

# **Review of Fonterra's 2016/17 Milk Price Manual: Dairy Industry Restructuring Act 2001**

**Final report**

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**Date of publication:** 14 December 2016



## Associated documents

Publication date	Reference	Title
15 October 2016	ISSN 2382-1779	<a href="#">Review of Fonterra's 2016/17 Milk Price Manual: Draft report</a>
15 September 2016	ISBN 978-1-869455-28-6	<a href="#">Our approach to reviewing Fonterra's Milk Price Manual and base milk price calculation</a>
15 October 2015	ISSN 2382-1779	<a href="#">Review of Fonterra's 2015/16 Milk Price Manual: Final report</a>

Commerce Commission

Wellington, New Zealand

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## Executive summary

### What this report covers

- X1 This report sets out our conclusions on our review of Fonterra's 2016/17 Milk Price Manual (the Manual). The Manual contains the methodology used by Fonterra to calculate Fonterra's base milk price each season.<sup>1</sup>

### About this review

- X2 Our review of the Manual is required as part of the milk price monitoring regime (monitoring regime), outlined in subpart 5A of the Dairy Industry Restructuring Act 2001 (the Act). More details about the intent of the regime can be found in our supporting paper.<sup>2</sup>
- X3 Under the Act we must report on the extent to which the methodology outlined in the Manual is consistent with the purpose of subpart 5A of the Act.<sup>3</sup> Our review considers the 'efficiency' and 'contestability' dimensions.<sup>4</sup> We focus on whether the Manual provides:
- X3.1 an incentive for Fonterra to operate efficiently (the 'efficiency dimension'); and
  - X3.2 for contestability in the market for the purchase of raw milk from farmers (the 'contestability dimension').
- X4 To satisfy the provisions in s 150A, we consider that our statutory reviews of the Manual and the base milk price calculation each season must assess both dimensions. We attach equal weight to both dimensions in our assessments.

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<sup>1</sup> The base milk price is the farm gate milk price expressed per kilogram of milk solids which is the price paid by dairy processors (eg, Fonterra) to dairy farmers for raw milk.

<sup>2</sup> Commerce Commission "Our approach to reviewing Fonterra's Milk Price Manual and base milk price calculation" (15 September 2016). Our report is supported by this separate paper that provides an overview of the approach we have taken in reviewing the Manual for the 2016/17 dairy season. The supporting paper outlines how we conduct our annual reviews of Fonterra's Milk Price Manual and each season's base milk price calculation. It includes our interpretation of key legislative provisions, our practical approach to the statutory reviews, an overview of how Fonterra sets its base milk price, assumptions of the notional producer, and internal and external controls surrounding the integrity of the milk price calculation.

<sup>3</sup> S 150I of the Act.

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

- X5 We have focused our review of Fonterra's 2016/17 Manual on:
- X5.1 Fonterra's amendments to the Manual;
  - X5.2 issues arising from our 2015/16 base milk price calculation review where these might suggest an amendment to the Manual;<sup>5</sup>
  - X5.3 issues arising from submissions on our process email and draft report where these might suggest an amendment to the Manual; and
  - X5.4 outstanding issues from previous Manual reviews.
- X6 In this report we have grouped issues by common themes with a focus on issues most likely to be material to the 2016/17 base milk price calculation.
- X7 We have relied on our previous conclusions for those parts of the Manual which have remained unchanged from previous seasons unless there was substantive information causing us to reconsider these.

### **Our conclusions**

- X8 We conclude that this season's Manual is largely consistent with the statutory purpose set out in s 150A of the Act.<sup>6</sup>
- X9 We cannot conclude that the Manual is fully consistent with the s 150A purpose because we have yet to completely conclude on the inclusion of off-GDT sales in the Manual.
- X10 There are also two further aspects of the Manual that are not consistent, but which are not material to our overall conclusion. These are lactose costs and supplier support costs.
- X11 In principle, we consider the new inclusion of off-GDT prices in the Manual to be consistent with the Act. However, we will be completing further analysis as part of our 2016/17 calculation review on the implementation of this amendment. We require this analysis for us to completely conclude whether the amendment to include off-GDT prices for the sales of whole milk powder (WMP), skim milk powder (SMP) and butter milk powder (BMP) is consistent with the s 150A purpose.

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<sup>5</sup> Commerce Commission "Final Report Base Milk Price Calculation Review 2015/16" (15 September 2016).

<sup>6</sup> We are required by s 150I to make a report on the extent to which the Manual is consistent with the statutory purpose set out in s 150A.

- X12 We also conclude the following aspects of the Manual, which we consider not material to our overall conclusions, are inconsistent with the s 150A purpose:
- X12.1 The current methodology for calculating lactose costs enables retrospectively picking those lactose costs which inform the calculation.<sup>7</sup>
  - X12.2 The omission from the Manual of costs associated with providing supplier support to ensure continued supply to the notional producer is not consistent with the contestability dimension.
- X13 To enable us to conclude on the consistency of the Manual as a whole with the s 150A purpose and to promote greater transparency, we recommend Fonterra makes the amendments and disclosures outlined in Table X1.

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<sup>7</sup> As noted in our 2016/17 calculation review, competitor lactose prices have been used as the price which informs the calculation every month since the 2013/14 season. Commerce Commission "Final Report Base Milk Price Calculation Review 2015/16" (15 September 2016), para 6.20.

