

# **Review of Fonterra's 2017/18 Milk Price Manual: Dairy Industry Restructuring Act 2001**

## **Final report**

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## Executive Summary

### What this report covers

- X1 This report sets out our conclusions on our review of Fonterra's 2017/18 Milk Price Manual (**the Manual**). The Manual contains the methodology used to calculate Fonterra's base milk price each season. This version of the Manual is for the 2017/18 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**), which is contained in subpart 5A of the Dairy Industry Restructuring Act 2001 (**the Act**). More details of the intent of the regime can be found in our supporting paper on our approach to the review.<sup>2</sup>
- X3 Our review considers the 'efficiency' and 'contestability' dimensions required by the Act. These focus on whether the Manual and the calculation provide:
- 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, our interpretation is that our statutory reviews must assess both dimensions. We attach equal weight to both dimensions in our reviews.
- X5 In response to our process email on this review of 14 September 2017, we received a submission that we consider called for further explanation of how the Manual and the base milk price calculation work under subpart 5A of the Act.<sup>3</sup> Responses to the key points raised in that submission are set out in Chapter 2.

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<sup>1</sup> The 2017/18 season runs from 1 June 2017 until 31 May 2018.

<sup>2</sup> Commerce Commission "Our approach to reviewing Fonterra's Milk Price Manual and base milk price calculation" (15 August 2017). Our report is supported by this separate paper that provides an overview of the approach we have taken in reviewing the Manual for the 2017/18 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 & L King "Submission regarding Fonterra milk price manual" (28 September 2017).

- X6 We have relied on our previous conclusions for those parts of the Manual that have remained unchanged unless there was information causing us to reconsider previous conclusions. We have not received, nor are we aware of any information which would warrant reconsideration of our previous conclusions.

### **Our conclusions**

- X7 We conclude that this season's Manual is largely consistent with the statutory purpose set out in s 150A of the Act.<sup>4</sup>
- X8 However, as outlined in previous calculation reviews and Manual reviews, there are two aspects of the Manual that we consider to be inconsistent with the purpose in s 150A or we would like to see more disclosure in the Manual:
- X8.1 farmer support; and
  - X8.2 capacity of standard plants.
- X9 We do not consider that either of these matters is sufficiently material to render the Manual inconsistent with the s 150A purpose as a whole.
- X10 We are encouraging Fonterra to provide more transparency of information to engender greater confidence for interested parties in Fonterra's base milk price setting process and better promote the purpose of the Act. We think it would be desirable for Fonterra to provide for additional transparency in the following areas:
- X10.1 consistency over time - disclosure requirement;
  - X10.2 actual FX rates assumed;
  - X10.3 base milk price on standard terms; and
  - X10.4 proposal for sales criteria clarity.
- X11 These are summarised in Attachment B.

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<sup>4</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. We note for completeness that we have previously observed that we are comfortable with the WACC methodology set out in the Manual. See for example para X26 of Commerce Commission "Final report – Review of Fonterra's 2015/16 base milk price calculation - 15 September 2016", footnote 15 of Commerce Commission "Final report – Review of Fonterra's 2016/17 Milk Price Manual – 14 December 2016", and paragraphs 2.24 to 2.27 of Commerce Commission "Final Report – Review of Fonterra's 2016/17 base milk price calculation – 15 September 2017".

**Our recommendations to Fonterra**

- X12 Fonterra's amendments to the Manual have improved its consistency with the overall purpose of the milk price monitoring regime. We continue to encourage Fonterra to consider how it could improve the clarity of the rules.
- X13 We welcome Fonterra's commitments to improve its disclosures on its application of the rules in the Manual.<sup>5</sup>

**Next steps**

- X14 Based on Fonterra's 2017/18 Manual amendments and our conclusions on this review, we do not have any new focus areas which we consider need to be added to the scope of our 2017/18 milk price calculation review.
- X15 An outline of our current thinking on how we will approach our review of the 2017/18 milk price calculation is provided in Attachment D. The primary focus of our calculation review for this year will be the estimate of the asset beta and estimated cost of capital used in the calculation.
- X16 A submitter has raised a question on the treatment of lactose costs. Although we consider this outside the scope of our current review of the Manual, we invite interested parties' comments on the treatment of lactose costs for consideration in future Manual reviews.

