides for practically feasible assumptions in aggregate

49. We also identify whether our assessment is being affected by unique features which are not subject to 'safe harbour' provisions. For example, we consider whether the Manual provides for assumptions that are individually practically feasible for Fonterra due to features unique to Fonterra, and which do not relate to Fonterra acting efficiently. In that case, any such notional costs, revenues, or other assumptions may not be practically feasible for another efficient processor.

50. Our approach also includes considering:

    50.1. the internal consistency of provisions in the Manual; and

    50.2. the overall impact on the Manual of any provisions which may not be individually practically feasible or that we are unable to conclude on at this stage.

Chapter 4: Overview of how the base milk price is set

Purpose of this chapter

51. This chapter:

    51.1. outlines the different milk prices within the milk supply chain;

    51.2. explains the unique nature of the farmgate milk market in New Zealand;

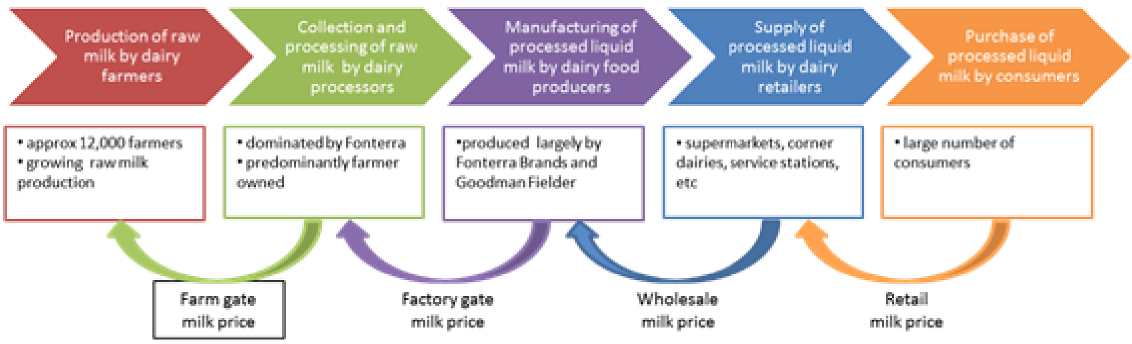
    51.3. provides an overview of our understanding of Fonterra's rationale for calculating its farmgate milk price; and

    51.4. explains the methodology Fonterra uses to calculate its farmgate milk price.[13]

Milk prices in New Zealand

52. The phrase "milk price" can have different meanings depending on which component of the milk supply chain is being considered. Figure 4.1 describes the milk supply chain in New Zealand and shows the different components of the "milk price" as generated by different milk markets within the supply chain.

Figure 4.1: Milk supply chain in New Zealand



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13 The Act uses the term "base milk price" and all references here to the farmgate milk price should be read as meaning the same.

53. As Figure 4.1 shows, the "milk price" in New Zealand is made up of the following four components:

    53.1. **Farmgate milk price** is the price paid by dairy processors (eg, Fonterra) to dairy farmers for raw milk;

    53.2. **Factory gate milk price** is the price paid by dairy processors (eg, Synlait, and dairy food and beverage producers, eg, Goodman Fielder) to other dairy processors (eg, Fonterra) for either raw milk or dairy ingredients;

    53.3. **Wholesale milk price** is the price paid by dairy retailers (eg, supermarkets) to dairy food and beverage producers (eg, Fonterra Brands and Goodman Fielder) for processed milk; and

    53.4. **Retail milk price** is the price paid by dairy consumers to dairy retailers (eg, supermarkets) for processed milk.

54. Given that approximately 95% of the total raw milk produced in New Zealand is exported in one or more product forms, all four components of the "milk price" are influenced by the demand and supply characteristics of the international dairy markets and by foreign exchange fluctuations.

55. The focuses of our Manual review and our base milk price calculation review are solely on the **farmgate milk price** and not any other milk price within the milk supply chain. The farmgate milk price accounts for between one quarter and one third of the retail milk price.[14]

Farmgate milk market in New Zealand

56. In a workably competitive farmgate milk market, the level of the farmgate milk price would be determined both through the process of competition between suppliers of raw milk (ie, farmers) to processors, and through those processors competing in both the purchase of raw milk and its onward sale after processing.

