ISBN no. 978-1-869453-42-8
Project no. 16.03/14306

Public version

The Dairy Industry Restructuring Act 2001

Review of Fonterra's 2013/14 Milk Price Manual

Final report

Date: 16 December 2013

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

Contents

Executive Summary

X1 This report sets out our conclusions, and the reasons for those conclusions, on the extent to which Fonterra's Milk Price Manual (Manual) for the 2013/14 dairy season is consistent with the purpose of the milk price monitoring regime set out in s 150A of the Dairy Industry Restructuring Act 2001 (the Act).[1]

X2 Section 150A of the Act specifies that the purpose of the milk price monitoring regime is to promote the setting of the base milk price by Fonterra:

X2.1 that provides an incentive for Fonterra to operate efficiently, while

X2.2 providing for contestability in the market for the purchase of milk from farmers.

X3 Our view is that setting any independent notional benchmarks for the revenue and cost calculations that underpin the base milk price setting would provide a stronger incentive for Fonterra to operate efficiently, than the use of Fonterra's actual values. This is consistent with the Act which envisages the use of notional values and in some instances requires the use of a notional business. Our approach to considering the efficiency dimension is, therefore, to assess the extent to which the provisions in the Manual incentivise Fonterra to operate efficiently, through the use of notional components.

X4 In assessing whether the base milk price setting provides for contestability, we considered whether the Manual provides for the setting of the base milk price that is practically feasible for Fonterra or another efficient processor.

X5 Our assessment of Fonterra's Manual for the 2013/14 dairy season is based on our previous reviews of Fonterra's Milk Price Manual for the 2012/13 dairy reason and Fonterra's 2012/13 base milk price calculation, as well as the supporting information we received from Fonterra and other interested parties for this and the previous reviews.

X6 Our conclusion is that, to the extent we are able to assess it, the Manual for the 2013/14 dairy season is largely consistent with the s 150A purpose statement.

X7 However, some of the changes made to the Manual for the 2013/14 dairy season and our increased understanding of how the Manual is presently applied, have raised for us a general concern about the flexibility of interpretation of the Manual. Specifically, the lack of prescription in some rules of the Manual:

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

X7.1 undermines the efficiency objective, as it is important that the Manual reflects a set of stable and prescriptive rules so that it provides a transparent benchmark for Fonterra management to beat and for external stakeholders to monitor Fonterra's performance against; and

X7.2 means that there is a risk that we may not be able to conclude on the extent to which some of the rules in the Manual are practically feasible for Fonterra or another efficient processor, or that our previous conclusions on the rules in the Manual may need to be modified in light of our assessment of the application of those rules.

X8 In respect of the Manual for the 2013/14 dairy season, we are unable to conclude on the extent to which the following rules in the Manual are practically feasible for Fonterra or another efficient processor, until we are able to assess their specific application:

X8.1 *The mechanism for providing for stranded assets risk in the calculation of asset beta in Rule 40.* Notwithstanding Fonterra's clarification on the allocation of stranded assets risk in Rules 31 and 32, we do not agree with Fonterra on the mechanism for providing for this risk in the calculation of asset beta. Furthermore, we are unable to conclude on the feasibility of Fonterra's asset beta estimate due to insufficiency of information provided to us by Fonterra.

X8.2 *The calculation of the 'repair and maintenance costs' in Rule 16.* The change to this rule introduces a significant degree of discretion as to how it might be applied. We are therefore no longer able to conclude on the extent to which the rule itself is practically feasible.

X8.3 *The calculation of 'other costs, including site overheads, general overhead costs and R&D costs' in Rule 19*. During our review of Fonterra's 2012/13 base milk price calculation, Fonterra signalled its intention to introduce methodological changes to calculating these costs, without requiring changes to the rule itself. We are therefore no longer able to conclude on the extent to which the rule itself is practically feasible.

X9 We will assess specific application of these rules as part of our review of Fonterra's 2013/14 base milk price calculation in 2014.

1. Introduction

1.1 In this chapter, we:

1.1.1 set out the purpose of this report and the scope of our review of the Milk Price Manual (Manual) for the 2013/14 dairy season; and

1.1.2 outline the structure of this report.

Purpose of this report

1.2 The purpose of this report is to set out our conclusions, and the reasons for those conclusions, on the extent to which the Manual for the 2013/14 dairy season is consistent with the purpose of the milk price monitoring regime set out in the Dairy Industry Restructuring Act 2001 (the Act). The purpose is to promote the setting of a base milk price by Fonterra:

1.2.1 that provides an incentive to Fonterra to operate efficiently, while

1.2.2 providing for contestability in the market for the purchase of milk from farmers.

Scope of our review of the Manual for the 2013/14 dairy season

Review of the Manual only

1.3 This report relates to the first of two separate statutory reviews of Fonterra's base milk price setting that we are required to undertake in each dairy season under the Act.

1.3.1 Review of Fonterra's Milk Price Manual (review of the Manual).

1.3.2 Review of Fonterra's base milk price calculation (review of the base milk price calculation).

1.4 This report relates to the review of the Manual for the 2013/14 dairy season only. This means that for this review, we have considered the provisions in the Manual that underpin Fonterra's methodology for setting the base milk price (ie, the principles, key assumptions, detailed rules and definitions as set out in the Manual), but not the application of the Manual (ie, the assumptions, inputs and processes that underpin the base milk price calculation). We will review the assumptions, inputs and processes that underpin the base milk price calculation in 2014, as part of our review of the 2013/14 base milk price calculation.

1.5 The limits of this review means that our conclusions may be different when we see those provisions in the Manual applied in the 2013/14 base milk price calculation.

Information used for this review

1.6 In order for us to carry out the review of the Manual, s 150L of the Act requires Fonterra to provide us with the following information:

1.6.1 the Milk Price Manual for the current season;

1.6.2 any recommendations by the Milk Price Panel in relation to the setting of the base milk price;

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

1.6.4 certification of the extent to which Fonterra considers that the Manual is consistent with the purpose; and

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

1.7 This information is provided in Fonterra's 'Reasons' paper in support of Fonterra's Milk Price Manual for the 2013/14 Season (Reasons paper), which we published on our website.[2]

1.8 The Act requires us to have regard to information provided by, and any submission made by Fonterra only. There is no requirement to consult more broadly with other interested parties. However, we decided to afford an opportunity for all interested parties to comment on Fonterra's Reasons paper, our process paper and our draft report.

1.9 We have had regard to information provided in Fonterra's Reasons paper and comment we received on our process paper and our draft report from all interested parties.

How we present our conclusions and analysis in this report

1.10 While we have considered all the provisions in the Manual, we have not reported on each of them individually or on the reasons provided by Fonterra. Instead, we set out the detail of those aspects of the Manual where we consider there is a need for particular comment.

1.11 We outline our conclusions, and the reasons why we have reached them, in Chapter 2 of this report. These conclusions reflect our assessment of the extent to which the Manual is consistent with the purpose in s 150A of the Act.

