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The Dairy Industry Restructuring Act 2001

Review of Fonterra's 2012/13 Milk Price Manual

Final report

Date: 14 December 2012

Confidential material in this report has been removed. Its location in the document is denoted by [ ].

Executive Summary

Background

X1 This report relates to the first of two statutory reviews of Fonterra's base milk price-setting that we are required to undertake for each milk season under the 2012 amendments to the Dairy Industry Restructuring Act 2001 (DIRA). The base milk price is the price paid by Fonterra to dairy farmers for raw milk. It is also known as the 'farm gate' milk price.[1]

X2 For this first statutory review the DIRA requires us to report by 15 December 2012 on the extent to which Fonterra's 2012/13 Farm Gate Milk Price Manual (Manual) is consistent with the purpose of the milk price monitoring regime in Subpart 5A (s 150A) of the DIRA (the purpose). The Manual contains a set of principles and detailed rules that underpin the definition of the notional farm gate milk price commodity business envisaged by the regime and the calculation of the base milk price.

X3 This report relates to the review of the Manual only. Under s 150I of the DIRA[2] we are required to examine the extent to which the Manual:

X3.1 Provides incentives for Fonterra to operate efficiently; and

X3.2 Provides for contestability in the market for the purchase of milk from farmers.

X4 Our view is that setting any independent benchmark for the revenue and costs that underpin the base milk price would provide an incentive for Fonterra's management to operate more efficiently. The level of the base milk price does not have to be 'right' to provide incentives for Fonterra to improve its productive efficiency.

X5 In assessing whether the setting of the base milk price provides for contestability, our main test is examining whether the assumption is practically feasible for an efficient processor. If the assumptions adopted are practically feasible for an efficient processor, then the base milk price is consistent with the contestability standard of s 150A. We also consider whether the assumptions are consistent with other assumptions used to calculate the base milk price.

X6 We consider that the implication of the DIRA is that it does not matter whether *existing* independent processors can necessarily achieve the level of efficiency implied by the base milk price or not. As long as Fonterra or a potential entrant can achieve that level of efficiency, then that ensures that the base milk price reflects a practically feasible level, and would provide a normal return on incremental investment.

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1 In this report we use 'base milk price' as it is more consistent with the legislation.

2 All statutory references in this report are to the DIRA, unless otherwise stated.

Conclusion

X7 Our conclusion is that, to the extent we are able to assess it, the Manual is not inconsistent with the purpose. Although some elements of Fonterra's 2012/13 Manual are not fully consistent with the efficiency dimension of the purpose, our view is that these will have a minor impact only on the overall purpose.

X8 There are a number of caveats to this conclusion.

X9 First, we note that we sought submissions on three particular matters about which we were unable to form a view in our draft report when looking at the Manual in isolation of the way in which it is applied, and which were considered potentially material.[3]

X10 We do not yet have sufficient evidence, from information provided in submissions, to form a view as to whether these three matters are inconsistent with the purpose. We will examine them again in our September 2013 review of the application of the Manual in the calculation of the base milk price.

X11 Secondly, the limits of this review mean that our conclusions may be different when we review how these assumptions are applied in the base milk price calculation. To explain, aspects of the Manual are relatively generalised. While they are not in themselves inconsistent with the purpose, they could be applied in a manner that is.[4]

X12 We anticipate that Fonterra's application of the Manual, including values adopted, will provide greater clarity on whether the setting of the base milk price in accordance with the Manual achieves both of the efficiency and contestability dimensions in section 150A.

X13 Thirdly, and as noted at paragraph X21 below, there are a number of aspects of the base milk price calculation that the Manual does not fully specify. We can therefore draw no conclusion in relation to those aspects in this review.

Incentives for Fonterra to operate efficiently

X14 We did not identify any aspects of the Manual which are materially inconsistent with the objective to provide incentives for Fonterra to operate efficiently. Most aspects of the Manual use notional values, which provide Fonterra with an incentive to operate efficiently. There are, however, some areas where the Manual requires the use of Fonterra's actual values, even though that may weaken Fonterra's incentives to operate efficiently. Our approach recognises that the use of actual costs is not necessarily inconsistent with the purpose, particularly where there is insufficient information to specify an appropriate notional value or Fonterra has very limited control over the actual costs used for the benchmark.

[3] See paragraphs X17-X20 below.

[4] For example, while the Manual doesn't in our view require over-optimisation of the notional efficient processor's business, this could still occur when the Manual is applied.

X15 Variable manufacturing costs and supply chain costs are examples of areas that we have identified where provision for the use of actual resource usage and unit cost rates does not appear to be consistent with s 150A. We have taken the view that these are minor inconsistencies given that actual values appear to be used only in respect of packaging costs and supply chain costs (eg. freight and storage) which are not material in the context of the variable costs that are set on a notional basis.

Provision for contestability

X16 To the extent we are able to assess it, we did not identify any areas where the assumptions as stated in the Manual are not practically feasible. We note that it is difficult to draw conclusions about practical feasibility in many areas when examining the Manual in isolation. We have therefore stated below the areas where we will not be able to draw any conclusions until the calculation of the base milk price for the 2012/13 season.

Matters requiring review upon implementation of the Manual

X17 We consider that the following rules may be inconsistent with the purpose, and are potentially material, but we can only consider the extent to which the rules may be inconsistent in our review of the application of the Manual in 2013.

X18 The manual defines regions as the North Island and South Island. However, as standard plants are only added in whole numbers to meet peak milk supply requirements at the level of the two defined regions, rather than to specific manufacturing sites, there may be an element of over-optimisation of assets which is not achievable for an efficient processor. This also has a flow-on effect to the relevant operating costs (eg, actual milk collection costs) which may need to be adjusted upwards to reflect the implicit optimisation.[5]

X19 A distinct but related question is whether a realistic achievable benchmark that is independent of Fonterra's actual performance can be estimated for milk collection costs and whether doing so would improve Fonterra's incentives to operate efficiently. [6] We will test Fonterra's assertions on these issues in detail when we review the application of the Manual.

X20 The Manual provides for different treatment of assets stranded through a change in RCPs (Rule 31) and as a result of surplus capacity (Rule 32). While we consider that sufficient allowance should be made, either ex ante or ex post, for the risk of asset stranding, it is not clear why there should be a different basis for the timing of recovery and allocation of risk depending on the circumstances of stranding. Additionally, where the risk of asset stranding is incorporated in the WACC, we do

5 Fonterra has argued that an element of over-optimisation would only occur if its actual incremental processing capacity were smaller than the notional incremental capacity, which has not been the case since 2009. *Submission to the Commerce Commission on its Draft Report on Fonterra's 2012/13 Farmgate Milk Price Manual*, 15 November 2012 (Fonterra Submission on draft report), page 5.

6 Fonterra (ibid.) asserts that it is not feasible to derive a realistic independent benchmark and therefore we have accepted that the use of actual data here may be reasonable in respect of the efficiency dimension of the purpose.

not consider that all of this should be through the asset beta as beta is a measure of an investment's exposure to market wide (systematic) factors, and we consider that most asset stranding risk is non-systematic.

Aspects of the milk price not specified in the Manual

X21 There were various other submissions on our process paper which questioned the practical feasibility of some of the inputs to the base milk price calculation that are not specified in the Manual including yields, selection of off-GDT contracts, and operating costs.

X22 We will examine the detailed implementation of the rules covering all of these elements when we review the calculation of the base milk price for the 2012/13 season.

1. Introduction

Purpose of this report

1.1. The purpose of this report is to set out our conclusions, and the reasons for those conclusions, on the extent to which the Manual is consistent with the purpose of the new milk price monitoring regime set out in the Dairy Industry Restructuring Act 2001 (DIRA).[7]

1.2. Our draft report was provided to Fonterra for comment in accordance with s150M of the Act. We also sought feedback from other interested parties on our draft report.

1.3. We have formed our conclusions after considering all comments on our draft report.

The scope of this report

This report reviews the Manual only

1.4. This report relates to the first of two statutory reviews of Fonterra's base milk price-setting that we are required to complete for each season under the DIRA.

1.5. The base milk price is the price paid by Fonterra to dairy farmers for raw milk. It is also known as the 'farm gate' milk price.[8] Fonterra's methodology for setting its base milk price is guided by a set of principles set out in Fonterra's constitution and prescribed in Fonterra's 2012/13 Farm Gate Milk Price Manual (the Manual). These principles govern the detailed rules that underpin the definition of the notional farm gate milk price commodity business and the calculation of the base milk price.[9]

1.6. The first statutory review requires us to report on the extent to which the Manual is consistent with the purpose of the milk price monitoring regime, and is to be published by 15 December (s 150J). This report therefore relates to the review of the Manual only.

1.7. Synlait has submitted that "the consistency of the Manual with the purpose in s 150A of DIRA needs to be judged with the Manual's milk price outcome in mind."[10] The first statutory review is limited to assessing the consistency of the Manual with the purpose, and does not extend to assessing the resulting milk price. As noted below (paragraph 3.13) the consistency of the base milk price with the purpose will become clearer when we assess how the Manual is actually applied.

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[7] The amending legislation that gives effect to this regime was enacted on 26 July 2012.

[8] In this report we use 'base milk price' as it is more consistent with the legislation.

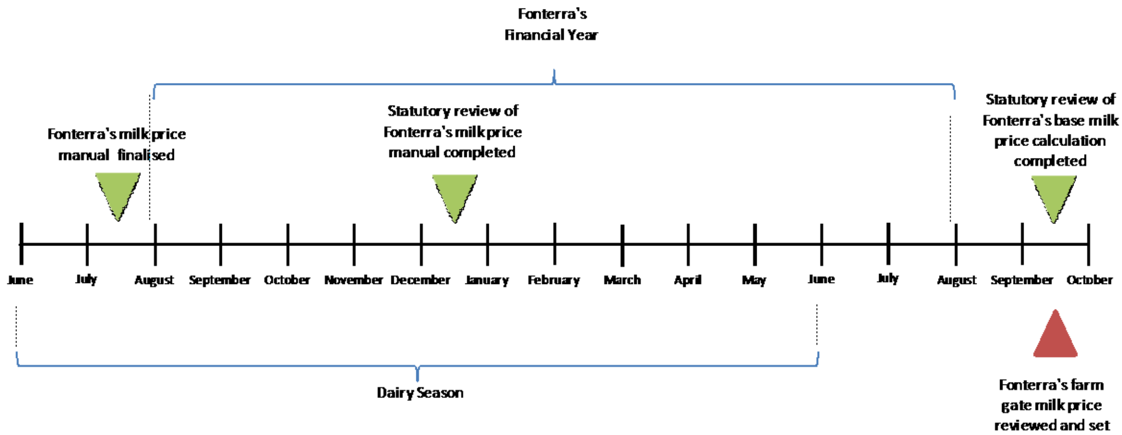
[9] Attachment A provides an overview of the setting of the base milk price in New Zealand.

[10] Synlait, *Submission to the Commerce Commission Regarding the Milk Price Manual*, 15 November 2012 (Synlait submission on draft report), paragraph 9.

We will review the application of the Manual by September 2013

1.8. The second statutory review for each season requires us to report on the extent to which the implementation of the assumptions adopted and the inputs and process used by Fonterra in calculating the base milk price for the season are consistent with the purpose. This report on the application of the Manual must be published by 15 September following the completion of the milk season (s 150Q).

Figure 1: Timeline for Fonterra's base milk price setting processes and statutory review process



How the scope of this review differs from the 'dry run' we completed in August 2012

1.9. The scope of this report is different from the 'dry run' review we undertook at the request of the Minister for Primary Industries prior to the enactment of the 2012 DIRA amendments in two main ways – the range of assumptions reviewed and the breadth of our assessment of the selected assumptions.[11]

1.10. The dry run review was a targeted review that considered a number of key assumptions from the Manual. [12]As the DIRA does not contain a materiality threshold, we have considered all elements of the Manual in this review.

1.11. The dry run review incorporated both forms of statutory review described above, which means the scope of our assessment was broader than in this report. In the dry run review we considered the extent of consistency with the purpose statement of the Manual and the application of the Manual at the same time.

1.12. In this report, however, although we have found that most of the elements in the Manual as stated are not inconsistent with the purpose statement, our conclusions may be different when those assumptions are applied in the base milk price

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11 Our final dry run review report was issued on 27 August 2012. The purpose of the dry run review was to help inform investors ahead of Fonterra launching Trading Among Farmers (TAF). In particular, the dry run review was intended to show investors how the Government-proposed milk price monitoring regime would work in practice.

