



Dairy for life

Submission to the Commerce Commission  
on its Draft Report on Fonterra's 2016/17  
Farmgate Milk Price Manual

15 November 2016

Public Version

## Glossary

<b>F16 Final Manual Report</b>	Commerce Commission, Review of Fonterra's 2015/16 Milk Price Manual, Final Report, 15 December 2015, <a href="http://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/">http://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/</a>
<b>F16 Base Milk Price Report</b>	Commerce Commission, Review of Fonterra's 2015/16 base milk price calculation, Final Report, 15 September 2016, <a href="http://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-201516-season/">http://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-201516-season/</a>
<b>F17 Draft Manual Report</b>	Commerce Commission, Review of Fonterra's 2016/17 Milk Price Manual, Draft Report, 14 October 2016, <a href="http://comcom.govt.nz/regulated-industries/dairy-industry/review-of-fonterra-s-farm-gate-milk-price-and-manual/statutory-review-of-milk-price-manual/201617-season/">http://comcom.govt.nz/regulated-industries/dairy-industry/review-of-fonterra-s-farm-gate-milk-price-and-manual/statutory-review-of-milk-price-manual/201617-season/</a>
<b>F16 Reasons Paper</b>	'Reasons' Paper in support of Fonterra's 2015/16 Milk Price Manual, 1 August 2015, <a href="http://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/">http://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/</a>
<b>DIRA</b>	Dairy Industry Restructuring Act 2001.
<b>NMPB</b>	Notional Milk Price Business, comprising the notional milk powder manufacturing business implied by Fonterra's Farmgate Milk Price Manual.
<b>R&amp;M</b>	Repairs and maintenance.
<b>RCP</b>	Reference commodity product, comprising WMP, SMP, BMP, Butter and AMF.
<b>Season</b>	The period commencing on 1 June 2016 and ending on 31 May 2017.

# 1 Introduction

This paper sets out Fonterra's submissions on the Commerce Commission's draft report, dated 15 October 2016, on Fonterra's Milk Price Manual (the Manual) for the 2016/17 Season, prepared in accordance with section 150I of the Dairy Industry Restructuring Act 2001 (DIRA). This submission is intended to satisfy Fonterra's obligations under section 150M(2) of DIRA. The submission has been prepared under the oversight of the Milk Price Panel, and where relevant reflects the Panel's views.

We note the Commission's overall draft conclusion is that the Manual is largely consistent with the section 150A purpose statement.

The submission is organised as follows:

- In section 2, we comment on the matters identified by the Commission as its key areas of focus for the current review. Our substantive comments in this section relate to the Commission's comments on the inclusion of off-GDT sales, the 'consistency over time' provision, and foreign exchange conversion rates.
- In section 3, we comment on the matters identified by the Commission as being non-substantive focus areas. Our comments in this section relate to the Commission's comments on winter milk premiums and on the approach used to establish lactose costs.

## 2 The Commission's key focus areas

The Commission explains that its key focus areas for the current review relate to:

- The inclusion of off-GDT sales to inform prices used for WMP, SMP and BMP
- The 'consistency over time' provision
- The capacity of plants for the manufacture of secondary reference products
- Repairs and maintenance costs, and
- Foreign exchange conversion rates.

We have only brief comments on the following matters:

- The capacity of plants for the manufacture of AMF, Butter and BMP (secondary RCPs), which the Commission recommends we consider disclosing in the Manual. The purpose of the Manual is to set out the principles and methodology to be applied in calculating the Farmgate Milk Price, rather than (in general) to set out the results of the application of those methodologies. For the latter purpose, our primary vehicles are the Farmgate Milk Price Statement and our annual 'reasons paper' in support of each year's base milk price. It is therefore not necessary to amend the Manual to disclose this information. As the Commission notes we set out the capacities of all standard reference plants in our reasons paper in support of the 2015/16 base milk price. We advise that we have maintained the same plant capacities for plants deemed to be installed in the period spanning the 2017 – 2020 seasons.<sup>1</sup>
- The treatment of repairs and maintenance costs, where the Commission proposes that a definition of 'maintenance department labour costs' be included in the Manual. We will consider including an appropriate definition in the Manual for the 2017/18 season.

### Off-GDT sales

The Commission notes that it concluded in its 2015/16 base milk price review that its "analysis suggests that using prices on the GDT as the sole basis for RCP reference prices for WMP, SMP and AMF may no longer be appropriate ..." <sup>2</sup> and that it "considers Fonterra needs to:

- Outline explicit criteria for determining the sales that inform the milk price calculation;
- Ensure historical data from GDT auctions is freely accessible; and
- Provide detail on how inclusion of off-GDT sales affects other assumptions." <sup>3</sup>

The relevant criteria used to select sales for inclusion in the Milk Price revenue calculation (including off-GDT sales) are already set out in the relevant definitions in Part C of the Manual, and we therefore do not propose further amending the Manual to provide additional detail on these criteria. The relevant definitions in Part C comprise the definitions of:

- **Qualifying Material**, which provides that the only products that can be taken into account are "relatively undifferentiated commodity product[s] that ... could be expected to transact at a comparable price" to similar commodity products.
- **Qualifying Reference Sale**, which provides that only sales of Qualifying Materials that are on arm's length terms and at a currently prevailing price can be taken into account.
- **Benchmark Selling Price**, which provides that only sales of Qualifying Materials contracted for sale between 1 and 5 months prior to the month of shipment will be used.