---

[2] Fonterra, *'Reasons' Paper in support of Fonterra's Milk Price Manual for the 2013/14 Seas*on, 1 August 2013.

1.12 We set out our interpretation of the key legislative provisions and our approach to the review of the Manual in Chapter 3 of this report. This chapter explains the key questions and concepts that have guided our assessment of the Manual and our rationale behind them.

1.13 We provide an overview of Fonterra's methodology for setting the base milk price in an information paper published on our website.[3] The content of this information paper was included in our previous reports on Fonterra's base milk price setting as Attachment A.

[3] Commerce Commission*, Information Paper – The Setting of the Farm Gate Milk Price in New Zealand,* 15 October 2013.

2. Conclusions from our review of the Manual

2.1 To the extent we are able to assess it, our conclusion is that the Manual for the 2013/14 dairy season is largely consistent with the legislative purpose.

2.2 While we have considered all the provisions in the Manual, we have not reported on each of them individually. Instead, we set out the detail of those aspects of the Manual where we consider there is a need for particular comment. These fall into the following categories:

1.1.1 Key issues we considered in our review of the Manual for the 2012/13 dairy season that now have be resolved.

1.1.2 One key issue we considered in our review of the Manual for the 2012/13 dairy season that remains unresolved.

1.1.3 Changes to the Manual since our review of the Manual for the 2012/13 dairy season.

1.1.4 Level of flexibility of approach afforded by the Manual.

2.3 In its certification on the consistency of the Manual for the 2013/14 dairy season with the legislative purpose, Fonterra has requested that in all respects other than the current year changes the 2013/14 Reasons paper be read in conjunction with its 2012/13 Reasons paper.[4]

2.4 Therefore, as well as the 2013/14 Reasons paper, our assessment takes into account Fonterra's 2012/13 Reasons paper and our conclusions based on those reasons, updated by our review of the 2012/13 base milk price calculation. Our conclusions on the extent to which the Manual for the 2013/14 dairy season is consistent with the legislative purpose are based on our review of these taken together.

---

[4] Fonterra, *'Reasons' Paper in support of Fonterra's Milk Price Manual for the 2013/14 Seas*on, 1 August 2013; and Fonterra, *'Reasons' Paper in support of Fonterra's Milk Price Manual for the 2012/13 Seas*on, 31 August 2012.

Key issues we considered in our review of the Manual for 2012/13 dairy season that have now been resolved

2.5 In our review of the Manual for the 2012/13 dairy season, we identified a number of rules in the Manual that we were unable to conclude on in the absence of seeing how these rules would be applied at the base milk price calculation level.[5] Having reviewed Fonterra's 2012/13 base milk price calculation and considered some matters further, we are satisfied that these rules are consistent with the purpose in s 150A of the Act based on the way that they have been applied.

Use of Fonterra's actual performance levels for the purposes of the base milk price setting (efficiency dimension)

2.6 Our review of the Manual for the 2012/13 dairy season identified that the Manual provides for a number of instances where Fonterra will set the base milk price by reference to its actual level of performance in the season for which the base milk price is being set. In particular, the Manual requires the use of actual values to set:

2.6.1 Allocation of milk to reference commodity products (Rule 7);

2.6.2 Variable manufacturing costs (Rule 13);

2.6.3 Milk collection costs (Rule 17) and milk collection assets (Rule 37), and

2.6.4 Supply chain costs (eg, freight and storage) (Rule 20).

2.7 Our concern was that the use of actual performance levels weakens any incentives to operate efficiently compared to using a notional benchmark, because variations in performance affect the base milk price rather than Fonterra's profits.

2.8 As outlined in Chapter 3 of this report, we consider that Fonterra will have a stronger incentive to operate efficiently where the base milk price is set independently of Fonterra's actual performance (ie, the calculation of the base milk price relies on notional data). This is because, for a given revenue, any improvements in cost efficiency will result in higher profits, providing Fonterra management with a benchmark to beat and therefore improve efficiency. Where actual data is used, improvements in cost efficiency will instead result in increases in the base milk price.

---

5 Commerce Commission, *Review of Fonterra's 2012/13 Milk Price Manual*, Final report, 14 December 2012.

2.9 As part of our review of the 2012/13 base milk price calculation, we considered whether notional data could be used instead to provide a stronger incentive for Fonterra to operate efficiently.

2.10 We concluded that the use of actual data, in these instances, was reasonable in respect of the efficiency dimension of the legislative purpose. The use of Fonterra's actual data with respect to allocation of milk to reference commodity products and milk collection costs is reasonable as there is insufficient information, or it would be unreasonably costly, to derive notional inputs. The use of actual usage and unit cost rates in determining some of the variable manufacturing costs and supply chain costs is unlikely to have a significant impact on the overall incentive for Fonterra to operate efficiently.

Potential 'over-optimisation' of assets (contestability dimension)

2.11 We identified a potential inconsistency between the approach for setting the number and location of standard plants, and the data used for the calculation of collection and other relevant operating costs (Rules 25 and 33 of the Manual). Such potential inconsistency could lead to 'over-optimisation' of these assumptions and therefore have implications for practical feasibility of the base milk price setting.

2.12 Because the Manual specifies that the notional producer could only add standard plants to meet peak milk supply requirements at the level of the North and South Islands, rather than at the regional (manufacturing site specific) level, the addition of standard plants is implicitly optimised for each island. We therefore considered whether using Fonterra's actual collection costs (which are reflective of the regional, manufacturing site specific, plant locations) should be adjusted upward to reflect this potential optimisation.

2.13 As part of our review of the 2012/13 base milk price calculation, we concluded that a level of 'over-optimisation' might occur if Fonterra's actual incremental plants had a materially smaller processing capacity than the notional producer's assumed incremental plant's capacity. If this were the case, Fonterra could, for example, add two plants, each on a separate site, while the notional producer might be assumed to have added only one plant. In this case, the assumed incremental collection costs of the notional producer would be lower than those achieved by Fonterra in terms of its actual incremental collection costs.

2.14 However, since Fonterra's actual recent incremental plants had a materially larger processing capacity than the notional producer's assumed plant's capacity, we are satisfied that this potential 'over-optimisation' has not materialised.

One key issue we considered in our review of the Manual for 2012/13 dairy season that remains unresolved

2.15 In our review of the Manual for the 2012/13 dairy season we highlighted that the Manual for the 2012/13 dairy season provided for different treatment of stranded assets in Rules 31 and 32. In particular:

2.15.1 In Rule 31 the risk of asset stranding due to adjustments to the basket of reference commodity products is borne by farmers as suppliers ex post (i.e. when a stranding occurs).

2.15.2 In Rule 32 the risk of surplus plant capacity is borne by shareholders, ex ante, through the asset beta input in the weighted average cost of capital calculation.

2.16 While we consider that sufficient allowance should be made, either ex post or ex ante, for the risk of asset stranding, it is not clear why there should be a different treatment which may affect the prospect of recovering sufficient costs where the stranding is due to changes in available milk supply, or allocation of risk depending on the circumstances of the stranding.