12 Commerce Commission, *Report on the dry run review of Fonterra's farm gate milk price* (dry run review), 27 August 2012, at http://www.comcom.govt.nz/assets/Dairy/Dry-run-review-2012/Final-Report-on-the-Dry-Run-Review-of-Fonterras-Farm-Gate-Milk-Price-27-August-2012.pdf

calculation. We anticipate that Fonterra's application of the assumptions will provide greater clarity on whether the setting of the base milk price achieves both of the efficiency and contestability dimensions in section 150A. For example, where assumptions are drafted in general terms, the effect depends on the inputs which are used in the calculation. Examples of this include yield assumptions and any adjustments made to account for off-GDT (Global Dairy Trade) sales.

How we have set out our analysis and conclusions in this report

1.13. The remainder of this paper outlines why we have reached the conclusion that the Manual is not inconsistent with the purpose.

1.14. In Chapter 2 we set out our interpretation of the key provisions of the legislation and our approach to the review of the Manual. Attachment B expands on our interpretation of this statutory framework.

1.15. Chapter 3 then summarises our conclusions and the reasons why we have reached them. These conclusions are supported by further detail in Attachment C.

1.16. We also provide an overview of how Fonterra sets its base milk price in Attachment A.

2. Our approach to this statutory review of the Manual

Purpose

2.1. This chapter sets out our interpretation of the key provisions of the DIRA and explains how we have practically applied those provisions for the purpose of this review.

2.2. Attachment B expands on the discussion in this chapter and sets out the relevant provisions in full.

Our interpretation of sections 150A, 150B and 150C of the DIRA

The purpose statement – section 150A

2.3. We consider that the efficiency and contestability requirements within s 150A are interlinked and that together, they require consideration of:

2.3.1 What is meant by 'efficiency'?

2.3.2 What is meant by 'contestability'?

2.3.3 How do the dimensions of efficiency and contestability inter-relate?

Our interpretation of efficiency

2.4. Section 150A refers to incentives for Fonterra to 'operate efficiently'. We have interpreted the primary focus of the efficiency dimension to be improving incentives for Fonterra to drive cost efficiencies (ie, productive efficiency).[13]

Our interpretation of contestability

2.5. Section 150A(2) states that the setting of a base milk price will provide for contestability if "any notional costs, revenues, or other assumptions taken into account in calculating the base milk price are practically feasible for an efficient processor". Our interpretation of s 150A is therefore that if the assumptions used in setting the base milk price are practically feasible, individually and in aggregate, the contestability dimension is satisfied.

How are the two dimensions reconciled?

2.6. It is our interpretation that to satisfy s 150A the Manual must be consistent with both dimensions, independently. As such, we are not required to choose between the priority of the contestability and efficiency dimensions in s 150A to assess whether the purpose is satisfied.

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[13] Productive efficiency is present when producers use inputs in such a manner as to minimise costs, subject to technological constraints. Refer footnote 36 for discussion of where other types of efficiency are relevant to the efficiency dimension.

Section 150B – "safe harbours"

2.7. We interpret section 150B as being intended to create 'safe harbours' where the setting of the base milk price by Fonterra is consistent with the assumptions listed in paragraphs (a) to (d). In performing our statutory review, we are therefore not required to assess any aspects of the Manual that are sheltered by the safe harbour provisions for consistency against the s 150A purpose.

Section 150C – "mandatory assumptions"

2.8. We interpret s 150C of the DIRA as setting out certain assumptions that Fonterra is required to make in setting the base milk price. Our review of the assumptions in s 150C is therefore limited to examining whether the Manual contains those assumptions.

Our practical approach to the review of the Manual

Our approach to the efficiency dimension – how Fonterra is provided with incentives

2.9. Fonterra will have an incentive to operate efficiently where the base milk price is set independently of Fonterra's actual performance, as this then provides Fonterra with a benchmark to beat.

2.10. Our view is that setting any independent benchmark for the costs that underpin the base milk price would provide an incentive for Fonterra's management to improve efficiency.

2.11. Notwithstanding the efficiency dimension of the s 150A purpose, there are instances where it is still reasonable to use actual data in setting the base milk price. In particular, where:

2.11.1 there is insufficient information to know what an appropriate notional value would be; or

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

2.12. Our approach to considering the efficiency dimension is to therefore assess the extent to which the base milk price, through the use of notional components, incentivises Fonterra to operate efficiently, recognising that the incentive for efficiency, overall, does not require notional values to be used instead of actual values for every component.

Our approach to the contestability dimension – what is practically feasible

2.13. If the assumptions adopted are practically feasible, then the Manual is consistent with the contestability standard of s 150A.

2.14. We interpret s 150A as meaning that the assumptions must at the very least be practically feasible today for an incremental plant efficiently built by Fonterra or another processor. It does not in our view require all of Fonterra's existing plants to be able to operate at that level of efficiency.[14]

2.15. We acknowledge that a potential outcome of the DIRA is that a base milk price could be consistent with the s 150A purpose, yet be set at a level such that some processors that are more efficient than Fonterra (on average) may not be able to enter or remain in the market. For example, the lowest practically feasible processing costs (including the cost of capital) might be associated with the incremental plant.

2.16. Under the DIRA, it does not matter whether existing independent processors can necessarily achieve that level of efficiency or not.[15] Other potential entrants may enter the market for the purchase of milk from farmers. As long as Fonterra's next plant or some other potential entrant can achieve that level of efficiency, then that ensures that the base milk price reflects a practically feasible level, and would provide a normal return on the incremental investment.

2.17. In assessing whether the assumptions are practically feasible, we have made an assessment of:

2.17.1 whether the individual assumptions are practically feasible;

2.17.2 whether the assumptions are internally consistent; and

2.17.3 we then drew a conclusion on the extent to which the Manual provides for contestability in the market within the review, ie, based on the aggregate impact of the assumptions.

2.18. In assessing internal consistency and making an aggregate assessment we are aware of the risk of over-optimisation, creating a notional 'super-competitor' that could not in fact exist, and cross-check for that, as far as we are able to in this review.

2.19. Given the information available to us, in assessing whether an assumption is practically feasible our main test is examining whether the assumption is practically feasible for Fonterra. It does, however, remain possible that an assumption is practically feasible for Fonterra due to features unique to Fonterra. In that case the assumption may not be practically feasible for another efficient processor.

2.20. We therefore include a reasonableness cross-check to identify whether our assessment is being affected by any unique features. If that was the case, we would then consider what further review is necessary, including potentially reviewing whether the assumption is feasible for another efficient processor.

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14 We note that even the current configuration of Fonterra's commodities business includes a number of legacy assets, and extends across a more diverse range of products and channels than envisaged in the Manual and by the DIRA. Any assessment of the Manual against 'Fonterra' is therefore against a notionally separated part of that entity that does not separately exist in practice.

15 Our view is that DIRA contemplates economies of scale in the safe-harbour assumptions in s 150B(a) and (b).

Information used for this review

2.21. Section 150L requires Fonterra to provide us with the following information:

2.21.1 the Manual for the current season;

2.21.2 any recommendations by the panel in relation to the setting of the base milk price;

2.21.3 notification of any change in the economic and business environment that, in Fonterra's view, requires a change to the Manual;

2.21.4 certification of the extent to which Fonterra considers that the Manual is consistent with the purpose in s 150A; and

2.21.5 reasons for the view expressed in Fonterra's certification.

2.22. As required by s 150L, Fonterra has provided the Commission with its certification that the 2012/13 Manual is consistent with the purpose in s 150A, along with the reasons for the view expressed in its certificate. We note that in accordance with s 150K we agreed to vary the due date for information to be provided by Fonterra under s 150L. This information was provided on 5 September 2012.

2.23. We have had regard to this information in making our report. We also had regard to submissions on our Process Paper[16]and Draft Report[17] as well as the material from our dry run review.[18]

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[16] *Process Paper – Review of Milk Price Manual, 7 September 2012.*

[17] *Draft Report on the Statutory Review of Fonterra's Milk Price Manual 19 October 2012*

[18] http://www.comcom.govt.nz/dry-run-review-of-fonterra-s-farm-gate-milk-price/

3. Conclusions from our review of the Manual

Purpose

3.1. Section 150I of the DIRA requires us to make an assessment of the extent to which the Manual is consistent with the s 150A purpose and give reasons for those conclusions.

3.2. This chapter summarises our conclusions from our review of the Manual and the reasons for those conclusions. It draws on the analysis of individual key issues that we discuss in Attachment C to this report.

3.3. We have not reported on each of the principles and rules set out in the Manual individually nor on the reasons provided by Fonterra, but have set out in this chapter and in Attachment C the detail of those areas where we consider there is a need for particular comment.

3.4. As discussed in Chapter 2, in assessing whether the rules and assumptions provide incentives to Fonterra to operate efficiently we have considered the use of notional assumptions and the extent to which the use of actual data is reasonable. We have also considered the incentives provided by individual assumptions, notwithstanding that some assumptions may not use notional data.

3.5. In assessing whether the assumptions are practically feasible, we have made an individual and an aggregate assessment. As discussed in Chapter 2, after we had assessed each selected issue, we did the following.

3.5.1 We considered whether there is consistency among the assumptions used to calculate the base milk price.

3.5.2 We then drew a conclusion on the extent to which the Manual provides for contestability in the market within the review, ie based on the aggregate impact of the assumptions.

3.6. Inevitably, our review involves a level of subjectivity and we have exercised a degree of judgement, based on our experience as an economic regulator.

Summary of our conclusions on the extent to which the Manual is consistent with the purpose

3.7. To the extent we are able to assess it, our conclusion is that the Manual is not inconsistent with the purpose. Although some elements of Fonterra's 2012/13 Manual are not fully consistent with the efficiency dimension of the purpose, our view is that these will have a minor impact only on the overall purpose.

3.8. Because some elements of the Manual appear to be inconsistent with the purpose, we are unable to conclude that the Manual is fully consistent with the purpose. In particular the use of Fonterra's actual values in some areas to set the base milk price may weaken incentives to operate efficiently in respect of those aspects.

3.9. It remains possible that an assumption is practically feasible for Fonterra due to features unique to Fonterra, which do not relate to Fonterra acting efficiently. In that case the assumption may not be practically feasible for another efficient processor.

3.10. In examining practical feasibility for Fonterra, we have therefore performed a reasonableness cross-check to identify whether our assessment is being affected by any assumptions that are practically feasible for Fonterra due to features unique to Fonterra and which may not be practically feasible for another efficient processor. We have not identified any unique features that would alter our assessment of the manual.

3.11. We note that we sought submissions on three particular matters about which we were unable to form a view when looking at the Manual in isolation of the way in which it is applied, and which were considered potentially material.

3.12. We do not yet have sufficient evidence, from information provided in submissions, to form a view as to whether these three matters are inconsistent with the purpose. We will examine them again in our September 2013 review of the application of the Manual in the calculation of the base milk price.

3.13. The limits of this review means that our conclusions may be different when we see these assumptions applied in the base milk price calculation. We anticipate that Fonterra's application of the assumptions, including values adopted, will provide greater clarity on whether the setting of the base milk price in accordance with the Manual achieves both of the efficiency and contestability dimensions in section 150A.

Issues we focus on in this report

3.14. As most matters in the Manual are consistent with the purpose, or are sheltered within the "safe harbour" provisions, we have focused in this report on those areas where further consideration or discussion was required. We have not discussed each element of the Manual in this report.

3.15. The issues fall into the following categories:

3.15.1 Statements about the objectives of the Manual which may appear to be inconsistent with s 150A, even though we consider the underlying rules and assumptions on balance are not. Our objective in commenting on them is to promote certainty and clarity only;

3.15.2 Examples of where the Manual requires the use of Fonterra's actual costs, even though that may weaken Fonterra's incentives to operate efficiently (relevant to the efficiency dimension);

3.15.3 The different treatment of asset stranding risk[19] and potential over-optimisation of assets (relevant to the contestability dimension);

3.15.4 Issues which we identified in the dry run review, and which have resulted in changes to the Manual for the 2012/2013 season compared to that used in the 2011/12 season; and

3.15.5 Rules whose apparent consistency with the purpose, or shelter within the "safe harbour" provisions depends upon how they are applied.

3.16. These issues are discussed below and in more detail in Attachment C to this report.

Principles and rules, which are not inconsistent with the DIRA, but require certainty and clarification

3.17. The Fonterra Milk Price principles include the statement:

> the milk price should be the maximum amount that Fonterra, reflecting its status as a properly-managed and efficiently-run, sustainable co-operative, [could pay] for milk supplied to it in a season… [20]

3.18. We read this as meaning that Fonterra is seeking to maximise supplier value, subject to the rules set out in the Manual, which does not appear to be consistent with the contestability dimension of the purpose.[21] However, our review of the underlying assumptions suggests that this statement of principle does not give effect to any material inconsistency between the Manual and the purpose, as the underlying assumptions seek to make sufficient allowance for the costs and returns required for an efficient processor to invest.