57. In New Zealand, the majority of farmers are also the owners of the majority of processing capacity (i.e. Fonterra, which collects approximately 89% of total raw milk supply in New Zealand). In this situation there is not a workably competitive market process to derive a farmgate milk price and it is determined by Fonterra using an administrative methodology (i.e. the Manual and the base milk price calculation model).

[14] The actual proportion of the farmgate milk price to the total combined milk price is difficult to estimate as each of the milk price components (particularly the retail milk price) varies among retailers.

Fonterra's approach to calculating its farmgate milk price

58. Since its formation and until 2009, Fonterra's payment to dairy farmers for their raw milk was bundled together with the returns to dairy farmers for their shareholding in Fonterra. During that time, Fonterra's farmgate milk price was calculated only for the purposes of estimating Fonterra's long-run earnings for share valuation purposes.

59. Shareholding dairy farmers have had two separate but related interests in Fonterra and have been recompensed through two revenue streams: payment for the raw milk they supplied and the dividend payments for the share capital they held in the cooperative.[15] As a result, it is the total return on raw milk and share capital invested in the cooperative that supplier-shareholders have tended to be interested in, rather than its individual components.

60. In 2009, Fonterra unbundled its total return to farmers into a farmgate milk price paid for raw milk and returns on share capital. With the unbundling came the need to set the farmgate milk price independently of Fonterra's share valuation processes.

61. In 2010, Fonterra shareholders voted to change Fonterra's capital structure to implement TAF. TAF replaces the Fonterra share purchase and sale process, where the Shares were issued and redeemed by Fonterra. TAF was endorsed by Fonterra shareholders in June 2012. Live trading of Shares commenced on 30 November 2012.

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[15] To supply raw milk to Fonterra, dairy farmers are required to hold one share for every kilogram of milk solids they wish to supply the cooperative. We understand that an average Fonterra supplier holds approximately half a million dollars in Fonterra shares at the current share valuation. There are a small number of dairy farmers who supply Fonterra with raw milk on a contract supply basis and do not hold shares.

62. As explained by Fonterra, there are two components to TAF:[16]

> Fonterra Shareholders' Market. This is a private market on which Farmer Shareholders can now buy and sell Shares among themselves, not with Fonterra. It is a private market because only Farmer Shareholders, Fonterra, and a specially appointed market maker will be allowed to trade Shares.
>
> The Fonterra Shareholders' Fund. The Fund is intended to:
>
> − supplement liquidity in the Fonterra Shareholders' Market through a liquid market for Units which can effectively be "exchanged" for Fonterra Shares (by Farmer Shareholders, Fonterra and the market maker) and vice versa;
>
> − provide additional financial flexibility for Farmer Shareholders, who will have the opportunity to sell Economic Rights of Shares to the Fund; and
>
> − permit a broader range of investors to buy a security (a Unit in the Fonterra Shareholders' Fund) that essentially passes through the Economic Rights.
>
> Although the markets are separate, they have been designed to work together. Farmer Shareholders, Fonterra and the RVP[17] can buy or sell Shares in the Fonterra Shareholders' Market, and buy or sell Units on the NZX Main Board or ASX (Australian Stock Exchange). They can effectively exchange Shares for Units and vice versa and therefore can shift between the two markets. Other investors will not be able to transact in the Fonterra Shareholders' Market and exchange Units for Shares.
>
> The Economic Rights of a Share are the rights to receive dividends and other economic benefits derived from a Share, as well as other rights derived from owning a Share. However, these rights do not include the right to hold legal title to the Share (i.e. to become registered as the holder of the Share), or to exercise voting rights, except in very limited circumstances.

63. Under TAF, the economic interests of external (non-farmer) investors will be to maximise the share price and the return on share capital invested in Fonterra, rather than the return on raw milk.

64. The Fonterra Board sets the farmgate milk price for each dairy season. The Board is advised by a Milk Price Panel, whose role is to oversee the governance of Fonterra's Manual. The Milk Price Panel has five members, with the majority and the chair of the panel being independent of farmer interests. All panel members are appointed by the Fonterra Board and ratified by Fonterra Farmer Shareholders.