2.17 We acknowledge that the issue of how to provide appropriately for the risk of stranding is a difficult one, and that given the strong historic growth in milk supply, and the projections for continued growth, the risk of asset stranding from an excess of capacity and/or a change in the reference commodity products may not currently be seen as high.

2.18 We consider nonetheless that the rules (depending on which one is applied) may be inconsistent with the purpose, and are potentially material. In our review of the Manual for the 2012/13 dairy season we deferred our conclusion on the extent to which these rules may be inconsistent with the purpose to our review of the 2012/13 base milk price calculation. However, we were unable to conclude on this issue and asked for comment, again, in our draft report on this review. We received one submission on this issue, from Fonterra. We have subsequently requested and published further clarification from Fonterra on this issue.[6]

2.19 From Fonterra's responses we understand that, despite the wording of Rule 31 (which implies that the risk of asset stranding arising from changes in the basket of reference commodity products is to be allocated to suppliers) the rule was not designed to deal with stranded asset risk. This is because Fonterra anticipates

---

6 See *Fonterra's clarification of rule 31 in the 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/201314-season/

that such changes will in most conceivable circumstances be incremental and gradual, resulting in additional investment being made to modify existing assets rather than having them 'written down'. In such circumstances, the costs associated with the additional investment should be recoverable by shareholders in Fonterra, ie, passed onto suppliers in the base milk price calculation, which is the intent of Rule 31 in the Manual. We agree that in this circumstance it is appropriate for equity holders to receive the returns on and of such additional investment.

2.20 Fonterra acknowledges that the Manual is not clear on the treatment of stranded assets that may occur from structural, rather than incremental, changes in the basket of reference commodity products (eg, when a new product is added to the basket, and assets used to manufacture the product(s) it replaces are no longer needed). Fonterra stated that, in its opinion, the risk of such changes occurring should be borne by shareholders. Such an approach would result in a similar treatment of stranded assets arising from changes in milk supply, as provided for in Rule 32 in the Manual. Fonterra stated that, while a clarification in the Manual may be desirable for completeness, it considers the risk highly unlikely to be triggered in practice. We agree that if stranded asset risk is borne by shareholders, then shareholders should be compensated ex ante for bearing this risk. This could be implemented through an increment to the weighted average cost of capital. We consider that an amendment should be made to the Manual to clarify this.

2.21 Notwithstanding this clarification, we do not agree with Fonterra on the mechanism for providing for the risk associated with stranded assets, namely by taking it into account in the calculation of asset beta. Rule 40 in the Manual requires the provision of an updated asset beta by an independent reviewer in a Review Year. As well as Fonterra's exposure to systematic earnings risk the independent expert is required to have regard to stranded asset risk.

2.22 We reported in our conclusions to our review of the 2012/13 base milk price calculation that we were unable to conclude on the feasibility of the asset beta due to the insufficiency of information provided by Fonterra. The information provided did not explain (among other things) why the risk of asset stranding should be a matter to be considered in the assessment of the asset beta rather than as a separate adjustment in the weighted average cost of capital calculation.

2.23 Fonterra, in its submission on our draft report on this review, stated that while it agreed with our technical definition of asset beta (which excludes any adjustment for firm-specific risk), from a practical perspective it does not matter whether an allowance for the risk of stranded assets is made through an adjustment to asset beta, or as a separate ad hoc adjustment in the weighted average cost of capital, or as an explicit provision in the notional producer's income statement. Fonterra's position is based on its estimate of the impact on the asset beta of incorporating within it a provision for stranded assets risk to be in the range of 1 – 3% of the asset beta estimate which, Fonterra believes, is within the margin of error attached to any beta estimate. While this may be the case, we consider that it is methodologically unsound to conflate the unsystematic risk represented by asset stranding with the systematic risk represented by the asset beta.

2.24 We are unable to conclude on the feasibility of Fonterra's asset beta estimate due to the insufficiency of information provided to us by Fonterra to support its conclusion. We will review Fonterra's information on asset beta as part of our review of Fonterra's 2013/14 base milk price calculation in 2014.

Changes to the Manual since our review of the Manual for the 2012/13 dairy season

2.25 There are two substantive changes that Fonterra has explained in its Reasons paper:

2.25.1 the revision of the rule for calculating repairs and maintenance costs (Rule 16), and

2.25.2 the removal of the requirement to have working capital inputs reviewed and, if need be, adjusted by an independent reviewer in a review year (Rule 38).

Repairs and Maintenance costs (Rule 16)

2.26 The calculation of the repairs and maintenance costs (Rule 16) has been significantly revised. The previous version of the rule in the 2012/13 Manual stated: [7]

> In calculating the Farmgate Milk Price a reasonable provision for Repairs and Maintenance Costs shall be deducted, calculated as the product of A x B x (1+C) where:
>
> A. is Fonterra's inflation-adjusted average total expenditure on manufacturing site repairs and maintenance (excluding costs relating to product stores or to milk collection or tanker depot assets) over the four Financial Years preceding the relevant Review Year;
>
> B. is the ratio in the Review Year of the assessed current cost of installing all assets included in the Farmgate Milk Price Fixed Asset Base to the assessed replacement cost for insurance purposes of all assets located on Fonterra's New Zealand manufacturing sites; and
>
> C. is, for a Year that is not a Review Year, a reasonable provision for the cumulative percentage change in the current cost of installing all assets included in the Farmgate

7 Pages 40-41 in Fonterra, *Farmgate Milk Price Manual*, 1 August 2012, 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-manual/201213-season/

Milk Price Fixed Asset Base over the period between the Year and the preceding Review Year.

2.27 The revised Rule 16 states:[8]

In calculating the Farmgate Milk Price a reasonable provision for Repairs and Maintenance Costs shall be deducted, calculated by reference to:

- Fonterra's average expenditure on repairs and maintenance with respect to assets comparable to those assumed in the Farmgate Milk Price Fixed Asset Base, relative to the assessed replacement cost, age, and any other relevant characteristics of those assets;
- The relevant characteristics of the assets included in the Farmgate Milk Price Fixed Asset Base, including the assumed age and economic lives of the assets; and
- Any other matters relevant to the assessment of a commercially reasonable provision for Repairs and Maintenance Costs.

2.28 The justification for the change is described in Fonterra's Reasons paper as follows:[9]

The amended provision is less prescriptive than the previous provision, which specified that the R&M allowance was to be rebased at four yearly intervals (in each review year), by reference to Fonterra's actual R&M spend relative to the replacement cost of relevant Fonterra assets over the preceding four years, with adjustments for inflation and changes in capacity of the NMPB asset base over the intervening period. Because the assets included in the NMPB asset base are all assumed to have finite economic lives that are in many instances shorter than the actual economic lives of Fonterra's assets, we consider there to be a risk that continued application of the previous approach would result in the Milk Price provision for R&M costs being overstated in some future year, relative to the amount that would in practice be incurred by a business with the characteristics of the NMPB. The amendment is intended to address this risk, by providing the flexibility to introduce an alternative approach.

