

Review of Fonterra's 2016/17 Milk Price Manual:

Dairy Industry Restructuring Act 2001

Draft report

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Associated documents

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15 September 2016	ISBN 978-1-869455-28-6	Our approach to reviewing Fonterra's Milk Price Manual and base milk price calculation
15 October 2015	ISBN 2382-1779	Review of Fonterra's 2015/16 Milk Price Manual: Final report

Commerce Commission

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Executive summary

What this report covers

- X1 This draft report sets out our conclusions on our review of Fonterra's 2016/17 Milk Price Manual (the Manual). The Manual contains the methodology used to calculate Fonterra's base milk price each season.
- X2 We invite submissions on this draft report from interested parties, which will help inform our final report.¹
- X2.1 Submissions are due by **5pm, 15 November 2016**.²

About this review

- X3 Our review of the Manual is required as part of the milk price monitoring regime (monitoring regime), outlined in subpart 5A of the Dairy Industry Restructuring Act 2001 (the Act). More details of the intent of the regime can be found in our supporting paper.³
- X4 Our review considers the 'efficiency' and 'contestability' dimensions.⁴ We focus on whether the Manual and the calculation provide:
- X4.1 an incentive for Fonterra to operate efficiently (the 'efficiency dimension'); and
- X4.2 for contestability in the market for the purchase of raw milk from farmers (the 'contestability dimension').
- X5 To satisfy the provisions in s 150A, we consider that our statutory reviews must assess both dimensions.⁵

¹ Our final report will be published on 15 December 2016.

² More detail on how you can provide your views can be found in paragraphs 10-17.

³ Commerce Commission "Our approach to reviewing Fonterra's Milk Price Manual and base milk price calculation" (15 September 2016). Our report is supported by this separate paper that provides an overview of the approach we have taken in reviewing the Manual for the 2016/17 dairy season. The supporting paper outlines how we conduct our annual reviews of Fonterra's Milk Price Manual and each season's base milk price calculation. It includes our interpretation of key legislative provisions, our practical approach to the statutory reviews, an overview of how Fonterra sets its base milk price, assumptions of the notional producer, and internal and external controls surrounding the integrity of the milk price calculation.

⁴ These two interlinked dimensions form the s 150A purpose under subpart 5A of the Act.

⁵ We attach equal weight to both dimensions in our assessment.

- X6 We have focused our review on:
- X6.1 Fonterra's amendments to the Manual;
 - X6.2 issues arising from our 2015/16 base milk price calculation review;⁶
 - X6.3 issues arising from comments on our process email; and
 - X6.4 outstanding issues from previous Manual reviews.
- X7 In our report, we have grouped issues by common themes, with a focus on issues most likely to be material to the 2016/17 base milk price calculation.
- X8 We have relied on our previous conclusions for those parts of the Manual which have remained unchanged unless there was substantive information causing us to reconsider previous conclusions.

Our conclusions

- X9 We conclude that this season's Manual is largely consistent with the statutory purpose set out in s 150A of the Act.⁷
- X10 However, to enable us to conclude on the consistency of all aspects of the current Manual and to promote greater transparency we recommend Fonterra makes the amendments and disclosures outlined in Table X1.

⁶ Commerce Commission "Final Report Base Milk Price Calculation Review 2015/16" (15 September 2016).

⁷ We are required by s 150I to make a report on the extent to which the Manual is consistent with the statutory purpose set out in s 150A.

Table X1 Summary of our recommendations to Fonterra

Category	Recommendation to Fonterra
Inclusion of off-GlobalDairyTrade (GDT) sales	Explicit criteria for determining which sales inform the milk price calculation.
	Ensuring historical data of prior GDT auctions is freely accessible to provide greater visibility of revenues assumed by the notional producer. ⁸
	Outlining how the assumptions associated with the calculation are or are not affected by the inclusion of off-GDT sales.
Average FX conversion rate	An average FX rate achieved should be disclosed throughout the season. Currently there is no disclosure of the average FX rate assumed to be achieved by the notional producer until the end of each season. Timely disclosure would let interested parties update their estimates of the revenues achieved by the notional producer across the season.
Consistency over time provision	The methodology for determining a 'material change' is needed to provide clarity with this provision.
Capacity of secondary plants	Fonterra should disclose its plant capacity for both primary and secondary plants.
Repairs and maintenance	A definition of 'maintenance department labour costs' is needed to provide greater clarity.
Farmer support	The costs associated with providing farmer support to ensure continued supply should be included in the calculation.
Lactose costs	The method outlined in the Manual for calculating lactose costs needs to remove the ability to pick pricing retrospectively.
Winter milk and other allocation costs	We understand the Manual does not consider allocation costs in its calculation of the base milk price. However, we consider disclosing the milk price on standard terms in periodic reviews would promote greater transparency.