**Table X1 Summary of our recommendations to Fonterra**

Category	Recommendation to Fonterra
<b>Inclusion of off-GlobalDairyTrade (GDT) sales</b>	Develop explicit criteria for determining which sales inform the milk price calculation. Ensure historical data of prior GDT auctions is freely accessible to provide greater visibility of revenues assumed by the notional producer. <sup>8</sup> Outline how the assumptions associated with the calculation are or are not affected by the inclusion of off-GDT sales.
<b>Lactose costs</b>	Remove the ability to pick pricing retrospectively for calculating lactose costs to ensure consistency with contestability.
<b>Supplier support</b>	Include the costs associated with providing farmer support (to ensure continued supply) in the calculation to be consistent with contestability.
<b>Winter milk and other allocation costs</b>	Disclose the milk price on standard terms in periodic reviews to promote transparency as to how allocation costs are considered. <sup>9</sup>
<b>Average foreign exchange (FX) conversion rate</b>	Disclose the average FX rate achieved throughout the season. Timely disclosure would let interested parties update their estimates of the revenues achieved by the notional producer across the season. <sup>10</sup>
<b>Consistency over time provision</b>	Outline the methodology for determining a 'material change' to provide clarity with this provision.
<b>Capacity of secondary plants</b>	Disclose the plant capacity for both primary and secondary plants.
<b>Repairs and maintenance</b>	Include a definition of 'maintenance department labour costs' to provide greater clarity.

X14 Our conclusions on these components are set out in Chapter 3.

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

<sup>9</sup> Standard terms means the milk price including allocation costs. Allocation costs include winter milk premiums, contract milk, discounts, demerits, volume charge net underpayment and presence of dichlorodiphenyl dichloroethene (a chemical which affects milk quality).

<sup>10</sup> Currently there is no disclosure of the average FX rate assumed to be achieved by the notional producer until the end of each season.

## Chapter 1 Introduction

### What this report covers

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

### We are fulfilling our statutory requirements

2. We are required to review the Manual for each dairy season and make a report on the extent to which the Manual is consistent with the purpose statement set out in the Act.<sup>11</sup>
3. The Act requires Fonterra to provide us with the following information for consideration in our review:
  - 3.1 Fonterra's Manual for the current season;
  - 3.2 Any recommendations by the Milk Price Panel in relation to the setting of the base milk price;<sup>12</sup>
  - 3.3 Notification of any changes in the economic and business environments that, in Fonterra's view, require a change to the Manual;
  - 3.4 Certification on the extent to which Fonterra considers that the Manual is consistent with the purpose of s 150A; and
  - 3.5 Reasoning behind the views expressed in Fonterra's certification.
4. Fonterra has provided the above information in its Reasons Paper in support of its Manual for the 2016/17 season. This paper is available on our website.<sup>13</sup>
5. We suggest reading this report on our review together with our supporting paper.<sup>14</sup>

### How this report is structured

6. Chapter 2 covers the scope of our review.

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<sup>11</sup> As required under s 150H and s 150J of the Act.

<sup>12</sup> The Milk Price Panel's role is defined in s 150D of the Act.

<sup>13</sup> Fonterra "Fonterra's Reasons Paper in support of Milk Price Manual for the 2016/17 season" (2016). Available at <[comcom.govt.nz/statutory-review-of-milk-price-manual/201617-season/](http://comcom.govt.nz/statutory-review-of-milk-price-manual/201617-season/)>.

<sup>14</sup> Commerce Commission "Our approach to reviewing Fonterra's Milk Price Manual and base milk price calculation" (15 September 2016).

7. Our conclusions are set out in Chapter 3 and are supported by the summary tables in Attachment A. We have focused our commentary in Chapter 3 on those issues which are likely to have a material impact on the base milk price calculation.
8. Chapter 4 and 5 discuss the key areas of focus and non-substantive focus areas. The reasons for selecting these focus areas were outlined in our process email to interested parties on 25 August 2016.
9. Our high level conclusions on minor amendments that are of a technical or drafting nature are set out in Attachment A. Where appropriate, brief commentary is provided about those amendments.
10. A glossary of key terms is provided in Attachment B.

## Chapter 2 Scope of this report

11. We outlined the scope of our review and process in our email to interested parties on 25 August 2016. This scope is aligned with the requirements of the Act.
12. As signalled in our process email, we have focused our review on:
  - 12.1 Fonterra's amendments to the Manual;
  - 12.2 issues arising from our 2015/16 base milk price calculation review where these might suggest an amendment to the Manual;<sup>15</sup>
  - 12.3 issues arising from submissions on our process email and draft report where these might suggest an amendment to the Manual; and
  - 12.4 outstanding issues from previous Manual reviews.
13. We have relied on previous conclusions for those unchanged areas of the Manual unless significant new information has caused us to reconsider these conclusions.
14. In this report we have grouped issues in the following order:
  - 14.1 the key focus areas of the Manual that are more likely to have a material impact on the base milk price calculation;
  - 14.2 non-substantive focus areas which are likely to be less material to the calculation of the base milk price; and
  - 14.3 minor amendments to the Manual of a technical or drafting nature (summarised in Attachment A).

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<sup>15</sup> We note that Miraka has suggested that our Manual review also addresses some issues raised in its "carried forward" list set out in Appendix B of its submission dated 15 November 2016, including the practical feasibility of the Notional Producer WACC. While we recognise that these are important issues for Miraka (and some other independent processors), we consider that they would be better addressed as part of the calculation review process.