We anticipate that we will not significantly revise the approach taken to calculating the R&M provision for the Milk Price for F14. In terms of consistency with section 150A, we consider that the amended provision is consistent with the application of an approach that is both practically feasible and which provides appropriate incentives on Fonterra to operate efficiently. We also note that the Commission will review the actual approach taken to applying the amended provision in F14, and that it will at that time form a view on practical feasibility and any efficiency implications.

---

[8] Page 41 in Fonterra, *Farmgate Milk Price Manual for 2013/14 Season, Marked up* , 1 August 2013, 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-manual/201314-season/

[9] Page 6 in Fonterra, *'Reasons' Paper in support of Fonterra's Milk Price Manual for the 2013/14 Seas*on, 1 August 2013 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-manual/201314-season/

Impact on the efficiency dimension

2.29 The new rule does not specify whether inputs, particularly average expenditure, are notional. We consider inputs to be notional if they are independent of Fonterra's current year expenditure. The average repairs and maintenance expenditure, whether in total or by asset class, could be an average of previous years, or an average of the current year. We note that previously Rule 16 clearly stated that the inputs would be based on averages from previous years. Also, the inclusion of "Any other matters relevant to the assessment of a commercially reasonable provision..." leaves room for a wide range of other inputs, whether notional or actual, to be included.

2.30 While an incentive for efficiency will exist regardless, this will be weaker if actual costs are included in the calculation. As discussed in Chapter 3 of this report, we consider Fonterra's incentives to maximise its profits (which results from using notional inputs) is stronger than its incentives to increase the base milk price (which results from using actual inputs). We have a particular concern that the greater use of actual inputs and the variability in the choice of inputs will further weaken incentives to improve efficiency as it may result in less transparency to stakeholders on whether efficiency gains have been achieved. This concern is allayed to some extent by Fonterra's stated intention to use historic costs as a basis for the calculation.[10]

Impact on the contestability dimension

2.31 We understand that Fonterra's concern with the existing rule relates primarily to the need to apply the higher costs of maintenance associated with the actual manufacturing sites, due to the existence of assets which are older than their notional counterparts assumed for the base milk price calculation.

2.32 The less prescriptive specification of the repairs and maintenance costs of notional assets which takes into account the specific characteristics of those assets does appear to provide the basis for greater internal consistency of assumptions, for example with the replacement of a reference asset at the end of its deemed economic life under Rule 30. In widening the scope of the average expenditure input from manufacturing site repairs and maintenance to average expenditure for all comparable assets it also appears to provide for a better alignment of expenditure by asset class.

2.33 On the other hand the new rule gives a significantly larger degree of discretion to how it is to be applied. The relative priority of the input considerations is not addressed. Nor for example are the level of asset detail and the question of how "comparable" assets will be identified. This last point appears particularly problematic given the finding of our independent experts in our 2012/13 review

---

[10] Refer paragraph 2.36

of the base milk price calculation that a feasibility study is necessary to properly define the scope of notional manufacturing assets.

2.34 It is also not clear to what extent a “commercially reasonable provision...” is consistent with the “practically feasible” standard required by the legislative purpose.

2.35 Miraka, in its submission on our process paper, expressed a concern that changes to repairs and maintenance costs (and a signalled change to finished goods freight) would reduce cost rates of the notional producer compared to Fonterra costs and that the reductions are not appropriate while there are concerns about the “practically feasible” requirements of s 150A of the Act.

2.36 Fonterra, in its submission on our draft report, acknowledged that the amended provision for the repairs and maintenance costs provides for additional flexibility of interpretation but confirmed its intention to draw on Fonterra’s historic, rather than the current year, repairs and maintenance costs in the calculation of the base milk price. Fonterra also stated that it will consider amending the rule for the 2014/15 dairy season to make it more prescriptive.

2.37 Our view is that, in the absence of seeing the rule applied in the base milk price calculation, given the various matters to be taken into account, we are unable to conclude on the extent to which the new Rule 16 is practically feasible at this time.

Working Capital (Rule 38)

2.38 Fonterra has also amended the application of Rule 38, which covers the “WACC recovery on Farmgate Milk Price Net Working Capital”. Rule 38 provides that:[11]

> Fonterra may recover the cost of financing the net working capital requirements implied in combination by:
>
> - The Farmgate Milk Price Production Plan and Sales Phasings;
> - Reasonable creditor and debtor days targets; and
> - The Supplier Payables days implied by Fonterra’s Advance Rate Schedule.

2.39 Fonterra has changed the application section of this rule to remove the requirement to have assumptions reviewed, and if need be, adjusted by an independent reviewer in each review year.

[11] Page 51 in Fonterra, *Farmgate Milk Price Manual for 2013/14 Season, Marked up* , 1 August 2013, 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-manual/201314-season/

2.40 This change is justified by Fonterra in its Reasons paper as follows:[12]

> The primary purpose of this amendment is to allow for the annual (rather than four yearly) update of relevant assumptions, among other things to ensure alignment between the sales prices assumed in the Milk Price revenue calculation (which will reflect the relevant payment terms) and the average number of days assumed between recognition of a sale and the receipt of cash.

Impact on the efficiency dimension

2.41 The annual update of relevant assumptions introduces greater scope for actual rather than notional inputs to be used. This, combined with the introduction of more variable benchmarks, may weaken incentives for efficiency (as discussed above).

Impact on the contestability dimension

2.42 We note that the key inputs of creditor and debtor days and supplier payable days are likely to be subject to external audit testing each year to determine their reasonableness, in terms of audit materiality, for Fonterra.

2.43 We sought comment from all interested parties on the implications, if any, of allowing an annual update of inputs for practical feasibility. We also invited comment on whether the use of the timing of Fonterra's Advance Rate Schedule as a basis for the working capital calculation constitutes a unique feature that cannot be replicated by another processor. We received one submission on these issues, from Fonterra. Fonterra submitted that its Advance Rate Schedule is widely publicised among suppliers, and can therefore be easily matched by other processors. In the absence of other views on these matters, we conclude that they are practically feasible for an efficient processor.

Other changes

2.44 Table A1 in Attachment A to this report sets out technical changes Fonterra has made to the Manual and the reasons Fonterra has given for these changes in its Reasons paper. In the main, these are technical corrections or are to provide clarification and consistency. We have provided our brief comments on these changes in Attachment A.

2.45 There are also a number of changes to the Manual that were not explicitly addressed in Fonterra's Reasons paper. Fonterra advised that these were not included in its Reasons paper because Fonterra considered them as 'corrections for minor drafting issues'. We have sought explanation of the rationale for these

---

[12] Pages 6 -7 in Fonterra, *'Reasons' Paper in support of Fonterra's Milk Price Manual for the 2013/14 Seas*on, 1 August 2013, 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-manual/201314-season/

changes from Fonterra, and set out these changes along with Fonterra's rationale and our brief comments on those changes in Table A2 in Attachment A to this report.