X11 Our conclusions on these components are set out in Chapter 4.

⁸ Fonterra have noted that GDT sales will continue to be used as the predominant source of pricing information for the calculation. Fonterra "Market Announcement: Fonterra Advises Changes to Farmgate Milk Price Manual" (1 August 2016), p.2.

Chapter 1 Introduction

What this report covers

1. This report sets out our review of the extent to which Fonterra's 2016/17 Manual is consistent with the purpose of the monitoring regime, which is set out in s 150A of the Act.

We are fulfilling our statutory requirements

2. We are required to review the Manual for each dairy season and make a report on the extent to which the Manual is consistent with the purpose statement set out in the Act.⁹
3. The Act requires Fonterra to provide us with the following information for consideration in our review:
 - 3.1 Fonterra's Manual for the current season;
 - 3.2 Any recommendations by the Milk Price Panel in relation to the setting of the base milk price;
 - 3.3 Notification of any change in the economic and business environment, that, in Fonterra's view, requires a change to the Manual;
 - 3.4 Certification on the extent to which Fonterra considers that the Manual is consistent with the purpose of s 150A; and
 - 3.5 Reasoning behind the views expressed in Fonterra's certification.
4. The above information has been provided by Fonterra in the Reasons Paper in support of Fonterra's Manual for the 2016/17 season and this is available on our website.¹⁰
5. We suggest reading this draft report with our supporting paper.¹¹

How this report is structured

6. Chapter 2 covers the scope of our review.

⁹ As required under s 150H and s 150J of the Act.

¹⁰ Fonterra "Fonterra's Reasons Paper in support of Milk Price Manual for the 2016/17 season" (2016). Available at <comcom.govt.nz/statutory-review-of-milk-price-manual/201617-season/>.

¹¹ Commerce Commission "Our approach to reviewing Fonterra's Milk Price Manual and base milk price calculation" (15 September 2016).

7. Our conclusions are set out in Chapter 3 and are supported by the summary tables in Attachment A. We have focused our commentary in Chapter 3 on those issues which are likely to have a material impact on the milk price calculation.
8. Our high level conclusions on minor amendments that are of a technical or drafting nature are set out in Attachment A. Where appropriate, brief commentary is provided about those amendments.
9. A glossary of key terms is provided in Attachment B.

How interested parties can provide their views

10. As required by the Act, we consult with Fonterra on our draft conclusions. We also invite other interested parties to comment.¹²
11. We welcome views on any aspects of this draft report or any additional issues that you think should be considered before finalising our conclusions. Your views on our draft report will help inform our final conclusions for our 2016/17 Manual review.

Deadline for submissions

12. To allow us time to consider your views, submissions must be provided to us by no later than **5pm, Tuesday 15 November 2016**. We will consider submissions and publish our final report by **Thursday 15 December 2016**.

Format of submissions

13. Submissions must be provided electronically in a format suitable for word processing and publication on our website.
14. You should address your response to:

Freyja Phillips, Project Manager Milk Price Manual Review

regulation.branch@comcom.govt.nz
15. We intend to publish all submissions on our website. If you would like the published electronic copy to be 'locked', we ask that you provide multiple versions of your comments. At least one version should be provided in a file format suitable for word processing, rather than a locked PDF file format.

¹² We consult with Fonterra under s 150U of the Act.

Requests for confidentiality

16. We encourage full disclosure of submissions so that all information can be tested in an open manner. However, we offer the following guidance where you wish to provide any information in confidence:
 - 16.1 If you include confidential material in your submission, both confidential and public versions of the submission should be provided; and
 - 16.2 The responsibility for ensuring that confidential information is not included in the public version of your submission rests entirely with you when you make your submission.
17. You can also request a confidentiality order under s 100 of the Commerce Act. We will provide further information on s 100 orders on request.

Chapter 2 Scope of this report

18. The scope of this review was signalled in our email sent to stakeholders outlining our 2016/17 review process. This is aligned with the requirements of the Act.¹³
19. As signalled in our process email, we have focused our review on:
 - 19.1 Fonterra's amendments to the Manual;
 - 19.2 issues arising from our 2015/16 calculation review (including submissions);
 - 19.3 issues arising from comments on our process email; and
 - 19.4 outstanding issues from previous Manual reviews.
20. Unless significant new information has caused us to reconsider, we have relied on previous conclusions for those unchanged areas of the Manual.
21. In this report we have grouped issues in the following order:
 - 21.1 The key areas of focus which are areas of the Manual that are more likely to have a material impact on the base milk price calculation;
 - 21.2 Non-substantive focus areas which are likely to be less material to the calculation of the base milk price; and
 - 21.3 Minor amendments to the Manual of a technical or drafting nature (summarised in Attachment A).