## Chapter 3 Conclusions

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

### Our conclusions

17. Our overall conclusion is that the 2016/17 Manual is largely consistent with the s 150A purpose.<sup>16</sup>
18. In principle, we consider the new inclusion of off-GDT prices in the Manual to be consistent with the Act. We will be completing further analysis as part of our 2016/17 calculation review on this amendment. This is required for us to completely conclude whether the amendment to include off-GDT prices for the sales of whole milk powder (WMP), skim milk powder (SMP) and butter milk powder (BMP) is consistent with the s 150A purpose.
19. We conclude the following non-substantive focus areas, which we consider are not material and therefore do not impact our overall conclusion, are inconsistent with the s 150A purpose:
- 19.1 The current methodology for calculating lactose costs enables retrospectively picking those lactose costs which inform the calculation.
- 19.2 The omission from the Manual of costs associated with providing supplier support (to ensure continued supply to the notional producer) is not consistent with the contestability dimension.

### Conclusions on key areas of focus

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

20. We consider that further quantitative analysis of the off-GDT revenue and the associated selling costs that inform the 2016/17 base milk price calculation is required in order to definitively conclude on this amendment. We propose to complete this quantitative analysis in our 2016/17 calculation review.

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<sup>16</sup> That is, the methodology in the Manual for the 2016/17 season is largely consistent with the efficiency and contestability dimensions outlined in s 150A of the Act.

21. We think the inclusion of off-GDT prices could produce a more accurate representation of what the notional producer might earn. However, we note that reference to Fonterra's reasons for changing the Manual does not mean that we accept or adopt those reasons. Our review role is focussed on the extent to which the Manual is consistent with subpart 5A of the Act.

*Consistency over time provision*

22. We agree with Fonterra that the Manual should evolve over time consistent with the methodology of a real world processor. We consider the Manual should outline what is considered a 'material change' when considering a change to the Manual and specify the timeliness of making such a change in order to set a minimum level for disclosure of changes.

*Capacity of secondary reference commodity products (RCPs)*

23. We recommend that Fonterra considers disclosing its plant capacity for both primary and secondary plants in the Manual. This earlier disclosure should provide increased transparency of the assumed capacity of the notional producer for the season. We consider Fonterra's latest amendment still allows a significant level of discretion.

*Determination of repairs and maintenance costs*

24. We suggest a specific definition of "maintenance department labour costs" is needed in the Manual to provide additional clarity.

*Foreign Exchange Conversion rates*

25. We consider there should be more transparency of information on the actual foreign exchange rates assumed to be achieved by the notional producer.<sup>17</sup> We suggest providing an average FX conversion rate assumed to be achieved by the notional producer throughout the season.

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<sup>17</sup> We note this is a safe harbour assumption under the Act, s 150B of the Act.

## Conclusions on non-substantive focus areas

### *Treatment of winter milk premium and allocation costs*

26. We note that the methodology Fonterra chooses to use in calculating the milk price is consistent with the Act. However, although immaterial to the calculation, we conclude that the costs incurred by Fonterra based on allocations of the milk price to its suppliers would be incurred by the notional producer in order for it to achieve its assumed levels of productivity (eg, winter milk premiums).<sup>18</sup>
27. We consider that if Fonterra disclosed the base milk price on standard terms in periodic reviews throughout the season, this would provide greater transparency of Fonterra's base milk price setting process.<sup>19</sup>

### *Consideration of costs incurred in providing supplier support*

28. We consider the omission from the Manual of the costs associated with ensuring continued supply by providing farmer support is inconsistent with the s 150A purpose. These costs should be included in the base milk price calculation in order to be consistent with the contestability dimension.

### *Methodology for calculating lactose costs*

29. We consider that the current method in the Manual for calculating lactose costs is not consistent with the contestability dimension because it provides an ability to pick pricing retrospectively. To remove that ability, we suggest removing Fonterra's price as a reference.
30. We note Fonterra's intention to complete a detailed investigation of alternative approaches to determining an appropriate lactose cost.<sup>20</sup> We will also review the lactose costs used to inform the base milk price calculation during our 2016/17 calculation review. We seek an appropriate amendment in the 2017/18 Manual.

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<sup>18</sup> Allocation costs include winter milk premiums, contract milk, discounts, demerits, volume charge net underpayment and presence of dichlorodiphenyl dichloroethene (a chemical which affects milk quality).

<sup>19</sup> In response to our conclusion on this in our draft report on the Manual, Fonterra advised that it would consider how to improve its disclosure in the 2016/17 Farmgate Milk Price Statement. However, this does not address the possibility of benefits to interested parties from more regular disclosures of that information as the milk price is updated during a season. See Fonterra "Submission to the Commerce Commission on its Draft Report on Fonterra's 2016/17 Farmgate Milk Price Manual" (15 November 2016), p.7.

<sup>20</sup> Fonterra "Submission to the Commerce Commission on its Draft Report on Fonterra's 2016/17 Farmgate Milk Price Manual" (15 November 2016), p.7.

