



Dairy for life

'Reasons' Paper in support of Fonterra's Milk Price Manual for the 2017/18 Season

1 August 2017

Glossary

F16 Base Milk Price Report	Commerce Commission, Review of Fonterra's 2015/16 base milk price calculation, 15 September 2016, http://comcom.govt.nz/regulated-industries/dairy-industry/review-of-fonterra-s-farm-gate-milk-price-and-manual/statutory-review-of-milk-price-manual/201516-season/
F16 Final Manual Report	Commerce Commission, Final Report on the Review of Fonterra's 2015/16 Milk Price Manual, 15 December 2015, http://comcom.govt.nz/regulated-industries/dairy-industry/review-of-fonterra-s-farm-gate-milk-price-and-manual/statutory-review-of-milk-price-manual/201516-season/
F17 Draft Manual Report	Commerce Commission, Review of Fonterra's 2016/17 Milk Price Manual, Draft Report, 15 October 2016, http://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/
F17 Final Manual Report	Commerce Commission, Final Report on the Review of Fonterra's 2016/17 Milk Price Manual, 14 December 2016, http://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/
F17 Submission	Fonterra, Submission to the Commerce Commission on its Draft Report on Fonterra's 2016/17 Farmgate Milk Price Manual, 15 November 2016, http://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/
F17 Base Milk Price Reasons Paper	Fonterra, 'Reasons' Paper in support of Fonterra's base milk price for the 2016/17 Season, 3 July 2017, 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/
MPG	The Milk Price Group, the independent unit responsible for determining and recommending to the Milk Price Panel the Farmgate Milk Price.
NMPB	Notional Milk Price Business, comprising the notional milk powder manufacturing business implied by Fonterra's Farmgate Milk Price Manual.
R&M	Repairs and maintenance.
RCP	Reference commodity product, comprising WMP, SMP, BMP, Butter and AMF.
F18 Season	The period commencing on 1 June 2017 and ending on 31 May 2018.

1 August 2017

To: The Commerce Commission

1. Fonterra Co-operative Group Limited (“Fonterra”), certifies that:
 - a. in terms of section 150L(d) of the Dairy Industry Restructuring Act 2001 (“Act”), Fonterra considers that its milk price manual to be applied in calculating Fonterra’s Farmgate milk price for the 2017/18 financial year is, in all material respects, consistent with the purpose of subpart 5A of the Act; and
 - b. none of the circumstances set out in section 150G(1) of the Act have occurred with respect to the milk price manual to be applied in calculating Fonterra’s Farmgate milk price for the 2017/18 financial year.
2. This certification is based on our interpretation of subpart 5A, and the other relevant assumptions, views and qualifications set out in the accompanying reasons provided pursuant to s 150L(e) of the Act.



Signed by

Andrew Cordner
Director, Legal

1 Introduction

This paper provides the reasons in support of Fonterra's certification in respect of the Milk Price Manual to be applied in the calculating Fonterra's Farmgate milk price in respect of Fonterra's 2017/18 financial year and the corresponding Season (the F18 Manual), as required under section 150L of the Dairy Industry Restructuring Act 2001 (DIRA). The paper has been prepared under the oversight of the Milk Price Panel, and where relevant reflects the Panel's views.

Section 150L provides that Fonterra must:

- Provide the Commission with the milk price manual for the current season (i.e., the season corresponding to Fonterra's 2017/18 financial year) (section 150L(a));
- Provide the Commission with any recommendations by the Milk Price Panel "in relation to the setting of the base milk price" (section 150L(b));¹
- Notify the Commission of any change in the economic and business environment that, in Fonterra's view, requires a change to the milk price manual (section 150L(c));
- Certify to the Commission the extent to which Fonterra considers that the milk price manual is consistent with the purpose of subpart 5A of DIRA (section 150L(d)); and
- Provide the Commission with reasons for the view expressed in its certificate (section 150L(e)).

In addition, section 150G sets out the steps that Fonterra is required to take if it does not amend the Manual in accordance with a recommendation by the Panel, if it amends the Manual contrary to a recommendation by the Panel, or if it amends the Manual without having received a relevant recommendation from the Panel. We advise that none of these circumstances has occurred with respect to the F18 Manual.

On 26 July 2017 the board of Fonterra approved a number of amendments to the Milk Price Manual, most of which were of a technical or drafting nature, and all of which were recommended by the Milk Price Panel. These amendments are set out in 'mark up' form in the Milk Price Manual attached to this paper and, where relevant, we explain their rationale below. In all other respects, the F18 Manual is identical to the Manual applied by Fonterra in respect of the 2016/17 season (the F17 Manual), and in respect of which Fonterra submitted a certification and reasons paper on 1 August 2016. Consistent with that paper, we have confined our comments in this paper to areas where our views have changed subsequent to preparing previous reasons papers, or where we wish to provide additional information. In all other respects, we request that this paper be read in conjunction with our reasons papers submitted in respect of the 2012 – 2017 seasons.

We have also recently provided (in our 'reasons paper' in respect of the 2016/17 base milk price) the Commission with our views on the appropriate interpretation of section 150A of DIRA (the purpose provision), and have not repeated these views in this paper.

The paper is intended to satisfy the section 150L(e) requirement to provide the Commission with the reasons for the view expressed in our certificate. The paper is organised as follows:

- In section 2, we set out, and explain the rationale for, the substantive amendments to the F18 Manual, and comment on the consistency of these amendments with section 150A.
- In section 3, we summarise changes in the economic and business environment that are potentially of relevance to the calculation of the base milk price, and explain why we have not amended the Manual in response to these changes for the 2018/18 year.