¹³ Our email was sent to our stakeholders on 25 August 2016.

Chapter 3 Conclusions

23. This chapter summarises our conclusions on the extent to which the 2016/17 Manual is consistent with the s 150A purpose.

Our conclusions

24. Our overall conclusion is that the 2016/17 Manual is largely consistent with the s 150A purpose.
25. However, we are unable to conclude on the consistency of the following aspects with the s 150A purpose:
- 25.1 The amendment to include off-GDT prices for the sales of whole milk powder (WMP), skim milk powder (SMP) and butter milk powder (BMP);
 - 25.2 The omission of the cost incurred in providing farmer support; and
 - 25.3 The methodology for calculating lactose costs.

Conclusions on key areas of focus

Including off-GDT prices for the sales of WMP, SMP and BMP

26. As outlined in our calculation review, we consider that the amendments to include off-GDT prices for the sales of WMP, SMP and BMP may in principle provide a more accurate basis for determining reference prices.
27. Further quantitative analysis of the off-GDT revenue and the associated selling costs that inform the milk price calculation is required in order to conclude on this amendment. We propose to complete this quantitative analysis in our 2016/17 calculation review.

Conclusions on non-substantive focus areas

Consideration of costs incurred in providing farmer support

28. We consider that the costs associated with providing farmer support to ensure continued supply should be included in the milk price calculation in order to be consistent with the contestability dimension.

Methodology for calculating lactose costs

29. We consider that the current method in the Manual for calculating lactose costs is not consistent with the contestability dimension. To remove the current ability to pick pricing retrospectively, we suggest removing Fonterra's price as a reference.

Treatment of winter milk premium and allocation costs

30. We conclude that adjustments made by Fonterra based on allocations of the milk price to its suppliers would be incurred by the notional producer in order for it to achieve its assumed levels of productivity (eg, winter milk premiums and other allocation costs).¹⁴
31. We consider disclosing the milk price on standard terms in periodic reviews of the farmgate milk price would promote greater transparency of Fonterra's base milk price setting process for interested parties.

Our recommendations to Fonterra

32. Due to the amendment to include off-GDT sales for WMP, SMP and BMP, we consider that Fonterra needs to:
 - 32.1 Outline explicit criteria for determining the sales that inform the milk price calculation;
 - 32.2 Ensure historical data from GDT auctions is freely accessible;
 - 32.3 Provide detail on how inclusion of off-GDT sales affects other assumptions; and
 - 32.4 Provide an average FX conversion rate assumed to be achieved by the notional producer.
33. This will enable interested parties to evaluate the estimated revenues of the notional producer.
34. We also recommend that Fonterra discloses:
 - 34.1 its methodology for determining a "material change" in applying its consistency over time provision;
 - 34.2 its plant capacity for both primary and secondary plants;¹⁵ and
 - 34.3 the milk price on standard terms (post the milk price adjustments) in periodic reviews of the farmgate milk price.

¹⁴ Adjustments include winter milk premiums, contract milk, discounts, demerits, volume charge net underpayment and presence of dichlorodiphenyl dichloroethene (a chemical which affects milk quality).

¹⁵ Primary plants are for the primary RCPs - WMP and SMP. Secondary plants are for the secondary or by-products of the primary RCPs, BMP, butter and AMF.

Next steps

35. Based on Fonterra's Manual amendments and the conclusions of this review, we plan to assess Fonterra's application of non-GDT prices and the associated non-GDT selling costs for WMP, SMP and BMP in our 2016/17 base milk price calculation review.
36. We have begun the process of resolving the asset beta issue for the 2016/17 calculation review. As outlined in our 2015/16 calculation review, we consider more information is necessary to allow us to conclude on the asset beta.¹⁶
37. In our 2015/16 base milk price calculation review, we were unable to conclude on the practical feasibility of the asset beta and the resulting WACC component in Fonterra's setting of the base milk price.
38. Given the high level of interest from the independent processors, we are looking for further quantitative information from them to assist as well. We intend to update interested parties on the process we intend to follow for the 2016/17 milk price calculation review shortly, including how we propose to resolve the asset beta issue.