### **Our recommendations to Fonterra**

31. Due to the amendment to include off-GDT sales for WMP, SMP and BMP, we consider that Fonterra needs to:
  - 31.1 Outline explicit criteria for determining the sales that inform the milk price calculation;
  - 31.2 Ensure historical data from GDT auctions is freely accessible;
  - 31.3 Provide detail on how inclusion of off-GDT sales affects other assumptions; and
  - 31.4 Provide an average FX conversion rate assumed to be achieved by the notional producer.
32. This would enable interested parties to better evaluate the estimated revenues of the notional producer.
33. We also recommend that Fonterra discloses:
  - 33.1 its methodology for determining a "material change" in applying its consistency over time provision;
  - 33.2 its plant capacity for both primary and secondary plants;<sup>21</sup> and
  - 33.3 the milk price on standard terms (post the milk price adjustments) in periodic reviews of the farmgate milk price.

### **Next steps**

34. Based on Fonterra's Manual amendments and the conclusions of this review, we plan to assess Fonterra's application of off-GDT prices and the associated off-GDT selling costs for WMP, SMP and BMP in our 2016/17 base milk price calculation review.
35. In our 2015/16 base milk price calculation review, we were unable to conclude on the practical feasibility of the asset beta and the resulting WACC component in Fonterra's setting of the base milk price.

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<sup>21</sup> Primary plants are for the primary RCPs - WMP and SMP. Secondary plants are for the secondary or by-products of the primary RCPs, BMP, butter and AMF.

36. We have begun the process of resolving the asset beta issue for the 2016/17 calculation review. As outlined in our 2015/16 calculation review, we consider more information is necessary to allow us to conclude on the asset beta.<sup>22</sup>
37. We intend to update interested parties on the process we intend to follow for the 2016/17 milk price calculation review shortly, including how we propose to resolve the asset beta issue.

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<sup>22</sup> We wish to conclude on whether we should assume that the notional producer (or any other New Zealand commodity milk processor) would be able to shift price risk to farmers. That is a shifting of risk onto its suppliers in a way that would justify the indicated downward adjustment in the asset beta from the mid-point estimate of the comparator sample in Fonterra's independent expert's report. See Commerce Commission "Final Report Base Milk Price Calculation Review 2015/16" (15 September 2016), para 4.56.

## Chapter 4 Key areas of focus

38. This chapter outlines our comments and conclusions on the key areas of focus. The following amendments or issues are likely to be material to the milk price calculation:
- 38.1 Inclusion of off-GDT sales to inform WMP, SMP and BMP prices;
  - 38.2 Consistency over time provision;
  - 38.3 Capacity of secondary reference commodity products (RCPs);
  - 38.4 Determination of repairs and maintenance costs; and
  - 38.5 FX conversion rates.

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

39. In principle, we consider the new inclusions of off-GDT prices in the Manual to be consistent with s 150A of the Act. However, we have concerns about the lack of detail about how Fonterra will implement this change.
40. The inclusion of off-GDT sales in the calculation means we need to ensure the associated notional costs, revenues or other assumptions taken into account in calculating the base milk price are practically feasible. We will therefore be assessing the practical feasibility of inputs associated with this amendment in our 2016/17 calculation review.
41. We propose to complete a quantitative analysis of revenues received on GDT and off-GDT in our 2016/17 calculation review to test the practical feasibility of the prices achieved from RCP's as a result of these amendments. We note Fonterra has provided quantitative analysis that suggests this amendment supports a milk price consistent with that achieved by independent processors on products with comparable specifications. We will be assessing this further in our calculation review.
42. The provisions in the Manual relating to off-GDT sales for WMP, SMP and BMP and other related amendments are summarised in Table 4.1.

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

Manual reference	Issue category	Description of issue	Fonterra reasons <sup>23</sup>
<b>Part C, Page 62</b>	New for 2016/17 Manual Review	Including sales undertaken off the GDT platform of similar specification product and sold on similar terms to GDT sales.	Previous approaches are not consistent with the milk price principles. <sup>24</sup>
<b>Part A, Section 4.3</b>	New for 2016/17 Manual Review	Change in overview section of the Manual to align with Part C amendment to revenue.	Amendments of this sentence are consequential on the revision to the definition of Qualifying Reference Sales in Part C.
<b>Part B, Rule 8</b>	New for 2016/17 Manual Review	Qualifying reference sales amended to "sales" that satisfy conditions set out in items 2 and 3 of the definition of Qualifying Reference Sales.	Technical amendment only - required as item 1 in the amended definition of Qualifying Reference Sales in Part C refers to the use of GDT-only prices for WMP, SMP and AMF.
<b>Part B, Rule 17</b>	New for 2016/17 Manual Review	Aligning this to the amendments to selling channels.	Previous drafting was not necessarily consistent with the mix of sales channels implied by Rules 5 and 8.

43. Fonterra has provided the information in Table 4.2 which outlines the decision criteria used in determining which off-GDT sales are included in the calculation.

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<sup>23</sup> We note that reference to Fonterra's reasons for changing the Manual does not mean that we accept or adopt those reasons. As discussed above, our review role is focussed on extent to which the Manual is consistent with subpart 5A of the Act.

<sup>24</sup> Fonterra refers to Principle 2 of its Milk Price Principles in its 'Reasons' Paper in support of Fonterra's Milk Price Manual for the 2016/17 Season, p8, noting that "continuing to place sole reliance on GDT would mean the Milk Price revenue inputs (and therefore the Farmgate Milk Price) were not consistent with the requirement in the Milk Price Principles (and Fonterra's constitution) which require that the Farmgate 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 the milk supplied to it in a season if Fonterra processed that milk into commodity products which were sold on freely contested global markets."