The attachments to this paper comprise:

- Attachment 1 – a paper to Fonterra's board of directors dated 26 July 2017, setting out the Milk Price Panel's recommendations with respect to amendments to the Milk Price Manual.
- Attachment 2 – a paper to the Milk Price Panel at its meeting on 31 May 2017, containing the Milk Price Group's initial recommendations with respect to amendments to the Milk Price Manual.
- Attachment 3 – a paper to the Milk Price Panel at its meeting on 28 June 2017, containing the Milk Price Group's final recommendations with respect to amendments to the Milk Price Manual.

¹ As in our previous 'reasons papers' we have interpreted this provision as in fact relating to recommendations by the Milk Price Panel in relation to amendments to the Milk Price Manual. The relevant paper to Fonterra's board is attached as Attachment 1.

- Attachment 4 – a ‘marked up’ version of the Milk Price Manual, identifying all amendments, and which satisfies the section 150L(1) requirement to provide the Commission with the manual for the current season. Brief comments on the rationale for each amendment are also included in this attachment.

2 Amendments to the F18 Manual

Attachment 2 to this paper comprises a paper from the MPG to the Milk Price Panel dated 31 May 2017, which explains the various amendments to the F18 Manual.² That paper notes that two amendments were intended to address matters raised by the Commerce Commission in the Commission's review of the F17 Milk Price Manual, and that the remaining amendments were technical or drafting in nature. We comment in this section on the rationale for these amendments addressing matters raised by the Commission and where relevant on the consistency of the amended provisions with section 150A.

Lactose costs

Rule 16 in Part B of the Manual provides that the lactose price for a season will be the weighted average of whichever of the landed cost of lactose imported into New Zealand by either Fonterra or other New Zealand processors, as reported to New Zealand Customs, is lowest. In its final report on the F17 Manual the Commission concluded that this approach "is not consistent with the contestability dimension because it provides an ability to pick pricing retrospectively. To remove that ability we suggest removing Fonterra's price as a reference."³

In response to the Commission's finding, we have retained the ability to use either Fonterra's or other NZ processors' weighted average landed lactose cost, but have added a requirement that a determination as to which of these series will be used must be made (by the MPG) prior to the commencement of the relevant season, based on the MPG's assessment of which volume weighted average price is likely to be lower.

Repairs and maintenance costs

Rule 14 in Part B of the Manual provides that the provision in the base milk price for labour related R&M costs ('maintenance department labour costs') is to be calculated by reference to relevant actual Fonterra costs for the prior year. In paragraph 24 of the F17 Final Manual Report the Commission suggested that a "specific definition of 'maintenance department labour costs' is needed in the Manual to provide additional clarity.

We have added a definition of Maintenance Department Labour Costs to Part C of the Manual.

² The recommendation to this paper seeks the Milk Price Panel's agreement to submit various amendments to the Fonterra Board and the Fonterra Shareholders' Council for consultation. No amendments were made as a consequence of this consultation process.

³ F17 Final Manual Report, paragraph 29, page 13.

3 Other matters

We have not incorporated several minor amendments to the Manual proposed by the Commerce Commission in the F17 Final Manual Report. We have previously explained (mainly in our submission on the Commission's draft report on the F17 Manual) our reasons for not adopting these amendments, and again summarise our position in the table below.

Paragraph ⁴	Proposal	Response
19.2	The omission from the Manual of costs associated with providing supplier support (to ensure continued supply to the notional producer) is not consistent with the contestability dimension.	No change to our position that it is not appropriate to fund these costs from the Milk Price.
22.	We agree with Fonterra that the Manual should evolve over time consistent with the methodology of a real world processor. We consider the Manual should outline what is considered a 'material change' when considering a change to the Manual and specify the timeliness of making such a change in order to set a minimum level for disclosure of changes.	No change, for reasons explained on page 5 of our submission on the Commission's F17 Draft Manual Report (a 'bright line' materiality threshold is actually likely to lead to less disclosure).
23	We recommend that Fonterra considers disclosing its plant capacity for both primary and secondary plants in the Manual. This earlier disclosure should provide increased transparency of the assumed capacity of the notional producer for the season. We consider Fonterra's latest amendment still allows a significant level of discretion.	We do not consider the Manual is the appropriate vehicle for these disclosures. We have previously put this information into the public domain, including in the F17 Base Milk Price Reasons Paper, and the relevant assumptions will not be revisited until F20.
25.	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.	Matters relating to the disclosure of current-year inputs into the milk price calculation are in our view outside the scope of the Commission's review of the Manual.
27.	We consider that if Fonterra disclosed the base milk price on standard terms in periodic reviews throughout the season, this would provide greater transparency of Fonterra's base milk price setting process.	Matters relating to the disclosure of current-year inputs into the milk price calculation are in our view outside the scope of the Commission's review of the Manual.

⁴ Paragraph references are to Commerce Commission, Review of Fonterra's 2016/17 Milk Price Manual – Final Report, 15 December 2016, <http://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/>

4 Changes in the economic and business environment

We confirm we are not aware of any changes in the economic or business environment that would in our view necessitate a change to the Milk Price Manual for the F18 Season. In arriving at this view, we have had regard to the following:

- None of the amendments to the Milk Price Manual set out in the attachments to this paper were prompted by changes in the economic or business environment.
- As a general matter, our view is that changes in the economic or business environment will in most circumstances not necessitate changes to the Manual, though they may result in changes in the approach taken to applying existing provisions of the Manual.⁵ Among other things, the existing provisions of the Manual could accommodate the changes in approach required to reflect the impact of changes in relative demand for (and profitability of) different product streams that affect industry-wide patterns of new investment, or of assets becoming 'stranded' due to a significant reduction in milk supply.

⁵ In accordance with section 2.6 of Part A of the Manual, we will publicly disclose and explain any material change in approach, generally in the Milk Price Statement for the preceding season.