¹⁶ We wish to conclude on whether the notional producer (or any other New Zealand commodity milk processor) has been able to shift systematic risk exposure. That is a shift onto its suppliers in a way that would justify the indicated downward adjustment in the asset beta from the mid-point estimate of the comparator sample in Fonterra's independent expert's report. See Commerce Commission "Final Report Base Milk Price Calculation Review 2015/16" (15 September 2016), para 4.56.

Chapter 4 Key areas of focus

39. This chapter outlines our comments and conclusions on the key areas of focus. The following amendments or issues are likely to be material to the milk price calculation:

- 39.1 Inclusion of off-GDT sales to inform WMP, SMP and BMP prices;
- 39.2 Consistency over time provision;
- 39.3 Capacity of secondary reference commodity products (RCPs);
- 39.4 Determination of repairs and maintenance costs; and
- 39.5 Foreign exchange (FX) conversion rates.

Inclusion of off-GDT sales to inform WMP, SMP and BMP prices

40. The provisions in the Manual relating to off-GDT sales for WMP, SMP and BMP and other related amendments are summarised in Table 4.1.

Table 4.1: Amendments to the Manual due to the inclusion of non-GDT sales

Manual reference	Issue category	Description of issue	Fonterra reasons
Part C, Page 62	New for 2016/17 Manual Review	Including sales undertaken off the GDT platform of similar specification product and sold on similar terms to GDT sales.	Previous approaches are not consistent with the milk price principles.
Part A, Section 4.3	New for 2016/17 Manual Review	Change in overview section of the Manual to align with Part C amendment to revenue.	Amendments of this sentence are consequential on the revision to the definition of Qualifying Reference Sales in Part C.
Part B, Rule 8	New for 2016/17 Manual Review	Qualifying reference sales amended to "sales" that satisfy conditions set out in items 2 and 3 of the definition of Qualifying Reference Sales.	Technical amendment only - required as item 1 in the amended definition of Qualifying Reference Sales in Part C refers to the use of GDT-only prices for WMP, SMP and AMF.
Part B, Rule 17	New for 2016/17 Manual Review	Aligning this to the amendments to selling channels.	Previous drafting was not necessarily consistent with the mix of sales channels implied by Rules 5 and 8.

41. As outlined in our 2015/16 calculation review, we concluded that using GlobalDairyTrade (GDT) as the predominant source of prices to calculate revenues might not be the most accurate basis for determining reference prices for Reference Commodity Products (RCPs).¹⁷
42. Fonterra announced that the expected net impact on the 2016/17 milk price from this amendment would be an increase of between 4 to 5 cents per kilogram of milk solids (KgMS). We acknowledge the material impact of Fonterra's decision on the industry.
43. Moving away from using prices determined on GDT means less visibility as to the revenues assumed to be earned by the notional producer. The amendments in the Manual do not provide clarity about which off-GDT sales will inform the milk price calculation.
44. Interested parties have expressed concerns that the change gives Fonterra significant discretion and potentially allows manipulation of the milk price to Fonterra's advantage. Open Country and Miraka both consider that the GDT is the most representative and transparent source of the benchmark price for commodity products.¹⁸
45. We agree with independent processors on the importance of transparency for the sales included in setting the reference prices. This would improve confidence that the milk price is not influenced by information that is not freely available.¹⁹
46. Fonterra has confirmed the following:
 - 46.1 product specifications of off-GDT qualifying sales do not vary materially from GDT specifications;
 - 46.2 using off-GDT sales enables greater flexibility on shipping timetables and allows larger customers to make substantial orders without impacting on the GDT auction prices; and


¹⁷ Commerce Commission "Final Report Review of Fonterra's 2015/16 Base Milk Price Calculation" (15 September 2016), X23. In completing our aggregate assessment we noted that in reality, Fonterra sells less than half of its products on-GDT, table 4.1.

¹⁸ Open Country Dairy "Submission on the Commerce Commission's Process and Fonterra's 2016/17 Milk Price Manual" (September 2016), p.3. Miraka "Submission to the Commerce Commission: Review of the 2016/17 Farmgate Milk Price Manual" (8 September 2016) para 4.2.

¹⁹ Independent processors share our concern here. Open Country Dairy "Submission on the Commerce Commission's Process and Fonterra's 2016/17 Milk Price Manual" (September 2016), page 3. Synlait "Submission on Fonterra's milk price manual for the 2016/17 season" (8 September 2016), para 14(b).

- 46.3 off-GDT sales will include sales to additional countries over those covered by the GDT.
47. We recommend Fonterra explicitly states in the Manual the criteria for off-GDT sales that will be included to inform the RCP prices in the calculation. In the meantime, Fonterra has provided the information in Table 4.2 which outlines the decision criteria used in determining what off-GDT sales are included in the calculation.