3.19. Similarly, the principle that the milk price should reflect the benefits that arise from the "collective selling power of shareholders as suppliers"[22] is peculiar to a supplier-owned co-operative, but does not of itself give rise to inconsistency with s 150A.

Use of Fonterra's actual performance levels to help set the base milk price (Efficiency dimension)

3.20. In Chapter 2 we explained that our approach to considering the efficiency dimension is to examine the extent to which the notional components of the base milk price incentivise Fonterra to operate efficiently.

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[19] We did not comment on this in the dry run review, as it was not considered material to the calculation of the base milk price. Our comments on asset stranding were directed mainly at the estimation of the asset beta. See paras A13.34-A13.37 of the dry run review.

[20] Section 2.1 Overview. Refer second principal in Table C.1, page 45 of this report.

[21] We note Fonterra's explanation that the phrase is intended to give certainty regarding the amount that is to be allocated to payments for milk consistent with the certainty of outcome associated with the contestability dimension. See Fonterra submission on draft report, page 3.

[22] Refer first principle in Table C.1, page 45 of this report.

3.21. The Manual identifies a number of instances where Fonterra will set the base milk price by reference to its actual level of performance in the season for which the base milk price is being set. In particular, the Manual uses actual values to set:

3.21.1 Allocation of milk to RCPs (rule 7);

3.21.2 Base milk price variable manufacturing costs (rule 13);

3.21.3 Milk collection costs (rule 17) and milk collection assets (rule 37); and

3.21.4 Supply chain costs (rule 20).

3.22. Potentially this use of actual performance levels weakens any incentives to operate efficiently compared to using a notional benchmark, because variations in performance affect the base milk price rather than Fonterra's profits. The incentives on Fonterra's board and management to lift performance in these areas may be weaker than it would be for other costs, based on notional values.

3.23. However, consistent with our view that notional data need not be used for all components, we consider that the allocation of milk to RCPs in accordance with the actual Farmgate Milk Production Plan is reasonable, as there is insufficient information available to know what an appropriate notional allocation would be.

3.24. Milk collection costs are material to the base milk price, and the use of Fonterra's actual milk collection costs does not appear to be consistent with the efficiency dimension of the purpose. It is uncertain as to whether a realistic achievable benchmark that is independent of Fonterra's actual performance can be estimated, and whether doing so would improve Fonterra's incentives to operate efficiently. We invited comments on this issue in our draft report and received one response, from Fonterra. Fonterra confirmed that it has examined this issue in some detail, and concluded that it is not feasible to derive a realistic independent benchmark. [23]

3.25. In light of this response, and subject to more detailed testing at the application level in our review of the base milk price calculation, we have accepted that the use of actual data here may be reasonable in respect of the efficiency dimension of the purpose.

3.26. We remain concerned that there could be potential inconsistency between the approach for setting the number and location of standard plants, and the data used for the calculation of collection and other relevant operating costs.[24] We will consider this matter further in our review of the base milk price calculation under s 150O.

3.27. Variable manufacturing costs and supply chain costs are areas where provision for the use of actual resource usage and unit cost rates does not appear to be consistent with s 150A. We have taken the view that these are minor inconsistencies given that actual values appear to be used only in respect of packaging costs and supply chain

23 Fonterra submission on draft report, page 4.
24 Refer paragraph A12.48 of the dry run review.

costs (eg. freight and storage) which are not material in the context of the variable costs that are notional. We will re-examine this view when we review the calculation of the base milk price for the 2012/13 season.

The different treatment of asset stranding risk and potential over-optimisation of assets (Contestability dimension)

3.28. The Manual provides for different treatment of stranded assets in rules 31 and 32. In rule 31 the risk is borne by farmers as suppliers ex post (i.e. when a stranding occurs). In rule 32 the risk is borne by shareholders, ex ante, through the WACC. While we consider that sufficient allowance should be made, either ex post or ex ante, for the risk of asset stranding, it is not clear why there should be a different treatment which may affect the prospect of recovering sufficient costs where the stranding is due to changes in available milk supply, or allocation of risk depending on the circumstances of the stranding.

3.29. Rule 31 deals with adjustments required from a change in the RCPs used in the base milk price. Under this rule, the remaining value of assets and annuity streams are removed from the base milk price calculation, lowering the base milk price that Fonterra pays. Fonterra has explained[25] that, due to the wide range of possible adjustments required to the asset base, and the consequent undesirable signalling of the possibility of significant swings in the milk price product mix from year to year that would arise, it is "not feasible to derive a supportable ex ante allowance for stranded asset risk due to changes in RCPs."

3.30. Rule 32 deals with situations where there is surplus capacity for processing available milk. The rule requires the removal of the reference asset from the base milk price asset base but without deducting the value of the remaining annuity streams when calculating the base milk price. The risk of stranding is borne by shareholders at the time of stranding but an annual allowance for this risk is recovered through the WACC.

3.31. The basis for the different timing of recovery and allocation of risk is not clear. Nor is it clear which of these rules would apply in practice. Consider if, for example, a competitor were to establish a plant making a non-RCP product and to win suppliers from Fonterra to it, with the result that an existing Fonterra plant becomes stranded. In this (hypothetical) example, an argument could be made that the basket of RCPs should be revised such that rule 31 would apply (lowering the milk price). However, arguably rule 32 would be applicable, as Fonterra has surplus capacity, and the costs of the stranded asset would not be deducted from the milk price.

3.32. The comments from Fonterra in respect of rule 32 included in their reasons provided in accordance with s 150L, suggest that, in Fonterra's view, the risk of asset stranding from surplus capacity is incorporated in WACC. Aside from our view that the basis for different treatment is not clear, we note that the amended Rule 40 states that, in a review year, an independent reviewer will provide an updated asset beta that is required to have regard to stranded asset risk.

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25 Fonterra submission on draft report, page 5.

3.33. We consider that beta should not generally include an allowance for all of the risk of asset stranding, as beta is a measure of an investment's exposure to market wide (systematic) factors, and we consider that most asset stranding risk is non-systematic.[26]

3.34. It is not clear to us whether rule 31 or 32 is more consistent with the contestability dimension of the purpose or whether such costs should be treated on an ex post or ex ante basis. However, we agree that an allowance for the costs of stranding should be included when calculating the base milk price. We acknowledge that the issue of how to provide appropriately for the risk of stranding is a difficult one, and that given the strong historic growth in milk supply, and the projections for continued growth, the risk of asset stranding from an excess of capacity and/or a change in RCPs may not currently be seen as high.

3.35. We consider nonetheless that the rules may be inconsistent with the purpose, and are potentially material, but we can only consider the extent to which they may be inconsistent in our review of the application of the Manual in 2013.

3.36. Rule 33 implies that peak milk supply is modelled for each major dairy region and notional plants are allocated to those regions to process the supply. Fonterra's submission on the dry run review draft report states that, in applying Rules 25 and 33 in the Milk Price Manual, Fonterra interprets 'region' to mean North Island or South Island and that this interpretation is consistent with the approach it employs in practice in making incremental capacity decisions.

3.37. As standard plants are only added in whole numbers to meet peak milk supply requirements at the level of the two defined regions, rather than to specific manufacturing sites, there may be an element of over-optimisation of assets which may not be achievable by an efficient processor. This would also have a flow-on effect to the relevant operating costs (eg, actual collection costs) which may need to be adjusted upwards to reflect the implicit optimisation.[27]

3.38. Fonterra has submitted[28] that the model's allowances for site overhead costs and site capital reflect an assumption that the number and location of manufacturing sites are the same as those it actually maintains. Fonterra also submits that the annual volumes of milk processed on each site are "materially aligned" to the volumes actually processed.

3.39. Fonterra acknowledges there could be an element of over-optimisation if "Fonterra's actual incremental plants had a materially smaller processing capacity than the Milk Price Model's incremental plants," but explains that the opposite situation has occurred since 2009 and therefore "it is likely that the Milk Price model could have achieved lower incremental collection costs than those actually achieved by Fonterra

[26] We discussed this in the final report of our dry run review at paragraphs A13.34-A13.37.
[27] The fewer the assumed processing locations, the greater the costs of transporting milk to them.
[28] Refer footnote 5.

(and therefore reflected in the Milk Price), though the difference will not have been material."[29]

3.40. At this point we do not have enough information on how the assumptions flow through to all the relevant operating costs in order to be able to form a conclusion on whether they are consistent with the purpose in s 150A. We consider that in light of the large processing capacity of Fonterra's recent actual investments the assumptions are not inconsistent. We will examine whether there is any actual over-optimisation when we review the application of the manual in the calculation of the base milk price.

Changes to the Manual following our dry run review

3.41. In the dry run review we identified certain areas where we thought the Manual could be clarified. With its amendments to the Manual Fonterra has addressed a number of these suggestions, namely:

3.41.1 Making explicit the definition of region;

3.41.2 Sales phasing;

3.41.3 How the beta will be estimated; and

3.41.4 The definition of the debt premium.

Definition of region

3.42. The definition of region has been amended to make it explicit that it refers to the North Island and South Island. This clarification does not, however, remove our concern that there may be an element of over-optimisation of assets which may not be achievable by an efficient processor. This is covered in more detail in paragraphs 3.36 to 3.40 above.

Sales phasing

3.43. The application of rule 10 of the Manual is now more explicit that sales phasings are to be determined on a prospective basis only. This addresses our concern (expressed in the dry run review) that the wording used in the 2011/12 version of the Manual may have permitted the setting of sales phasings retrospectively.

How the beta will be estimated

3.44. The application of rule 40 provides that the estimation of beta will focus on the exposure of the Farm Gate Milk Price Business' to systematic risk in addition to the risk of asset stranding. Compared to the 2011/12 version of the Manual this re-orients the focus more towards assessing the exposure to systematic risks. As noted in paragraph 3.33, however, we do not consider that the risk of asset stranding should be wholly dealt with through the asset beta.

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[29] Ibid. Page 6.

The definition of the debt premium

3.45. The definition of the debt premium makes allowance for certain costs when raising debt including issuance costs and the cost of transferring the funds raised from US dollars to NZ dollars, given debt capital is assumed to be raised in the US but almost all the assets are located in NZ.

Rules whose apparent consistency with the purpose, or shelter within the "safe harbour" provisions depends upon how they are applied.

Discretion to select off-GDT contracts

3.46. Placing reliance on GDT only prices appropriately incentivises Fonterra management to maximise prices achieved for sales off-GDT. It also enhances the transparency of the revenue inputs into the Milk Price, as GDT prices are publicly available. Rule 5 does, however, give Fonterra discretion to use off-GDT prices. We note that if Fonterra uses every price achieved by Fonterra or has too much flexibility to choose off-GDT prices then the use of actual prices will undermine incentives for Fonterra to act efficiently. Whether this occurs in practice will be examined in our review of the calculation of the base milk price.

Practical feasibility of yield assumptions

3.47. Provided that the yield assumption is practically feasible, yields are covered by the safe harbour established in s 150B(d). The Manual provides that:

> The yield assumptions used to determine the Farmgate Milk Price Production Plan for a Season will reflect:
>
> - The Composition Target for each Reference Commodity Product; and
> - The Allowable Yield Losses for each Reference Commodity Product.

3.48. Submissions on our Process Paper highlighted the importance of the yield assumption but the Manual does not specify what production yield is assumed. We have therefore not examined whether the yield assumption Fonterra uses is practically feasible as part of this review, but will do so on in our review of the calculation of the base milk price.

Attachment A: The setting of the farm gate milk price in New Zealand

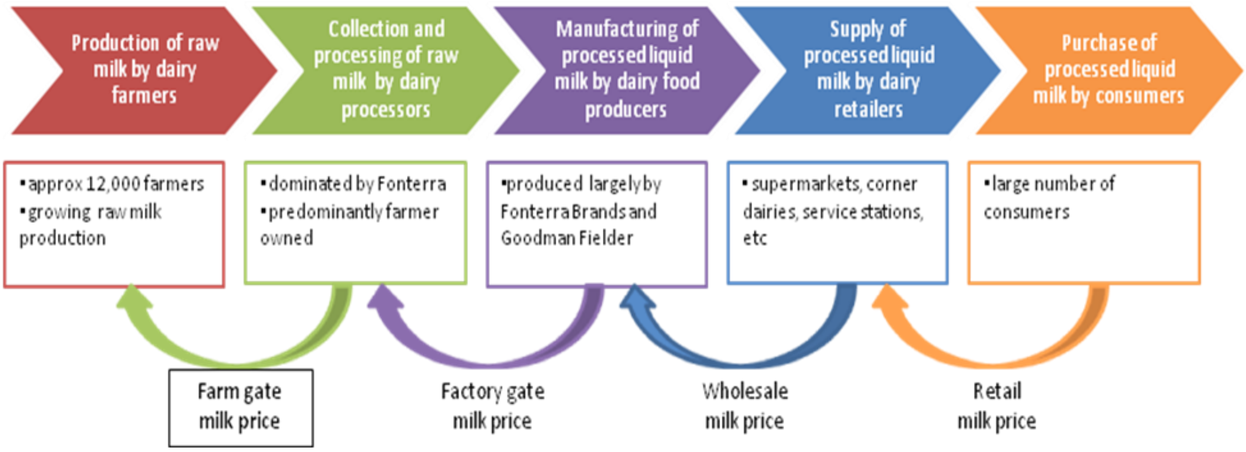
A1 This attachment outlines the different milk prices within the milk supply chain and explains the unique nature of the farm gate milk market in New Zealand. It also provides an overview of our understanding of Fonterra's rationale for calculating its farm gate milk price and the methodology Fonterra uses to calculate its farm gate milk price. The DIRA uses the term "base milk price" and all references here to the farm gate milk price should be read as meaning the same.