2.46 One of the changes, which Fonterra considered as a 'correction for minor drafting issues' is the removal of the requirement in Rule 24 to determine the market value of land required for the production of the reference commodity products at each of Fonterra's manufacturing sites. Fonterra explains that this requirement is being removed because it conflicts with its practical approach adopted in the base milk price calculation of revaluing land by applying the Capital Goods Price index to its acquisition value. Notwithstanding that it was not being complied with, the removal of this requirement in Rule 24 leaves no specific provision in the Manual for how land assets, existing after 31 May 2008, are to be valued.[13] We discuss our general concern with the level of flexibility of approach afforded by the Manual in paragraphs 2.45 to 2.51 below.[14]

2.47 Fonterra, in its submission on our draft report, acknowledged that the Manual does not contain any provision specifying how the initial value of the land required for a new manufacturing site is to be determined. Fonterra confirmed that its approach has been to use independent market valuations to set the initial land values from 2008 and that it will look to amend the Manual to address this issue for the 2014/15 dairy season.

Level of flexibility of approach afforded by the Manual

2.48 The changes made to the Manual for the 2013/14 dairy season that we consider have introduced a greater degree of discretion, together with our understanding of how the rules are presently applied in the calculation of the base milk price, have raised for us a general concern about the flexibility of interpretation of the Manual. The lack of prescription in some parts of the Manual:

2.48.1 undermines the efficiency objective, as it is important that the Manual reflects a set of stable and prescriptive rules so that it provides a transparent benchmark for Fonterra management to beat and for external stakeholders to monitor Fonterra's performance against; and

2.48.2 means that there is a risk that we may not be able to conclude on the extent to which the rules in the Manual are practically feasible for Fonterra or another efficient processor (eg, the new provision for Repairs and

---

13 Section 4.5 of the Manual provides for the determination of a deemed acquisition cost for the assets by reference to the replacement costs calculated as at 31 May 2008, and to the total movement in the Capital Goods Price index between the deemed acquisition date and 31 May 2008.

14 We note that the land assets represent only one, relatively small, class of the fixed assets covered by Rule 24.

Maintenance costs in Rule 16 and the treatment of stranded assets in Rules 31 and 32, as discussed in paragraphs 2.23 -2.32 and 2.15 - 2.21 respectively); or that our conclusions on the rules of the Manual may need to be modified in light of our assessment of the rules' specific application (eg, the calculation of 'other costs, including site overheads, general overhead costs and R&D costs' in Rule 19, as discussed in paragraph 2.46 below).

2.49 Rule 19 only requires that a reasonable provision is made for costs in respect of site overheads, general overheads, information systems and research and development. We note that in Fonterra's submission to our draft report on the 2012/13 base milk price calculation, Fonterra stated that its review of these costs will "generate a new set of administrative and other overhead costs for implementation in 2014/15."[15] Given the lack of prescription in Rule 19 it would appear no change to the rule is necessary to accommodate methodological changes to calculating these costs, so long as it results in a "reasonable provision." We are therefore no longer able to conclude on the extent to which this rule is consistent with the legislative purpose until we are able to assess its specific application. Fonterra, in its submission on our draft report, submitted that our review of the Manual for the 2013/14 dairy season should not be affected by its intention to implement methodological changes in the 2014/15 dairy season. Our view is that if significant methodological changes are possible without changing the rules in the Manual (irrespective of which season these rules apply to), the rules of the Manual are not prescriptive enough to enable our assessment of those rules in isolation against the legislative purpose.

2.50 Similarly, the lack of a requirement in the Manual to adhere to a particular tax methodology over time means that changes could be introduced from time to time to raise or lower the milk price, in a way that would not be practically feasible, given Inland Revenue tax rules.[16] We note that there was in fact a change from straight-line depreciation to DV depreciation for calculating the tax charge in the 2012/13 base milk price calculation. Although in this case the change better aligned the Manual's assumptions to the way that Fonterra actually calculates its tax obligations. Moreover the steady state asset base assumption, underpinning the tax calculation, potentially provides greater tax relief for a potential entrant.[17]

---

15 Page 11 in Fonterra, *Submission to the Commerce Commission on its Draft Report on its review of the F13 base milk price*, 30 August 2013, 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/

16 The tax rules would not allow changes to be retrospectively spread over previous years, in effect re-writing depreciation already charged.

17 A potential entrant would in fact obtain greater tax relief than the notional producer through the use of DV depreciation, as the higher front-end depreciation would apply to all plant investment, whereas the

2.51 Our report on the 2012/13 base milk price calculation also highlighted the lack of clarity around what constitutes a "Review Year", when particular assumptions must be subjected to 'review year' verification by independent experts. This is because a rolling review programme has now been adopted by Fonterra, with no apparent formal process for the designation of review year status other than by including items in the Milk Price Group's annual work programme. Fonterra, in its submission on our draft report, stated that the Milk Price Panel has formal responsibility for determining the timing of the 'review year' and set out the decisions by the Milk Price Panel on when a selected number of rules are to be subjected to the 'review year' processes. We remain of the view that the transparency about when the 'review year' requirements apply is important to external stakeholders and we would expect to see a formal calendar of the designated 'review years' for all rules in the Manual incorporated into the Manual and linked to the definition of 'review year'.

2.52 Our finding in our report on the 2012/13 base milk calculation in respect of Fonterra's description of assumptions adopted, and inputs and process used applies equally to the description of the provisions in the Manual: [18]

> This leaves discretion for Fonterra to make year-on-year methodological changes to the way individual assumptions, inputs and processes are determined. This could lead to year-on-year changes in the base milk price that are due to methodological choices rather than the underlying performance factors. We recognise that in some instances methodological improvements in the base milk price calculation would be beneficial (eg, where more or better evidence becomes available over time). However any such improvements should be signalled through transparent changes to documented methodology.

2.53 In our view, the level of flexibility of approach afforded by the Manual in some cases undermines the efficiency objective, as it is important that the Manual reflects a set of stable and prescriptive rules so that it provides a transparent benchmark for Fonterra management to beat and for external stakeholders to monitor Fonterra's performance against.

2.54 Fonterra, in its submission on our draft report, stated that the Manual is not a primary source of information for Fonterra management on the benchmarks used in the base milk price calculation. Instead, it is the base milk price itself and the more detailed information contained in the various internal operating manuals and position papers that set out the benchmarks for Fonterra management to

---

steady state assumption underlying the tax treatment in Fonterra's milk model means the early high depreciation for new assets (relative to straight-line depreciation) is offset by much lower depreciation on older assets. The change to a DV approach occasioned no alteration to the base milk price as it was concurrently applied with a new 'policy' to round the tax depreciation ratio to the nearest 10%.

[18] Paragraph 2.26.4 in Commerce Commission, *Review of Fonterra's 2012/13 base milk price calculation, Final Report*, 16 September 2013.

beat. Fonterra also stated that it faces strong incentives to maintain stable benchmarks from the capital markets.

2.55 We accept that there are various factors, in addition to the Manual, that incentivise Fonterra management to operate efficiently and that those factors may in some cases provide stronger efficiency incentives that those provided by the Manual. However, our review is on the extent to which the Manual provides incentives for Fonterra to operate efficiently. The efficiency incentives arising from other factors are outside the scope of our review.