Table 4.2: Criteria for determining off-GDT sales to inform milk price²⁰



Decision criteria

Milk Price Revenue Informing Inclusions	Milk Price Revenue Informing Inclusions
Criteria to determine if particular categories of off-GDT sales are sales of "commodity products"	Criteria to determine if particular categories of off-GDT sales are sales in "freely contested global markets"
RCP's (WMP, SMP, Butter, BMP, AMF)	FAS equivalent GDT Sales and Non GDT sales
Standard material requiring no additional specialised plant or technical resources	C1 – C5 contract tenor
Standard product offering	Spot pricing mechanism in contract
Standard packaging	
Cascadable to general trade materials	

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48. We consider the historical data of auction results should be freely accessible given the GDT platform will continue to be used as the benchmark source of prices, and would seem to have a greater role as a measure of the practicality of the off-GDT prices.²¹

²⁰ Information request by the Commerce Commission to Fonterra. Fonterra "Off GDT Spot Sales Revenue to Milk Price" (23 September 2016) p.1.

²¹ Previously historical data of the GDT auctions was freely accessible. It is now only available by subscribing at a cost of \$240USD per month.

49. We are proposing to complete a quantitative analysis of revenues received on GDT and off-GDT in our 2016/17 calculation review to test the practical feasibility of the prices achieved from RCP's as a result of these amendments. We welcome information relating to RCP prices received by independent processors to assist us with our review.²²

Selling costs

50. Rule 17 has been amended to align it with the selling channel amendments.²³ The Manual assumes that the notional producer participates as a third party seller on the GDT.²⁴
51. This participation should only be restricted to the assumed volumes on GDT; any discounts should not be available for the percentage of sales assumed to be sold off-GDT. We consider this rule should be more specific in outlining that the notional costs should only include products assumed to be sold on the GDT.
52. In our 2016/17 milk price calculation review we will assess the adequacy of costs associated with including off-GDT sales. This additional analysis is required for us to conclude on whether the assumed off-GDT selling costs are practically feasible.

Consistency of other assumptions

53. The inclusion of off-GDT sales to inform WMP, SMP, BMP prices may result in inconsistencies of assumptions with the rest of the milk price calculation. For example, the yields assumption relies on one standard specification product for each RCP.²⁵
54. If the off-GDT sales included in the calculation are different from the standard specification product, then the loss and specification offsets in the yields may no longer hold. This may result in the volumes of RCPs not being practically feasible overall.

²² This might include, for example, the experience of independent processors of the relativity of their off-GDT prices achieved for GDT-specification commodity product relative to GDT prices. Fonterra has indicated that there seems to be a relatively constant relationship over time.

²³ Amendment to Part B, Rule 17 of Fonterra's 2016/17 Milk Price Manual.

²⁴ Fonterra "Fonterra's marked up version of 2016/17 Manual for the 2016/17 season" (1 August 2016), p.43.

²⁵ See definition of 'standard specification product' in Manual. Fonterra "Fonterra's marked up version of 2016/17 Manual for the 2016/17 season" (1 August 2016), p.59.

55. Fonterra has confirmed that the specifications of the off-GDT sales do not materially vary from GDT specifications and that the yield assumptions hold. We consider that Fonterra should look at how it can provide supporting publishable evidence on this.

Consistency over time

56. We agree with Fonterra that the Manual should evolve over time consistent with the methodology of a real world processor.²⁶ Our concerns are that the Manual does not supply:
- 56.1 what is considered a 'material change' when considering a change to the Manual; and
 - 56.2 the timeliness of making such a change.
57. Fonterra has advised that not setting a materiality measure is intentional. This enables additional discretion to disclose changes irrespective of whether there is a material impact on the calculation.
58. We support additional disclosure, but would like to see further thought given to the methodology behind determining what a 'material change' would be, in order to set a minimum level for disclosure of changes. Also, to be of value, a material change should be disclosed in a timely manner (eg, prior to the beginning of the season).
59. Miraka has concerns that a material amendment to the Manual, such as a change to the RCP mix, could be made in retrospect (ie, after the start of a season).²⁷ We agree that such a substantive change should be signalled prior to the season commencing and milk being processed. Fonterra has advised that an amendment to the RCP mix would always be made prior to the start of a season.

²⁶ This amendment is also supported by other interested parties. Synlait "Submission on Fonterra's milk price manual for the 2016/17 season" (8 September 2016), p.4.