Milk prices in New Zealand

A2 Public concerns have been raised about the "milk price" in New Zealand.[30] The phrase "milk price" can, however, have different meanings depending on which component of the milk supply chain is being considered.

A3 Figure A.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 A.1: Milk supply chain in New Zealand



A4 As Figure A.1 shows, the "milk price" in New Zealand is made up of the following four components:

A4.1 **Farm gate milk price** is the price paid by dairy processors (eg, Fonterra) to dairy farmers for raw milk;

A4.2 **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;

30 In response, we considered whether to initiate an inquiry into milk prices under Part 4 of the Commerce Act, but concluded that there was no valid basis for a price control inquiry under Part 4. See: Commerce Commission, *Milk markets - consideration of whether to initiate a Commerce Act Part 4 Inquiry into milk prices,* August 2011.

A4.3 **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

A4.4 **Retail milk price** is the price paid by dairy consumers to dairy retailers (eg, supermarkets) for processed milk.

A5 Given that approximately 95 percent of the total raw milk produced in New Zealand is exported, 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.

A6 The focus of our review is solely on the **farm gate milk price** and not any other milk price within the milk supply chain. The farm gate milk price accounts for between one quarter and one third of the retail milk price.[31]

Farm gate milk market in New Zealand

A7 In a workably competitive farm gate milk market, the level of the farm gate 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.

A8 In New Zealand, the majority of farmers are also the owners of the majority of processing capacity (ie, Fonterra, which collects approximately 89 percent of total raw milk supply in New Zealand). In this situation there is not a workably competitive market process to derive a farm gate milk price and it is determined by Fonterra using an administrative methodology. Given Fonterra's dominant position in the market for farmers' raw milk, Fonterra's farm gate milk price also effectively sets the minimum price that other dairy processors need to pay farmers for raw milk in order to attract and retain supply.

Fonterra's approach to calculating its farm gate milk price

A9 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 farm gate milk price was calculated only for the purposes of estimating Fonterra's long-run earnings for share valuation purposes.

A10 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.[32] As a result, it is the total return on raw milk and share capital

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31 The actual proportion of the farm gate 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.

32 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

invested in the cooperative that supplier-shareholders have tended to be interested in, rather than its individual components.

A11 In 2009, Fonterra unbundled its total return to farmers into a farm gate milk price paid for raw milk and returns on share capital. With the unbundling came the need to set the farm gate milk price independently of Fonterra's share valuation processes.

A12 In 2010, Fonterra shareholders voted to change Fonterra's capital structure to implement Trading Among Farmers (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 a second vote in June 2012. Live trading of shares commenced on 30 November 2012.

A13 As explained by Fonterra[33], there are two components to TAF:

A13.1 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.

A13.2 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" or 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.

A13.3 Although the markets are separate, they have been designed to work together. Farmer Shareholders, Fonterra and the RVP[34] can buy or sell Shares in the Fonterra Shareholders' Market, and buy or sell Units on the NZX Main Board or ASX. 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.

A13.4 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.

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number of dairy farmers who supply Fonterra with raw milk on a contract supply basis and do not hold shares.

33 Source: http://www.fonterra.com/global/en/Financial/Trading+Among+Farmers

34 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.

A14 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.

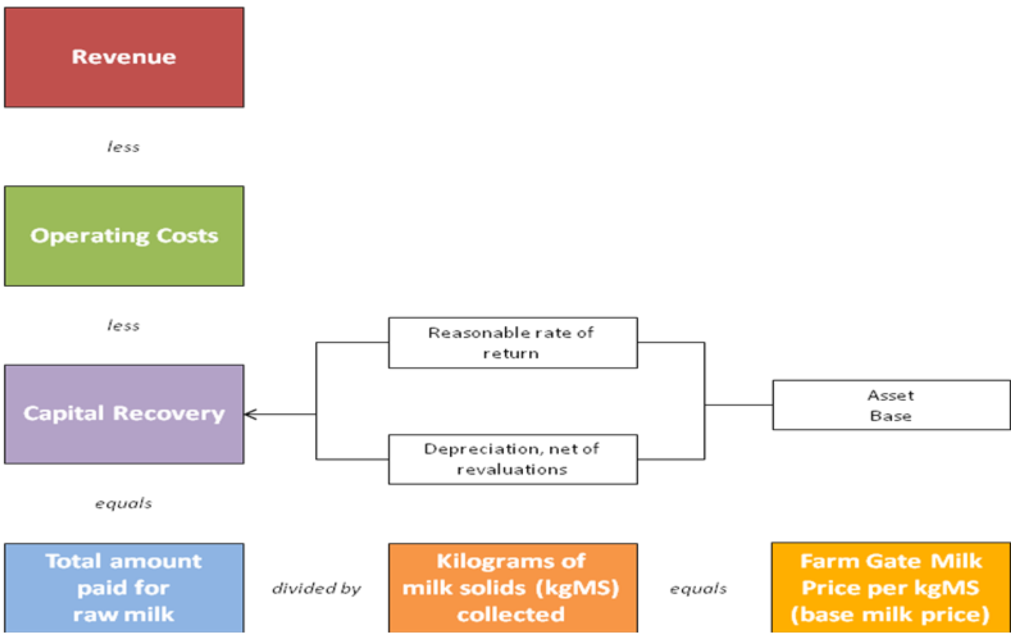
A15 In 2011, Fonterra released its methodology for calculating the farm gate milk price, contained in Fonterra's Manual, on its website. Fonterra's release of its methodology was accompanied by a Milk Price Statement which provided some information about the key elements of the 2010/11 calculation.

A16 The Fonterra Board sets the farm gate 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.

Fonterra's methodology for setting its farm gate milk price

A17 Fonterra's methodology for calculating its farm gate milk price is guided by a set of principles set out in Fonterra's constitution and outlined in Fonterra's Manual. Figure A.2 provides a visual representation of Fonterra's methodology.

Figure A.2: Fonterra's Farm Gate Milk Price methodology



A18 Fonterra calculates the farm gate 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:

A18.1 The **revenue** Fonterra would earn in NZ dollars if the equivalent of all the raw milk Fonterra collects in New Zealand was converted into a chosen product mix, and sold on international dairy markets; less

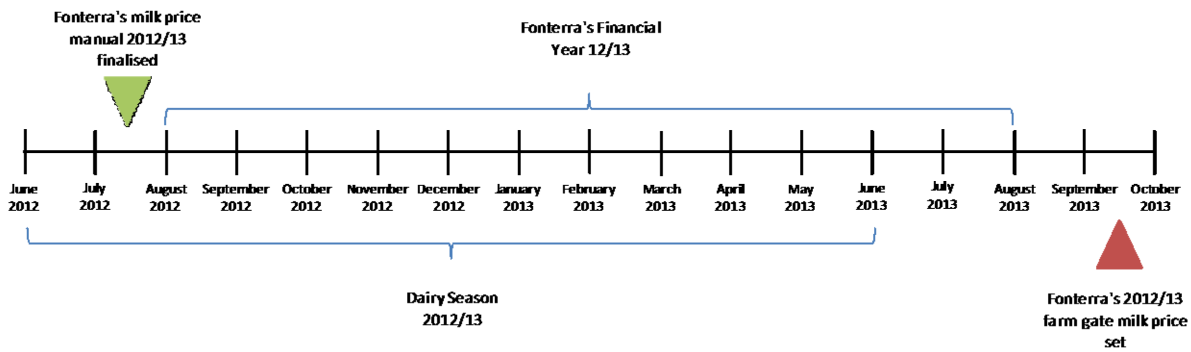
A18.2 The **costs** of collecting raw milk from farms, processing it into the chosen product mix and then transporting this product mix to the point of export from New Zealand, along with sales and administration expenses, depreciation and a return on investment on fixed assets and working capital.

A19 The farm gate milk price is expressed in terms of dollars per kilograms of milk solids (kgMS) supplied to Fonterra. Payments to individual farmers for their milk are, however, adjusted for the composition of milk supplied (in terms of the fat and protein components) and the timing of supply (eg, milk supplied during the winter period attracts certain premiums).

A20 Although Fonterra makes a number of payments to farmers for raw milk during the dairy season (based on its forecast farm gate milk price), its current policy is to confirm the final farm gate milk price for the season a few months after the end of that season. The dairy season runs from 1 June to 31 May. Fonterra's final farm gate milk price is typically set in late September after the end of the relevant season. This results in end of year 'wash-up' payments to farmers.

A21 Fonterra's current policy is that its Manual is subject to comprehensive review every four years. However, changes to the Manual can be made in the interim on a prospective basis. 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 A.3 shows a timeline of Fonterra's decisions for the 2012/13 season.

Figure A.3: Timeline for setting the Farm Gate Milk Price



Attachment B: Our approach to the statutory review of the Manual

Purpose

B1 This attachment sets out:

B1.1 the key legislative provisions of the DIRA;

B1.2 our interpretation of those provisions;

B1.3 our approach to the review of the Manual; and

B1.4 the scope of, and processes for, our review.

The DIRA

B2 The 2012 DIRA amendments introduced a new Subpart 5A into Part 2 of the DIRA relating to Fonterra's calculation of its base milk price.

B3 We are required to review the Manual against the purpose statement set out in section 150A of the DIRA. [35] We set out the purpose and other related provisions of Subpart 5A of the DIRA below.

"Subpart 5A – Base Milk Price

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 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.

"150B Certain assumptions do not detract from purpose of subpart

It does not detract from the achievement of the purpose set out in section 150A that new co-op sets the base milk price using assumptions that include any of the following:

(a) that new co-op operates a national network of facilities for the collection

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[35] We note that the DIRA also contains a purpose statement in s 4(f) that more generally seeks to "promote the efficient operation of dairy markets in New Zealand by regulating the activities of new co-op to ensure New Zealand markets for dairy goods and services are contestable". We consider that this general purpose statement is consistent with the more specific purpose statement in s 150A, and therefore does not alter the interpretation of that section.

and processing of milk:

(b) that the size of new co-op's assumed units of processing capacity approximates to the average size of new co-op's actual units of processing capacity:

(c) that gains and losses experienced by new co-op resulting from foreign currency fluctuations, including from new co-op's foreign currency risk-management strategies, are incorporated in the base milk price:

(d) that all milk collected by new co-op is processed into commodities at yields that are practically feasible.

150C Setting of base milk price in way that is consistent with certain principles

(1) For the achievement of the purpose set out in section 150A, the base milk price must be set in a way that is consistent with the following principles:

(a) revenue taken into account in calculating the base milk price is determined from prices of a portfolio of commodities at the times that those commodities are contracted to be sold by new co-op:

(b) costs taken into account in calculating the base milk price include costs (including capital costs and a return on capital) of—

(i) collecting milk; and

(ii) processing milk into the same portfolio of commodities as the portfolio adopted for the purposes of paragraph (a); and

(iii) selling those commodities:

(c) new co-op collects all milk that it processes from the farms on which the milk is produced.

(2) For the purposes of subsection (1)(a) and (b)(ii), the portfolio of commodities must be determined having regard to the following:

(a) in respect of the commodities included in the portfolio,—

(i) the commodities that are likely to be the most profitable over a period not exceeding 5 years from the time when the portfolio is determined; and

(ii) the need for commodities included in the portfolio to utilise all components of milk; and

(b) in respect of the relative proportions of the commodities included in the portfolio, the quantities of commodities likely to be produced by new co-op based on—

(i) the mix of commodities that are likely to be most profitable; and

(ii) new co-op’s physical manufacturing capacity for the production of those commodities; and

(iii) the need to utilise all components of the milk processed.

Our interpretation of sections 150A, 150B and 150C of the DIRA

B4 In summary, we have interpreted the purpose provisions of subpart 5A of the DIRA as follows.