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<sup>5</sup> As noted in our 2016/17 calculation review, we welcome Fonterra's commitment to additional disclosures relating to the inclusion of off-GDT sales. The effectiveness of Fonterra's additional disclosures in this regard will be tested in our 2017/18 calculation review. See Commerce Commission "Final report – Review of Fonterra's 2016/17 base milk price calculation" (15 September 2017), paras X15 and X18.

## Chapter 1 Introduction

1. This report sets out our review of the extent to which Fonterra's 2017/18 Manual is consistent with the purpose of the monitoring regime, which is set out in s 150A of the Act.

### How this report is structured

2. Chapter 2 covers the scope of our review.
3. Our conclusions are set out in Chapter 3 and are supported by the summary tables in Attachments A and B.
4. We have focused our commentary in Chapter 3 on those areas which could affect the extent to which the Manual is consistent with s 150A.
5. Our high-level conclusions on minor technical and drafting amendments to the Manual are set out in Attachment A. Where appropriate, our brief commentary is provided.
6. Manual amendments that we proposed to Fonterra in prior reviews and which we consider still outstanding have been summarised in Attachment B.
7. A glossary of key terms is provided in Attachment C.
8. An outline of our current thinking on how we will approach the 2017/18 milk price calculation review is provided in Attachment D.
9. We recommend reading this report with our supporting paper.<sup>6</sup>

### We are fulfilling our statutory requirements

10. 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 subpart 5A of the Act.<sup>7</sup>
11. The Act requires Fonterra to provide us with the following information for consideration in our review:

11.1 Fonterra's Manual for the current season;

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<sup>6</sup> Commerce Commission "Our approach to reviewing Fonterra's Milk Price Manual and base milk price calculation" (15 August 2017).

<sup>7</sup> As required under s 150H and s 150J of the Act.

- 11.2 Any recommendations by the Milk Price Panel in relation to the setting of the base milk price;
  - 11.3 Notification of any change in the economic and business environment that, in Fonterra's view, requires a change to the Manual;
  - 11.4 Certification on the extent to which Fonterra considers that the Manual is consistent with the purpose of s 150A; and
  - 11.5 Reasoning behind the views expressed in Fonterra's certification.
12. The above information has been provided by Fonterra in the 'Reasons' Paper in support of Fonterra's Manual for the 2017/18 season which is available on our website.<sup>8</sup>

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<sup>8</sup> Fonterra "Fonterra's Reasons Paper in support of Milk Price Manual for the 2017/18 season" (2017) at [www.comcom.govt.nz/review-of-milk-price-manual-201718-season](http://www.comcom.govt.nz/review-of-milk-price-manual-201718-season)



## Chapter 2 Scope of this report

13. The scope of this report was signalled in our process email of 14 September 2017 and is aligned with the requirements of the Act.
14. We have relied on conclusions from our previous reviews for unchanged areas of the Manual unless significant new information has come up that has caused us to reconsider previous conclusions. We have not received, nor are we aware of any information which would warrant reconsideration of our previous conclusions.
15. As signalled in our process email, we have focused our review on:
  - 15.1 Fonterra's amendments to the Manual;
  - 15.2 issues arising from our 2016/17 base milk price calculation review;<sup>9</sup>
  - 15.3 issues arising from comments on our process email; and
  - 15.4 outstanding issues from previous Manual reviews.
16. In this report we have grouped issues in the following order:
  - 16.1 The areas of the Manual that are more likely to have an impact on the extent to which the Manual is consistent with s 150A.
  - 16.2 Minor amendments to the Manual of a technical or drafting nature (Attachment A).
  - 16.3 A summary of the Manual amendments we have proposed to Fonterra over the course of our milk price reviews which have not been adopted. Given the ongoing nature of our reviews we consider these issues to be of continuing relevance (Attachment B).