<sup>1</sup> Approximately 2.4 million litres per day for WMP and SMP plants, 500 million litres per day for AMF and butter plants, and 800 million litres per day for BMP plants.

<sup>2</sup> F16 Base Milk Price Report, paragraph 4.13, page 16.

<sup>3</sup> F17 Draft Manual Report, paragraph 32, page 11.

We understand users will appreciate guidance on the interpretation of these definitions, along the lines set out in Table 4.2 of the Commission's Draft Manual Report, and undertake to provide appropriate guidance (including explicit notice of any relevant change in interpretation) in our annual reasons paper in support of the base milk price.

We also advise that:

- We expect to publish periodic updates on both off-GDT margins and historic GDT prices, but that we are still considering the format, precise content and timing of this information.
- We will provide in our reasons paper in respect of the 2016/17 base milk price details of adjustments to other assumptions, including sales costs, which result from the inclusion of additional off-GDT sales.

### Consistency over time provision

In its comments on the 'consistency over time' provision in Part A of the Manual, the Commission notes its concerns that the Manual does not:

- Include a definition of 'material change', or
- Provide an absolute assurance around the timing of material changes.

As the Commission explains, our omission of a materiality threshold is intentional, and is intended to enable additional discretion to disclose less substantive changes in the calculation methodology while avoiding imposing an unduly onerous process around determining whether relatively insignificant items should or should not be disclosed. We confirm, however, that we would always disclose in the Farmgate Milk Price Statement changes in calculation methodology with an anticipated impact on the then current year base milk price in excess of the materiality threshold applied for external audit purposes.

On timing:

- All changes to the methodology that require a change to the Manual are made prior to the start of the relevant financial year, and are publicly disclosed in our 1 August reasons paper to the Commission and through publication of the updated Manual on Fonterra's website.
- More material changes to the calculation methodology that do not require an amendment to the Manual will typically be made prior to publication of the Farmgate Milk Price Statement for the prior season, in which case we will disclose the anticipated impact in the prior season's Statement. We cannot, however, undertake that this will always occur, in which case disclosure will normally first be made in the 1 July reasons paper in support of the current season's base milk price, and subsequently in the Farmgate Milk Price Statement.

### Foreign exchange conversion

The Commission notes that the use in the base milk price calculation of Fonterra's actual average foreign exchange conversion rates is a safe harbour assumption under s 150B of DIRA, and that it is therefore not required to conclude on the consistency of this approach with s 150A. The Commission nonetheless suggests that Fonterra disclose its average conversion rates "at various stages of the season" so to "better enable interested parties to evaluate the estimated revenues which inform the milk price."

We accept that differences between Fonterra's average conversion rates and the corresponding spot rates are material to the base milk price calculation, and that external parties are better placed to forecast Fonterra's milk price if they have access to information on Fonterra's hedging position. We note that:

- We already provide forward-looking information in the Milk Price Statement. As at finalisation of the Statement in mid-September Fonterra typically has foreign exchange cover in place in respect of around 60 to 70 percent of its forecast annual exposure for the then current season. Our analysis suggests that using just the forecast information currently provided in the Milk Price Statement, external parties would have been

able to derive estimates of the annual average FX conversion rates for each of the past three seasons that were within a range of +/- 1 cent of the actual final rates.

- We will further consider the practicality and commercial sensitivity to Fonterra of providing additional information on foreign exchange conversion rates in the course of a season.

### 3 Non-substantive focus areas

The Commission raises three matters as “focus areas that are likely to be less material to the milk price calculation.” We have only brief comments on two of these matters, comprising the Commission’s comments on:

- The distinction between the average milk price per kgMS calculated under the Manual and the average price paid for milk supplied on standard terms, where the Commission has proposed that we separately disclose both the average milk price calculated under the Manual and the corresponding average price for milk supplied on standard terms when providing routine updates on the forecast milk price. The difference between these amounts has not exceeded 0.8 cents per kgMS in any of the past four seasons, and would therefore not be considered material by interested parties in the context of announcements of the forecast milk price within a season. We will however further consider how to improve our disclosure around the difference between these amounts in the Farmgate Milk Price Statement for the 2016/17 Season.
- Financing and administration costs associated with farmer support payments. We advise that we have not changed our position as previously advised, and do not propose including these costs either in the Manual or in the calculation of the milk price.

#### Lactose

The Commission has concluded that our treatment of lactose costs, under which the lower of the weighted average prices reported by Fonterra and other NZ processors (in aggregate) to NZ Customs are used in the base milk price calculation, is not practically feasible. The Commission has proposed we address this matter by amending the Manual to provide that sole reliance will be placed on prices declared by other NZ processors.

We acknowledge the Commission’s conclusion, and advise that a detailed investigation of alternative approaches to determining an appropriate lactose price is included in the work programme relating to milk price matters for the current financial year.<sup>4</sup> [Redacted]

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<sup>4</sup> We will consider the Commission’s proposal that we rely solely on prices declared to NZ Customs by other NZ processors in the course of this exercise. [Redacted]