2.56 The lack of prescription in some parts of the Manual also means that there is a risk that we may not be able to conclude on the extent to which they are consistent with the legislative purpose until we review specific application of these parts of the Manual.

2.57 Fonterra, in its submission on our draft report, acknowledged our difficulty with concluding on some aspects of the Manual, and attributed this to the shortcomings in the Act, which requires a review of the Manual to be undertaken in isolation from the review of the application of the Manual. In light of these requirements in the Act, Fonterra submitted that it does not consider the effectiveness of the milk price monitoring regime to be compromised if our conclusions on the Manual are cast as "…a rule is 'consistent with' or 'does not preclude' the establishment of inputs that are practically feasible".

2.58 We note that Fonterra's submission raises questions for policy makers about the efficacy of having separate Manual and base milk price calculation reviews, which might be included in the scope of the terms of reference for the upcoming report the Minister for Primary Industries must request under ss 148 and 148A of the Act.

3. Our approach to this statutory review of the Manual

3.1 In this chapter, we:

3.1.1 summarise our interpretation of the key provisions in the Act relevant to the review of the Manual for the 2013/14 dairy season; and

3.1.2 explain our practical approach to this review.

Our interpretation of key legislative provisions guiding our review

Our review and report – section 150H, 150I and 150J

3.2 Section 150H of the Act requires us to review the Manual for each dairy season.

3.3 Sections 150I and 150J of the Act require us to make and publish a report on the extent to which the Manual is consistent with the purpose set out in s 150A of the Act.

The purpose statement – section 150A

3.4 Section 150A(1) states that the purpose of Subpart 5A of the Act is to promote the setting of a base milk price that provides an incentive to new co-op to operate efficiently while providing for contestability in the market for the purchase of milk from farmers.

3.5 Section 150A(2) specifies that the setting of the base milk price provides for contestability in the market for the purchase of milk from farmers if any notional costs, revenues, or other assumptions taken into account in calculating the base milk price are practically feasible for an efficient processor.

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

3.6.1 What is meant by ‘efficiency’?

3.6.2 What is meant by ‘contestability’?

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

Our interpretation of efficiency

3.7 Section 150A refers to incentives for Fonterra to ‘operate efficiently’. We have therefore interpreted the primary focus of the efficiency dimension to be improving incentives for Fonterra to drive cost efficiencies (ie, productive and dynamic efficiency).[19]

Our interpretation of contestability

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

How are the two dimensions reconciled?

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

'Safe harbours' – section 150B

3.10 Section 150B lists certain assumptions that, if used in the base milk price calculation, are considered to not detract from the achievement of the purpose set out in s 150A.

3.11 We interpret s 150B as being intended to create 'safe harbours' where Fonterra sets the base milk price using any of the assumptions listed in subparagraphs (a) to (d). Section 150B prevents the use of any of those assumptions from having the effect of detracting from the achievement of the purpose set out in s 150A where the use of any such assumption might otherwise have had that effect.

'Mandatory assumptions' – section 150C

3.12 Section 150C states that for the achievement of the purpose set out in s 150A, the base milk price must be set in a way that is consistent with a number of principles, listed in s 150C.

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

---

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

Our practical approach to the review of the Manual

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

3.14 Fonterra has incentives to maximise the overall payments it makes to farmers and to shareholders. It has incentives to increase the base milk price, to ensure farmers continue to supply Fonterra, and to satisfy its farmer shareholders. Fonterra also has incentives to maximise profits so it can pay dividends to its shareholders (including unit holders in the publicly listed Fonterra Shareholders Fund). Fonterra's incentives to maximise profits are reinforced by the remuneration arrangements that apply to its senior management. For the most part, management are rewarded on the basis of profits and earnings, with the farm gate milk price accounting for less than 10% of their remuneration.[20]

3.1 We consider that these arrangements mean that, in the context of setting the base milk price, Fonterra's incentives to maximise its profits are stronger than its incentives to increase the base milk price. Miraka, in its submission on our draft reports, stated that our position on Fonterra's profit maximising incentives requires further testing. In particular, Miraka is concerned that our position is based solely on the remuneration arrangements for very senior Fonterra management and only for the variable component of the remuneration. We acknowledge Miraka's submission on this matter but remain of the view that, in setting a base milk price under the Act, Fonterra's incentives to maximise its profits are stronger than its incentives to increase the base milk price. However, we recognise that Fonterra has other incentives to maximise its profits and the base milk price outside of this process.

3.2 We, therefore, consider Fonterra will have a stronger incentive to operate efficiently where the base milk price is set independently of Fonterra's actual performance (ie, the calculation of the base milk price relies on notional data). This is because, for a given revenue, any improvements in cost efficiency will result in higher profits, providing Fonterra management with a benchmark to beat and therefore improve efficiency. Where actual data is used, improvements in cost efficiency will instead result in increases in the base milk price.

3.3 There are also instances where it is still reasonable to use Fonterra's actual data in setting the base milk price. These include where:

3.3.1 there is insufficient information to know what an appropriate notional value would be, or it would be unreasonably costly to obtain this information; or

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

---

[20] Page 56 in Fonterra Shareholders' Fund Prospectus and Investment Statement, 26 October 2012, available at http://www.fonterra.com/nz/en/Financial/Fonterra+Shareholders+Fund

3.4 Our approach to considering the efficiency dimension is to therefore assess the extent to which the provisions in the Manual incentivise Fonterra to operate efficiently, through the use of notional components. As discussed in paragraph 3.3 above, there may be instances where it is reasonable to use actual data. Where the provisions in the Manual require the use of actual values, we have explored whether notional data could reasonably have been used instead, and whether the use of actual data distorts or weakens incentives for Fonterra to improve efficiency.

Our approach to the contestability dimension – what is practically feasible

Our interpretation of efficient processor in s 150A

3.5 Section 150A(2) states that 'for the purposes of this subpart, the setting of the base milk price provides for contestability in the market for the purchase of milk from farmers if any notional costs, revenue, or other assumptions taken into account in calculating the base milk price are practically feasible for an efficient processor'.

3.6 The term ‘efficient processor’ is not defined in the Act. It is our interpretation, within the context of the Act, including s 150A, that the term means a processor that is able to operate at least cost over time. This is consistent with our view that the primary focus of the efficiency dimension is on improving incentives for Fonterra to drive cost efficiencies over time (ie, productive and dynamic efficiency).

3.7 We consider that expansion by an existing processor or entry by a new processor would be most likely to achieve least cost operation over time. That is because a newly built (ie, 'incremental') plant would be able to take advantage of the latest technology, and could be built at a capacity to take the best possible advantage of cost efficiencies in not only processing, but in associated activities as well (such as the collection of milk).

3.8 Therefore, conceptually, we consider the Manual is consistent with the contestability dimension in s 150A of the Act if the Manual provides for the setting of the base milk price that is practically feasible for Fonterra or another processor that is efficiently building an incremental plant.