B4.1 The focus of the base milk price monitoring regime is on providing incentives for Fonterra to drive efficiencies while also providing for contestability in the farm gate milk market.

B4.2 The base milk price is intended to reflect notional costs (which may be lower than Fonterra's current actual costs), to encourage Fonterra to be efficient.

B4.3 To ensure contestability in the market, any assumptions taken into account in calculating the base milk price must be practically feasible for an efficient processor to replicate.

B4.4 It is not mandatory for us to model the base milk price that independent processors can afford to pay.

B5 We explain how we have reached this view below.

B6 Sections 150B and 150C provide for 'safe-harbours' and mandatory assumptions that Fonterra must apply. Many of the assumptions that Fonterra makes in setting the base milk price are not referred to in sections 150B or 150C. When considering these assumptions, we will be guided by our interpretation of the purpose statement.

The purpose statement – section 150A

B7 We consider that the efficiency and contestability requirements within s 150A are interlinked and that together, they require consideration of:

B7.1 What is meant by 'efficiency'?

B7.2 What is meant by 'contestability'?

B7.3 How do the dimensions of efficiency and contestability inter-relate?

Our interpretation of efficiency

B8 Section 150A refers to incentives for Fonterra to 'operate efficiently'. We have therefore interpreted the primary focus of the efficiency dimension to be improving incentives for Fonterra to drive cost efficiencies (ie, productive efficiency).[36] We discuss our practical approach to assessing against the efficiency dimension of the purpose statement below.

Our interpretation of contestability

B9 While the DIRA does not define contestability, practical guidance on what is required to provide for contestability in the market for the purchase of milk from farmers is provided by s 150A(2).

B10 Section 150A(2) states that the setting of a base milk price will provide for contestability if "any notional costs, revenues, or other assumptions taken into account in calculating the base milk price are practically feasible for an efficient processor". Our interpretation of s 150A is therefore that if the assumptions used in setting the base milk price are practically feasible, the contestability dimension is satisfied.

B11 Miraka[37] submitted that the DIRA allows the Commission to adopt a different position on contestability that is consistent with case law such as *Telecom Corporation of New Zealand Limited v Commerce Commission,*[38] and particularly the Efficient Component Pricing Rule. Given the different legislative contexts, any comparisons between the express requirements in section 150A and the requirements of s 36 of the Commerce Act 1986 which were relevant to that case must be made with caution.

B12 We discuss our practical approach to assessing against the contestability dimension of the purpose statement below.

How are the two dimensions reconciled?

B13 It is our interpretation that to satisfy s 150A the Manual must be consistent with both dimensions, independently. As such, we are not required to choose between the priority of the contestability and efficiency dimensions in s 150A to assess whether the purpose is satisfied.

B14 The Primary Production Select Committee commentary in its report back of the Dairy Industry Restructuring Amendment Bill 2012 (which was ultimately enacted

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

37 Miraka, *Miraka Response: Process Paper – Review of Milk Price Manual*, 21 September 2012, page 2.

38 [2012] NZCA 278 (27 June 2012). The Telecom case concerned a breach of section 36 of the Commerce Act 1986 by Telecom. Our view is that the DIRA milk price monitoring regime is intended to be different to s 36 of the Commerce Act. Under subpart 5A of the DIRA, we are required to assess the Manual against the purpose in s 150A(1). The DIRA competition standard chosen by Parliament is contestability, and how we are to assess against that standard is set out in sections 150A(2), 150B and 150C. This legislative scheme is different to s 36 of the Commerce Act, which focuses on whether a person with substantial market power has taken advantage of that substantial market power for a prohibited purpose.

to amend the DIRA) confirmed that the efficiency dimension was not intended to have priority over the contestability dimension:

> The Bill introduced [ie the draft Bill] could have the effect of prioritising Fonterra's efficiency over the contestability of the farm gate milk market. This is contrary to the intent of the principal Act where contestability is a means to achieving efficient dairy markets. To reflect the principal Act's intention, the farm gate milk price should be set at a level that provides an incentive to Fonterra to operate efficiently, while also providing for contestability in the farm gate milk market. [39]

B15 Synlait has argued that the two objectives are interrelated: "the features of the current Notional Efficient Producer milk price that the Government and the Commission say will incentivise Fonterra to be more efficient, are what (in aggregate) lowers returns across the industry and substantially reduces contestability and the threat of entry."[40]

B16 Our statutory task is not to set what the farm gate milk price should be, ie. to make trade-offs on the likelihood of meeting each of the objectives. We must simply answer a binary question as to whether the objectives are met rather than exercise any further judgement on what costs reflect the most efficient market outcome.

Section 150B – "safe harbours"

B17 We interpret section 150B as being intended to create 'safe harbours' where the setting of the base milk price by Fonterra is consistent with the assumptions listed in paragraphs (a) to (d). In performing our statutory review, we are therefore not required to assess any aspects of the Manual that are sheltered by the safe harbour provisions for consistency against the s 150A purpose.

Section 150C – "mandatory assumptions"

B18 We interpret s 150C of the DIRA as setting out certain assumptions that Fonterra is required to make in setting the base milk price. Our review of the assumptions in s 150C is therefore limited to examining whether the Manual contains those assumptions.

Our practical approach to the review of the Manual

B19 In this section we set out in more detail our approach to assessing whether the Manual is consistent with the purpose in s150A, and particularly how we approach each of the efficiency and contestability dimensions.

Our approach to the efficiency dimension – how Fonterra is provided with incentives

B20 This section explains our approach to assessing whether the Manual provides incentives to Fonterra to operate efficiently.

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[39] Select Committee Commentary; see section "Milk Price" on page 2 http://www.parliament.nz/en-NZ/PB/SC/Documents/Reports/2/6/9/50DBSCH_SCR5490_1-Dairy-Industry-Restructuring-Amendment-Bill-11-2.htm.

[40] Synlait submission on draft report, paragraph 7.

B21 Fonterra will have an incentive to operate efficiently where the base milk price is set independently of Fonterra's actual performance, as this then provides Fonterra with a benchmark to beat.

B22 To explain, we expect Fonterra's Board and management to be subject to normal drivers to increase Fonterra's profit. If the base milk price is set independently of Fonterra's performance, and is allowed to operate mechanically, any improvements in Fonterra's profit will depend mostly on its actual yields getting better, its actual product portfolio migrating to more valuable options, and its operating costs being reduced. In this setting, Fonterra has a strong incentive to make these gains.

B23 Our view is that setting any independent benchmark for the costs that underpin the base milk price would provide an incentive for Fonterra's management to improve efficiency. There is no unique price that needs to be ascertained to provide incentives for Fonterra to improve its productive efficiency. Setting any independent benchmark provides a target.[41]

B24 Subpart 5A of DIRA is consistent with this view. It envisages the use of notional values and in some instances requires the use of a notional business. These notional components create the benchmark that provides Fonterra with efficiency incentives.

B25 Notwithstanding the efficiency dimension of the s 150A purpose, there are instances where it is still reasonable to use actual data in setting the base milk price. These particularly include where:

B25.1 there is insufficient information to know what an appropriate notional value would be; or

B25.2 Fonterra has very limited control over the actual costs used for the benchmark.

Practical questions we have considered in assessing efficiency

B26 Our approach to considering the efficiency dimension is to therefore assess the extent to which the base milk price, through the use of notional components, incentivises Fonterra to operate efficiently. The practical questions we have considered in making this assessment are:

B26.1 Have actual or notional values been used?

B26.2 Where actual data is used:

B26.2.1 Is this consistent with the assumed product mix?

B26.2.2 Why was actual data used?

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41 The benchmark should be stable over time in order to provide an incentive to operate efficiently over time.

B26.2.3 Could the use of the notional data instead provide an incentive for Fonterra to operate efficiently?

B26.3 Where notional data is used:

B26.3.1 Is it exogenously determined, or is it adjusted for Fonterra's actual results?

Our approach to the contestability dimension – what is practically feasible

B27 This section explains our approach to assessing whether assumptions are practically feasible for an efficient processor. If the assumptions adopted are practically feasible, then the Manual is consistent with the contestability standard of s 150A.

B28 We interpret s 150A as meaning that the assumptions must at the very least be practically feasible today for Fonterra or another processor efficiently building an incremental plant. It does not in our view require all of Fonterra's existing plants to be able to operate at that level of efficiency.

B29 In assessing whether an assumption is practically feasible, our main test is examining whether the assumption is practically feasible for Fonterra. This reflects the majority of the data that we have available to us, and is consistent with s 150P(3)(a), which confirms that the Commission is not required to model the costs of an independent processor.

B30 It does, however, remain possible that an assumption is practically feasible for Fonterra due to features unique to Fonterra, which do not relate to Fonterra acting efficiently. In that case the assumption may not be practically feasible for another efficient processor.

B31 In examining practical feasibility for Fonterra, we therefore include a reasonableness cross-check[42] to identify whether our assessment is being affected by any unique features. If that was the case, we would then consider what further review is necessary, including potentially reviewing whether the assumption is feasible for another efficient processor.[43]

B32 In assessing whether the assumptions are practically feasible, we have made an individual and an aggregate assessment. For the purposes of this review, after we had assessed each selected issue, we did the following.

B32.1 We considered whether there is consistency amongst the assumptions used to calculate the base milk price; and

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[42] We note that Fonterra in page 6 of its reasons document submitted that the Commission's assessment of the contestability dimension in the dry run report is more onerous than the standard in s 150A. It appears that Fonterra formed the view that the Commission was essentially applying a two-stage (practical feasibility and reasonableness) test, which was correct during much of the dry run (applying different draft legislation), but is not the case now.

[43] An example of this may be if Fonterra was to restate retrospectively an assumption in the calculation of the base milk price

B32.2 We then drew a conclusion on the extent to which the Manual provides for contestability in the market within the review based on the aggregate impact of the assumptions (ie. on the basis of the high level principles and rules provided by the Manual).

B33 Inevitably, our review involves a level of subjectivity and we have exercised a degree of judgement, based on our experience as an economic regulator.

An efficient processor is not limited to an existing processor

B34 Our interpretation of the DIRA is that in assessing practical feasibility we are not required to limit our assessment to whether the assumption is feasible for existing independent processors (ie, small corporate processors). Other potential entrants exist and may enter the market for the purchase of milk from farmers.

B35 Open Country Dairy has submitted that our interpretation confuses what is theoretically feasible with what is practically feasible. It argues that if only potential entrants can reach a given level of efficiency this is strong evidence that it is not practically feasible (as that implies actual delivery and achievement).[44]

B36 We do not agree that 'practically feasible' means that something must be actually delivered or achieved by existing independent processors. If the cost, revenue or other assumption could be achieved by an efficient processor, then that means that it is practically feasible. The DIRA does not limit the Commission to looking at existing processors.

B37 We acknowledge that a potential outcome of the DIRA is that a base milk price could be consistent with the s 150A purpose, yet be set at a level such that some processors that are more efficient than Fonterra (on average) may not be able to enter or remain in the market. For example, the lowest practically feasible processing costs (including the cost of capital) might be associated with the next plant of efficient scale. Under the DIRA, it does not matter whether existing independent processors can necessarily achieve that level of efficiency or not. As long as Fonterra or some other potential entrant can achieve that level of efficiency, then that ensures that the base milk price reflects a practically feasible level, and would provide a normal return on the incremental investment.

Scope of our review

B38 Under subpart 5A of the DIRA, the Commission must undertake separate annual reviews of the Manual and the base milk price calculation against the specified purpose in s 150A of the DIRA.[45]

B39 This means that for this review, we have reviewed Fonterra's methodology and assumptions for setting the base milk price, but not how the base milk price has been calculated (ie, how the Manual has been applied). We will review the

[44] Open Country submission on *Process Paper*, dated 21 September 2012, page 1.

[45] By contrast, for the dry run review we reviewed Fonterra's 2011/12 manual for setting the base milk price and the application of that methodology in calculating the base milk price together.

application of the Manual, and the inputs and processes used by Fonterra to calculate the base milk price, in 2013.[46]

B40 Synlait submitted that it was unclear where the boundaries lie between our separate reviews of the Manual and the milk price calculation.[47] We do not agree. The DIRA is clear that this review is limited to testing the assumptions and methodology contained in the Manual against s 150A.

B41 The limits of this review means that our conclusions may be different when we see those assumptions applied in the base milk price calculation. We anticipate that Fonterra's application of the assumptions will provide greater clarity on whether the setting of the base milk price achieves both of the efficiency and contestability dimensions in s 150A. For example, where assumptions are drafted in general terms, the effect depends on the inputs which are used in the calculation. To illustrate this point, the measures to be used as inputs in the yields assumptions are stated as composition targets and allowable yield losses but the practical feasibility of these depends on the actual numbers that they produce.