### Submission on our process email

17. In response to our process email of 14 September 2017, we received a submission from Stuart and Lorae King, Fonterra farmers and shareholders, who have raised some concerns about how the base milk price is set under the Manual and the Act.
18. We consider these questions important enough to them and other stakeholders that we have included below a summary of our responses to the points raised. These are provided in Table 2.1.

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<sup>9</sup> Commerce Commission "Final Report Base Milk Price Calculation Review 2016/17" (15 September 2017).

**Table 2.1 Response to questions raised by S & L King<sup>10</sup>**

Issues raised	Explanatory comment
<p><b>In setting the Fonterra milk price, the Manual needs to ensure that all income derived from Fonterra's milk business (Fonterra Ingredients) goes toward milk price.</b></p>	<p>In order to give effect to the s 150A purpose, the Act requires the base milk price to be set in accordance with certain principles.</p> <p>The Act requires the revenue taken into account in calculating the base milk price to be determined using the prices of a portfolio of commodities.<sup>11</sup> It would therefore be impermissible for the Manual to ensure that all income derived from Fonterra's milk business goes to the milk price, as that income includes profits and losses from value-added products that do not meet the definition of a commodity. Profits and losses from value-added products remain a shareholder return rather than a milk supplier return.</p>
<p><b>We believe our view is supported by Fonterra's constitution which in annex 1 states; "...the Milk Price should be the maximum amount that the Company, reflecting its status as properly managed and efficiently run sustainable co-operative, could pay for the Milk supplied to it in a Season if: The Company, on their behalf, processed that Milk into commodity products which were sold on freely contested global markets."</b></p>	<p>We note that the Manual and base milk price must be set under the requirements of the Act. We therefore cannot take account of Fonterra's constitution when we carry out our reviews.</p>
<p><b>We believe that the present Manual is giving a milk price which understates the value contribution to the company of their members' milk and overstates the perceived investment returns as expressed in the earnings and dividend results.</b></p>	<p>We note that the base milk price is only intended to provide the return on the commodity value of the milk supplied by Fonterra farmers, as provided in the Act. The value-added component affects the dividends paid to farmers and investors for their investment in Fonterra.</p>
<p><b>We ask Fonterra to review the range of reference products and to use the value of actual product sales rather than just GDT when calculating the Milk price.</b></p>	<p>Following the amendment to the 2016/17 milk price Manual, Fonterra now includes both on-GDT and off-GDT sales in the recognition of revenue earned from the sale of its commodity products.</p>

<sup>10</sup> S & L King "Submission regarding Fonterra milk price manual" (28 September 2017) at [www.comcom.govt.nz/regulated-industries/dairy-industry/review-of-fonterra-s-farm-gate-milk-price-and-manual/statutory-review-of-milk-price-manual/review-of-milk-price-manual-201718-season/](http://www.comcom.govt.nz/regulated-industries/dairy-industry/review-of-fonterra-s-farm-gate-milk-price-and-manual/statutory-review-of-milk-price-manual/review-of-milk-price-manual-201718-season/).

<sup>11</sup> See s 150C of the Act. A commodity means a product made by the processing of milk that is - (a) traded in significant quantities in globally contested markets; and (b) characterised by uniform technical specifications, as outlined in section 5 of the Act. Further, Fonterra is required to select those commodities that "are likely to be the most profitable over a period not exceeding 5 years from the time when the portfolio is determined".

19. In addition to the matters raised in Table 2.1 above, the King's have also raised the question of whether or not there is a requirement in the Act that reference products have local market manufacturing competition.<sup>12</sup> There is no requirement for local manufacturing competitors to the notional producer. Local manufacturing competitors are used for the purpose of comparative reference only.
20. We have received an additional email submission (24 November 2017) from the King's regarding the treatment of winter milk premiums and allocation costs. They question whether the adjustment should be treated as a cost or a distribution of the farm gate milk price. Fonterra treats the winter milk premium as an additional allowance or distribution of the milk price, not a further cost, and based on our earlier review we are satisfied that this treatment is consistent with the Act.<sup>13</sup>