**Table 4.2: Criteria for determining off-GDT sales to inform milk price<sup>25</sup>**


### Decision criteria

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

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44. Fonterra has submitted to us that:
- 44.1 product specifications of off-GDT qualifying sales do not vary materially from GDT specifications;
  - 44.2 using off-GDT sales enables greater flexibility on shipping timetables and allows larger customers to make substantial orders;<sup>26</sup> and
  - 44.3 off-GDT sales will include sales to additional countries over those covered by the GDT.
45. Fonterra has announced that the expected net impact on the 2016/17 base milk price from this amendment would be an increase of between 4 to 5 cents per kilogram of milk solids (KgMS). Fonterra's change to the Manual therefore has a material impact on the industry.

<sup>25</sup> Information request by the Commerce Commission from Fonterra. See Fonterra "Off GDT Spot Sales Revenue to Milk Price" (23 September 2016) p.1.

<sup>26</sup> Fonterra has advised that some larger customers prefer to make orders directly with a sales representative of Fonterra to develop supplier relations and ensure security to buy. Fonterra notes that larger orders over a long period of time will not inform the milk price as these fall out of the 1-5 month contract tenor.

46. Moving away from using prices determined on GDT potentially means less visibility as to the basis of calculation of the revenues assumed to be earned by the notional producer. We agree with independent processors on the importance of transparency of information for the sales included in setting the reference prices. This would improve confidence that the milk price is not influenced by information that is not freely available or by other factors, other than those identified by Fonterra.<sup>27</sup>
47. We note Fonterra has advised that prices achieved through GDT sales will continue to be the benchmark pricing used for informing revenues in the milk price calculation.<sup>28</sup> Because the GDT sales will continue to act as a benchmark source of prices and would seem to have an increasing role as a measure of the practicality of the off-GDT prices, we consider the historical data of auction results should be freely accessible.<sup>29</sup>
48. Fonterra has responded to our observation that the amendments in the Manual do not provide clarity about which off-GDT sales will inform the milk price calculation. It points out that the criteria to select sales for inclusion in the calculation are set out in Part C of the Manual, in particular the definitions of 'Qualifying Material', 'Qualifying Reference Sale' and 'Benchmark Selling Price'. In addition, it has undertaken to provide appropriate guidance (including explicit notice of any relevant change in interpretation) in its annual reasons paper in respect of the milk price calculation.<sup>30</sup>
49. We acknowledge interested parties' concerns that the change gives Fonterra significant discretion. Open Country and Miraka both consider that the GDT is the most representative and transparent source of the benchmark price for commodity products.<sup>31</sup>

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<sup>27</sup> Open Country Dairy "Submission on the Commerce Commission's Process and Fonterra's 2016/17 Milk Price Manual" (September 2016), page 3. Synlait "Submission on Fonterra's milk price manual for the 2016/17 season" (8 September 2016), para 14(b).

<sup>28</sup> In response to Miraka "Submission to the Commerce Commission Draft Report (14 October 2016): Review of Fonterra's 2016/17 Milk Price Manual, para 4.1.1.

<sup>29</sup> Previously historical data of the GDT auctions was freely accessible. It is now only available by subscribing at a cost of \$240USD per month.

<sup>30</sup> Fonterra "Submission to the Commerce Commission on its Draft Report on Fonterra's 2016/17 Farmgate Milk Price Manual" (15 November 2016) p.5.

<sup>31</sup> Open Country Dairy "Submission on the Commerce Commission's Process and Fonterra's 2016/17 Milk Price Manual" (September 2016), p.3. Miraka "Submission to the Commerce Commission: Review of the 2016/17 Farmgate Milk Price Manual" (8 September 2016) para 4.2. See also, Miraka "Submission to the Commerce Commission Draft Report (14 October 2016): Review of Fonterra's 2016/17 Milk Price Manual, para 4.1.1.

50. In this respect, Fonterra has advised that it expects to publish periodic updates on off-GDT margins and historic GDT prices. However, it has advised that it is still considering the format, precise content and timing of that information. We will be following up with Fonterra about this lack of availability of information as this type of information is important in addressing interested parties' concerns.<sup>32</sup>
51. Fonterra has also said it will provide details in its 2016/17 base milk price calculation reasons paper on adjustments to any other assumption including sales costs that result from the inclusion of additional off-GDT sales.

#### *Selling costs*

52. Rule 17 of the Manual has been amended to align it with the selling channel amendments.<sup>33</sup> The Manual assumes that the notional producer participates as a third party seller on the GDT.<sup>34</sup>
53. This participation should be restricted to the assumed volumes on GDT; any discounts for volume should not be available for the percentage of sales assumed to be sold off-GDT. We consider this rule should be more specific in outlining that the notional costs should only include products assumed to be sold on the GDT.
54. In our 2016/17 milk price calculation review we will assess the adequacy of costs associated with including off-GDT sales. This additional analysis is required for us to conclude on whether the assumed off-GDT selling costs are practically feasible.

#### *Consistency of other assumptions*

55. The inclusion of off-GDT sales to inform WMP, SMP, BMP prices may result in inconsistencies of assumptions with the rest of the base milk price calculation. For example, the yields assumption relies on one standard specification product for each RCP.<sup>35</sup>

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<sup>32</sup> Fonterra "Submission to the Commerce Commission on its Draft Report on Fonterra's 2016/17 Farmgate Milk Price Manual" (15 November 2016) p.5.