B42 As the DIRA does not contain a materiality threshold, the Commission has considered all elements of the Manual in this review.

Responses to key points raised in submissions regarding our review framework

Interpretation of "consistent with"

B43 Synlait has submitted that "The Commission appears to have adopted a very literal interpretation of the phrase "consistent with", and not considered whether the Manual is actually likely to *serve* or help *achieve* the objectives."[48]

B44 Our report does discuss the 'extent' of consistency where an assumption is inconsistent with the Manual. In our view this is the extent of our task under Subpart 5A of the DIRA. As noted at footnote 35, we do not believe there is any inconsistency between Subpart 5A and the broader purpose of the DIRA set out in section 4.

Commission's approach to the efficiency dimension

B45 Synlait has also argued that the Commission's interpretation of sections 150A, 150B and 150C of the DIRA is incorrect on a number of grounds. The first of these relates to the Commission's view (B23 supra.) that setting any independent benchmark for the costs that underpin the base milk price would provide an incentive for Fonterra's management to improve efficiency. Three points raised against the Commission's view are:

46 See section 150O.

47 Synlait, *Submission on the Commission's Review of the Milk Price Manual,* dated 21 September 2012, pages 1 and 2.

48 Synlait submission on draft report, paragraph 63.

B45.1 "the milk price regime simply determines the split of the total payout between milk payments and equity returns, but does not alter the total payout. Fonterra will always have an incentive to focus on productive efficiency to increase the total payout over time;

B45.2 almost all other businesses report only their actual results, and do not set notional benchmarks, yet still successfully strive for efficiency gains; and

B45.3 in any event, the notional milk price (and the milk price gap) can still be calculated as a performance measurement, without actually *paying* that price to farmers."[49]

B46 The Commission has explained (para. B24 above) that Subpart 5A of the DIRA envisages the use of notional values and in some instances requires the use of a notional business. As we also explain, to create an incentive, the benchmark cannot be absolutely actual. Against this framework we respond to each of Synlait's points:

B46.1 Whether or not Fonterra has other incentives, Subpart 5A of the DIRA clearly envisages the farm gate milk price setting process itself creating incentives for operational efficiencies, so that is what the Commission must assess.

B46.2 Again the Commission's assessment must be against Subpart 5A, not what applies to "almost all" other businesses (which in any case may face quite different competitive pressures and constraints to Fonterra); and

B46.3 The Commission's statutory obligation is to report on the Manual as the basis for the setting of the base milk price, which is the price paid to farmers. We are unable to assess a performance measurement tool that is not the price paid to farmers.

B47 Synlait also submitted that it is open to the Commission to conclude that the efficiency limb is ineffective. Our view is that Parliament created the milk price monitoring regime earlier this year, after having considered submissions from all interested parties. Our statutory task now is to consider the extent of the consistency of the Manual with the purpose.

B48 Synlait further submitted that the contestability and efficiency dimensions are interrelated. As discussed above, to satisfy s 150A it is necessary to satisfy both limbs of that proposed provision. So, the efficiency dimension is not prioritised over the contestability dimension. As such, we are not required to choose between the priority of the contestability and efficiency dimensions in s 150A to assess whether the purpose is satisfied.

[49] Ibid. paragraph 10.

Commission's approach to the contestability dimension

B49 Synlait argues that "We believe the "practically feasible" test in s150A(2) should be interpreted to mean that the assumptions used are not only individually feasible, but also internally consistent and, in aggregate, represent a processor that could exist in practice."[50]

B50 In assessing whether the assumptions are practically feasible, our approach is to make an assessment of:

B50.1 whether the individual assumptions are practically feasible;

B50.2 whether the assumptions are internally consistent; and

B50.3 we then drew a conclusion on the extent to which the Manual provides for contestability in the market within the review, ie, based on the aggregate impact of the assumptions.

B51 We agree with Synlait's submission as we understand it: if the Manual is effectively creating a processor that could not exist, it should not satisfy the contestability dimension. In assessing internal consistency and making an aggregate assessment we therefore specifically consider the risk of over-optimisation, creating a notional 'super-competitor' that could not in fact exist, and cross-check for that, as far as we are able to in this review.

Performance gap

B52 Synlait also cited a model run by Deloitte which showed a significant performance gap and indicated the need for the review to include the identification of performance gaps between Fonterra's existing commodities business and the Notional Producer.

B53 Our view is that defining the gaps between Fonterra's actual commodity business and the Notional Producer is outside of scope of this review. We will consider the outcome of the milk price during our review in 2013 on the implementation of the Manual.[51]

Inconsistencies

B54 In paragraph 87 of its submission Synlait gives three examples of where it believes there is inconsistency between assumptions. These relate to:

B54.1 the specification of the assumed output compared with that of commodity product sold on GDT;

B54.2 the negative effect on GDT prices of the assumed volumes; and

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[50] Ibid. Paragraph 14.

[51] We are mindful that Fonterra's existing commodities business is not what we are testing the Manual against.

B54.3 the assumption of a depreciated asset base together with using yields based on current technology.

B55 With respect to the first example, the Manual is silent on the specification of the assumed output, therefore we are unable to say whether there is any inconsistency until we review the application of the Manual.

B56 It is not clear to us what effect there would be on GDT prices of using the volumes assumed in the notional producer model. If volumes were to be switched from alternative channels, where typically there is some additional service requirement, such as security of supply, the buyers of these products might respond in various ways including buying more volumes on GDT. The prices they would be prepared to pay on GDT to secure required commodity volumes is unknown, although we understand that GDT prices have a strong influence on prices negotiated through other channels. We do not see any way of reliably quantifying an adjustment to currently observed GDT prices as a result of an assumed increase in on-GDT sales volumes, even if this were considered to be appropriate, which is not obvious.[52]

B57 The capital costs assumptions do provide for a tilted annuity depreciation to be applied across the notional asset base. We understand that this is largely to smooth the capital costs and avoid swings in the milk price arising from adding irregular increments of capital. The costs applied to the assets notionally aged in this way are, however, the inflation adjusted costs associated with the technology of the modern plant. Therefore we do not see that there is an inconsistency in using yields based on current technology.

B58 Whether the yield assumptions are unreasonably aggressive, as Synlait asserts, is a matter we have indicated we will examine in more detail when we review the calculation of the base milk price.

B59 The Commission has assessed the relevant assumptions both individually and in aggregate, and in our view there is no evidence of internal inconsistency that would suggest the Manual is not consistent with the purpose. We will however consider the effect of the values adopted as a part of our cross-check on the consistency of the assumptions when we review the application of the Manual in our review of the base milk price calculation.

‘Super-competitor’

B60 Synlait also submits that the Commission’s “incremental” approach is flawed. It argues that:

- new entry and competition is undertaken by firms, not individual plants. Section150A(2) refers to “an efficient processor”, not “an efficient plant”, and the milk price calculation correctly models the costs of a whole firm; and
- in practice processors will each have their competitive advantages and disadvantages, but as discussed above none will have the Notional Producer’s artificial mix. So, for example,

52 This issue was discussed in paragraph A7.27 of our dry-run review.

> if it is a small new entrant building the next plant, it will not have the Notional Producer's economies of scale in relation to selling and overhead costs. If it is Fonterra building the plant, it could not pay the Notional Producer milk price and earn WACC across its actual mix of plants and commodity products. (Also, in neither case do we believe the modelled yield is practically achievable throughout a whole season).[53]

B61 The Commission's position, as outlined in paragraph B28, is that our focus in assessing contestability from an operational perspective is on the incremental plant efficiently built by Fonterra or another processor. If Fonterra can build the incremental plant efficiently due to economies of scale then this is consistent with the safe harbour assumptions in s 150B(a) and (b).[54]

B62 We have stated our view in paragraph B37 above that a potential outcome of the DIRA is that a base milk price could be consistent with the s 150A purpose, yet be set at a level such that some processors that are more efficient than Fonterra (on average) may not be able to enter or remain in the market.

B63 We also consider that we are not required to limit our assessment to whether the assumption is feasible for existing independent processors (ie, small corporate processors). Other potential entrants may enter the market for the purchase of milk from farmers

B64 We do not agree that 'practically feasible' means that something must be actually delivered or achieved by existing independent processors. If the cost, revenue or other assumption could be achieved by an efficient processor, then that means that it is practically feasible. The DIRA does not limit the Commission to looking at existing processors, who may not be efficient.

B65 Finally, in relation to the broader nature of the Commission's milk price monitoring assessment:

B65.1 Synlait has compared the contestability standard provided for by s 150A to a "workably competitive" model. In response we simply note that the Commission must apply the existing statutory test in carrying out its statutory duty;

B65.2 Synlait also argued that Fonterra's milk pricing behaviour since FY06 is best seen as an anti-competitive response to entry. To the extent that Synlait has concerns about Fonterra's behaviour over the last six years, that is a matter that is appropriately considered under Part 2 of the Commerce Act 1986. By contrast the Commission's annual assessment of the Manual is against a specific purpose and within specific parameters under the DIRA.

Provisions relating to the process for this review

B66 The requirements and procedure for our review are contained in sections 150H to 150M of the DIRA.

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53 Ibid. Paragraph 15.
54 Refer footnote 15.

B67 Section 15OH requires the Commission to review the Manual and make a report for each season.

B68 Sections 15OI and 150J set out requirements for our report:

150I Commission's report

(1) The Commission must make a report on the extent to which the milk price manual is consistent with the purpose of this subpart (see section 150A).

(2) In making the report, the Commission must—

(a) have regard to the information provided to it by new co-op under section 150L or under the procedure agreed under section 150K; and

(b) have regard to any submission made by new co-op under section 150M(2)(a) or under the procedure agreed under section 150K; and

(c) give reasons for its conclusions.

150J Commission must make final report publicly available

The Commission must finalise its report under section150I and make it publicly available by 15 December in the season to which the milk price manual relates.

B69 The procedure for our review is contained in sections 150K to 150M:

150K Procedure for review of milk price manual

(1) The procedure for the review by the Commission of the milk price manual is—

(a) the procedure set out in sections 150L and 150M; or

(b) if a procedure is agreed between new co-op and the Commission, that procedure.

(2) If new co-op fails to comply with the agreed procedure,—

(a) the agreed procedure lapses; and

(b) the procedure set out in sections 150L and 150M applies to the extent that anything that is required to be done by new co-op under those sections remains still to be done.

150L New co-op must provide Commission with milk price manual and other information

New co-op must, not later than 1 August in each year,—

(a) provide the Commission with the milk price manual for the current season; and

(b) provide the Commission with any recommendations by the panel in relation to the setting of the base milk price; and

(c) notify the Commission of any change in the economic and business environment that, in new co-op's view, requires a change to the milk price manual; and

(d) certify to the Commission the extent to which new co-op considers that the milk price manual is consistent with the purpose of this subpart (see section 150A); and

(e) provide the Commission with reasons for the view expressed in new co-op's certificate given under paragraph (d).

150M Draft Commission report

(1) Not later than 15 October in the season to which the milk price manual relates, the Commission must provide new co-op with a draft of its report made under section 150I.

(2) Not later than 15 November in the season to which the milk price manual relates, new co-op must—

(a) make a submission to the Commission on the draft report; or

(b) notify the Commission that it does not wish to make a submission.

B70 We note that in accordance with s 150K we agreed to vary the due date for information to be provided by Fonterra under s 150L. This information was provided on 5 September 2012.

B71 We also agreed to 19 October 2012 as the date by which our draft report was to be provided to Fonterra in accordance with s 150K(1)(b). There are no other date changes as a result of this agreement.

Attachment C: Table of key issues for the Manual review

Purpose

C1 In this attachment we set out our views on the principles and rules identified in the statutory review of Fonterra's 2012/13 Milk Price Manual (the Manual) that we consider require particular comment.

Key principles and rules in the Manual requiring comment in this report

C2 Similar to the analysis in Chapter 3 of this report, the key principles and rules are discussed in the following categories:

C2.1 Statements about the objectives of the Manual which may appear to be inconsistent with s 150A, even though we consider the underlying rules and assumptions on balance are not. Our objective in commenting is to promote certainty and clarity only;

C2.2 Rules of the Manual that appear to be inconsistent with the efficiency dimension of the DIRA (Efficiency dimension);

C2.3 Rules of the Manual that appear to be inconsistent with the contestability dimension of the DIRA (Contestability dimension);

C2.4 Issues which we identified in the dry run review, and which have resulted in changes to the Manual for the 2012/2013 seasons (Responses to the dry run review);

C2.5 Rules whose apparent consistency with the purpose, or shelter within the "safe harbour" provisions depends upon how they are applied;

C2.6 Rules of the Manual that are outside the scope of the monitoring review of the DIRA (Issues outside the scope of the monitoring review).