### **Other matters raised in submissions on our draft report**

21. Some of the submissions we received were on matters we considered outside of the scope of our review of the Manual.
22. Open Country submitted that a lack of transparency creates significant risk for including off-GDT sales. We concluded in our 2016/17 review that Fonterra's inclusion of off-GDT sales was consistent with the efficiency and contestability dimensions of the Act and we welcomed Fonterra's "commitment to additional disclosures in support of off-GDT sales".<sup>14</sup>

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<sup>12</sup> Stuart and Lorae King "Submission on draft report on Fonterra's 2017/18 Milk Price Manual" (n.p.), at <http://www.comcom.govt.nz/regulated-industries/dairy-industry/review-of-fonterra-s-farm-gate-milk-price-and-manual/statutory-review-of-milk-price-manual/review-of-milk-price-manual-201718-season/>

<sup>13</sup> Commerce Commission "Review of Fonterra's 2016/17 Milk Price Manual: Dairy Industry Restructuring Act 2001", 14 December 2016, p.13, Table 5.1, pp. 27-28, at <http://www.comcom.govt.nz/regulated-industries/dairy-industry/review-of-fonterra-s-farm-gate-milk-price-and-manual/statutory-review-of-milk-price-manual/201617-season/>

<sup>14</sup> Commerce Commission "Review of Fonterra's 2016/17 base milk price calculation: Dairy Industry Restructuring Act 2001", 15 September 2017, pp. 6-7, para. 2.104, p.36, at <http://www.comcom.govt.nz/regulated-industries/dairy-industry/review-of-fonterra-s-farm-gate-milk-price-and-manual/statutory-review-of-milk-price-calculation-2/review-of-milk-price-calculation-201617-season/>. See also Open Country Dairy "Submission on Commerce Commission's Draft Report on the 2017/18 Milk Price Manual", pp. 2-3, at <http://www.comcom.govt.nz/regulated-industries/dairy-industry/review-of-fonterra-s-farm-gate-milk-price-and-manual/statutory-review-of-milk-price-manual/review-of-milk-price-manual-201718-season/>

23. We further note the range of other submissions that Open Country made relating to transparency of information, including the statements that:
- 23.1 lack of transparency damages market contestability; and
  - 23.2 the Manual lacks adequate disclosure and transparency.
24. As noted in our draft report, we agree that greater transparency in some areas (for example, where the Manual allows Fonterra to make discretionary decisions on model inputs and calculations) may better promote the s 150A purpose and provide greater confidence in the milk price monitoring regime.<sup>15</sup> However, we do not consider that these issues have limited our ability to perform our review to an appropriate standard or hindered our ability to conclude on the extent to which the Manual is consistent with the s 150A purpose. Accordingly, as noted in Attachment B, we do not consider those matters to be material to our overall conclusion on s 150A.<sup>16</sup>
25. Miraka has also submitted to us on matters where it does not feel that Fonterra has met its undertakings for disclosure in a way that meets a good standard of transparency of information.<sup>17</sup>
26. We will consider whether there is a need to further examine the adequacy of Fonterra's committed disclosures in this regard in our forthcoming 2017/18 review of the farm milk gate price calculation.
27. We acknowledge the submission from Gerard van Beek in general and on the treatment of lactose costs in particular. We consider the general methodological comments to fall outside the scope of the current review of the Manual. We also consider that the Fonterra's treatment of lactose in the Manual as a cost in the base milk price calculation is consistent with the requirements of the Act.
28. It appears from the submission that the proposed alternative treatment of lactose costs would be an allowance akin to the current treatment of winter milk as raised above by the King's, rather than a cost to be included in setting the base milk price. It does not therefore appear to be a milk price calculation issue for resolution through

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<sup>15</sup> See paragraphs 28 and 29, page 10, and Table B1, page 15 of the draft report.

<sup>16</sup> Further information about our position on the transparency of information in relation to our reviews can be found in the post-Workshop note we published addressing concerns on practical feasibility and transparency on 19 July 2017. The note is available at <http://www.comcom.govt.nz/regulated-industries/dairy-industry/review-of-fonterra-s-farm-gate-milk-price-and-manual/statutory-review-of-milk-price-calculation-2/review-of-milk-price-calculation-201617-season/>.