²⁷ Miraka "Submission to the Commerce Commission: Review of the 2016/17 Farmgate Milk Price Manual" (8 September 2016), para 3.4.

Capacity of secondary RCPs

60. We had previously noted that the Manual did not state how capacities for secondary plants are determined.²⁸ Fonterra has amended rule 26 to outline how the capacity of standard plants of secondary products (ie. AMF, butter and BMP) is determined. Our concern is that this amendment still allows a significant level of discretion.²⁹
61. We recommend Fonterra considers disclosing its plant capacity for both primary and secondary plants in the Manual to provide certainty of the notional producer's assumed capacity for the related season. We consider this would improve the ability of interested parties to assess the practical feasibility of the assumed production volumes. We note that Fonterra has outlined the number and capacities of all of the notional producer's plants in its 2015/16 calculation reasons paper.³⁰

Determination of repairs and maintenance (R&M) costs

62. Although the amendment to R&M costs was made to provide a more specific provision, we are unsure this intent has been fulfilled. Fonterra has advised these costs are the R&M costs incurred by each individual site's engineering department. To be more specific, a definition of "maintenance department labour costs" is needed in the Manual.³¹
63. We note that there has been no change in the methodology of the calculation of R&M costs. Rather this amendment was intended to provide additional clarity.

FX conversion rates

64. We suggest more transparency of information on the actual FX rates assumed to be achieved by the notional producer.

²⁸ Commerce Commission "Final report: Review of Fonterra's 2015/16 Milk Price Manual" (15 December 2015), paragraph 106.

²⁹ This concern is also shared by Open Country Dairy. Open Country Dairy "Submission on the Commerce Commission's Process and Fonterra's 2016/17 Milk Price Manual" (September 2016), p4.

³⁰ Fonterra "Reasons paper in support of Fonterra's base price for the 2015/16 season (1 July 2016), Attachment 3: Milk price fixed assets - supplementary information.

³¹ Supported by Synlait. Synlait "Submission on Fonterra's milk price manual for the 2016/17 season" (8 September 2016), para 5.

65. We note that this is a safe harbour assumption under the Act and we are not required to conclude on the consistency with the efficiency and contestability dimensions.³² However, we consider the assumed rates would be valuable information for interested parties in assessing the milk price calculation.
66. We understand Fonterra has a complex hedging structure on which the safe harbour assumptions are based. We therefore suggest disclosure of the average FX conversion rates used at various stages of the season. This would better enable interested parties to evaluate the estimated revenues which inform the milk price.³³

³² Under s 150B gains and losses experienced by Fonterra resulting from foreign currency fluctuations, including from its foreign currency risk-management strategies may be incorporated in the base milk price without detracting from the s 150A purpose.

³³ As the GDT prices would be used as a benchmark for the calculation, the NZD revenues achieved could be estimated using the average conversion rates provided by Fonterra.

Chapter 5 Non-substantive focus areas

67. This chapter outlines our comments and conclusions on the following focus areas that are likely to be less material to the milk price calculation:

67.1 The treatment of winter milk premium and other milk price adjustments;

67.2 The consideration of farmer support; and

67.3 The methodology for calculating lactose costs.

68. Table 5.1 summarises our conclusions on these points.

Table 5.1 Summary of our conclusions on less material focus areas

Manual reference	Definition	Category	Description of issue	Fonterra reasoning	Commission comment
N/A	From 2015/16 milk price calculation review	Winter milk costs	The treatment of winter milk in the calculation.	Total aggregate amount available to pay for milk, not the allocation of that aggregate amount across individual suppliers of milk	We consider periodic reviews of the farmgate milk price (ie, the average milk price per the base milk price calculation) should also include the disclosure of the standard milk price, to provide greater quality of disclosure as intended by the Act.
Part B, Rule 19	From 2015/16 milk price calculation review	Farmer support	Financing and associated administration costs of providing farmer support loans and costs of providing other mechanisms of farmer support.	No comment made by Fonterra	We conclude that associated costs of providing supplier support to ensure continued supply to the notional producer to be consistent with the contestability dimension. ³⁴

³⁴ As outlined in Commerce Commission "Final Report Review of Fonterra's 2015/16 Base Milk Price Calculation" (15 September 2016), para 5.6.