<sup>33</sup> Amendment to Part B, Rule 17 of Fonterra's 2016/17 Milk Price Manual.

<sup>34</sup> Fonterra "Fonterra's marked up version of 2016/17 Manual for the 2016/17 season" (1 August 2016), p.43.

<sup>35</sup> See definition of 'standard specification product' in Manual. Fonterra "Fonterra's marked up version of 2016/17 Manual for the 2016/17 season" (1 August 2016), p.59.

56. If the off-GDT sales included in the calculation are different from the standard specification product then the loss and specification offsets in the yields may no longer hold. This may result in the volumes of RCPs not being practically feasible overall.
57. Fonterra has confirmed that the specifications of the off-GDT sales do not materially vary from GDT specifications and that the yield assumptions hold. We acknowledge Fonterra's commitment to providing details of adjustments to other assumptions which result from the inclusion of additional off-GDT sales.<sup>36</sup> However, we consider that disclosures should be made on a timelier basis prior to the start of the season.

### **Consistency over time**

58. We agree with Fonterra that the Manual should evolve over time consistent with the methodology of a real world processor.<sup>37</sup> Our concerns are that the Manual does not supply:
- 58.1 what is considered a 'material change' when considering a change to the Manual; and
  - 58.2 the timeliness of making such a change.
59. Fonterra has advised that not setting a materiality measure is intentional. This enables additional discretion to disclose changes irrespective of whether there is a material impact on the calculation.
60. We support additional disclosure, but would like to see further thought given to the methodology behind determining what a 'material change' would be in order to set a minimum level for disclosure of changes. Also, to be of value, a material change should be disclosed in a timely manner (eg, prior to the beginning of the season).

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<sup>36</sup> Fonterra "Submission to the Commerce Commission on its Draft Report on Fonterra's 2016/17 Farmgate Milk Price Manual" (15 November 2016) p.5.

<sup>37</sup> This amendment is also supported by other interested parties. Synlait "Submission on Fonterra's milk price manual for the 2016/17 season" (8 September 2016), p.4.

61. Miraka has concerns that a material amendment to the Manual, such as a change to the RCP mix, could be made in retrospect (ie, after the start of a season).<sup>38</sup> We agree that such a substantive change should be signalled prior to the season commencing and milk being processed. Fonterra has advised it will disclose any material change to the reference basket and provide an explanation of its rationale in the Farmgate Milk Price Statement in advance of the season starting.<sup>39</sup>

### **Capacity of secondary RCPs**

62. We had previously noted that the Manual did not state how capacities for secondary plants are determined.<sup>40</sup> Fonterra has amended rule 26 to outline how the capacity of standard plants for secondary products (ie, AMF, butter and BMP) is determined. Our concern is that this amendment still allows a significant level of discretion.<sup>41</sup>
63. We recommend Fonterra considers disclosing its plant capacity for both primary and secondary plants in the Manual early in each season to provide certainty of the notional producer's assumed capacity for the related season. We consider this would improve the ability of interested parties to assess the practical feasibility of the assumed production volumes. We note that Fonterra has partially addressed this by outlining the number and capacities of all of the notional producer's plants in its 2015/16 calculation reasons paper.<sup>42</sup>

### **Determination of repairs and maintenance (R&M) costs**

64. Although the amendment to R&M costs was made to provide clarification, we are unsure this intent has been fulfilled. Fonterra has advised these costs are the R&M costs incurred by each individual site's engineering department.

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<sup>38</sup> Miraka "Submission to the Commerce Commission: Review of the 2016/17 Farmgate Milk Price Manual" (8 September 2016), para 3.4.

<sup>39</sup> See Fonterra "Fonterra's marked up version of 2016/17 Manual for the 2016/17 season" (1 August 2016), p.11.

<sup>40</sup> Commerce Commission "Final report: Review of Fonterra's 2015/16 Milk Price Manual" (15 December 2015), paragraph 106.

<sup>41</sup> This concern is also shared by Open Country Dairy. Open Country Dairy "Submission on the Commerce Commission's Process and Fonterra's 2016/17 Milk Price Manual" (September 2016), p4.

<sup>42</sup> Fonterra "Reasons paper in support of Fonterra's base price for the 2015/16 season (1 July 2016), Attachment 3: Milk price fixed assets - supplementary information.

65. We suggest a specific definition of "maintenance department labour costs" is needed in the Manual.<sup>43</sup> We note that there has been no change in the methodology of the calculation of R&M costs. Rather this amendment was intended to provide additional clarity.

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<sup>43</sup> Supported by Synlait. Synlait "Submission on Fonterra's milk price manual for the 2016/17 season" (8 September 2016), para 5.

### Foreign exchange conversion rates

66. We suggest there should be more transparency of information on the actual FX rates assumed to be achieved by the notional producer. We note that this is a safe harbour assumption under the Act and we are not required to conclude on the consistency with the efficiency and contestability dimensions.<sup>44</sup> However, we consider the assumed rates would be valuable information for interested parties in assessing the base milk price calculation.
67. We understand Fonterra has a complex hedging structure on which the safe harbour assumptions are based. We therefore suggest disclosure of the average FX conversion rates used at various stages of the season. This would better enable interested parties to evaluate the estimated revenues which inform the milk price.<sup>45</sup>
68. Fonterra has submitted to us that the forecast foreign exchange information provided in the Farmgate Milk Price Statement for each following season has historically given an acceptable level of accuracy. However, it has indicated that it will further review the practicality and commercial sensitivity to Fonterra of providing more information on foreign exchange during the course of a season.<sup>46</sup>
69. We acknowledge Fonterra's effort to provide improved disclosure in relation to this safe harbour provision and look forward to our further consideration of any additional disclosures.