<sup>17</sup> Miraka Limited: Letter to the Commission of 1 December 2017.

the Manual. However, we invite interested parties' comments on why they would consider the alternative treatment of lactose costs outlined in the submission would better meet the milk price calculation requirements in the Act.<sup>18</sup>

29. We are particularly interested in parties' views on whether or not the supply of lactose by farmers should be priced separately from the farm gate milk price, or whether this is an issue outside of the ambit of the Act.<sup>19</sup>
30. We note the submission from TDB Advisory on the use of Fonterra's asset beta. This is outside the scope of the review of the Manual, but the information contained in the submission will be considered in our forthcoming review of the milk price calculation. See Attachment D.

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<sup>18</sup> Gerard van Beek: Submission: "Issue: Treatment of lactose cost in Milk Price Manual", at <http://www.comcom.govt.nz/regulated-industries/dairy-industry/review-of-fonterra-s-farm-gate-milk-price-and-manual/statutory-review-of-milk-price-manual/review-of-milk-price-manual-201718-season/>.

<sup>19</sup> This is essentially a question about whether the average cost of lactose should be treated as a manufacturing cost (ie, current treatment), or whether the value of lactose should be treated for each farmer supplier as a differential part of the milk price they receive.

## Chapter 3 Conclusions

31. This chapter summarises our conclusions on the extent to which the 2017/18 Manual is consistent with the s 150A purpose and areas where we consider it desirable for Fonterra to provide additional transparency to better promote the purpose of the Act.
32. Our overall conclusion is that the 2017/18 Manual is largely consistent with the s 150A purpose.
33. However, as outlined in previous calculation reviews and Manual reviews, there are two aspects of the Manual that we consider to be inconsistent with the purpose in s 150A or would like to see more disclosure in the Manual:
  - 33.1 farmer support;<sup>20</sup> and
  - 33.2 capacity of standard plants.<sup>21</sup>
34. We do not consider that either of these matters is sufficiently material to render the Manual inconsistent with the s 150A purpose as a whole.
35. To better promote the purpose of the Act and engender more confidence for interested parties in Fonterra's base milk price setting process, we think it would be desirable for Fonterra to provide additional transparency of information in the following areas:
  - 35.1 consistency over time - disclosure requirement;

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<sup>20</sup> We note that a key focus of our role in reviewing the Manual is to assess the extent to which the Manual is consistent with the s 150A purpose as a whole. We note the submission from Open Country Dairy on this matter. However, we do not have sufficient grounds or supporting evidence to change our overall conclusion. We do not consider that any inconsistency with the s 150A purpose arising from farmer support costs is sufficiently material to render the Manual inconsistent with the s 150A purpose as a whole. We therefore remain of the view that the Manual is largely consistent with the s 150A purpose. See Open Country Dairy "Submission on Commerce Commission's Draft Report on the 2017/18 Milk Price Manual", at <http://www.comcom.govt.nz/regulated-industries/dairy-industry/review-of-fonterra-s-farm-gate-milk-price-and-manual/statutory-review-of-milk-price-manual/review-of-milk-price-manual-201718-season/>.

<sup>21</sup> Fonterra disagreed in its submission on our draft report with our statement that we had characterised this as being inconsistent with s 150A of the Act. As this matter is not material to our overall conclusion on s 150A, we agree with Fonterra that this is a matter of disclosure of information. Fonterra: "Review of Fonterra's 2017/18 Milk Price Manual", at <http://www.comcom.govt.nz/regulated-industries/dairy-industry/review-of-fonterra-s-farm-gate-milk-price-and-manual/statutory-review-of-milk-price-manual/review-of-milk-price-manual-201718-season/>.

- 35.2 actual FX rates assumed;
- 35.3 base milk price on standard terms; and
- 35.4 proposal for sales criteria clarity.
36. These are summarised in Attachment B.

### Conclusions on Fonterra's amendments

37. Table 3.1 summarises our conclusions on the changes to the Manual for this season where Fonterra has provided specific commentary in its 2017/18 Reasons paper.