Part B, Rule 16	Fonterra Manual Amendment	Lactose costs	Process for determining lactose costs now aligned with actual approach taken in calculation	Amended to align to actual approach (ie, lesser of Fonterra/average competitor import price)	The current approach in the Manual for determining lactose costs is not consistent with the contestability dimension.
					To remove the current ability to pick pricing retrospectively, we suggest removing Fonterra's price as a reference. Rather, it would be preferable to determine lactose costs by the volume of weighted average prices declared to New Zealand Customs by other processors. ³⁵

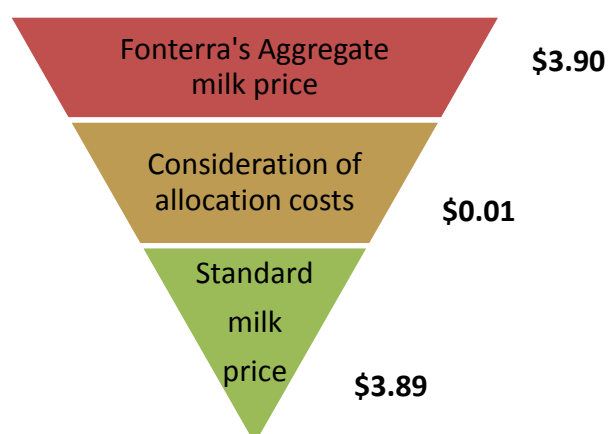
The treatment of winter milk and other adjustments

69. Fonterra currently calculates the base milk price as the aggregate amount available to be paid to suppliers prior to any allocation costs.³⁶ The milk price on standard terms accounts for these allocation costs and is disclosed annually in Fonterra's Farmgate Milk Price Statement.³⁷ Fonterra also discloses the difference between these milk prices, which was 1.1 cents per kgMS for the 2015/16 season. Figure 5.1 below outlines the difference using Fonterra's latest farmgate milk price statement.

³⁵ Notwithstanding the Manual, we note that this is also the pricing methodology used in practice over the last three seasons.

³⁶ Such costs include winter milk premiums, contract milk, discounts, demerits, volume charge net underpayment and presence of dichlorodiphenyl dichloroethene (a chemical which affects milk quality).

³⁷ We note Fonterra is required to disclose certain information including the forecast and actual figures for the season. This disclosure includes the estimated and actual additional cost of winter milk for each island.

Figure 5.1 Aggregate milk price to standard milk price

70. Interested parties have raised concerns that Fonterra's current approach to winter milk is not practically feasible.³⁸ We also consider these allocation costs would be incurred by the notional producer in order for it to achieve its assumed levels of productivity. However, Fonterra cites that if winter milk premiums (and other allocation costs) were to be included as a cost in the Manual, then the definition of the milk price would need to change to the milk price paid on standard terms.
71. Table 5.2 below outlines the process taken by Fonterra in determining typical allocation costs considered in individual supplier payments.

Table 5.2 Determining Farmer supplier payments

Your Farm's Performance		
Fonterra Farmgate Milk Price 2015/16 season		\$3.90
	\$ Paid	\$/kgMS
Standard Components		
Protein	XX	
Milkfat	XX	
Capacity Adjustment - Co-operative Average	XX	
Total Standard	XX	0.XX
Volume Adjustment	XX	0.XX
Capacity Adjustment - Variation from Co-operative Average	XX	0.XX
Total Adjustments	XX	0.XX
Winter Contract	XX	
Winter Premium	XX	
Total Premiums	XX	0.XX
Total Payments for 2015/16 Season	XX	X.XX

³⁸ Open Country Dairy "Submission on the Commerce Commission's Process and Fonterra's 2016/17 Milk Price Manual" (September 2016), p.5. Synlait "Submission on Fonterra's milk price manual for the 2016/17 season" (8 September 2016), para 26.

Requirements of the Act

72. The Act identifies the specific costs to be taken into account in setting the base milk price. These are the costs of collecting, processing and selling milk, including capital costs and a return on capital.³⁹ The notional producer has a 'bucket of money' available to purchase milk. To the extent that the notional producer pays premiums for winter milk the amount of money available for non-winter milk is reduced, but the overall 'bucket of money' remains the same.
73. We note that the Act does not provide much assistance in determining whether the intention was for the base milk price to be disclosed on standard terms or average terms. However, Fonterra's Manual and the annual base milk price calculations have consistently been expressed on the basis of the average milk price per kgMS.
74. We consider that the calculation of the average price is sufficient to provide an incentive for Fonterra to operate efficiently while providing for contestability. This approach reflects that, in the real world, processors will compete for different categories of milk by paying higher prices for the milk they value more highly. At the same time contestability is provided for because the overall 'bucket of money' available for purchasing milk under the Manual calculation remains the same.