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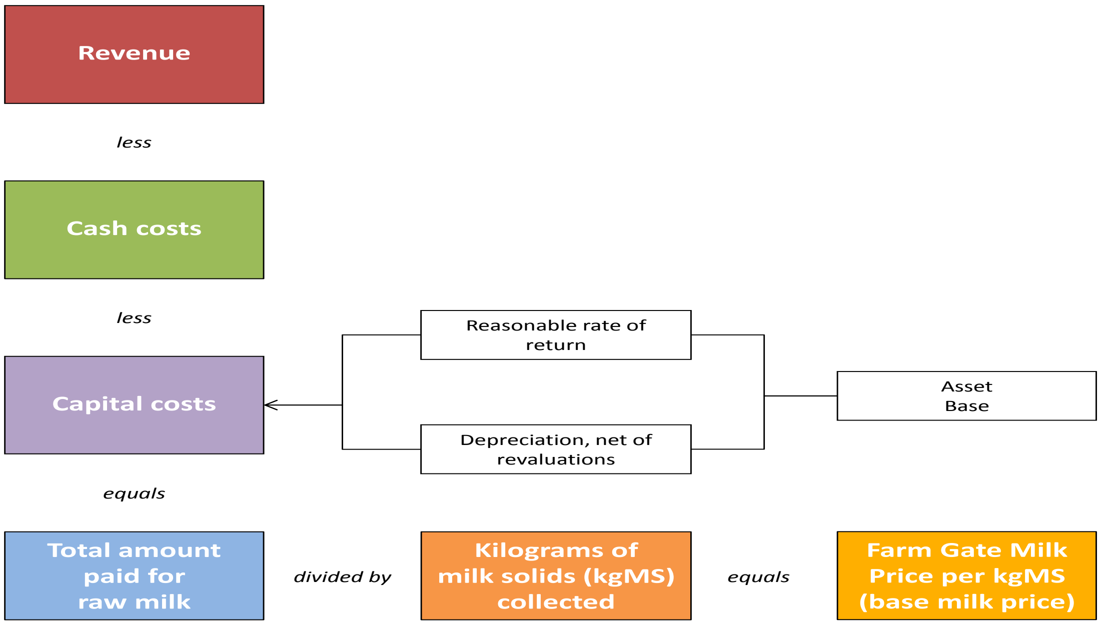
[16] Source: http://www.fonterra.com/global/en/Financial/Trading+Among+Farmers

[17] There is a market maker (known as the Registered Volume Provider or RVP) who is continuously active in offering to buy and sell Shares on the Fonterra Shareholders' Market during the periods of operation of the Fonterra Shareholders' Market (other than in the case of a temporary halt in, or suspension of, trading in Shares). This is intended to assist the liquidity of trading on the Fonterra Shareholders' Market to make it easier for Farmer Shareholders to buy or sell Shares on that market.

Fonterra's methodology for setting its farmgate milk price

65. Fonterra's methodology for calculating its farmgate milk price is guided by a set of principles set out in Fonterra's constitution and outlined in Fonterra's Manual. Figure 4.2 provides a simplified visual representation of Fonterra's methodology.

Figure 4.2: Fonterra's Farmgate Milk Price methodology



66. Fonterra calculates the farmgate milk price from the total pool of money available for payment to farmers for their raw milk supply to Fonterra in a season, which is determined by:

66.1. the **revenue** Fonterra would earn in NZ dollars if the equivalent of all the raw milk supplied to Fonterra in New Zealand was converted into the RCP product mix, and sold on international dairy markets; less

66.2. the **'cash' costs** (or operating costs) of collecting raw milk from farms, processing it into the RCP product mix and transporting this product to the point of export from New Zealand, plus the costs of selling the finished product, administration/overhead and tax expenses; less

66.3. the **capital costs**, which provide for depreciation of fixed assets, return on and of capital investment, and working capital.

67. The farmgate milk price is expressed in terms of dollars per kilograms of milk solids (kgMS) supplied to Fonterra. The actual payments to individual farmers for their milk are adjusted for the composition of the milk supplied (in terms of the fat and protein components) and the timing of supply (e.g. milk supplied during the winter period attracts certain premiums).

68. Although Fonterra makes a number of payments to farmers for raw milk during the dairy season (based on its forecast farmgate milk price), its current policy is to confirm the final farmgate milk price for the after the end of that season. The dairy season runs from 1 June to 31 May. Fonterra's final farmgate milk price is typically set in September after the end of the relevant season. This results in end of year 'wash-up' payments to farmers.

69. Any changes to the Manual take effect in the financial year after the year in which the changes are made (Fonterra's financial year is from 1 August to 31 July). Figure 4.3 shows a timeline of Fonterra's decisions in each dairy season and how it fits with our statutory review processes.

Figure 4.3: Timeline for Fonterra's FGMP setting processes and statutory review process