**Table 3.1 Summary of our conclusions on Fonterra's amendments<sup>22</sup>**

Manual reference	Detail	Description of issue	Fonterra reasoning	Commission comment
<b>Part B, Rule 16</b>	Rule 16, Amendment to solve ability to retrospectively pick the lactose cost informing the calculation.	Added requirement that the determination as to which lactose cost methodology is used must be made by the MPG prior to the commencement of the relevant season removing the ability to pick retrospectively.	Retains the same approach as used previously but adds a requirement that the choice between price series must be made prospectively, at the start of the season, rather than retrospectively, at the end of the season. Made in response to Commerce Commission's finding that a retrospective choice is not practically feasible.	Fonterra's amendment resolves Commission's concern.
<b>Part B, Rule 14 and Part C, Definition</b>	Rule 14, R&M costs - making rule more explicit by referencing a defined term for Maintenance Department Labour Costs (previously an undefined generic cost category).	R&M rule has been amended to include a specific definition of Maintenance Department Labour Costs (as defined in Part C).	New definition consistent with undertaking in Fonterra's submission on Commission's draft report on the F17 Manual.	No consistency issue; the change responds to an issue previously raised by the Commission. Fonterra's amendment resolves Commission's concern.

<sup>22</sup> See also Attachment A which outlines the amendments of a minor or drafting nature.

*Lactose costs*

38. We conclude that Fonterra's amendment solves our concern that Fonterra's ability to retrospectively pick the lactose cost informing the milk price calculation was not consistent with the contestability dimension. By adding the requirement to make a decision about the methodology used prospectively this removes the ability to pick pricing retrospectively for calculating lactose costs and thereby ensures consistency with contestability.
39. We consider it would be desirable for Fonterra to publicly disclose this decision prior to the beginning of the season to better promote the purpose of the Act. This would provide interested parties with certainty of the methodology used for determining the lactose costs.

*Repairs and maintenance costs*

40. Fonterra's amendment to the repairs and maintenance rule responds directly to our recommendation to Fonterra to include a definition of 'maintenance department labour costs' to provide greater clarity raised in our 2016/17 Manual review.<sup>23</sup>
41. We are satisfied with this change as it responds directly to our recommendation to provide greater clarity.

*Amendments of a minor technical and drafting nature*

42. Table A1 of Attachment A sets out our conclusions on minor technical and drafting amendments to the Manual.

**Future Manual developments**

43. We welcome Fonterra's commitment to providing additional disclosures in the Manual in support of the inclusion of off-GDT reference sales. Fonterra has advised that it intends to include definitions of "standard packaging", "specialised plant or technical resources", and "standard product offerings" in its 2018/19 Manual.<sup>24</sup>

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<sup>23</sup> Commerce Commission "Review of Fonterra's 2016/17 Milk Price Manual: Dairy Industry Restructuring Act 2001 - Final Report" (14 December 2016), Table X1.

<sup>24</sup> Commerce Commission "Review of Fonterra's 2016/17 base milk price calculation: Dairy Industry Restructuring Act 2001 - Final report" (15 September 2017), Table X1. We note that Fonterra proposed the inclusion of these additional definitions after it had already provided the amended 2017/18 Manual to us (1 August 2017).



## Attachment A Conclusions on minor amendments

**Table A1 Summary of minor technical and drafting changes**

Manual reference	Detail	Category	Description of issue	Fonterra reasoning	Commission comment
<b>Part A</b>	Fonterra Manual Amendment	Added complete year for clarity ie, F16 to F2016 (which in this example refers to the 2015/16 season)	N/A	N/A	No consistency issue; minor drafting amendment
<b>Part B, Rule 21</b>	Fonterra Manual Amendment	The word "GlobalDairyTrade" changed to "GDT"	N/A	N/A	No consistency issue; minor drafting amendment
<b>Part B, 29</b>	Fonterra Manual Amendment	Rule removed	Removed rule. Considered superfluous given: (a) independent test for surplus assets is already required under Rule 34 (b) MPG annually determines, on a forward looking basis, whether there is currently sufficient capital in the model (c) consequences of insufficient peak processing capacity are dealt with automatically in the calculation and (d) the MPG's assessment is subject to review by external auditor and the Commerce Commission.	N/A	No consistency issue; minor technical amendment
<b>Part C, Definition</b>	Fonterra Manual Amendment	Qualifying reference sales - Definition	Added bullet point numbers for clarity.	N/A	No consistency issue; minor drafting amendment
<b>Part C, Definition</b>	Fonterra Manual Amendment	kgMS farmgate milk price - Definition	Added kgMS to definition for clarity.	N/A	No consistency issue; minor drafting amendment