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<sup>44</sup> Under s 150B gains and losses experienced by Fonterra resulting from foreign currency fluctuations, including from its foreign currency risk-management strategies may be incorporated in the base milk price without detracting from the s 150A purpose.

<sup>45</sup> As the GDT prices would be used as a benchmark for the calculation, the NZD revenues achieved could be estimated using the average conversion rates provided by Fonterra.

<sup>46</sup> Fonterra "Submission to the Commerce Commission on its Draft Report on Fonterra's 2016/17 Farmgate Milk Price Manual" (15 November 2016) p.5.

## Chapter 5 Non-substantive focus areas

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

70.1 treatment of winter milk premium and allocation costs;

70.2 consideration of costs incurred in providing farmer support; and

70.3 methodology for calculating lactose costs.

71. Table 5.1 summarises our conclusions on these points.

**Table 5.1 Summary of our conclusions on less material focus areas**

Manual reference	Definition	Category	Description of issue	Fonterra reasoning	Commission comment
<b>N/A</b>	From 2015/16 milk price calculation review	Winter milk costs	The treatment of winter milk in the calculation.	Total aggregate amount available to pay for milk, not the allocation of that aggregate amount across individual suppliers of milk.	Although the current methodology used in determining the consideration of allocation costs is not inconsistent with the Act, we consider periodic reviews of the farmgate milk price (ie, the average milk price per the base milk price calculation) should also disclose the standard milk price, to provide greater quality of disclosure.
<b>Part B, Rule 19</b>	From 2015/16 milk price calculation review	Farmer support	Financing and associated administration costs of providing farmer support loans and costs of providing other mechanisms of farmer support.	Fonterra has advised in response to our draft report that it has not changed its previously advised position and that it does not propose to include these costs either in the Manual or in the calculation of the milk price. <sup>47</sup>	We conclude that including costs associated with providing supplier support (to ensure continued supply) is consistent with the contestability dimension. <sup>48</sup> These costs do not on their own have a material impact on the base milk price. <sup>49</sup> We propose to review the potential impact of the omission again in our aggregate assessment of the 2016/17 calculation.

<sup>47</sup> Fonterra "Submission to the Commerce Commission on its Draft Report on Fonterra's 2016/17 Farmgate Milk Price Manual" (15 November 2016) p.7.

<b>Part B, Rule 16</b>	Fonterra Manual Amendment	Lactose costs	Process for determining lactose costs now aligned with actual approach taken in calculation.	Amended to align to actual approach (ie, lesser of Fonterra/average competitor import price).	The current approach in the Manual for determining lactose costs is not consistent with the contestability dimension.  To remove the current ability to pick pricing retrospectively, we suggest removing Fonterra's price as a reference. Rather, it would be preferable to determine lactose costs by the volume of weighted average prices declared to New Zealand Customs by other processors. <sup>50</sup>
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<sup>48</sup> As outlined in Commerce Commission "Final Report Review of Fonterra's 2015/16 Base Milk Price Calculation" (15 September 2016), para 5.6.

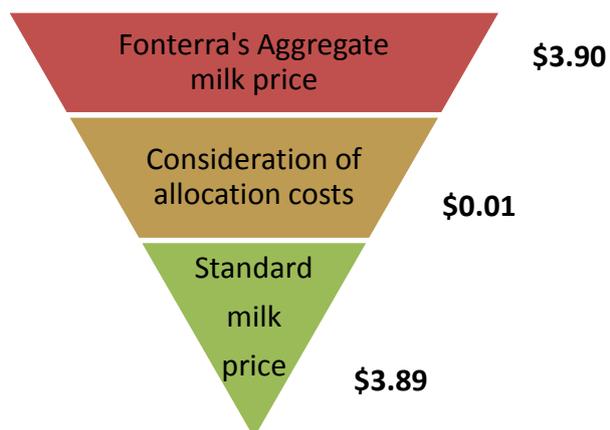
<sup>49</sup> The impact of this loan support would result in an estimated reduction to the milk price of 0.95c per kgMS. See Alastair Marsden "Update on Asset Beta for Fonterra's New Zealand based Commodity Manufacturing Businesses and Specific Risk Premium for Fonterra's Notional Business" (report to Fonterra, April 2016), para 4.13.

<sup>50</sup> Notwithstanding the Manual, we note that this is also the pricing methodology used in practice over the last three seasons.

### Treatment of winter milk premium and allocation costs

72. Fonterra currently calculates the base milk price as the aggregate amount available to be paid to suppliers prior to any allocation costs.<sup>51</sup> The milk price on standard terms accounts for these allocation costs and is disclosed annually in Fonterra's Farmgate Milk Price Statement.<sup>52</sup> Fonterra also discloses the difference between these milk prices, which was 1.1 cents per kgMS for the 2015/16 season. Figure 5.1 below outlines the difference using Fonterra's latest Farmgate Milk Price Statement.