C3 Table C.1 below summarises the key issues identified during the statutory review based on the categories defined above. The table shows the relevant principle, rule or definition in the Manual, Fonterra's comment on the issue identified (as expressed in its s 150L certification) and our preliminary review of whether the principle or rule is consistent with the purpose.

Table C.1: Our analysis on the key issues identified during the statutory review of the 2012/2013 Manual

Principles and rules, which are not inconsistent with the DIRA, but require certainty and clarification

Principle/ Rule	Fonterra's Comments	Commerce Commission Review
The Milk Price for a Season should reflect the benefits that arise from the collective selling power of Shareholders as suppliers to Fonterra, and from scale and other economies Fonterra enjoys in production and sales.	S150B provides that it "does not detract from the achievement of" the DIRA purpose provision that Fonterra's Milk Price reflects Fonterra's scale economies. The Milk Price only reflects any scale economies that Fonterra would enjoy if it were a New Zealand-only, commodity-only business, and also reflects a number of costs that effectively reflect diseconomies attaching to Fonterra's scale and unique position under DIRA (including, for example, Fonterra's actual milk collection costs which are materially affected by Fonterra's DIRA obligations).	The milk price principle refers to both the benefit of economies of scale and the collective selling power. Our view is that the DIRA contemplates economies of scale in Fonterra's safe-harbour assumptions in s 150B(a) and (b) of the DIRA. We therefore consider that Fonterra's economies of scale are captured as a safe harbour in the DIRA. However, s 150(B) only considers the "new co-op" and not the "collective selling power of Shareholders as suppliers to Fonterra". Our view is that this differentiation is not relevant as long as the Manual considers and applies efficient costs. We do not consider this statement to be inconsistent with the efficiency dimension of s150A.
In this context, the Milk Price should be the maximum amount that Fonterra, reflecting its status as a properly-managed and efficiently-run, sustainable co-operative, could be paid for Milk supplied to it in a Season if:	The phrase 'maximum amount' is used in this context (a) to identify the amount Fonterra could afford to pay if it were a commodity-powder manufacturer and still able to earn a WACC return on new investment, and (b) provide assurance to Fonterra's suppliers that the Milk Price will not be arbitrarily adjusted so as to result in a higher-than-WACC return on new commodity milk powder assets (an outcome that would not occur if the market for milk at the farm gate in NZ was competitive).	We note that the text here should read "could pay" rather than "could be paid." We read this as meaning that Fonterra is seeking to maximise supplier value, which appears to be inconsistent with the contestability dimension of the purpose. However, our review of the underlying assumptions suggests that this statement of principle does not give effect to any material inconsistency between the Manual and the purpose.
Risks should be allocated between Milk suppliers and Fonterra in a manner which appropriately reflects the relative abilities of each party to manage those risks.	The explanatory text and table accompanying this principle in the Milk Price Manual note that the intent of this provision is to ensure that, amongst others: "Where a risk lies outside the ability of both farmers and Fonterra to control, such as commodity price risk and general movements in costs, the consequences should flow through to the Milk Price, on the basis that this results in farmers receiving accurate signals about the true value of on-farm production, and therefore incentivises them to	We note that the safe harbour in s 150B(c) allocates foreign currency risk rather than judging it under this principle. We consider that the underlined section in Fonterra's comment of this principle is not relevant to the purpose but may reflect other concerns about which we have not sought to reach a view.

Principle/ Rule	Fonterra's Comments	Commerce Commission Review
	respond appropriately, for example by managing discretionary expenditure on supplementary feed and fertiliser or (at the margin) by deciding to move land to or from alternatives uses. s150A refers to incentives on Fonterra to operate efficiently, and we consider it appropriate to read into this provision that, where relevant, the Milk Price should also incentivise farmers to operate efficiently."	
Initial Reference Basket (Rule 2)	S 150C(2) provides that the portfolio of commodities should, at the time the portfolio is selected, represent the commodities most likely to be profitable over the following 5 years. This portfolio was selected in 2008, and our analysis at the time indicated (among other things – see the discussion in section 3) that these commodities were most likely to be profitable over the medium term. Basing the Milk Price on a sample of the products manufactured by Fonterra, rather than all products, appropriately incentivises Fonterra in its product mix decisions, since decisions to manufacture and sell non Milk Price products at relative prices below milk powder prices directly affect Fonterra's earnings. The initial Reference Basket will comprise standard speciation commodity product manufactured from four 'base' milk powder streams, comprising four combinations of WMP, SMP, Butter or AMF, and BMP.	We note the Manual does not provide any evidence or a description of the approach to determining the RCPs and that the RCPs are in accordance with the all the requirements in s 150C(2). This is a matter relevant to s 150F and therefore outside the scope of this review. Rule 2 on RCPs appears to be consistent with the purpose and our conclusions from the dry run review remain:[55] Fonterra's profits are calculated after payment of the base milk price. The selection of WMP and SMP and the by-products of WMP and SMP as the RCPs ensures the products and prices used in the base milk price are determined exogenously, using widely traded commodities. The size of Fonterra's profits depends on it operating more efficiently than implied by the revenue assumptions that underpin the base milk price (eg, by producing and selling more profitable commodities than those used to set the base milk price). The use of WMP and SMP in setting the Base Milk Price therefore provides an incentive for Fonterra to operate efficiently.
Subsequent revisions to Reference Basket (Rule 3)	The underlying rationale for this provision is that it is reasonable to expect Fonterra will face sustained competition for milk from manufacturers of a particular commodity product only if that product is profitable, and that this test is therefore consistent with s 150C(2). Note also that the test is not exhaustive – it is highly unlikely, for example, that an additional product would be added to the reference basket if Fonterra itself was not investing in new capacity for the manufacture of the product.	This rule appears to be consistent with the DIRA. We note that the 5-year period required in s 150C(2) should provide for stability, and that production patterns and demand patterns are likely to shift within a 5-year period and the RCPs should reflect this. But this does not imply changing plants and commodities on an annual basis to optimise the base milk price. We also note that the latter is not Fonterra's practice to date.

[55] See paragraph A4.14 of our final report on the dry run review

Efficiency dimension

Rule	Fonterra Comment	Commerce Commission Review
Farmgate Milk Price Production Plan (Rule 7)	The default approach is to align the Milk Price allocation of milk to, first, WMP or SMP and, secondly, butter or AMF, to Fonterra's actual allocation, under the assumption that Fonterra's allocation will be commercially supportable. The MPG [Milk Price Group] monitors the allocation process to attain assurance that this assumption is reasonable. Because this approach results in the consequences of any 'poor' decisions flowing to the Milk Price, it does not provide a strong incentive on Fonterra with respect to this process. However, historical experience shows that relative returns to these products are normally closely aligned when considered over a reasonable (say 3 – 6 month) period, and that the potential consequences of weaker incentives in this area should ordinarily not be material. The alternative to relying on Fonterra's allocation decisions would be for the MPG to maintain independent capability to forecast prices and monitor global demand and supply conditions, and we strongly consider this additional cost would not be warranted.	This rule states that Fonterra uses its actual production plan to determine the proportions of each selected RCP. Fonterra acknowledges the weak incentives to optimise the allocation of RCPs. We note that this rule appears to be inconsistent with the efficiency dimension of the purpose. We consider that for the base milk price to provide an incentive to operate efficiently, the base milk price should be based on notional data that is independent of Fonterra's actual performance. This implies that to create an incentive to improve productive efficiency, the benchmark cannot be based on Fonterra's actual costs or actual production plans. However, we also consider that there are instances where it is still reasonable to use actual data. For example, we consider that it is reasonable to use actual data if there is insufficient information to know what the appropriate notional value would be.[56] We consider that this rule is an example where insufficient information is available to determine what the appropriate notional production plan should be. We also consider that attempting to seek notional forecasts, which were independent of Fonterra's own forecasts, would require considerable additional effort by Fonterra. In that context, we consider use of Fonterra's allocation decisions is reasonable.
Milk collection costs (Rule 17)	Inter-factory diversion costs aside, the Milk Price picks up Fonterra's actual milk collection costs. Consequently the milk price methodology does not actively incentivise Fonterra to minimise its collection costs, at least to the extent the relevant incentives are earnings-based. Fonterra's management and Board are aware of this issue, and of the consequential need to rely on incentive mechanisms that are not earnings-based for this activity. We note, however, that: • the pass-through of milk collection costs to the Milk Price does not create perverse incentives to inflate collection costs, and • Fonterra as a whole is still incentivised to minimise collection costs, to the extent that costs that were materially too high would result in a loss of milk supply and a consequential risk of stranded assets, which would impact on earnings.	This rule states that Fonterra uses actual milk collection costs. The use of actual milk collection costs does not incentivise Fonterra to operate efficiently. Milk collection costs are material to the base milk price, and the use of Fonterra's actual milk collection costs does not appear to be consistent with the efficiency dimension of the purpose. It is uncertain as to whether a realistic achievable benchmark that is independent of Fonterra's actual performance can be estimated, and whether doing so would improve Fonterra's incentives to operate efficiently. We remain concerned that there could be potential inconsistency between the approach for setting the number and location of standard plants, and the data used for the calculation of collection costs.[57]

56 Refer paragraph B25 of this report.
57 Refer paragraph A12.48 of the dry run review.

Rule	Fonterra Comment	Commerce Commission Review
Milk collection assets (Rule 37)	Per Summary of Manual Amendments: Aligns treatment of milk collection capital costs to use of Fonterra actual operating costs	The use of actual milk collection assets may undermine the incentives for Fonterra to operate efficiently. We note that milk collection assets are based on a national network (with some potential over optimisation within the two regions), which is inconsistent with modelling an incremental plant. We also note the potential inconsistency between the use of actual collection costs and the approach for the setting the number of standard plants, and their location. Although this inconsistency may appear to be also inconsistent with s 150A, we will consider this aspect in the application of the Manual because it is uncertain what the application will be. In particular, our conclusion in the dry run was:[58] As standard plants are only added in whole numbers to meet peak milk supply requirements at the level of the two defined regions, rather than to specific manufacturing sites, the incremental number of standard plants is implicitly optimised for each island. Unless the relevant operating costs (eg, actual collection costs) have been appropriately adjusted upwards to reflect this implicit optimisation, this approach may not be consistent with the milk price purpose statement. Fonterra's submission on the draft report notes that they do not consider that 'optimisation' at the level of the North Island and South Island could be interpreted to imply 'over optimisation'. However, the Fonterra submission does not directly address whether any relevant operating costs (eg actual collection costs) need to be adjusted, to ensure internal consistency.
Variable Manufacturing Costs (Rule 13)	Energy costs comprise approximately 45% of variable manufacturing costs, followed by packaging costs at 33%. Energy usages are assumed to vary in full with finished product volumes (this is a simplification of reality, but is in our view materially reasonable), and are set at manufacturer's specified rates, thereby appropriately incentivising Fonterra to minimise its actual energy usage. Usage rates for packaging materials are set by reference to Fonterra actuals, but are easily verified. (Provisions for wastage are however independent of actual current-year wastage, ensuring Fonterra is appropriately incentivised to minimise wastage.) Resource usages on the remaining variable cost inputs are set by reference to Fonterra's budgeted rates for a year (subject to review by the MPG for reasonableness), leaving Fonterra appropriately incentivised to minimise actual usages. Unit resource costs are set:	The provision for the use of actual resource usage rates and unit costs appears to be inconsistent with the DIRA. We consider that for the base milk price to provide an incentive to operate efficiently, the base milk price should be based on notional data that is independent of Fonterra's actual performance, where obtainable. We consider that the use of actual resource units may undermine the incentive for Fonterra to operate efficiently. In this instance, we consider that an independent benchmark is able to be estimated and would be more appropriate for base milk price variable manufacturing costs to provide incentives for Fonterra to operate efficiently. We don't believe this is material given the reasons state it applies only to packaging costs, which constitute 33% of the total variable manufacturing costs and have taken this view for the purpose of our review of the Manual. We will review the implementation for all variable manufacturing costs and re-examine the materiality of

58 Paragraph A.12.48 of the dry run review

Rule	Fonterra Comment	Commerce Commission Review
	• For energy, at Fonterra's budgeted average unit rates, leaving Fonterra incentivised to minimise actual – budget variances within a year, although arguably leaving Fonterra with weakened incentives to negotiate the lowest possible energy costs. Use of actual costs was settled on the basis that it is difficult to obtain appropriate benchmark rates for a business of Fonterra's size and geographic scale of operations. • For packaging, at Fonterra's actual unit costs: since the Milk Price model uses a relatively small subset of Fonterra's actual packaging costs, Fonterra is still appropriately incentivised to minimise its packaging costs, though the Milk Price does create an incentive to manage packaging costs for milk price products less intensively than other costs. The MPG therefore monitors movements in the cost of packaging for milk price products relative to movements in other packaging costs. • For other variable costs, at Fonterra's budgeted rates, leaving Fonterra with an appropriate incentive to minimise actual costs.	the variable manufacturing cost estimates in the review of the application of the Manual.
Supply chain (Rule 20)	Again, as a matter of practical necessity, supply chain costs are generally calculated by reference to Fonterra's actual costs, but are established in a manner (e.g. from budgeted costs) that normally leaves Fonterra appropriately incentivised to control its actual costs.	This rule suggests that Fonterra uses its actual supply chain costs to determine the base milk price. Supply chain costs include freight costs, storage costs, minor supply chain costs and supply chain overheads costs. We note that this rule appears to be inconsistent with the DIRA, as the use of actual supply chain costs may undermine the incentive for Fonterra to operate efficiently. We consider that an independent benchmark is more appropriate in this instance to provide incentives for Fonterra to operate efficiently. We don't believe this is material and have taken this view for the purpose of our review of the Manual. We will re-examine the materiality of the variable manufacturing cost estimates in the review of the application of the Manual.