## **Attachment B Outstanding amendments proposed earlier to Fonterra**

- B1 This Attachment provides a summary of the amendments we have proposed to Fonterra over the course of our milk price reviews which have not been adopted.<sup>25</sup> For the continuity of our reviews and consideration of future submission points, we consider this to be a valuable summary for all interested parties.
- B2 We do not consider these outstanding amendments to be material to our overall conclusion on s 150A. However, we consider these proposed amendments would better promote the setting of a base milk price that provides an incentive to Fonterra to operate efficiently while providing for contestability in the market for the purchase of milk from farmers.<sup>26</sup>
- B3 Table B1 outlines our proposed amendments, Fonterra's responses and our brief comments.

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<sup>25</sup> Both the Manual and calculation reviews.

<sup>26</sup> s 150A of the Act.

**Table B1 Summary of amendments proposed earlier to Fonterra**

Manual reference	Detail	Category	First raised by the Commission	Previous Commission conclusion <sup>27</sup>	Description of issue	Fonterra reasoning
<b>N/A</b>	Fonterra decision for no change	Farmer support	2015/16 calculation review	Although, non-material, we conclude that Fonterra should include the costs of providing shareholder support to ensure continued supply to be consistent with the contestability dimension.	Financing and associated administration costs of providing farmer support loans and costs of providing other mechanisms of farmer support. <sup>28</sup>	No change to our previous position that it is not appropriate to fund these costs from the Milk Price.
<b>Part A, Section 2.6</b>	Fonterra decision for no change	Consistency over time - disclosure requirement	2016/17 Manual review	No consistency issue; however, we consider such disclosure would provide greater transparency of information.	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. <sup>29</sup>	No change, for reasons explained in our F16 reasons paper (a 'bright line' materiality threshold is actually likely to lead to less disclosure).

<sup>27</sup> Our previous conclusions in these areas from prior reviews. These reports can be found at <http://www.comcom.govt.nz/regulated-industries/dairy-industry/review-of-fonterra-s-farm-gate-milk-price-and-manual/>.

<sup>28</sup> We note Open Country Dairy's views on farmer support costs in its submission "Submission on Commerce Commission's Draft Report on the 2017/18 Milk Price Manual", p.2, at <http://www.comcom.govt.nz/regulated-industries/dairy-industry/review-of-fonterra-s-farm-gate-milk-price-and-manual/statutory-review-of-milk-price-manual/review-of-milk-price-manual-201718-season/>. However, we disagree that the amount of the loans is the relevant issue. We rather consider that the cost of funding the loans (and any loan forgiveness) is the more relevant issue for the base milk price calculation.

<sup>29</sup> Our conclusion on this issue is supported in Open Country Dairy's "Submission on Commerce Commission's Draft Report on the 2017/18 Milk Price Manual", p.1, at <http://www.comcom.govt.nz/regulated-industries/dairy-industry/review-of-fonterra-s-farm-gate-milk-price-and-manual/statutory-review-of-milk-price-manual/review-of-milk-price-manual-201718-season/>.

Manual reference	Detail	Category	First raised by the Commission	Previous Commission conclusion <sup>27</sup>	Description of issue	Fonterra reasoning
<b>Part B, Rule 26</b>	Fonterra decision for no change	Capacity of standard plants	2016/17 Manual review	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 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.	No change – we do not consider the Manual is the appropriate vehicle for these disclosures. We have previously put this information into the public domain, and the relevant assumptions will not be revisited until F20.
<b>N/A</b>	Fonterra decision for no change	Actual FX rates assumed	2016/17 Manual review	We suggest there should be more transparency of information on the actual FXD rates assumed to be achieved by the notional producer.	We consider there should be more transparency of information on the actual foreign exchange rates assumed to be achieved by the notional producer. We suggest providing an average FX conversion rate assumed to be achieved by the notional producer throughout the season.	Outside scope of Manual. <sup>30</sup>

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<sup>30</sup> Although outside of the scope of the Manual and a safe harbour under the Act, we consider the disclosure of the assumed rates would promote the purpose of the Act. We note this does not affect our ability to conclude on the Manual.