3.9 Miraka, in its submission on our draft report, stated that our interpretation of the term ‘efficient processor’, combined with the safe harbour provisions of s 150B of the Act, mean that no efficient processor of feasible scale can match the ‘efficient processor’s’ performance. This, in Miraka’s view, means that the contestability objective of s 150A of the Act can never be achieved. We acknowledge Miraka’s submission on this matter, but remain of the view that our interpretation of the term ‘efficient processor’ is consistent with the contestability objective set out in s 150A of the Act.

3.10 In our first review of the Manual, which we undertook for the 2012/13 dairy season, we assessed whether the provisions in the Manual are practically feasible, by making both an individual and an aggregate assessment (as described in paragraphs 3.23 to 3.26 below). For our review of the Manual for the 2013/14 dairy season, we have relied on our conclusions from the review of the previous season for the provisions that have not changed, considered any issues that were outstanding from that review, and assessed the provisions of the Manual that have changed for the 2013/14 Manual in accordance with our practical approach.

We have assessed whether the provisions in the Manual are individually practically feasible for Fonterra

3.11 The Manual provides, for the most part, for the use of performance parameters based on the average across all relevant (reference commodity product) Fonterra notional plants, rather than on a single recently built Fonterra plant. Doing so is consistent with assuming that there is a national network of facilities for the collection and processing of milk (ie, the safe harbour provision in s 150B(a)). In addition, the notional plants assumed by Fonterra in setting the base milk price approximate the average capacity of Fonterra's actual plants, consistent with the safe harbour provision in s 150B(b).

3.12 Our practical approach examines whether the Manual provides for the setting of the base milk price that is practically feasible for Fonterra. This approach is appropriate because, more often than not, the Manual provides for the use of parameters reflective of Fonterra's 'average' plant rather than its most cost efficient plant(s), and therefore an efficient processor (building an incremental plant) should be able to achieve lower costs.

3.13 In reaching our conclusion we have also considered whether the provisions in the Manual are practically feasible for Fonterra due to features unique to Fonterra, which do not relate to Fonterra acting efficiently. In that case, these provisions may not be practically feasible for another efficient processor. We therefore included a cross-check to identify whether our assessment is being affected by unique features which are not subject to 'safe harbour' provisions.

We undertake a number of cross-checks to ensure the provisions in the Manual are practically feasible in aggregate

3.14 We acknowledge there is a potential risk that the individual provisions in the Manual may not collectively be practically feasible. To ensure this does not occur:

3.14.1 we check the provisions in the Manual are internally consistent with each other. We have been largely guided by submissions to identify areas where there are potential inconsistencies between the provisions in the Manual, and have reviewed these areas in our analysis; and

3.14.2 we consider the overall impact on the Manual of the provisions which may not be individually practically feasible or that we are unable to conclude on at this stage.

Information used for this review

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

3.15.1 the Milk Price Manual for the current season;

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

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

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

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

3.16 As required by s 150L, Fonterra has provided the Commission with its certification that the 2013/14 Manual is consistent with the purpose in s 150A, along with the reasons for the view expressed in its certificate.

3.17 We have had regard to this information in making our report. We also had regard to comments on our process paper, draft report and the supporting information and analysis from our reviews of the Manual for 2012/13 dairy season and 2012/13 base milk price calculation.[21]

[21] Commerce Commission, *Review of Fonterra's 2012/13 Milk Price Manual,* Final Report, 14 December 2012; and Commerce Commission, *Review of Fonterra's 2012/13 Base Milk Price Calculation*, Final Report, 16 September 2013.

Attachment A: Review of technical changes to the Manual

A1 Table A1 below sets out technical changes Fonterra has made to the Manual and the reasons Fonterra has given for these changes in its Reasons paper. In the main, these are technical corrections or are to provide clarification and consistency. We have provided our brief comments on these changes.

A2 Table A2 below sets out changes to the Manual not explicitly addressed in Fonterra's Reasons paper, together with an explanation of the rationale for each of these changes, and our brief comments on those. Fonterra advises that these were not included in the original Reasons paper because Fonterra considered them as 'corrections for minor drafting issues'.

Table A1: Review of technical changes to the Manual, as set out in Fonterra's Reasons paper

Reference	Change	Fonterra Comment	Commission Comment
p.19	Substitution of 'should' for 'will' in context of use of GDT-only prices resulting in 'correct' pricing series for Milk Price.	No comment provided.	Change is consistent with language used elsewhere in this rule.
pp.26-27	Removal of references to valuer and fair value share process.	No comment provided.	Although no reason is given for why these changes have been made, it is likely that these changes are reflective of Fonterra moving to Trading Among Farmers, which makes these references redundant.
p.34, Rules 4 and 5 p.36, Rule 9	Substitution of "FAS-equivalent" for "FAS".	No substantive impact. Amendment recognises use in Milk Price calculation of FAS-equivalent prices derived from sales on other terms. (Most sales are in fact on a FAS-equivalent, rather than direct FAS, basis.)	Clarification.
p.34, Rule 5	Amendment to reference "terms typically provided by sellers of [standard commodity] products", rather than "terms comparable to those applying to sales on GDT."	No substantive impact, but recognises that terms applying to sales on GDT will not necessarily reflect the full range of 'normal' terms available to buyers of commodity products.	Clarification.

Reference	Change	Fonterra Comment	Commission Comment
p.36, Rule 10	Amendment to sales phasing rule to provide that an alternative set of sales phasings could result in notional sales occurring later, as well as earlier, than actual sales.	Manual includes ability (which has not been exercised to date) to impose a set of sales phasings different to Fonterra's actual sales phasings if the Board "has reasonable cause to consider that Fonterra's actual phasing of sales is not consistent" with maximising returns. Current rule provides that alternative phasings must necessarily bring sales forward. While this is what would most likely occur in practice, there may conceivably be circumstances where in a rising market it would be commercially appropriate to notionally defer sales.	The prospective adoption of an alternative notional sales phasing profile (whether sales are brought forward or deferred) is consistent with setting a notional benchmark.
p.38, Rule 12	Removal of reference to 'selling costs' from rule, and amendment to make it clear Standard Plants are allocated to Regions, whereas other assets are allocated to sites.	No substantive impact. Reference to selling costs not required, as covered separately under Rule 6.	Removes duplication and improves internal consistency of the Manual.
p.39, Rule 13	Removal of redundant requirement for independent review of usage rates.	No substantive effect, as independent review is still required in immediately following paragraph.	Removes redundancy.
p.40, Rule 13	Amendment to recognise that a portion of some costs described as 'variable' may be fixed.	Accommodates minor change in approach to modelling certain costs, esp. energy, which have fixed components, and to remove reference to storage costs, which are separately covered under Rule 20.	This rule defines the following costs as variable manufacturing costs: energy, water, chemicals, consumables, effluent, product testing, packaging and product downgrade. The change gives more flexibility for the forthcoming review of these costs, which may result in some parts of these costs being designated as fixed. It is not stated why site storage costs have been removed from this rule, but to some extent these appear to be fixed costs.