Contestability dimension

Rule	Fonterra Comment	Commerce Commission Review
Adjustments for amendments to Reference Commodity Products (Rule 31) And Surplus capacity (Rule 32)	This provision is intended to ensure that the Milk Price model captures all the real-world consequences of a decision to adjust the range of products manufactured, including the economic consequences of any resultant stranded assets (Rule 31). The Milk Price model WACC incorporates a provision for the risk of having stranded assets due to a shortfall in required milk supply. It is therefore not appropriate that the Milk Price continue to bear annual WACC / depreciation charges in respect of stranded assets (Rule 32).	There is an inconsistency in treatment for stranded assets between assets stranded due to changes in RCPs (Rule 31) and assets stranded due to changes in milk supply (Rule 32). Refer to the discussion of this in chapter 3 of the main text. This issue is also linked to the asset beta. We note that the amended Rule 40 states that, in a review year, an independent reviewer will provide an updated asset beta that is required to have regard to stranded asset risk. We consider that beta should not generally include an allowance for all asset stranding risk, as beta is a measure of an investment's exposure to market wide (systematic) factors, and not risks reflecting individual investments (or plants).[59]

[59] We discussed this in the dry run review at paragraphs A13.34-A13.37

Amendments to the Manual in response to the dry run review

Rule	Fonterra Comment	Commerce Commission Review
Shortfalls in capacity (Rule 33)	This provision is simply intended to ensure that aggregate notional processing capacity is maintained at a level consistent with aggregate milk supply.	Rule 33, which relates to shortfalls in capacity, refers to regions. Our conclusion in the dry run review was:[60] Rule 33 implies that peak milk supply is modelled for each major dairy region and notional plants are allocated to those regions to process the supply. However, the model only allocates (or adds) a standard plant to one of two regions in New Zealand (the North Island or the South Island), rather than to a specific dairy region or actual processing site. Fonterra's submission on the draft report states that, in applying Rules 25 and 33 in the Milk Price Manual, Fonterra interprets 'region' to mean North Island or South Island and that this interpretation is consistent with the approach they employ in practice in making incremental capacity decisions. However, Fonterra accept that the Milk Price Manual is not explicit on this point. We also reported that:[61] As standard plants are only added in whole numbers to meet peak milk supply requirements at the level of the two defined regions, rather than to specific manufacturing sites, the incremental number of standard plants is implicitly optimised for each island. Unless the relevant operating costs (eg, actual collection costs) have been appropriately adjusted upwards to reflect this implicit optimisation, this approach may not be consistent with the milk price purpose statement. In response to the conclusion in the dry run review, Rule 33 now defines the regions in the Manual. This does not, however, address our underlying concern both in the dry run review and this report that assets may be over-optimised and relevant operating costs may not have been adjusted upwards to reflect the implicit optimisation.
Farmgate Milk Price Sales Phasing (Rule 10)	The comments above with respect to Rule 7 are also relevant to sales phasings: • The default assumption involves aligning the Milk Price phasing of sales to Fonterra's actual phasing of sales of the reference products manufactured from current season milk supply. • Particularly because the Milk Price model's holding and logistics costs are	Our conclusion in the dry run review was: [62] Fonterra could consider generating sales phasings on a more objective and transparent basis either by linking sales phasings to modelled RCP production or by using Fonterra's historic RCP sales phasing profiles (eg, last season's profile or an average of the previous three years). As noted above at paragraph A6.20, Fonterra is considering clarifying the drafting of the Manual to remove the prospect that sales phasings could be made retrospectively.

60 Paragraph A12.13 in the dry run review
61 Paragraph A12.48 in the dry run review
62 Paragraph A6.27 in the dry run review

Rule	Fonterra Comment	Commerce Commission Review
	calculated largely independently of Fonterra's, it is generally reasonable to assume that Fonterra faces appropriate incentives to manage the timing of its sales. • Any alternative set of phasings would involve an element of arbitrariness and therefore result in an arbitrary reallocation of gains / losses due solely to movements in market prices between earnings and the Milk Price. To avoid this outcome, management would be incentivised to align actual sales phasings to the model benchmarks, effectively resulting in the model driving real business decisions. This outcome would not be consistent with the s150A purpose. • This Rule has been amended with effect from F13, so as to make it unambiguous that the sales phasing assumptions cannot be adjusted retrospectively based on information not available at the time the phasings would have been established by a real-world processor.	In response to the dry run review, Rule 10 has been amended and is now more explicit that sales phasings are to be determined on a prospective basis only. This removes our concern that actual sales phasings could be retrospectively applied so as to undermine the practical feasibility of assumptions used in the base milk price calculation.
Asset beta (Rule 40)	The current asset beta (of 0.45) is higher than it would be if it only reflected stranded asset risk, which is relatively immaterial under most scenarios, given a continuing upward trend in forecast milk supply, and the fact that decreases in absolute supply would initially be handled by removing the oldest notional assets, per Rule 32, which will have small depreciated replacement cost values. However, the asset beta also incorporates a provision for 'relative performance risk', reflecting the fact that there will inevitably be some variance between Fonterra's actual net returns on its commodity milk powder manufacture business and the returns allowed for under the Milk Price model. This Rule has been amended with effect from F13 to make it more explicit that the asset beta should reflect the full range of factors normally taken into account in an assessment of relative risk. The amendment will not have any impact on the substantive approach taken to establishing this input.	Our conclusion in the dry run review was: [63] We consider that the estimation of the asset beta should be specified in terms of the exposure to systematic risk, rather than the exposure to stranded asset risk (as the risks of asset stranding may be diversified away by well diversified investors). In response to the dry run, Rule 40 now provides that the estimation of asset beta will focus on the exposure of the base milk price Business' exposure to systemic risk in addition to the risk of asset stranding. This re-orientates the focus more towards the exposure of systematic risk. We consider this may still overstate the influence of asset stranding on beta but this is a matter which the independent reviewer who is tasked with setting beta will need to address. We will review the estimate after it is determined.
Definition on Debt Premium (DM)	The sum of: (a) The average spread over US Treasury strips for A- rated debt with a five year term to maturity issued by US industrial companies, as reported by Bloomberg for the	Our conclusion in the dry run review was: [64] We consider that the estimation of the debt premium should be specified in a form consistent with its use in a New Zealand dollar denominated WACC (ie, either a New Zealand dollar denominated debt premium or a US dollar denominated debt premium correctly

63 Paragraph A13.36 in the dry run review
64 Paragraphs A.13.24 and A.13.27 in the dry run review

Rule	Fonterra Comment	Commerce Commission Review
	60 months preceding the first day of the Season, rounded to the nearest 5 basis points (b) A reasonable provision for any costs that would ordinarily be incurred in swapping item (a) to NZD, and (c) A reasonable provision for the annualised cost associated with issuing debt, to the extent such costs are not otherwise provided for.	converted to its New Zealand dollar equivalent). The impact of this is likely to be small. Under Input Methodologies for the cost of capital under Part 4 of the Commerce Act we made an allowance of 0.35 percent per annum for debt issuance costs to support a New Zealand public bond programme. The Manual does not make any explicit allowance for debt issuance costs, though we are advised that the allowance for Treasury Operations in Corporate overheads in the Manual may cover the costs of roadshows. The definition of debt premium was changed in response to the dry run review. The definition of the debt premium now makes allowance for certain costs when raising debt including issuance costs and the cost of transferring the funds raised from US dollars to NZ dollars, given debt capital is assumed to be raised in the US but almost all the assets are located in NZ. However, we note that the Manual as stated makes allowance only for swap costs in respect of the debt premium, and not in respect of the swap rate component of the cost of debt. The calculation of the base milk price could still correctly treat such costs and we will consider this matter again in our review under s 150O next year.

Rules whose apparent consistency with the purpose, or capture by the "safe harbour" provisions depends upon how they are applied.

Note that this section of the table only considers potential issues identified that are not considered in other sections of this table

Rule	Fonterra Comment	Commerce Commission Review
Sales through GDT (Rule 5) And Definition on Shipment Month	Placing reliance on GDT only prices appropriately incentivises Fonterra management to maximise prices achieved for sales off GDT. It also enhances the transparency of the revenue inputs into the Milk Price, as GDT prices are publicly available. From F12, prices for WMP, SMP and AMF are obtained solely from GDT. These products in aggregate represent approximately 90% of Milk Price revenue. Butter is not sold on GDT, so it is necessary to use a sample of FAS equivalent prices achieved by Fonterra on other sales (see below for further detail) and BMP is typically sold on GDT for only approximately 6 months in a 12 month financial year. The MPG as a matter of course monitors variances between GDT prices and available	This rule does not appear to be inconsistent with the DIRA. Our interpretation of s 150C(1)(a) is not requiring Fonterra to use every price achieved by Fonterra to be reflected in the base milk price. We note that it is reasonable to take a sample of prices as long as it is transparent. We also consider that if every price achieved by Fonterra is used it will represent a Fonterra actual rather than notional. This will undermine incentives for Fonterra to operate efficiently. Products sold on GDT are homogenous while products sold off-GDT may be differentiated. We will therefore require more information on any non-GDT prices used to set the base milk price and will consider this in the review of the application of the Manual.

Rule	Fonterra Comment	Commerce Commission Review
	information on prices achieved by both Fonterra and other NZ manufacturers off GDT for compliance with this condition. A possible interpretation of s 150C(1)(a) is that all prices, rather than a sample, achieved by Fonterra for reference commodities should be taken into account in calculating the Milk Price. However, we consider that this interpretation would not be consistent with the 'incentives' objective of s 150A. The shipment month is the month in which a sale would be deemed for financial reporting purposes to have been completed, and will normally be the month in which the sale is invoiced and the product is shipped.	
Product Yields (Rule 8)	The yield assumptions used to determine the Farmgate Milk Price Production Plan for a Season will reflect: ▪ The Composition Target for each Reference Commodity Product; and ▪ The Allowable Yield Losses for each Reference Commodity Product. The yield assumptions will be subject to review by an independent expert in each Review Year. See below for further detail on how these provisions are established. Yield assumptions reflect actual milk composition and reasonable provisions for manufacturing tolerances and losses of milk in the production process. These latter items are set independently of (but having regard to) Fonterra's actual tolerances and losses, and therefore appropriately incentivise Fonterra to maximise its ratio of finished product to raw milk inputs.	We consider that the rule does not appear to be inconsistent with the DIRA. Provided that the yield assumption is practically feasible, yields are covered by the safe harbour established in s 150B(d). We also noted in the dry run review that:[65] We note that the manufacturing tolerances applied by Fonterra for WMP and SMP (which represent the majority of production output) are substantially lower than those assumed by Westland. On the other hand, we also note that [confidential]. This provides additional assurance that the manufacturing tolerances applied by Fonterra are practically feasible. We recognise that this is an area where we would like to take further advice and will look to engage an independent expert for future statutory reviews. We will consider the issues identified in the dry run review and whether target numbers used are practically feasible in our review of the application of the Manual.

65 Paragraphs A5.40 and A.5.41 in the dry run review

Outside of scope of the monitoring review

Rule	Fonterra Comment	Commerce Commission review
Volume of milk processed (Rule 1)	Consistent with s 150B(d). An implication of this provision is that any difference between the FGMP and the price received by Fonterra for milk supplied to third party processors in accordance with Fonterra's obligation under DIRA to supply Milk to third party processors will accrue to Fonterra.	The focus of the monitoring review is on ss 150A, 150B, 150C of the DIRA. We consider that implication of differences between base milk price and price received by Fonterra for DIRA milk accrues to Fonterra is superfluous to the sections of the DIRA. Additional volumes supplied outside the mandatory milk supply are an externality and outside the scope of the base milk price monitoring review.