Manual reference	Detail	Category	First raised by the Commission	Previous Commission conclusion <sup>27</sup>	Description of issue	Fonterra reasoning
<b>N/A</b>	Fonterra decision for no change	Base milk price on standard terms	2015/16 calculation review	We consider disclosure of the cost of milk in standard terms (prior to any adjustments) would provide greater transparency to the milk price regime.	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.	Outside scope of Manual. <sup>31</sup>
<b>Part C, Definition</b>	Amendment proposed but not made	Proposal for sales criteria clarity	2016/17 calculation review	We welcome such additional definitions to provide greater clarity around sales criteria.	In Fonterra's submission on the 2016/17 Milk Price Calculation draft report it proposed including definitions of "standard packaging", "specialised plant or technical resources", and "standard product offerings" and "standard packaging" in its Milk Price Manual.	N/A

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<sup>31</sup> Although outside of the scope of the Manual and a safe harbour under the Act, we consider the disclosure of the assumed rates would promote the purpose of the Act. We note this does not affect our ability to conclude on the Manual.

## Attachment C    Glossary

Term/Abbreviation	Definition
<b>The Act</b>	Dairy Industry Restructuring Act 2001
<b>Base milk price</b>	Farm gate milk price expressed per kilogram of milk solids
<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 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>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)

## Attachment D Our proposed process for the 2017/18 Milk Price calculation review

D1 This Attachment provides an overview of our proposed:

D1.1 focus area for our 2017/18 base milk price calculation review; and

D1.2 process for the 2017/18 base milk price calculation review.

### Our primary focus of our review

D2 The primary focus of our review this year will be the estimate of the asset beta and estimated cost of capital used in the 2017/18 Milk Price Calculation.

### *Scope of our 2017/18 review*

D3 Based on outstanding issues from our 2016/17 base milk price calculation review we have one remaining key focus area for our 2017/18 review.

D4 This area is the asset beta. In our 2016/17 calculation review we were unable to conclude on the consistency of the asset beta with the contestability dimension of the s 150A purpose in the milk price setting. We indicated that we consider our standard approach for estimating the asset beta to be appropriate for this sector too, and therefore anticipate basing future calculation reviews on this approach.

D5 To assist with our review we have recommended that Fonterra provides detailed evidence of the extent to which firms in the sample transfer price risk to farmers or others, and how this compares to the notional producer that fully passes through that risk.

D6 In addition, we plan to conduct some work of our own in this area, aimed at helping us reach a more definitive conclusion on whether or not Fonterra's estimate of the asset beta is consistent with the Act.

D7 We note the submission from TDB Advisory on the asset beta used by Fonterra. We note that this submission is out of scope for the review of the milk price Manual but will consider the arguments made in its submission when conducting our review of the asset beta in the forthcoming review of the base milk price calculation.<sup>32</sup>

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<sup>32</sup> TDB Advisory "Asset beta discussion", at <http://www.comcom.govt.nz/regulated-industries/dairy-industry/review-of-fonterra-s-farm-gate-milk-price-and-manual/statutory-review-of-milk-price-manual/review-of-milk-price-manual-201718-season/>.

**Process outline**

- D8 We currently plan to issue an Emerging Views Paper on the asset beta and on our accompanying 'fit for purpose' review in March 2018 and will consult with interested parties on that paper.
- D9 Following consideration of submissions received, we will then publish further details on the process through to our draft 2017/18 base milk price calculation review decision paper, which will be published on Wednesday 15 August 2018. This process update will include whether we will seek submissions publicly on our draft decision.
- D10 If you have any comments on our key focus area or our proposed review process, please send these to us by 5.00pm Thursday 1 February 2018.