Reference	Change	Fonterra Comment	Commission Comment
p.40, Rule 14	Deletion of specific rule relating to laboratory costs.	Not required, as separately covered under Rule 13.	Removes duplication and improves internal consistency of the Manual.
pp.40-41, Rule 15	Amendment to definition of Fixed Manufacturing Costs.	Extended to include fixed portion of any costs previously considered fully variable.	Similar to change to Rule 13 above.
p.44, Rule 20	Minor amendments to supply chain provision to align terminology in Parts B and C.	No substantive impact.	Minimal changes - largely capitalising certain words.
p.44, Rule 23	Removal of requirement for independent reviewer to review assumed level of manufacturing performance of standard plants.	Redundant – requirement overlaps with independent review requirement in Rule 13 (4 yearly review of resource usage assumptions).	Removes duplication and improves internal consistency of the Manual.
p.46, Rule 24	Addition of reference to dry stores assets.	No substantive impact – dry stores have always been included in model, but not explicitly references. [sic]	Improves clarity of what is in the Fixed Asset Base.
p.47, Rule 25	Amended to explicitly account for difference between milk collected by, and milk processed by, Fonterra.	No substantive impact – calculations to date have assumed the modified definition.	Clarification.
p.57, definition of Valued Component Usage	Amended to remove reference to specification limit.	Amendments to definitions of Valued Component Usage, and addition of definition of Composition Offset, are all technical in nature, and correct minor errors in previous drafting.	Appears to provide greater accuracy of description.

Reference	Change	Fonterra Comment	Commission Comment
p.57, definition of Composition target	Amended to include reference to moisture and to specification limit.	No comment provided.	Appears to provide greater accuracy of description.
p.57, definition of Composition Offset	New definition.	No comment provided.	Appears to provide greater accuracy of description.
p.59, definition of Standard Commodity Price	Make it clear that post-FAS costs are to be deducted “from the actual selling price” to determine a FAS-equivalent price.	Clarifying amendment – no substantive impact.	Clarification.
p.60, definition of Incremental Product Cost	Addition of reference to incremental manufacturing cost, relative to cost of manufacturing standard specification product.	Clarifying amendment – no substantive impact.	Clarification.
p.61, definition of Freight Costs	Added language enabling use of alternative estimates if Fonterra’s costs are not representative of the costs an efficient processor would incur.	No immediate impact – enables, but does not require, use of alternative source to Fonterra for freight costs.	Impact is unclear. Changes provide for greater flexibility in the approach.
p.62, definition of Lactose Price	Amended to include reference to price a “commercially astute” NZ based manufacturer of milk powders would pay.	Aligns language to corresponding provision in Part B – no substantive impact.	Improves internal consistency of the Manual.
p.63, definition of Variable Manufacturing Costs	Amended to provide for a portion of these costs to be fixed.	Aligned to amendment to Rule 13 in Part B, per above.	Improves internal consistency of the Manual.

Reference	Change	Fonterra Comment	Commission Comment
p.64-65	Amended definitions of Water Cost, Cleaning and CIP Cost, Consumables Cost and Effluent Cost, to allow for potential that these costs may not be fully variable.	Basis of calculation of these inputs is under review, and it is possible the review will conclude a portion of some of these costs should be treated as fixed. Amendment accommodates, but does not require, assumption that some costs are fixed.	Appears to provide for fixed nature of some costs but does relax prescription.
p.65	Removal of definition of Raw Materials Cost, and reference to same in definition of Variable Manufacturing Costs.	Provision is not required.	Removes redundancy.
p.65, definition of Laboratory Cost	Amended to provide for possibility that these costs do not vary in full with production volumes.	No comment provided.	Appears to provide for fixed nature of some costs but does relax prescription.
p.67, definition of Fixed Manufacturing Costs	Amended to include any fixed portion of variable manufacturing costs.	Aligned to amendment to Rule 15 in Part B, per above.	Internal consistency change to reflect changes to Rule 15.
p.67, definition of FTE Allowance	New definition.	No substantive change – corresponds to requirement to establish the number of FTEs by independent review.	Appears to provide greater accuracy of description.
p.67, definitions of Manufacturing Overheads and Corporate Overheads	Merged into single definition of General Overheads. Modified to include overhead costs of a 'one-off' nature.	No substantive change. First amendment aligns to approach taken in F13 Reset Year Review, where there was generally no clear distinction between the two categories of overhead. Second amendment aligns to distinction incorporated last year in Rule 15 to provide for costs of a one-off nature.	Clarification.

Reference	Change	Fonterra Comment	Commission Comment
p.67, definition of Information Systems Cost	New definition.	No substantive change – aligns Part C to Rule 15 in Part B.	Improves internal consistency of the Manual.
p.68, definition of Farmgate Milk Price EBIT	Amended to incorporate new definitions of General Overheads and Information Systems Costs.	No substantive impact.	Consistent with other changes.

Table A2: Review of changes to the Manual, not explicitly addressed in Fonterra's Reasons paper

Reference	Change	Fonterra Comment	Commission Comment
p.34, Rule 5 p.36, Rule 9	Rule 5: Replacement of "Once" with "If". Rule 9: Replacement of "For so long as" with "If".	Drafting amendment: removes the (unintended) potential interpretation that transition to use of GDT-only prices for an RCP is a one-way move – it is always possible that changing circumstances mean it is no longer appropriate to place sole reliance on GDT sales.	Clarification.
p.39, Rule 13	Deletion of "actual".	Drafting only: "actual" is (generally) implicit in "achievable".	Removes redundancy.
p.40, Rule 15	Deletion of "based on Fonterra's budgeted resource requirements and its actual costs for the relevant Year, and having regard to the Farmgate Milk Price Production Plan,"	Drafting tidy-up: Fixed manufacturing costs primarily comprise manufacturing FTEs, which are reset every 4 years (per language later in the rule), and R&M, which is subject to a separate rule, so deleted language wasn't consistent with mandated approach for either item.	Improves internal consistency of the Manual.
p.42, Rule 19	Merging of "Manufacturing Overheads" and "Corporate Overheads" into a single "General Overheads" item, and addition of "Information Systems".	Drafting only: Explanation provided with respect to the corresponding Part C amendments. (IS costs split out so as to separately reference capital cost portion per Part C.)	Improves internal consistency of the Manual.
p.46, Rule 24	Tidy up of language around ancillary assets.	Drafting only.	Improves clarity.
p.46, Rule 24	Removal of requirement for market valuation	Not required, as not used in model. (Model uses market values in 2008, cost of land at	Notwithstanding that this requirement was not being complied with before, its removal affords

Reference	Change	Fonterra Comment	Commission Comment
	of manufacturing site land.	incremental sites, and assumed rate of price increase).	additional flexibility in the approach (as discussed in 2.46 of this report).
p.57	Amendment to definition of Composition Target. Insertion of new definition of Composition Offset.	These were identified in our supporting table, but no explanation for the changes was provided. Amendments make more explicit the approach used to establish yields.	Improves clarity.