Our recommendation

75. Although the Act is not specific and the base milk price could also be instead expressed as the milk price on standard terms, there is not a strong case for a change from the average price basis to a price expressed on standard terms. We consider the better solution would be for Fonterra to more frequently and publicly disclose the milk price on standard terms (post adjustments) in its periodic reviews of the base milk price. This would better promote the purpose in s 150A of the Act by providing greater transparency of Fonterra's base milk price setting process.

³⁹ As outlined in s 150C of the Act.

Attachment A Conclusions on minor amendments

A1 This attachment sets out our conclusions on minor amendments to the Manual. These amendments are of a technical or drafting nature.

A2 Table A1 outlines our comments and conclusions on these areas.

Table A1 Summary of technical or drafting change issues

Manual reference	Definition	Category	Description of issue	Fonterra reasoning	Commission comment
Glossary	Fonterra Manual Amendment	GDT definition	GDT prices sourced from twice monthly GDT transactions and not one-off transactions	To clarify that base GDT prices will continue to be sourced from twice monthly GDT events platform, and not from one-off transactions on the new GDT marketplace.	No consistency issue; the change improves drafting accuracy.
Part B, Rule 18	Fonterra Manual Amendment	Continuing reasonableness review - no longer required	Removed requirement of Milk Price Group to complete a continuing reasonableness review annually	Removed as creates an unduly onerous annual requirement - catch all within-period review provision in Rule 23 adequately provides an ability/requirement to review where the Milk Price Group has cause to believe an inflation-indexed provision is no longer appropriate.	For Rule 23 to be effective in covering any changes in continued reasonableness in "within-period reviews", 'exceptional circumstances' needs to be defined. This would provide clarity as to what triggers a review.

Part B, Rule 34	Fonterra Manual Amendment	Surplus capacity - reference to region	Where there is excess capacity, the standard plant in the region with the earliest deemed acquisition date (or dates) will be removed from the Farmgate Milk Price Fixed Asset base	We undertook to consider this change, which reflects our intended practice, in our submission on the Commission's draft F16 Manual Report.	No consistency issue; the change improves drafting accuracy. ⁴⁰
Part A, Section 6.1	Fonterra Manual Amendment	Overview section - drafting change	Minor adjustments to the wording in the Disclosure - Overview section	All amendments to this section are drafting in nature only.	No consistency issues; the change improves drafting accuracy.
Part B, Rule 3	Fonterra Manual Amendment	Wording amendment - Farmgate	Amended 'milk price' to 'Farmgate Milk Price' per our comment in 89.2 of 15/16 Manual Review	Addresses minor point made by Commission in para 89.2 of the F16 Manual Report.	No consistency issues; the change improves drafting accuracy.
Part B, Rule 14	Fonterra Manual Amendment	Labour costs	Added "(but excluding any labour costs provided for in the immediately preceding calculation)"	To clarify that labour costs are not to be double-counted, consistent with actual practice.	No consistency issues; the change improves drafting accuracy.
Part B, Rule 8	Fonterra Manual Amendment	GlobalDairyTrade renamed to 'GDT'	Amended to acronym	No comment on this amendment.	No consistency issues; "GDT" sufficient wording given full description is in glossary.

⁴⁰ See our conclusion in para 4.64 of Commerce Commission "Final Report Review of Fonterra's 2015/16 base milk price calculation" (15 September 2016).

Attachment B Glossary

Term/Abbreviation	Definition
The Act, or DIRA	Dairy Industry Restructuring Act 2001
AMF	Anhydrous milk fat
Base milk price	Farm gate milk price expressed per kilogram of milk solids
BMP	Butter milk powder
Calculation review	Review of Fonterra's base milk price calculation for the prior season
Dairy season	1 June to 31 May annually
FX	Foreign exchange
GDT	GlobalDairyTrade, Fonterra's online auction platform used to sell commodity products
kgMS	Kilogram of milk solids
Manual review	Review of Fonterra's Milk Price Manual for the current season
Milk Price Manual or the Manual	Fonterra's farm gate milk price Manual
Notional producer	The notional commodity business that is used to calculate the base milk price
R&M	Repairs and maintenance
RCP	Reference commodity product, currently this consists of WMP, SMP, BMP, Butter, AMF
Reasons paper	Fonterra's Reasons paper which is provided alongside the Manual for each dairy season (this is also provided when Fonterra discloses its base milk price calculation at the end of each dairy season)
SMP	Skim milk powder
WMP	Whole milk powder
Milk Price on standard terms	The total pool available for individual suppliers who are on standard terms and condition contracts after deducting for payment of winter milk premiums, specialty contracts and other allocations. The pool is divided by total KgMS collected by Fonterra