**Figure 5.1 Aggregate milk price to standard milk price**



73. Interested parties have raised concerns that Fonterra's current approach to winter milk is not practically feasible.<sup>53</sup> We also consider these allocation costs would be incurred by the notional producer in order for it to achieve its assumed levels of productivity. However, Fonterra cites that if winter milk premiums (and other allocation costs) were to be included as a cost in the Manual, then the definition of the milk price would need to change to the milk price paid on standard terms.
74. Table 5.2 below outlines the process taken by Fonterra in determining typical allocation costs considered in individual supplier payments.

<sup>51</sup> Such costs include winter milk premiums, contract milk, discounts, demerits, volume charge net underpayment and presence of dichlorodiphenyl dichloroethene (a chemical which affects milk quality).

<sup>52</sup> We note Fonterra is required to disclose certain information including the forecast and actual figures for the season. This disclosure includes the estimated and actual additional cost of winter milk for each island.

<sup>53</sup> Open Country Dairy "Submission on the Commerce Commission's Process and Fonterra's 2016/17 Milk Price Manual" (September 2016), p.5. Synlait "Submission on Fonterra's milk price manual for the 2016/17 season" (8 September 2016), para 26.

**Table 5.2 Determining Farmer supplier payments**

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

*Requirements of the Act*

75. The Act identifies the specific costs to be taken into account in setting the base milk price. These are the costs of collecting, processing and selling milk, including capital costs and a return on capital.<sup>54</sup> The notional producer has a 'bucket of money' available to purchase milk. To the extent that the notional producer pays premiums for winter milk the amount of money available for non-winter milk is reduced, but the overall 'bucket of money' remains the same.
76. We note that the Act does not provide much assistance in determining whether the intention was for the base milk price to be disclosed on standard terms or average terms. However, Fonterra's Manual and the annual base milk price calculations have consistently been expressed on the basis of the average milk price per kgMS.
77. We consider that the calculation of the average price is sufficient to provide an incentive for Fonterra to operate efficiently while providing for contestability. This approach reflects that, in the real world, processors will compete for different categories of milk by paying higher prices for the milk they value more highly. At the same time contestability is provided for because the overall 'bucket of money' available for purchasing milk under the Manual calculation remains the same.

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<sup>54</sup> As outlined in s 150C of the Act.

*Our recommendation*

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

## Attachment A Conclusions on minor amendments

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

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

**Table A1 Summary of technical or drafting change issues**

Manual reference	Definition	Category	Description of issue	Fonterra reasoning	Commission comment
<b>Glossary</b>	Fonterra Manual Amendment	GDT definition	GDT prices sourced from twice monthly GDT transactions and not one-off transactions.	To clarify that base GDT prices will continue to be sourced from twice monthly GDT events platform, and not from one-off transactions on the new GDT marketplace.	No consistency issue; the change improves drafting accuracy.
<b>Part B, Rule 18</b>	Fonterra Manual Amendment	Continuing reasonableness review - no longer required	Removed requirement of Milk Price Group to complete a continuing reasonableness review annually.	Removed as creates an unduly onerous annual requirement - catch all within-period review provision in Rule 23 adequately provides an ability/requirement to review where the Milk Price Group has cause to believe an inflation-indexed provision is no longer appropriate.	For Rule 23 to be effective in covering any changes in continued reasonableness in 'within-period reviews', 'exceptional circumstances' needs to be defined. This would provide clarity as to what triggers a review. <sup>55</sup>

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<sup>55</sup> We acknowledge Miraka's comment on exceptional circumstances. See Miraka "Submission to the Commerce Commission Draft Report (14 October 2016): Review of Fonterra's 2016/17 Milk Price Manual" (15 November 2016), p5. We note Fonterra is yet to advise on the definition of an 'exceptional circumstance'. We anticipate guidance on this and will review in our 2017/18 Manual Review.

<b>Part B, Rule 34</b>	Fonterra Manual Amendment	Surplus capacity - reference to region	Where there is excess capacity, the standard plant in the region with the earliest deemed acquisition date (or dates) will be removed from the Farmgate Milk Price Fixed Asset base.	We undertook to consider this change, which reflects our intended practice, in our submission on the Commission's draft F16 Manual Report.	No consistency issue; the change improves drafting accuracy. <sup>56</sup>
<b>Part A, Section 6.1</b>	Fonterra Manual Amendment	Overview section - drafting change	Minor adjustments to the wording in the Disclosure - Overview section.	All amendments to this section are drafting in nature only.	No consistency issues; the change improves drafting accuracy.
<b>Part B, Rule 3</b>	Fonterra Manual Amendment	Wording amendment - Farmgate	Amended 'milk price' to 'Farmgate Milk Price' per our comment in 89.2 of 15/16 Manual Review.	Addresses minor point made by Commission in para 89.2 of the F16 Manual Report.	No consistency issues; the change improves drafting accuracy.
<b>Part B, Rule 14</b>	Fonterra Manual Amendment	Labour costs	Added "(but excluding any labour costs provided for in the immediately preceding calculation)."	To clarify that labour costs are not to be double-counted, consistent with actual practice.	No consistency issues; the change improves drafting accuracy.
<b>Part B, Rule 8</b>	Fonterra Manual Amendment	GlobalDairyTrade renamed to 'GDT'	Amended to acronym.	No comment on this amendment.	No consistency issues; "GDT" sufficient wording given full description is in glossary.

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<sup>56</sup> See our conclusion in para 4.64 of Commerce Commission "Final Report Review of Fonterra's 2015/16 base milk price calculation" (15 September 2016).

## Attachment B Glossary

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